The Thinking Man’s Target Date Fund

- Target date funds are for people who don’t want to think
- This $2 trillion industry is dominated by just 3 firms with mediocre products
- Individual investors can do much better

Target date funds (TDFs) are enormously successful, having grown from nothing to $2 trillion in just the past decade. Their main appeal is that someone has done all the thinking, so the investor can sit back and relax – their only jobs are depositing and spending money. Most assets in TDFs are from financially unsophisticated participants in 401(k) plans who have defaulted their investment decision to their employer. TDFs are the most popular fiduciary choice of QDIA (Qualified Default Investment Alternative). Defaulted participants do not have the education to think about investment decisions. These TDFs are for people who don’t want to think. Will Rogers said “Everyone is stupid, but about different things.”

TDFs manage risk through time along what is called a glide path. Young investors take a high amount of risk and old investors take a low amount. The fund provider defines “young” and “old”, and “high” and “low”, but not to worry because it’s the same definition for everybody in a particular TDF. These definitions vary somewhat across providers, but not that much. Uniformity is the consequence of an oligopoly of just 3 firms who manage more than 60% of the $2 trillion. It’s been a very profitable product for these fortunate investment companies.

So what do investors give up when they decide not to think, to entrust a TDF to think for them? Control of their destiny. Millions of investors in TDFs are bonded together on a ride to who knows where, trusting their employers and hanging on the hope that there’s safety in numbers.

TDFs for Thinking People

But no one has to buy a one-size-fits-all off-the-shelf TDF, especially individual investors in Individual Retirement Accounts (IRAs). We all have our individual needs and
circumstances that should drive our investment decisions. We are different from those in a particular fund in the following ways:

- Risk tolerance
- Goals
- Circumstances like wealth, health and family

This is where financial planning can help. A “good” adviser (see description below) can guide an investor to appropriate investment decisions through time.

The TDF model is helpful for this guidance as it leads to what we call a Lifetime Asset Management Plan (LAMP). The key to a comfortable retirement is to (1) save enough, and (2) keep it. TDFs have elements of this discipline that can be improved upon by individual investors who follow a LAMP. A wise investor will protect his/her lifetime of savings in the Risk Zone that spans the transition from working life to retirement. A generic LAMP is shown as the red line in the following picture:

A successful LAMP is the result of 3 disciplines:

- Saving enough and spending wisely in retirement
Making wise risk decisions. This can be distilled down to the “Triangulating Risk Decisions” discussed below.

Using a good financial advisor

**Saving Enough and Spending Wisely**

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, demonstrate that savings are far more important than asset allocation. To summarize, all cash is a fine investment strategy if you save enough.

As a rough guide, you should aim to save 15% of earnings each year and to accumulate twelve times the amount you’d like to spend annually in retirement. So, for example, if you plan to spend $100,000 per year in retirement, you’ll need to save $1.2 million. You can use a [retirement readiness score](#) and the [following chart](#) to track your progress toward saving enough:

![Savings factors to help you on your journey to retirement](image)

Retirement is filled with challenges. Most importantly, we all want our savings to support a comfortable lifestyle and to last a lifetime. Financial planners have long
debated and sought the “right” spending rule. One such rule is **The 4% Withdrawal Rule** that stems from a *1994 study* by financial planner William Bengen. After testing a variety of withdrawal rates using historical rates of return, Bengen found that 4% was the highest rate that held up over a period of at least 30 years. The 4% withdrawal rule spends 4% of savings in the first year, & then that dollar amount increases by inflation in each subsequent year.

Other spending rules have also been introduced, like spending 5% instead of 4%, and variable spending rules like the one introduced by [Waring and Siegel](#).

You should discuss your choices with your financial planner, and commit to follow a reasonable spending discipline.

Importantly you should develop an investment plan that helps savings last a lifetime, as discussed in the next section.

**Triangulating Risk Decisions**

A TDF template is helpful to formulating your risk decisions. As shown in the following graph, there are 3 critical decision points: (A) Risk when you’re young, (B) Risk when you enter retirement, and (C) Risk in retirement. The graph uses equity allocation as the measure of risk. “Equities” should be broadly diversified and include global stocks, real estate and alternatives like commodities.
We think points (A) and (C) – beginning and end of the glide path – are reasonable starting points for personalizing your TDF, but believe that the typical TDF is way too risky at the retirement date, point (B). The typical 2010 TDF lost more than 30% in the 2008-2009 market correction, and this level of loss is destined to repeat. We recommend that you take a safer position for the following reasons;

- Losses in the Risk Zone can devastate lifestyles
- There is currently a real possibility that the bull market of the past 12 years is coming to an end
- An optimized glide path in retirement argues for starting low and re-risking, as discussed next

What is the “right” investment plan for a retiree? This question is addressed in Dr Wade Pfau and Michael Kitces’ Reducing Retirement Risk with a Rising Equity Glide Path, where they compare and contrast increasing equity glide paths to flat glide paths in retirement. Dr Wade Pfau, Ph.D and CFA, is Professor of Retirement Income at the American College of Financial Services. He writes extensively on retirement savings and investments. Mr. Michael Kitces, MSFS, MTAX, CFP,CLU, ChFC, RHU, REBC, CASL, is a highly regarded financial planner who holds Masters Degrees in Financial Services and Taxation, plus extensive professional designations.

K&P conclude: the results reveal that rising glidepaths are even more effective, especially when they start off conservatively. The most favorable (i.e., least adverse) shortfall actually occurs with a glidepath that starts at only 10% in equities and rises to “only” 50% in equities. The low starting point defends against Sequence of Return risk and the re-risking extends the life of assets.

Getting It Done

You can certainly implement this Thinking Man’s TDF on your own, but you should consider employing a financial advisor for help. If you do, you’ll want to choose wisely.