Who Should Design Target Date Funds? Who Should Not?

"The function of design is letting design function." -- Micha Commeren, designer

- Target date funds should be designed by financial engineers for the benefit of beneficiaries.
- Most target date funds are designed by investment firms for profit, i.e. for the benefit of the designer.
- Although risk has been highly rewarded in recent times, dangers lie ahead, even beyond Covid-19.

Certain professions should not attempt to invade the provinces of other professions. For example, butchers should not design furniture and geologists should not design toilet seats.

Toilet Seat Designed by Geologists

and

Furniture Designed by Butchers

Such is the case with target date funds (TDFs). TDFs should be designed by financial engineers, following the specifications of experts in retirement savings and investments. In this article we discuss the differences between TDFs designed by investment firms and those designed by financial engineers.

When TDFs are designed by investment management firms

Investment management firms are in the business of investing other people's money for profit, the more profit the better. Accordingly, their design of a TDF maximizes profits within the rules of TDFs. The only such rule is that the glide path should reduce risk through time, but the amount of reduction is unspecified. On the profit side, the greatest profit is made at the target date because that's when account balances are their highest. Combining the rules with the profit motive leads to a design with the highest equity allocation allowed at the target date. That highest acceptable allocation is about 60% based on the actual TDFs designed by investment management companies.

The other consideration is how the remainder is invested, basically the amounts in long term bonds and safe assets like stable value. Since fees on long term bonds are higher than those on safe assets, the majority of the balance is in long term bonds.

TDFs designed by investment management companies start out invested mostly in equities for young beneficiaries. This is particularly good for fund companies except there is not much money in these long-dated funds. The real money is in funds near the target date. These near-dated funds are relatively less risky than long-dated, with 55% in equity, but still quite risky.

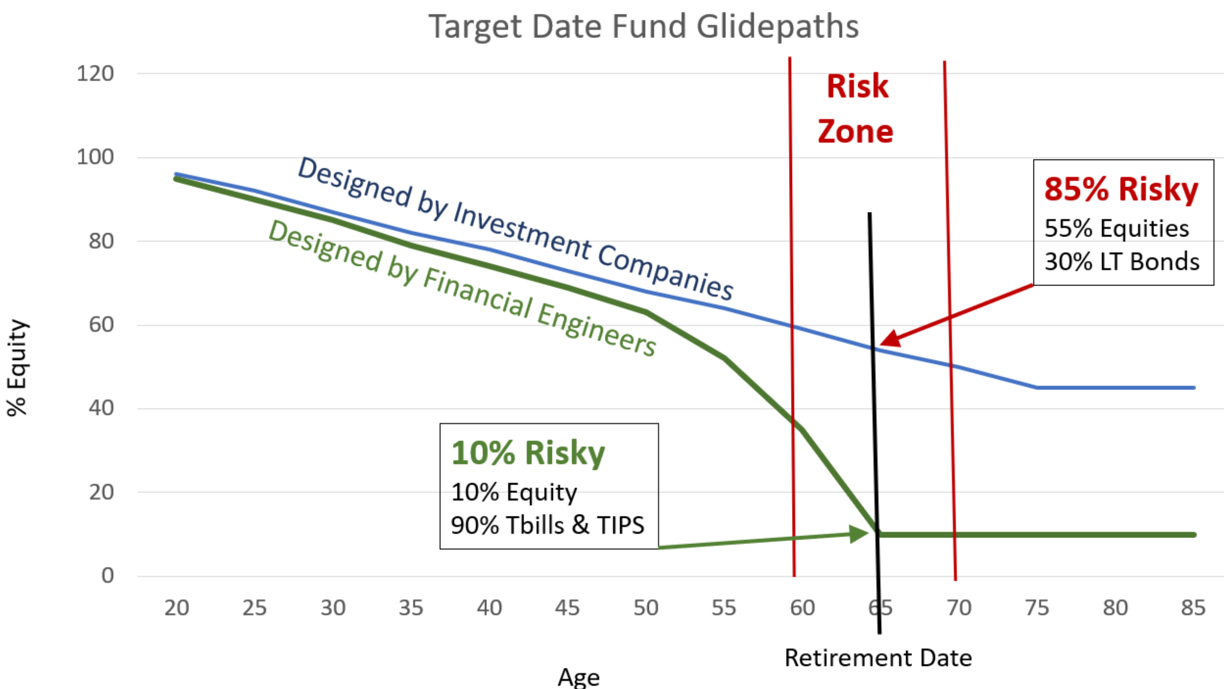
Near dated funds are high risk because most of the balance is in long-term risky bonds. They are about 55% in risky equities and at least 30% in risky bonds, so 85% in risky assets in total. This is much riskier than near-dated funds designed by financial engineers, putting beneficiaries at substantial risk. Be aware that beneficiaries bear this risk, not fund companies.

When TDFs are designed by financial engineers

Financial engineers are trained to design investment risk and reward tailored to investor specifications. Experts in retirement savings and investments like Dr Wade Pfau and Professor Moshe Milevski say that it is important to not lose beneficiary savings, especially as beneficiaries transition from working life to retirement. This transition period is called the Risk Zone. Financial engineers use a discipline called "liability-driven investing" (LDI) to guard against losses along the glide path, and to protect in the Risk Zone with very safe investment – much safer than the designs created by investment firms. A financially engineered glidepath ends at the target date with 10% in equities and the balance in safe assets like T-bills, TIPS, and stable value.

The incredible differences

The following picture summarizes the differences.



Those familiar with target date funds will recognize the glidepath designed by investment companies because it is the path followed by all but a few TDFs. The path designed by financial engineers is the patented Safe Landing Glide Path (SLGP). It is followed by the SMART Fund Target Date Fund Index and the Office and Professional

Employees international Union (OPEIU). There are a few TDFs with glidepaths similar to SLGP, but none with a 12 history like SMART.

Why this matters

There is a lot of money and a lot of people in TDFs. More than $2.5 trillion is invested in TDFs by approximately 40 million people. Many of these people are in the Risk Zone and are facing not just the current pandemic but a whole host of disasters as discussed in this video. At least one of these disasters is highly likely to occur as our 78 million baby boomers transition through the Risk Zone this decade.

When baby boomers are financially harmed they become increasingly dependent on welfare programs that could be overwhelmed. 55 million baby boomers are dependent on welfare programs.

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