Union 401(k) Plans Need Safer Target Date Funds

The truth is rarely pure and never simple
Oscar Wilde

- Everyone wants to be protected. Beneficiaries want protection from losses. Fiduciaries want protection against lawsuits. The best fiduciary protection is beneficiary protection. Prudence protects everyone.
- The typical TDF is expected to suffer excessive losses near the target date in 3 years out of 20. A few prudent TDFs are unlikely to ever suffer such losses.
- Just as the Roaring Twenties set the stage for the Great Depression, the Roaring Twenty-Tens could bring in the Next Great Depression. There's never a good time for imprudent risk taking in target date funds, but the current climate is unusually dangerous.
- 78 million baby boomers are currently passing through the investment Risk Zone and will continue for the next decade. There has never before been so many seniors at risk at the same time. These dedicated workers cannot afford investment risk at this critical time in their lives.

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The main purpose of labor unions is empowering workers through collective bargaining to secure favorable working conditions and employee benefits. That includes a retirement with dignity, which means building a sufficient level of savings in a 401(k) defined contribution retirement plan. Unfortunately, that critical objective is at risk due to the wide use of poorly designed retirement target date fund (TDFs) – products that are the default retirement-savings-plan option for most workers.

Investing in one of the many subpar TDFs on the market needlessly introduces substantial hazards for investors who are approaching retirement or newly retired. The news will likely come as a shock for the average investor, who's looking for peace of mind in a TDF investment. Instead of assuming unnecessarily high risk, (s)he wants to be protected from investment losses.

Most investors believe they are being protected through their TDF investments. Many even think their TDF is guaranteed to not lose money. The reality, unfortunately, is quite different because many of these products are managed with a higher level of risk than retirees expect and (more importantly) need.

The good news: prudently managed TDFs exist. The bad news: these products are the exception to the rule in this corner of the investment-product marketplace.

The Risk Of Mismanaged TDFs

Most retirees reason that they have saved their money in their 401(k) account and as retirement approaches they should be able to depend on their plans to manage their savings wisely. That starts by avoiding the key risk for new retirees: suffering investment losses at, near or just after retirement – a risk that can bring painful and unexpected reductions in savings, which in turn may lead to a major downgrade of lifestyle in the years ahead.

In other words, poorly designed TDFs threaten to break the promise of a retirement with dignity.

Fiduciaries also want to be protected from poorly managed TDFs, mainly from lawsuits. At the same time, they have an obligation to do what is best for beneficiaries – an obligation that starts by avoiding mistakes.

Plan trustees are charged with protecting all beneficiaries, especially those who are 5-10 years from retirement – a group that's especially vulnerable to poorly designed TDFs.

A PIMCO survey of pension advisors reports that a loss of 10% or more is considered "excessive" in the accounts of those near retirement. The bad news: most TDFs recently lost more than 10% and they lost far more than 10% in 2008. That's an appalling record: abject failure in 2 years out of the past 13.

Unfortunately, old habits die hard for most TDF strategies. As discussed below, the typical TDF is expected to lose more than 10% in 3 years out of 20.

Protecting Beneficiaries Near Retirement Is The Top Priority

In "Prudent Target-Date Fund Decisions for Fiduciaries," published in the July 2015 issue of the International Foundation of Employee Benefit Plans *Benefits Magazine*, I detail the meaning of "prudence" in TDFs. In a nutshell, there are three priorities for a prudently managed TDF:

* protect older beneficiaries as they near retirement
* diversify the investment portfolio
* maintain low fees

Protecting older beneficiaries approaching retirement is the primary goal because these investors are about to leave the workforce and cannot afford to lose savings that have been accumulated over a lifetime of working.

There are only a few TDFs that meet the prudence standards -- standards that union trustees need and want and, perhaps most importantly, that beneficiaries deserve. This elite group of prudent TDFs are safe at the target date with less than 30% of assets at risk.

Risky assets are typically defined as equities (stocks, real estate, alternatives, etc.) plus risky long-term bonds. Losses greater than 10% at the target date are highly unlikely for prudent TDFs.

By contrast, most TDFs hold more than 75% in risky assets at the target date, which means that they are not prudently managed because the risk of large losses (10% decline or deeper) is unacceptably high. The probability of losing more than 10% at the target date in risky TDFs is about 15%; losses greater than 10% are expected to occur in 3 years out of 20 for these poorly designed funds. I estimate a 10% loss to be one standard deviation below the mean, at the 15% probability mark.

These are not good odds for anyone who is about to retire because each of us only get one chance to invest and navigate retirement successfully. There are no do-overs and so the stakes are high.

Failure, in other words, isn't an option—or at least it doesn't have to be with a prudently run TDF.

Providers defend high-risk at the target date with the pretense that people have not saved enough, and they are living longer so beneficiaries need to strive for higher returns. The facts are (1) whatever you've saved throughout your life has to be "enough" because that's all there is – risking it as you enter retirement is not a good gamble – and (2) most retirees withdraw assets from their TDF accounts soon after retirement, which makes the longevity argument for these products moot while raising the potential that investors may lock in investment losses.

Lifespans are not the issue -- safety is. Retirees who remain in the plan are best served by annuities and guaranteed withdrawal plans rather than high-risk TDFs.

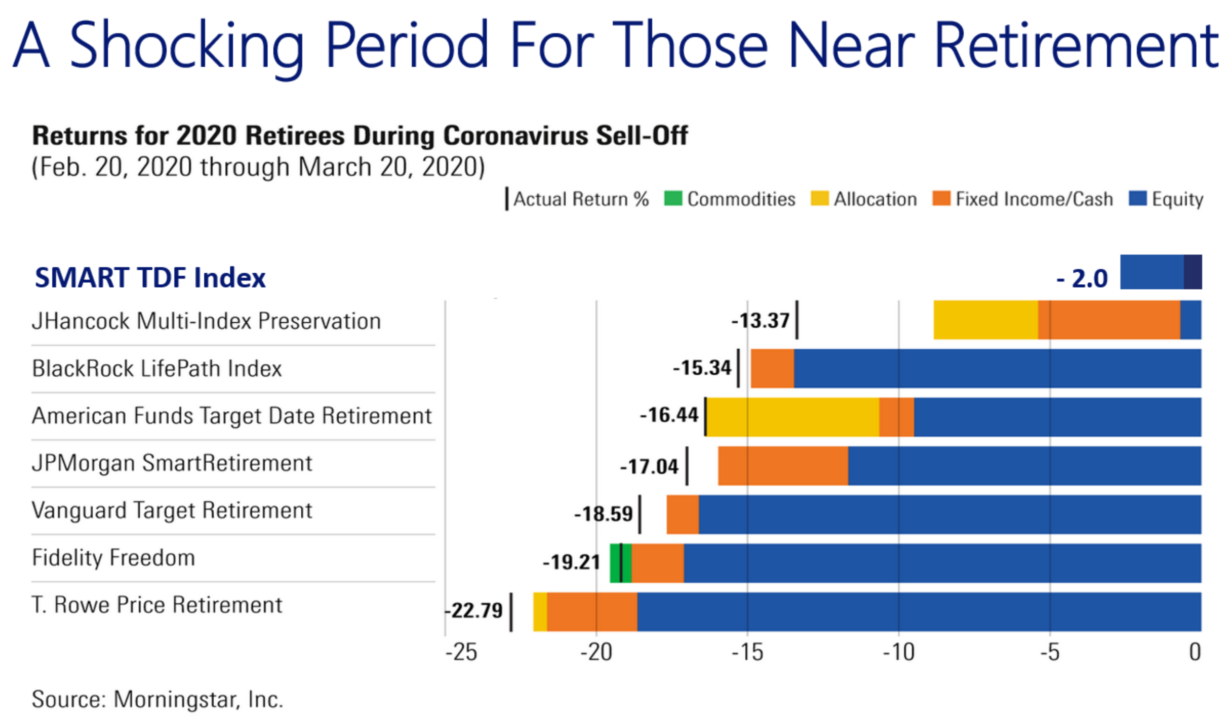
Union trustees succeed by shepherding beneficiaries safely to their retirement date with their accumulated savings intact. Furthermore, the Department of Labor advises fiduciaries to choose their TDF on the basis of demographics. This advice favors prudence since the only demographic that virtually all defaulted participants have in common is lack of financial literacy – they are financially naïve and therefore in need of protection. The Duty of Care fiduciary responsibility is akin to the obligation to protect young children. Accordingly, the best fiduciary protection is beneficiary protection. Everyone wins with prudent decisions, both trustees and beneficiaries.

The Pandemic and Prudence

Prudence is not rewarded with better performance… until it is. In fact, prior to the pandemic, the last time prudence was rewarded was in 2008-09, when prudent TDFs lost less than 10% while imprudent funds suffered losses of 30%-plus. Indeed, the long run suggests that prudence wins by not losing. There will be more market crashes.

After 2008, however, there was a decade when imprudent TDFs performed best – the greater the US stock allocation, the higher the return. But counting on a repeat performance, decade after decade, is probably naïve. The Roaring Twenties set the stage for the Great Depression. As discussed below, it could be that the recent Roaring Twenty-Tens have set the stage for the Next Great Depression. According to a recent Forbes article *In the Great Depression it was "stock market crash" followed by "banking crisis." Here it will be "lockdown" followed by "stock market crash."*

These days there's an added complication: COVID-19, which threatens our health and wealth, especially for seniors. Its ultimate effects remain to be seen, but the pandemic awoke a prudence concern in March 2020, when the US stock market at one point fell more than 30%. Morningstar reports the steep decline that spilled over to TDFs as follows:



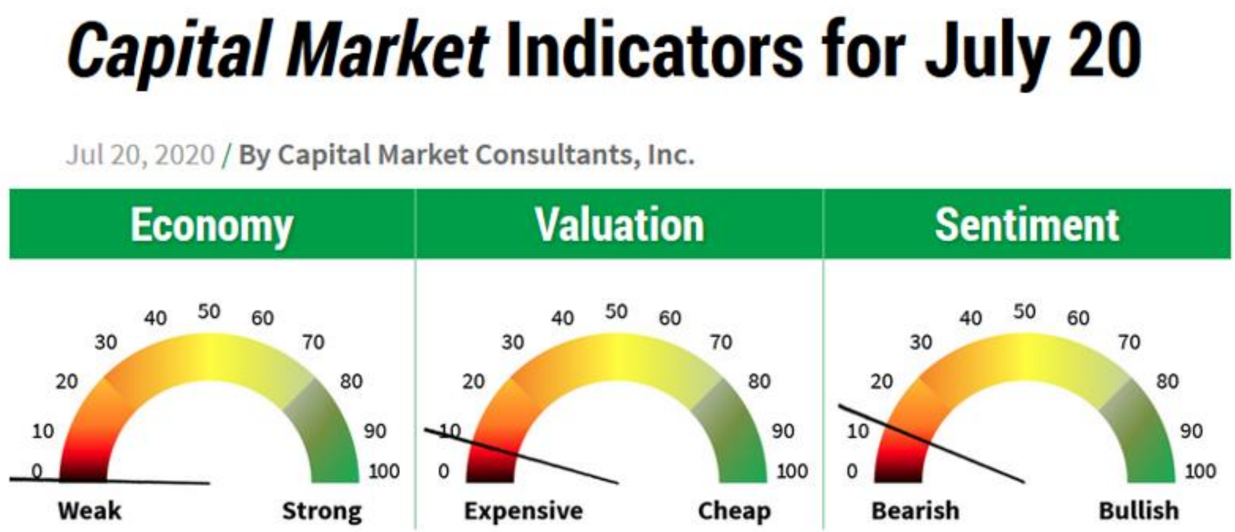
We have had a V-shaped recovery since the market low in late-March, but this V is likely to be the beginning of a string of Ws yet to come. The Great Depression lasted a decade and included ten Ws – recoveries followed by crashes.

Today, the global economy is in shambles. Many believe that central banks can bail the world out with paper by ramping up money printing in the extreme. Yet the consequences of these "Quantitative Easings" (QE) are dire and merely defer the pain… maybe. QE is likely to lead to serious inflation.

Sure, it's nice to get a check in the mail for doing nothing. But there are no free lunches. When things simply do not feel right, there is usually a good reason.

Plus, there is a wide range of at least ten threats to the securities markets that we address in this video. COVID-19 is just one of many reasons that stock markets will fall sometime in this decade -- a decade that will see 78 million American baby boomers passing through the Risk Zone that spans the five years before and after retirement.

The ultimate impact of COVID and other threats to the economy aren't fully known at this time. But many will continue to lose jobs and businesses and stocks are at risk of suffering from dwindling demand. As shown in the following indicators, the stock market was detached from the economy at the end of July, but this incongruity will likely not last. Wishing for the best doesn't always work.



There's never a good time for imprudent risk taking in target date funds, but the current climate is unusually dangerous.

Conclusion

Unions are by their very nature paternalistic, protecting their members. This protection can and should extend to retirement benefits, and into the investments of the most vulnerable, namely, those near retirement in target date funds. There are five ways that

TDFs can be safer, smarter and better for union 401(k) plans. Only a few TDFs provide these union benefits.

One of the major benefits/promises of being a union member is a comfortable retirement. Saving and protecting assets are the keys to achieve this goal.

Union trustees encourage savings through education and plan design. Protecting those savings is the critical next step to delivering on the promise. Some members make their own investment decisions and should be smart enough to protect their savings. Others rely on the plan's trustees to choose a target date fund that protects their lifetime savings.

Everyone wants to be protected. Fortunately, there's no reason why that protection can't be offered. The key is using prudently designed and managed TDFs. Union baby boomers will be passing through the investment Risk Zone for the next decade. There has never before been so many seniors at risk at the same time. These dedicated workers cannot afford investment risk at this critical time in their lives.

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