CRUISIN’ FOR A BRUISIN’ WITH TDFS

Five Reasons Why Target-Date Funds Should Be Made Safer

By Ronald J. Surz
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So don’t stop, stop the music!
We ride fast like a bullet
We do anything we want, anytime we want
Oh yeah! Oh yeah!¹

Something is seriously wrong with target-date funds (TDFs), despite their popularity. Logic argues for greater safety at the target date than is currently being provided. Surveys argue for greater safety as well although no one seems to get the connection. Prior to the target date, younger participants can tolerate more risk because their horizons are longer.

TDFs exhibit this devil-may-care attitude at the target date primarily because the risk is borne by investors, not fund companies. But beneficiaries are the ones that “ride fast like a bullet” and fund companies get paid regardless of the outcome.Beneficiaries don’t feel like bullets until they hit the wall of a market crash.

Sure, TDFs are less aggressive at the target date than before the target date, but they still operate with one foot on the brake and the other stomping the accelerator. The top three TDF providers, referred to here as A, B, and C, “do anything [they] want, anytime [they] want” because they own the TDF market as an oligopoly² with 63 percent of a $1.7-trillion treasure trove.³ Figure 1 shows what they do.

Here are five reasons that 55 percent in equities in the risk zone is way too high and should in fact be no more than 20 percent.

REASON 1: REASONABLE OBJECTIVES
Fiduciaries should be setting objectives for their TDFs, but they aren’t. Rather, fiduciaries are basing their TDF choices on limiting their liability. They believe that (1) any qualified default investment alternative (QDIA) will do and (2) you can’t go wrong with the top three because everyone else is using them. This is a breach of the duty of care, which requires fiduciaries to select the option that best serves the beneficiaries. That’s simply not happening.

What are the objectives that fiduciaries should establish? TDF providers say they’ve designed their products to replace pay and manage longevity risk, but these are mere hopes, not reasonably achievable objectives. Saving enough is the only way to replace pay and manage longevity risk and hoping that you can make up for inadequate savings with investment returns is not a prudent choice. The top three are 55 percent in equities in the risk zone because they have chosen growth over safety as a means to make up for inadequate savings. Their foot is mostly on the accelerator.

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⁷ What are the objectives that fiduciaries should establish? TDF providers say they’ve designed their products to replace pay and manage longevity risk, but these are mere hopes, not reasonably achievable objectives. Saving enough is the only way to replace pay and manage longevity risk and hoping that you can make up for inadequate savings with investment returns is not a prudent choice. The top three are 55 percent in equities in the risk zone because they have chosen growth over safety as a means to make up for inadequate savings. Their foot is mostly on the accelerator.
A reasonable objective would be to get participant savings safely to the target date intact and to earn a reasonable return on those savings. In other words, if the account balance is $10,000 today, the objective would be to have an account balance of at least $10,000 at the target date, absent cash flows. The Hippocratic Oath of TDFs should be, “Don’t lose participant savings.”

TDF Provider D is designed to achieve this objective. It looks much like the largest provider until it reaches the risk zone, then it moves to defend savings by reducing equity exposure to 10 percent at the target date and beyond, as shown in figure 2.

**REASON 2: DEMOGRAPHICS**

In its 2013 “Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries,” the U.S. Department of Labor recommends that fiduciaries select TDFs to match workforce demographics. This has led to the growing popularity of custom TDFs, which are purported to tailor a glide path to participant demographics. But many participants have only one demographic in common—lack of financial sophistication. As such, these folks need to be kept safe, especially in the risk zone. Like the TDFs of the top three, custom TDFs generally are not safe in the risk zone (see figure 2).

**REASON 3: BENEFICIARIES WANT TO BE PROTECTED IN THE RISK ZONE**

Beneficiaries want to be safe in the risk zone, and they may think that they are, but they are not. The recent MassMutual Retirement Savings Risk Study examines beneficiary risk preferences in 401(k) plans. The methodology is as follows:

On behalf of MassMutual, Greenwald & Associates, an independent research firm, conducted an online survey that included 804 pre-retirees and 801 retirees. Respondents were drawn from ResearchNow’s online panel. To qualify for the survey, all respondents had to be at least 40 years old. Pre-retirees were required to have a household income of at least $40,000.
work full-time for a private sector employer, and be participating in that employer’s DC retirement plan.

Retirees were required to have total investable assets of at least $100,000. They had to be retired from a private sector employer and participating in that employer’s DC retirement plan at the time of retirement.

Figure 3, which is drawn from the MassMutual report, shows beneficiary preference for safety over growth in the risk zone.

At 15 years to the target date, the vast majority (75 percent) want growth over safety, but this preference dramatically shifts so that only 17 percent prefer growth over safety at retirement. Those with another source of income, such as a defined benefit (DB) plan, opt for some—what more growth, obviously because their other assets are safe.

The preferences shown in figure 3 can be used as proxies for preferred equity allocations along the glide path. Figure 4 shows these preferences in contrast to TDF Providers A, B, C, and D.

**.reason 4: Consultants want to protect beneficiaries in the risk zone**

Consultants say they want to protect beneficiaries from harm in the risk zone, but they choose TDFs that do not afford this protection. Rather, consultants likely are choosing TDFs to protect themselves rather than beneficiaries: They opt for the procedural prudence that the top three embody.

Pacific Investment Management Company (PIMCO) conducted its 2018 12th Annual Defined Contribution Consulting Support and Trends Survey, which they describe as follows:

> Our 2018 survey captures data, trends and opinions from 77 consulting firms across the U.S., the highest number in the 12-year history of the survey. These firms advise over $4.4 trillion in U.S. DC assets, accounting for almost 60% of all U.S. DC assets.

The survey addresses loss avoidance at various dates along the TDF glide path. The survey responses are summarized in figure 5.

The survey shows that consultants want TDFs to defend against losses of 10 percent or more at the target date, and to become even more defensive beyond the target date, defending against losses of 5 percent or more. These goals argue for very conservative allocations, assuming that the objective is to have a low probability of the indicated loss. For example, a 10/90 stock/bond mix has a 95-percent probability of protecting against a 5-percent loss in a year.

**Reason 5: 75 million baby boomers are in the risk zone**

This reason goes beyond individual plan workforces to the entire U.S. population,
so this discussion includes individual retirement accounts (IRAs) as well as TDFs. The average IRA is 55 percent in equities regardless of age.

Most boomers currently are taking more risk than they should because they are in the risk zone, a time when they should protect their lifetime savings. Of course, if boomers do sell a substantial part of their $30 trillion, it will cause a market correction, so you don’t want to be the last one out the door. The boomer population is so big that a market failure in the next 20 years will be catastrophic. If they don’t sell, the next meltdown (whenever it occurs) will create a public outcry like the world has never heard. It will take 20 years for boomers to pass through the risk zone, so there’s a good chance of a correction in that time span.

Can society support tens of millions of broke boomers? Will it? If boomers lose, we all lose.

CONCLUSION

Just because something is currently a certain way doesn’t mean that it is the right way. If target-date funds continue in the current way, TDF beneficiaries are cruisin’ for a bruisin’, as are baby boomers because they too tend to be invested 55 percent in equities.

Ronald J. Surz is president of PPCA Inc. and its division, Target Date Solutions. He earned an MBA in finance from the University of Chicago and an MS in applied mathematics from the University of Illinois. Contact him at ron@ppca-inc.com.

ENDNOTES

1. This is the chorus from “Cruisin’ for a Bruisin’,” a popular song from the 2013 Disney Channel Film Teen Beach Movie. Listen to the song here: https://www.youtube.com/watch?v=nEvq5zTxX5I.
2. Oligopoly is a market structure with a small number of firms, none of which can keep the others from having significant influence. The concentration ratio measures the market share of the largest firms. A monopoly is one firm, duopoly is two firms, and oligopoly is two or more firms. There is no precise upper limit to the number of firms in an oligopoly, but the number must be low enough that the actions of one firm significantly influence the others. https://www.investopedia.com/terms/o/oligopoly.asp#ixzz5O604Xbzy.

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