Save and Protect: Two Indisputable Retirement Savings Truths That Are Being Ignored

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There are two indisputable truths in defined contribution retirement savings:

1) Saving enough is critical to retiring with dignity.
2) There is a risk zone spanning the 5 years before and after retirement during which losses can materially disrupt retirement lifestyles, even if savings are sufficient. You only get to do this once. No do-overs.

These facts are largely ignored when it comes to target date funds (TDFs), the most popular choice of qualified default investment alternative (QDIA). Specifically, target date funds are designed to make up for inadequate savings by earning substantial investment returns through high equity exposure, even at the retirement date. The typical target date fund is invested 40% in equities at the target date. This practice simply does not stand up to scrutiny in light of known truths, as described in the following.

Save

In a recently published Working Paper (*Pension Research Council Working Paper*, The Wharton School, University of Pennsylvania, August, 2012), authors Alicia H. Munnell, Natalia Orlova, and Anthony Webb, using real-world data, discover that savings are far more important than asset allocation. To summarize, all cash is a fine investment strategy if you save enough.

This is of course common sense but you'd think otherwise when you read the sales literature for target date funds (TDFs). The stated objectives of TDFs are to replace pay and manage longevity risk, but that's just the hype that lets fund providers sell product rather than solution. Please note that you will not find these objectives in prospectuses or factsheets – they're just in sales materials.

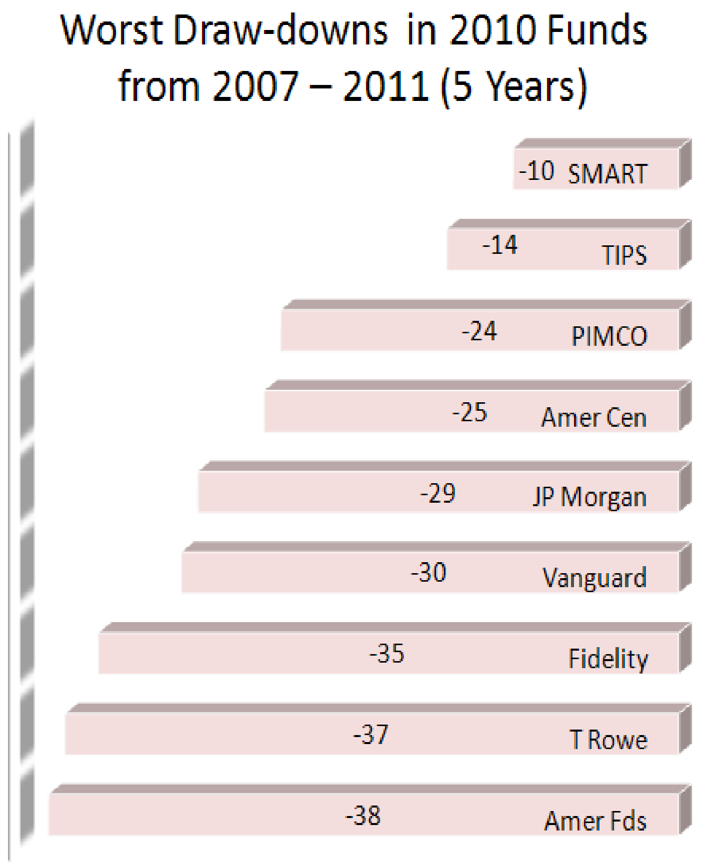
The industry doesn't agree on the appropriate risk exposure near the target date. It's no surprise that bond shops are mostly bonds (80%) at the target date while equity shops are 80% equities. The target date is critical for profits since that's when account balances are their highest. It's also critical to participants because lifestyles are at stake. There is a conflict of interest. Fund companies say the wide dispersion of equity allocations at target date is because of demographics – undersavers need more risk than the wealthy. Don't believe it. There is a better way. Capital preservation should be the number one objective of TDFs. The presumption should be that participants have saved enough to support a lifestyle that is acceptable to them. Some may plan for a life in a modest shack while others see a yacht in their future. It's all the same. A plan is a plan.

Protect

Prior to the Pension Protection Act of 2006, the most common investment default was very safe cash and stable value, which was probably too safe for younger employees but just right for those nearing retirement. But now the risk pendulum has swung too far for those nearing retirement. 2008 is all the proof we need.

Contrary to popular participant need and belief, TDFs do not protect the vulnerable from equity loss. They sure didn't in 2008, and nothing has happened to change that. Most participants in TDFs are defaulted into this product, which means that most participants rely upon their employers to do the right thing by protecting savings, especially near retirement (even though they are not). The Center for Fiduciary Due Diligence recently surveyed investment advisors regarding the protection of assets for those nearing retirement. The majority of respondents want no risk of loss in their TDFs near retirement. The unfortunate disconnect is that the majority also believe that current equity exposures are about right, suggesting that 2008 is perceived to be an unrepeatable anomaly.

Older participants are not getting the protection they want and deserve. The history of TDFs in 401(k)s, albeit a short 5 years, demonstrates that these funds are very risky near the target date. The table on the right lists the worst draw-downs (cumulative losses) in 2010 funds over the past 5 years. It's shocking. SMART Funds and TIPS (Treasury Inflation-Protected Securities) were the only reasonably safe investments. SMART Funds® are collective investment funds that follow the patent-pending Safe Landing Glide Path®, which ends 95% in Treasury bills and short term TIPS. It's no surprise that SMART has defended best because it is designed for safety.



The worst draw-downs for all funds except SMART occurred in the 16-month period 11/07-2/09.
The SMART 10% draw-down occurred in the 5 months 7/08-11/08.
TIPS 14% draw-down is for the 7 months 4/08-10/08.

Resisting reform, the industry has forgiven itself for these losses by noting that these draw-downs were subsequently recovered. "Forget 2008" is the industry's Jedi mind trick (Star Wars Chapter 1, 1977). Fiduciaries have fallen for this insult to their intelligence, choosing to believe that "no harm no foul" constitutes vindication. The fact is that many who suffered these losses did not participate in the subsequent recovery. See our short movie at **The Sad Comedy of Target Date Funds** .

Fiduciary Duty

You may feel that it's OK to ignore these truths because everyone else is ignoring them too, but everyone may be breaching their fiduciary duty. We won't know until we know, but class action lawsuits are a real possibility, in which case it will become clear that "no misery" is preferred to "misery loves company." Fiduciaries are exposed to lawsuits because they have the duty of care, so they are obligated to actually vet their TDF selections and to establish objectives that are truly in the best interests of participants. It's important to recognize that default investments are employer-directed rather than participant-directed, so a higher duty of care applies, warranting a separate statement of investment policy. Fiduciaries are duty bound to seek solutions rather than settling for high-risk products that are oblivious to history. Ignoring the past (especially 2008) and hoping it's different the next time is not an option, and it's certainly not an enlightened view of risk management.