

Letter to the Editor of *The Wall Street Journal*

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Dear Editor,

Your Tuesday, February 26, 2008 “Fund Track” column is an article by Jillian Mincer entitled “Target-Date Funds Are Holding Up So Far”, which declares that “near-term target-date funds have emerged relatively uncracked” in the recent stock market decline because they “have lost less than the Standard and Poor’s 500-stock index according to Morningstar. The average total return among these funds was a decline of 4.8% from Oct 1 through Feb 20, compared with a decline of 10.2% for the S&P500.”

This is the optimist plummeting off the skyscraper while shouting “So far, so good.” There are several flaws in Ms. Mincer’s statements:

- The S&P is not an appropriate benchmark for near-dated target-date funds.
- Her choice of time periods is not entirely a down market.
- Target date funds should not be evaluated on the basis of just one target date.

Allow me to elaborate on each of these observations.

Appropriate benchmark

Our firm, Target Date Analytics, has spent considerable time and effort thinking about and developing benchmarks for target date funds (TDFs). In a Jan 20 WSJ column Eleanor Laise introduces our firm and two others in her “New Indexes Keep Tabs on Target-Date Funds.” The challenges to benchmarking TDFs lie in the lack of common practices and the use of what has come to be known as a “glide path”, which shifts allocations through time to reduce risk as the target date nears. Ms. Mincer touches on these points in her article but fails to recognize that



these characteristics necessitate benchmarks that are different than the S&P in all cases, especially near-dated funds.

Focusing on near-dated funds, our view is that an appropriate benchmark is invested entirely in safe inflation-protected assets such as Treasury bills and TIPS. An investor at target date, which is presumed to be his or her retirement date, shifts from asset accumulation to asset distribution. These are materially different life phases that are creating materially different suites of investment products. TDFs are accumulation funds and as such should keep the retired investor insulated from market moves while (s)he is making the transition to distribution. After all, these folks cannot readily go back into the workforce to make up investment losses – what’s gone is gone.

In other words, losing less than the S&P is not a success. Rather, it’s akin to being the “best ballerina in Waco,” to quote my business partner Dr. Craig Isrealson. Losing anything in a near-dated fund is a failure, regardless of how the S&P performs. The appropriate benchmark for near-dated funds is TIPS and T-bills. Keep your powder dry while you’re deciding what to do with the rest of your life.

Choice of time period

The 5 months Oct 1 to Feb 20 include a month when the S&P returned 1.6%, namely October. A better test is to start the monthly clock in November. The S&P lost 11.5% for the 4 months Nov 1 to Feb 28, which is a greater loss than the 10.2% reported in Ms. Mincer’s article. It’s the bigger challenge.

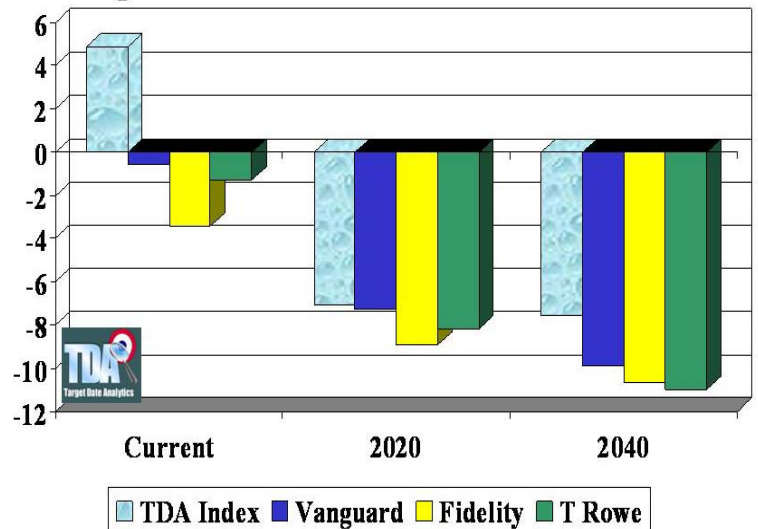
More than just near-dated funds

Investors in TDFs are usually offered a single family of target date funds on their 401(k) platforms. Fidelity, Vanguard and T. Rowe Price currently dominate the TDF market, collectively representing more than 80% of this \$200 Billion pool, so these are the names that most associate with target date investing. Retirement plan sponsors select one fund family that they make available to employees. This decision is clearly more complex than simply choosing a near-dated fund. Accordingly, an assessment of target date funds should look at the whole horizon of target dates, not just near-dated funds.

A contrasting view

Let's look at an evaluation that addresses these flaws. The exhibit to the right shows the performance of the major fund families for the 4 months Nov 1 to Feb 28, and contrasts them to our indexes for each target date. As you can see, these funds have not fared well in this market climate, underperforming our benchmarks in every instance, although the 2020 funds have performed close to their index.

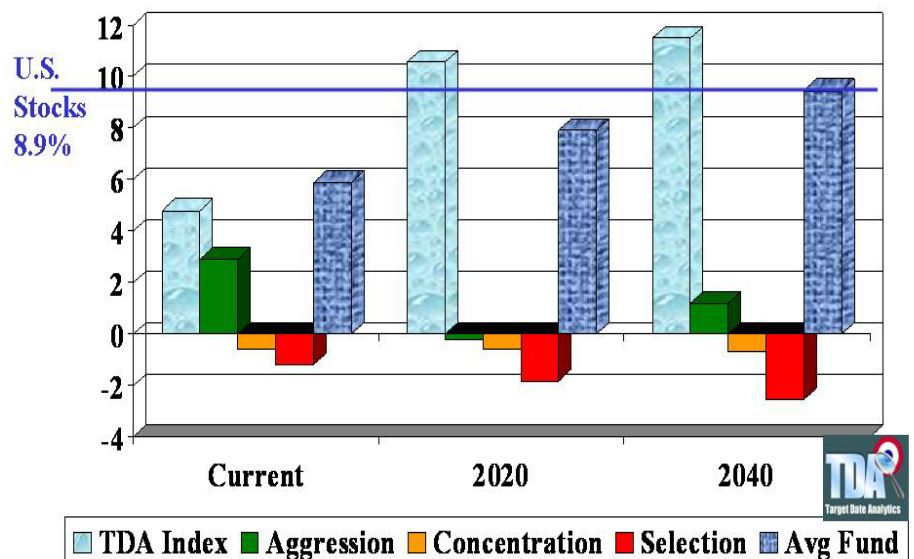
Target Date Returns for 11/07-2/08



But 4 months is a very short period of time, and there are more fund families than just the big 3. We have conducted extensive analyses on all mutual funds with at least 3 years of history through 2007. This comprehensive study covers 90+ funds, 15 fund families, and \$180 Billion. Several studies have been conducted on the longer-term performance of TDFs, but we are the first and only to perform attribution analyses, determining the reasons for success and failure. The following exhibit presents our findings.

Aggression is the value added or subtracted because the mutual fund has an equity allocation that is different than the index. The average mutual fund has more equities than the index in both near- and far-dated funds, but is similar to the index for mid-dated funds. This higher equity exposure added 290 basis points per year to the average Current fund's performance and 118 basis points per year to the average 2040 fund's

Target Date Attribution for 2005-2007



$$\text{Index Return} + \text{Aggression} + \text{Concentration} + \text{Selection} = \text{Fund Return}$$



performance. This is of course due to the fact that this particular 3-year period has seen stocks outperform bonds.

Concentration is the effect of being less diversified than the index. For this 3- year period the average mutual fund has been penalized about 60 basis points per year across the target date spectrum, primarily due to less exposure to foreign markets than the indexes.

Selection is the difference between the fund's actual return and the return the fund would have earned had it implemented its asset allocations passively, using all index funds. It is the value added or subtracted by active management, and is net of all fees. Selection subtracted 120 basis points per year from Current fund performance, 181 basis points from 2020 fund performance, and 255 basis points from 2040 fund performance. One of the reasons for the larger deterioration in longer-dated fund performance is fees. Higher fees are paid for equity management than bond management and the longer the target date the greater the equity exposure. This selection result is our most disturbing finding.

Conclusion

The results thus far for target date mutual funds have been disappointing, but this is a relatively new product that is evolving even as this is being written. We expect to see substantial improvements going forward.

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