Surveys Say Target Date Funds Are Losing Their Allure. What Should Fiduciaries Do?

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"Everything should be made as simple as possible, but not simpler." **--Albert Einstein**

Recent surveys, including ***Pensions & Investments*** report on a Dimensional Fund Advisors study, conclude that interest in target date funds is waning. Once the darling of 401(k) pension plans, target date funds have lost much of their allure, and for good reason: confusion and disagreement bedevil these qualified default investment alternatives (QDIAs). What's worse, fiduciaries are not vetting these investments, entrusting target date assets to their bundled service providers out of convenience and familiarity. The lipstick on this pig is wearing off.

All is not lost. Concurrence on objectives will restore the former glory. The world's awash in definitions of risk, but one of the most meaningful and practical is identifying risk as the possibility of falling short of investment objectives.

Recognizing what could go wrong and designing a plan to avoid critical failure is at the heart of goals-based investing, a popular and sensible approach to money management. A simplified risk management strategy for target date funds (TDFs) begins with the identification of objectives. The decisive question: What do you want TDFs to achieve?

The answer is indisputable. Objective one: avoid losses. Second: Maximize performance without violating the first goal. These two objectives lay the groundwork for investment success with a simple but effective risk management process.

<u>Primary objective:</u> Do not lose participant money

TDFs are qualified default investment alternatives (QDIAs), which is why these products are selected by employers on behalf of participants who cannot or will not

make the necessary decisions on their own. In essence these participants are admitting: "I have no knowledge of investing so I trust you, my employer, to do what is right. I believe that my savings will be protected by you, especially when I'll need them most, when I retire."

Secondary objective: Earn as much as you can, but do not lose participant money

The price of safety is sacrificed return, an opportunity cost. Intelligently exposing a portfolio to risk is generally rewarded, especially over long horizons. No wonder that employees with long horizons, namely the young, can and should be more aggressive with risk allocation. This quest for growth can be delivered without jeopardizing the preservation objective if allocations are moved to safety at the appropriate time.

The shift from growth to safety over the employee's working life is the purpose of target date funds. Timing and tactics are critical. The key decisions: determining when to apply the brakes and how forcefully. These are the factors that define a TDF's "glide path."

Setting the glide path

The crucial issue for TDFs is identifying a glide path that will achieve our two main objectives with a high conviction for success. High conviction is synonymous with low risk when risk is defined as the possibility of failure.

The optimal glide path integrates the strategic wisdom of modern portfolio theory with the economic logic of liability-driven investing (LDI). The financial engineering begins with the "separation principle," which employs a very broadly diversified world market portfolio for growth that's combined with a safe asset for protection. Young employees are invested entirely in a world market portfolio until the investment horizon for the target date becomes risky. This is the point when the primary objective of not losing money is in jeopardy.

The glide path estimates the worst-case loss from the current date to the target date. It then moves sufficient assets into the safe portfolio such that the return on the safe allocation will compensate if the worst-case loss threatens. This is the discipline of liability-driven investing where the liability is defined as the accumulated contributions plus inflation.

Research demonstrates that a broadly diversified growth portfolio is highly unlikely to lose money over a holding period of 15 years or longer, which inspires applying the brakes gently starting at 15 years to target date. In time, the mathematics of liability-driven investing triggers a more-forceful application of safety and emphasizes a curvilinear glide path that reduces equity exposure to zero by the target date.

The end justifies the means

A glide path with a primary directive of not losing money must end entirely in safe assets. A simple yet practical definition of risk management allows for nothing less. Prior to the target date the glide path can and should strive to balance the accumulation of growth, using the world market portfolio strategy, with the mandate to defend so as to not run afoul of the primary objective.

This simplified approach eliminates the need for the complexities and confusion that otherwise bedevil TDFs. The details of product structure, debating "through" vs. "to" strategies, etc., simply don't matter when you systematically maximize the odds for investment success with a prudent risk management strategy that's as simple as possible, but no simpler.

It's very important to recognize that the end of the glide path is not the beginning of the retirement allocation. Most participants withdraw their accounts at retirement, and many elect to invest in protection against mortality risk, a risk that cannot be managed in a TDF. A safe ending point in the accumulation phase protects savings so they can be rolled over confidently into the distribution phase, an important objective.

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There is no Fiduciary Upside to Equity Exposure at the Target Date

Only Downside

Losses can lead to Litigation: Loss-Suits

No Fiduciary has ever been sued for protecting beneficiaries.