A Brief Response to the Criticisms of Target Date Funds

By Ron Surz
Ron@TDBench.com 949/488-8339
September 2, 2008

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

Some argue that target date funds don't make sense because glide paths make no sense. See for example the References at the end of this commentary. These skeptics contend the following:

1. A constant stock/bond mix (a balanced portfolio) provides a reasonable, simpler alternative to target date funds.

2. A glide path executed in reverse provides higher terminal wealth. A "glide path" determines the mix of assets, specifically the allocation between equity and fixed income. The goal of the glide path is to decrease in risk through time.

3. Target date funds are too conservative because some constant mix balanced portfolios beat them, and because investors are living longer.

4. Target date funds are too risky because there is an alternative that essentially guarantees against loss.

5. A bonds-plus-calls strategy dominates both a constant blend and a glide path because it provides greater safety and upside potential. We explain this strategy below.

We discuss the first three criticisms as a group called "glide paths don't work." We agree with the fourth criticism of too much risk, but for a different reason. We then conclude with a discussion of the bonds-plus-calls alternative, which we see as promising.

Glide Paths Don't Work

[Edesess 2008] shows that any glide path's ending value can be replicated with an equivalent constant stock-bond mix. [Schleef and Eisinger 2007] use historical simulations to compare and contrast fixed mix balanced fund results to those of variable mix target date funds, and find the two approaches to be quite similar in

© Copyright 2008, Advisor Perspectives, Inc. All rights reserved.

risk and ending wealth. This simulation research also finds that reversing the glide path leads to greater wealth, albeit at higher risk.

The above findings are not surprising. Both balanced funds and target date funds are designed to deliver performance that is middle of the road, blending the returns of multiple asset classes. Comparisons of balanced funds to target date funds merely show that both approaches produce similar ending wealth, unless we alter risk, like reversing the glide path. Schleef and Eisinger (S&E) recommend increasing the risk of some target date funds to better match some balanced funds, while others argue for the same thing to better serve investors with long life expectancies. We address the longevity issue in the next section. S&E miss the key distinction. What differs between the two approaches is risk exposure through time.

So here's the point. Target date funds are the more comfortable path to riches. No science here, but an important application of the adage "incentives modify behavior." Because more assets are at stake, investment returns in later years are more financially critical than returns earned earlier in the accumulation process. Importantly, these later results are also more emotionally critical. A 20% loss when a few dollars are at stake is simply less painful than when thousands are at stake and retirement is near. Glide paths don't subtract value as they move to defend, as some contend; they make it easier for the investor to stay the course than does the alternative of a balanced fund, and without jeopardizing long-run performance since researchers find similar distributions of terminal wealth with balanced funds and target date funds. Ending wealth is indeed the name of the game, but there are many paths that can get us to the same place, some easier to travel than others. Balanced funds and target date funds are both Qualified Default Investment Alternatives (QDIAs) because they are generally better choices than those of the typical plan participant, namely all cash or all stock. So there's a benefit to keeping the participant in the QDIA.

The critics demonstrate that balanced funds and target date funds produce roughly the same results, and suggest that balanced funds are the better choice because they're simpler. We believe the tie breaker should be behavioral. After all, the cornerstone of automatic enrollment and QDIAs is behavior modification. Choose the alternative that is most likely to keep the participant in the better game.

Target Date Funds are Too Risky

In contrast to the criticism of inadequate risk, some argue that target date funds are too risky because there is financial engineering that can protect contributions and lock in market gains. We discuss this alternative in the next section. We agree that target date funds are too risky, especially at target date, but for a

© Copyright 2008, Advisor Perspectives, Inc. All rights reserved.

different reason. There is a real problem with target date funds: they pose the danger of being all things to all people and in so doing become the comical "jack of all trades but master of none." Target date funds do not close down at target date, rather they continue indefinitely as "current" or "income" funds, with too much risk for the end of the accumulation phase and not enough risk for the next phase, which is distribution. There is a brief phase between accumulation and distribution that is called "transition", or "how will I live the rest of my life." Target date funds should stick to the accumulation phase because the complex issues of the distribution phase, which include spending budgets and life expectancies, cannot be addressed by a simple glide path.

We can't have it both ways, as desired by those who argue for greater risk. Risk at the target date should be non-existent, enabling the investor to move on to the distribution phase without the possibility of loss during the transition process. In fact, the next section carries this idea to the extreme.

A Safe Alternative: Bonds and Calls

[Bodie and Treussard 2007] and [O'Brien and Ransenberg 2007] recommend a safe alternative to both target date funds and balanced funds. Every contribution is invested in Treasury Inflation-Protected Securities (TIPS) maturing on the target date, plus calls on risky assets with a strike date at the target date. Alternatively, the TIPS allocation could be used instead to purchase deferred annuities. In either case, this structure guarantees return of principal, plus inflation, and also provides upside participation in risky markets, through the purchase of calls.

It is a very appealing payoff with a couple of caveats. There is no free lunch here. With lower risk comes lower return, suggesting that bonds-and-calls should appeal most to the wealthy, who have less reason to take risk. The mix of bonds and calls is driven by retirement income requirements: put aside all or most of your retirement needs in bonds and/or deferred annuities, and invest the rest in calls. Also, there is an embedded insurance premium associated with bonds-plus-calls that cannot be known in advance since insurance premiums vary with market risk, as they should. In other words, the cost of calls will fluctuate. We expect there will be extensive research and discussion of this financially engineered solution, and that it could very well become standard practice, at least among the well funded.

Conclusion

Nothing is perfect, including target date funds. This article counterbalances the literature. The rising level of criticism of target date funds should not go

© Copyright 2008, Advisor Perspectives, Inc. All rights reserved.

unanswered. Target date funds are gaining in popularity, and it is for good reason.

REFERENCES

Bodie, Zvi and Jonathan Treussard. "Making Investment Choices as Simple as Possible: An Analysis of Target Date Retirement Funds", *SSRN* January 2007

Edesess, Michael. "The Trouble with Target Date Funds", *Google Knol*, posted 8/24/08

O'Brien, John and Dan Ransenberg. "Life Cycle Funds: The Good, The Bad, and the Possible", *IMCA Monitor*, Jan-Feb, 2007, pp. 13-15

Schleef, Howard J. and Robert M. Eisinger. "Hitting or missing the retirement target: comparing contribution and asset allocation schemes of simulated portfolios", *Financial Services Review*, vol 16, 2007, pp. 229-243

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit: http://www.advisorperspectives.com/subscribers/subscribe.php

© Copyright 2008, Advisor Perspectives, Inc. All rights reserved.