The Price of Prudence in Target Date Funds

- Prudent TDFs have underperformed in the last decade. You could say that the "Price of Prudence" has been 1% per year
- Prudence is worth paying for, but you want to buy Substantive prudence rather than Procedural prudence.
- Someday markets will go down again, rather than up, and Substantive prudence will shine.

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Do not trust all men, but trust men of worth; the former course is silly, the latter a mark of prudence. Democritus, Greek philosopher 400 BC

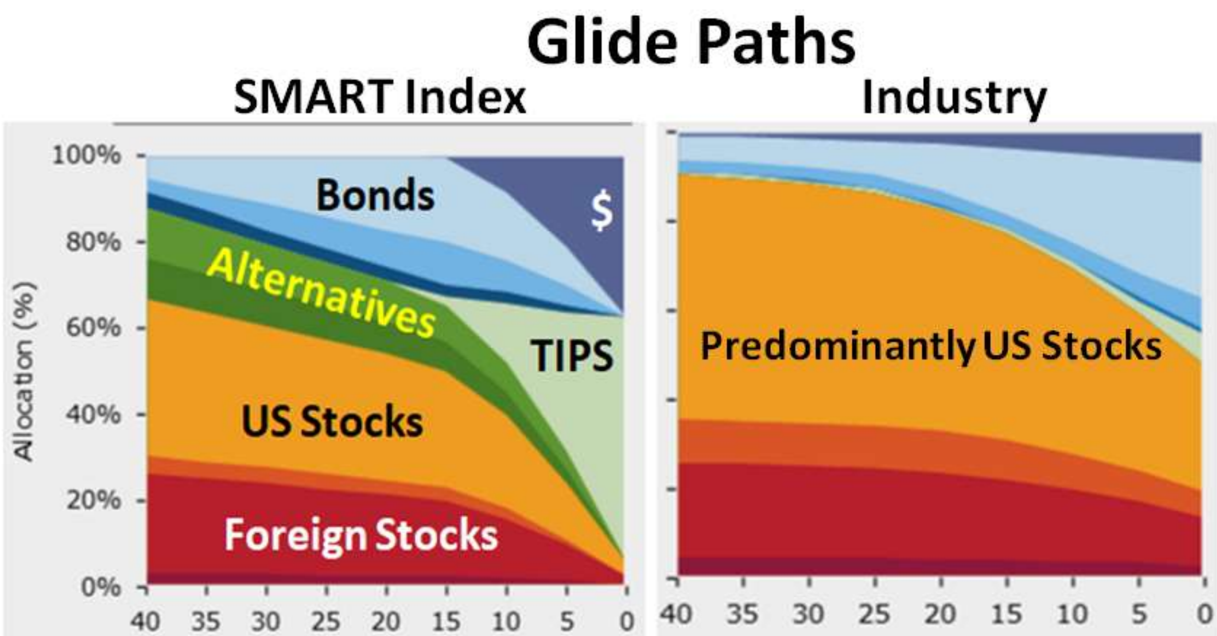
I define Prudence in target date funds (TDFs) as low cost, tight risk controls and broad diversification. These characteristics might not produce the best performance but they are the best for beneficiaries. Case in point, the TDF "Price of Prudence" in the past decade has been 1% per year for reasons that are explained in the following. Prudent TDFs have underperformed the TDF industry by 1% per year. At a time when fees that average 0.8% are being scrutinized, a 1% "cost" is a big deal.

It's been a very unusual 10 years, and it may be that the next decade will be unusual as well. Who knows, maybe prudent target date funds will perform well in the future, but they sure have not performed well in the past decade relative to their imprudent competitors.

A benchmark for prudent target date funds

There are two kinds of prudence: procedural and substantive. A fiduciary can use a benchmark that captures common practice, which is a Procedural Prudence benchmark. Procedural Prudence is satisficed when a fiduciary acts as others act in a similar capacity, following commonly accepted processes: follow the herd. The S&P and Morningstar Target Date Indexes are Procedural Prudence benchmarks because they are composites of all TDF mutual funds – they're consensus indexes. By contrast, a benchmark of Substantive Prudence reflects best practices, doing what is right for the beneficiaries, regardless of common practices. This may sound like a high and mighty benchmark, but it's not. Its derivation ties directly to something quite simple: what are the appropriate objectives for a TDF.

Reasonable objectives that represent best practices are capital preservation (don't lose money) and earn as much as you can without losing money. These Substantive Prudence objectives can be met by (1) being very safe at the target date and (2) being broadly diversified at long dates. These are the primary ways that the SMART TDF Index differs from Industry practice as shown in the following graph.



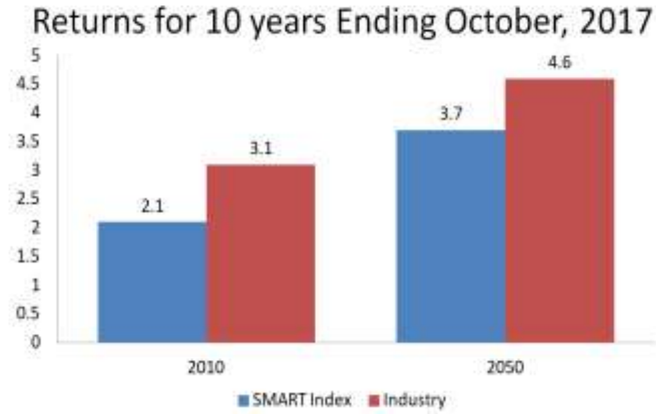
Source: PIMCO Glide Path Analyzer

As you can see, the Industry is about 55% in stocks at the target date with most of the balance in (risky) long term bonds. By contrast, the SMART index is less than 10% in risky assets at the target date, and is more than 90% in short term TIPS and cash.

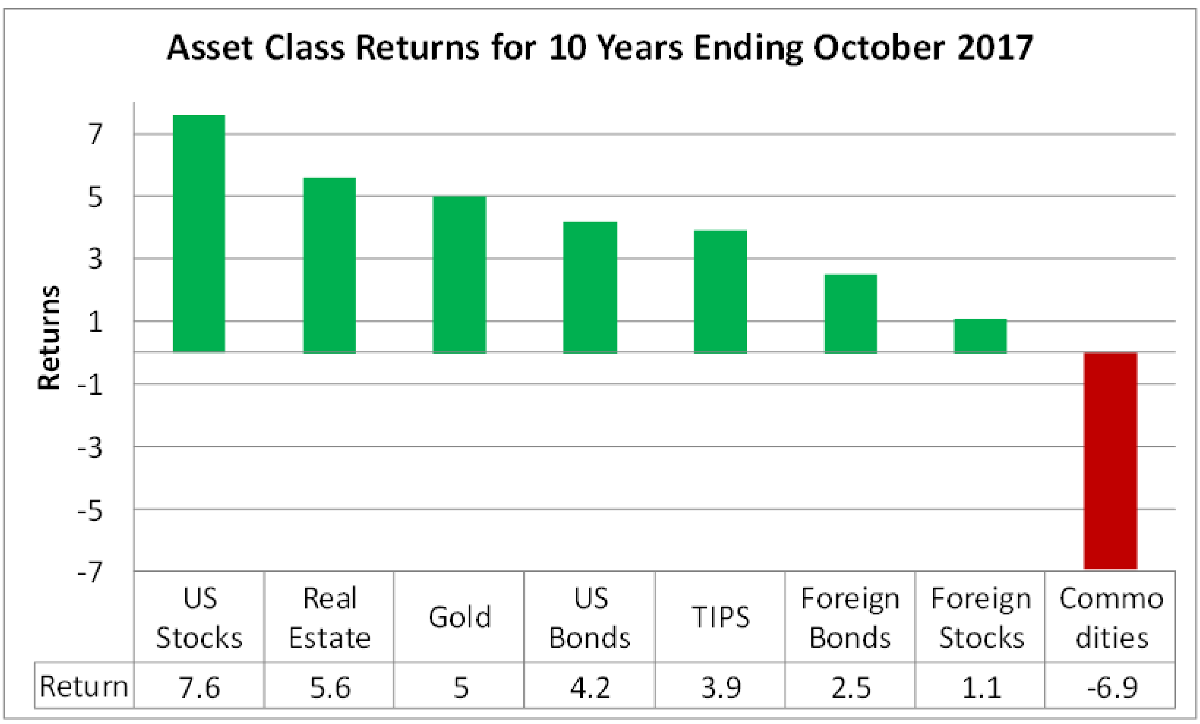
You can also see that the Industry is mostly US stocks at longer dates, whereas SMART incorporates broad diversification, where the "Alternatives" that are indicated include real estate and commodities.

The price of prudence

As shown in the graph on the right, the substantively prudent SMART Index has underperformed the industry by 1% per year over the past decade.



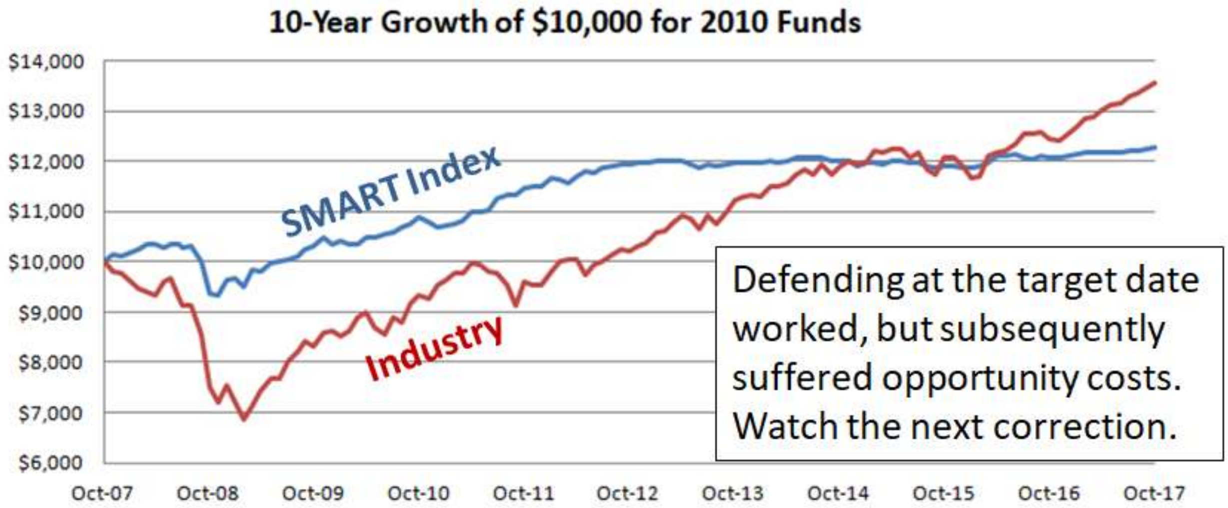
The explanation for the underperformance in the 2010 fund is the opportunity cost of being safe; risky assets have performed better than cash. The underperformance of the longer-dated 2050 fund is due to the fact that diversification has been penalized in this decade because US stocks have dominated, as shown in the following graph.



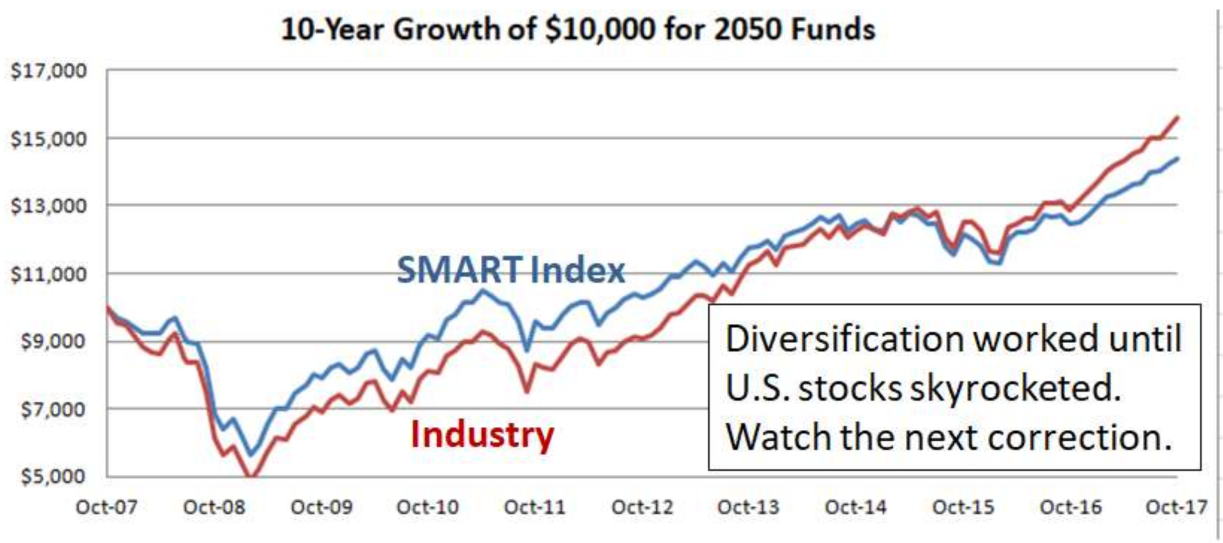
Source: The Capital Spectator

US stocks have earned 7.6% per year while diversifiers like commodities have suffered 7% losses.

But this underperformance evolved through time. The 2010 fund came through 2007-2008 with flying colors, and led the industry for many years, but gradually lost ground to the riskier Industry 2010 fund, as shown in the following:



Similarly, diversification helped control the pain in the 2007-2008 market collapse, and the SMART 2050 Index beat the Industry for many years, until the US stock dominance took hold.



Conclusion

Substantive prudence pays off in disasters. It shined in 2008, but that has been forgotten. Someday markets will go down again rather than up.

Substantive prudence is a good choice for fiduciaries, but fiduciaries need to understand the circumstances under which prudence will perform well and when it will not. Or more to the point, choosing a TDF on the basis of investment performance can be a mistake, especially in rising markets. Substantive prudence is worth paying for and it begins with recognizing the difference between procedural prudence and substantive prudence.