

Bad Match

Overly aggressive target-date funds ignore the fact that investors may choose to cash out after they retire. By Craig L. Israelsen

THE PENSION PROTECTION ACT (PPA) of 2006 created two dominant qualified default investment alternatives (QDIA) for retirement plans—target-date funds and balanced funds. But even the best-laid plans can be offset by bad timing or poor execution. Most target-date funds experienced a combination of both in 2008.

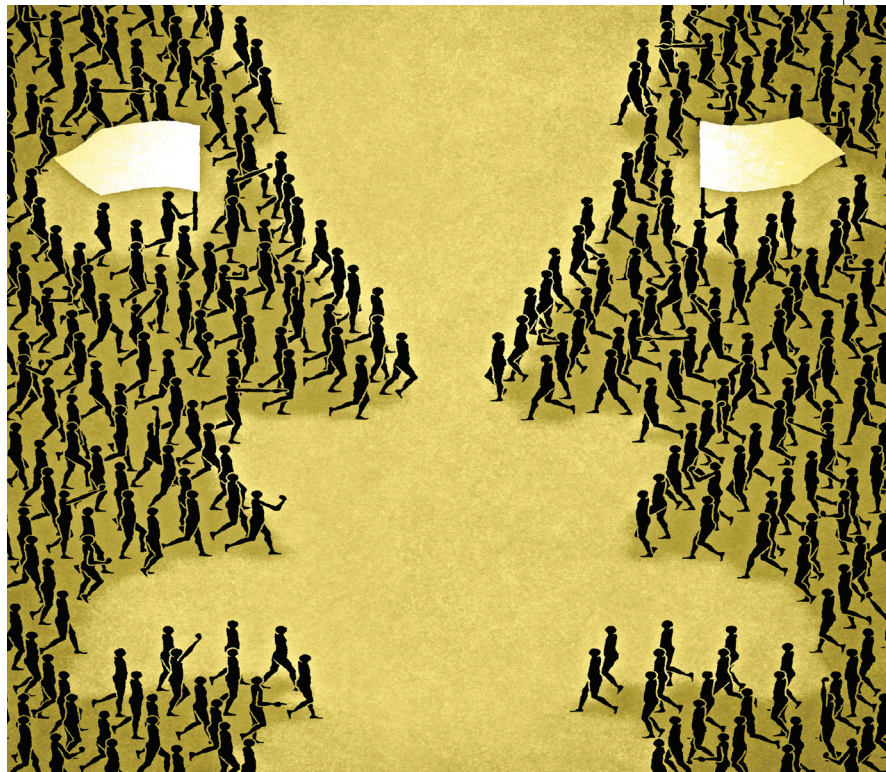
The poor performance of target-date funds, particularly 2010 funds, as QDIAs has not gone unnoticed in Washington. The U.S. Dept. of Labor (DOL) and the SEC held a joint hearing on June 18 to look into how target-date fund managers determine the asset allocation of their funds. New regulations are likely from both agencies.

After a similar hearing in February, the U.S. Senate Special Committee on Aging noted that the DOL had issued regulations allowing target-date funds to be used as a QDIA in employer-sponsored retirement plans, but there were no requirements for the appropriate ratio of stocks to bonds as the fund nears its target.

A LITTLE HISTORY

A QDIA is designed to position investors in age-appropriate investments during their lifetimes. In general, this theory requires high equity exposure (higher risk and return) when the investor is younger and lower equity exposure (lower risk and return) when the investor is approaching the target date.

Ironically, prior to the PPA, industry observers felt that too many young investors had parked their 401(k)



balance in cash or stable value funds and, as a result, were missing needed growth potential in their retirement portfolios. This was true in many cases, and it made sense to take action to remedy the situation. The so-called remedy was to encourage the use of balanced funds or target-date funds as defaults instead of cash funds and stable value funds. Thus, in recent years the pendulum swung from a pair of low-risk default investment products (cash and stable value) to higher-risk default investment products (target-date funds and balanced funds).

For young investors with a long investing horizon in front of them, this was a welcome change.

For some older investors with only a few years separating them from retirement, the transition has been catastrophic. The issue, as always, is timing. But more than that, it also involves a misalignment between product design and usage.

Let's first examine target-date funds, since we're now within five months of reaching the first major target date: the year 2010. A significant controversy is determining what the target date represents: Is it the year the investor retires, the year he or she dies or even the year a child enters college (if the investor is targeting something other than retirement)? The answer to this question has a pro-

found impact on the design of the target-date fund because it reflects three dramatically different ways investors might use the fund. Recognizing that investors can use a target-date fund in different ways is vital to its design.

The glidepath (or dynamic asset allocation model) in a target-date fund produces a more risky portfolio with higher return potential when the target date is far in the future, and a less risky portfolio as the target date nears. The appropriate time to begin reducing portfolio risk is within five to 10 years of the target date. Nevertheless, nearly all target-date funds fail to do so. A target-date fund that fails to protect account value as the target date approaches has failed in its primary task.

INVESTOR LIFE CYCLE

Most investors assume the target date represents the year they will retire. An investor's life cycle can be segmented into three distinct phases (see "The Game of Life," at right):

- Accumulation phase prior to retirement (ages 25-55)
- Transition phase as the investor prepares for retirement (ages 55-65)
- Distribution phase during the retirement years (over age 65).

The primary objective during the accumulation phase is to grow assets. As a result, the portfolio will consist primarily of equities until the investor is approximately 55 years old. At this time, a target-date fund should begin to protect the assets in the portfolio, while still attempting to achieve prudent growth.

In the transition phase, the target date represents the year of retirement. When an investor is 63 years old, he or she has only two years until the target date, and should be brought safely to this stage. Once safely at the point of retirement, the individual should engage in a complete financial review and make needed preparations to begin the last phase.

THE GAME OF LIFE

An investor's life has three stages. Target-date funds may be inappropriate in the last stage, although their designers believe otherwise.

Life cycle Investment Stage	Approximate Ages	Investment Phase	Primary Goal	Secondary Goal	Appropriate Investment Vehicles
1	25-55	Accumulation	Growth	Asset Protection	Target-Date Fund, Balanced Fund, Multi-Asset Portfolio
2	55-65	Transition	Asset Protection	Reasonable Growth	Conservative Target-Date Fund, Conservative Balanced Fund
3	Over 65	Distribution	Asset Preservation	Modest Growth	TIPS, Cash, Annuities, Conservative Equity, Very Conservative Balanced Fund

Source: www.TDBench.com

The distribution phase represents an entirely different experience for the individual. The investor is no longer adding new money, but is now withdrawing money from his or her portfolio. As a result, the portfolio needs to be designed differently. A target-date fund may not be the correct vehicle at this stage, or at least most of the target-date funds currently in circulation are not appropriately designed for the distribution phase.

THE MISMATCH

But is the way investors use a target-date fund consistent with the assumptions used to design the fund? In fact, there is a serious disconnect between the two.

The makers of target-date funds, of course, are driven by asset acquisition and retention. As a result, they assume an investor will stay in the fund until he or she dies. For example, nearly all target-date fund manufacturers believe a 63-year-old has about 20 years until death. Based on these assumptions, they design an asset allocation model (or glidepath) that is very aggressive near and at the target date.

The investor, on the other hand, likely assumes that the target date actually means something specific.

He or she assumes that in the years leading up to the target date, the fund will be insulated from dramatic losses. Many investors may, in fact, plan to arrive safely at the target date and then withdraw the funds and purchase annuities. This is a classic mismatch.

Recall that target-date funds can also be used to prepare for college funding. If the target-date fund looks beyond the target year, the fund will be far too aggressive and could suffer a large loss when the money is needed for tuition.

As 2010 funds approach their target date after one of the worst market free falls in history, this mismatch is becoming all too clear (see "Failing Grade," on page 70). Last year, 2010 funds lost 23.2%, on average. The largest single 2010 fund (which holds about half of all 2010 assets) had a one-year return in 2008 of -25.3%. The average return of the four largest 2010 funds (collectively holding 87% of all 2010 assets) was -25.8%; their equity exposure ranged from 45.5% to 57.4%.

Balanced funds with a moderate allocation did not fare any better. Moderate balanced funds have an equity allocation of around 60% and a fixed-income allocation of about

40%, which (unlike a target-date fund) does not vary according to the age of the investor. In 2008, the 125 moderate allocation balanced funds lost a discouraging 26.6%, on average. The four largest balanced funds, accounting for nearly half of all balanced assets, performed even worse, down 29.9% on average. By comparison, the 100% equity S&P 500 index lost 37%. The risk-reducing concepts of “balanced” and “target-date glide-path” did not shine in 2008.

However, the table also includes a 2010 index and a balanced index that performed considerably better—precisely because they had more modest exposure to equities. With an 8% exposure to equities, The Plan-Sponsor OnTarget Defensive 2010 Index lost only 4.7% in 2008, while the 7Twelve Balanced Index Life Stage 60-70 was down 14.4%, with a 40% equity stake. (Full disclosure: My company, Target Date Analytics, developed the target-date index. I developed the 7Twelve Portfolio.)

Prudence dictates reduced equity exposure as the target date (i.e., retirement date) approaches. Better QDIA product design exists, it’s just not being followed by QDIA product manufacturers.

BAD TIMING

The move from cash and stable value QDIAs to overly aggressive target-date fund and balanced fund QDIAs came at a bad time in light of what happened in 2008. Many older investors would have fared far better in either stable value (with returns of around 4.5% in 2008) or cash (returns in the 2.5% range).

The solution, though, is not to switch the QDIA back to cash and stable value products. Rather, the solution is to build QDIA products that are designed to control risk late in the glidepath.

In the case of target-date funds, this would require a dramatic reduc-

FAILING GRADE

Now five months away from their target date, the four biggest 2010 funds lost 25.8% on average in 2008. Balanced funds did worse; the four largest funds were down 29.9% on average last year.

Four Largest 2010 Target Date Funds (Representing 87% of all 2010 assets)	% of Total 2010 Fund Assets	Total % Equity in Portfolio as of 12/31/08	2008 Return (%)	\$ Impact of 2008 Performance on \$500,000 Account
Fidelity Freedom 2010	51	45.5	(25.3)	(126,500)
T. Rowe Price Retirement 2010	18	57.4	(26.7)	(133,500)
Vanguard Target Retirement 2010	11	53.6	(20.7)	(103,500)
Principal L/T 2010	7	48.2	(30.3)	(151,500)
PLANSPONSOR On Target Defensive 2010 Index	--	7.8	(4.7)	(23,500)

Four Largest Mod. Allocation Balanced Funds (Representing 48% of all balanced assets)	% of Total Balanced Fund Assets	Total % Equity in Portfolio as of 12/31/08	2008 Return (%)	\$ Impact of 2008 Performance on \$500,000 Account
American Funds Balanced	22	63.5	(25.7)	(128,500)
Fidelity Balanced	10	59.2	(31.3)	(156,500)
Fidelity Puritan	9	59.2	(29.2)	(146,000)
Dodge & Cox Balanced	8	66.3	(33.6)	(168,000)
7Twelve Balanced Index Life Stage 60-70	--	40.0	(14.4)	(72,000)
S&P 500		100.0	(37.0)	(185,000)

Sources: Morningstar, www.TDBench.com, www.7TwelvePortfolio.com

tion in the amount of equity exposure within five to seven years of the target date. The current design of 2030 and 2040 funds is fine, with their 80% to 90% equity exposure. The problem is the overly aggressive 2010, 2015 and 2020 funds—those funds that are closing in on their target dates.

Among balanced funds, an appropriate solution would be to expand the asset mix within the fund. Nearly all balanced funds rely primarily on two domestic assets—large stocks and fixed income. In addition, balanced funds could be more clearly titled, such as aggressive balanced, moderate balanced or conservative balanced. Doing so would allow investors of different ages or risk tolerances to

discriminate better between the hundreds of balanced funds out there.

In summary, a default investment product should not be an aggressive product. QDIA should be synonymous with age-appropriate risk, particularly as the target date approaches. Better designed target-date funds and balanced funds will be the QDIA solution going forward. **FP**

Craig L. Israelsen, PhD, an associate professor at Brigham Young University, is a principal at Target Date Analytics and designer of the 7Twelve Portfolio (www.7TwelvePortfolio.com).

TO TAKE THE CE QUIZ ONLINE, GO TO WWW.FINANCIAL-PLANNING.COM **CE**