The Pros and Cons of Target-Date Funds in the Accumulation Phase

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Lifecycle or target-date funds (TDFs) are frequently criticized for not being customized or tailored to individual situations. But this is unfair, as they are meant to serve as default investment options for individuals who are otherwise unwilling or unable to put in the effort to obtain a better result. Nonetheless, the debates around TDFs provide an opportunity for advisors to make clear how they can serve their clients.

TDFs have enjoyed rapid growth in recent years. Confidence in the approach led the U.S. Department of Labor to adopt them as a qualified default investment alternative for corporate defined-contribution pension plans in 2007.

Let’s look beyond using TDFs as the default option. I will explore the benefits of TDFs, and then turn to the challenges that have been raised against them – and how advisors can respond to those challenges and obtain the best retirement outcomes for their clients. This discussion focuses only on the pre-retirement portion of the glidepath.

The case for target-date funds

TDFs are promoted as a simple solution for retirement savers to invest with a hands-off approach. This investment strategy involves allocating a high proportion of one’s assets to equities during the early years, and gradually shifting to more conservative assets, such as bonds and bills, as the target date draws near. Two general justifications exist for TDFs.

The academic justification considers a household’s balance sheet over its lifecycle. At the beginning of one’s career, the present value of future labor earnings (human capital) typically dwarfs the size of accumulated financial assets, which may even be zero. Thus, even a 100% stock allocation represents a small portion of one’s household wealth. With a long time horizon to make plan adjustments and with most wealth stored in future salary, an aggressive asset allocation can be justified for young workers. As one ages and approaches retirement, however, financial assets grow relative to human capital, justifying a reduced allocation to stocks and other risky assets in the financial portfolio in order to reduce the volatility of overall household wealth. Figure 1 illustrates these lifecycle dynamics.
The second justification focuses on the idea that declining equity glidepaths provide greater risk-adjusted wealth at the target date. TDFs provide an appropriate balance between two competing desires: savers wish to maximize their wealth at retirement, but they also wish to reduce volatility for their absolute wealth accumulation. Historically, allocations with greater exposure to equities support the highest expected wealth. At the same time, however, savers are the most vulnerable to absolute wealth losses when wealth is the largest.

Switching to a less volatile portfolio as the target date approaches reduces the risk of potentially catastrophic losses when the portfolio is most vulnerable. When many years from retirement, a riskier allocation is justified to take advantage of the equity premium and grow wealth. But as the target date looms, volatility threatens the wealth that has built up, while reduced volatility can lock in wealth accumulation. TDFs are meant to manage these tradeoffs in an effective manner.

**A challenge to target-date funds: The portfolio size effect**

Anup Basu and Michael Drew wrote an article for the * Journal of Portfolio Management* in 2009 which argued that TDFs threaten a client’s goals by not taking enough risk at the pivotal time in the individual’s career. They argued that the upside potential provided by a high equity allocation near the target date dwarfs any potential downside risks related to volatility in wealth accumulation.

They argued that TDFs are counterproductive to the retirement goals of typical individual investors because they reduce equity exposure at precisely the wrong time. Their conclusion resulted from the portfolio size effect, an idea they attributed to Robert Shiller. The idea is that most of the portfolio growth for individuals will occur late in their careers, when they can enjoy capital gains from larger portfolio balances. After all, a 10% gain means a lot more for a $1 million portfolio than for a $10,000 portfolio.

Because TDFs have switched to more conservative assets by this time, investors miss out on their
biggest opportunity to enjoy outsized capital gains. Instead, unless an investor has already saved a sufficient amount to finance a comfortable retirement (which does not represent the situation of a typical saver), Basu and Drew argued that a high equity allocation should be maintained in TDFs.

They arrived at this conclusion by simulating the results of different investment strategies: a lifecycle strategy with a portfolio of all equities that is gradually shifted to a mix of only bonds and bills by retirement, and a contrarian strategy with the opposite approach of holding bonds and bills early on and gradually shifting to only equities as retirement approaches. They did not suggest that the contrarian rising glidepath is what one should choose, as their more general point was that clients still require aggressive asset allocations near the target date. The contrarian glidepath provides a clear way to illustrate this, as it maintains the same average asset allocation in the accumulation stage as the traditional glidepath. Basu and Drew’s argument has been made most recently by Rob Arnott and co-authors in a 2013 *Journal of Retirement* article, *The Glidepath Illusion… and Potential Solutions.*

I wrote a response to the Basu and Drew research that was published in the *Journal of Portfolio Management* in 2011. I provided four reasons why the arguments in favor of a contrarian rising equity glidepath (during the accumulation stage) were overstated and why risk-averse individuals may still prefer the distribution of wealth supported by a traditional TDF.

But there is no agreement about what represents an appropriate glidepath, as we are dealing with the fundamental tradeoffs between risk tolerance and the downside and upside created by greater equity exposure.

TDF glidepaths vary among fund families. Individuals face a challenge understanding whether the glidepaths offered by their favorite fund family, or the fund family used in their employer plan, are aggressive or conservative, especially if they have little investment knowledge. In 2013, Morningstar reported equity allocations for 2015 TDFs ranging from 8% to 58%. During the financial crisis in 2008, one 2010 TDF lost more than 40% of its value. Policy makers found this disheartening, considering the widespread public perception that TDFs would guide individuals smoothly to their retirement goals.

**Another challenge to target-date funds: the funded ratio**

The next challenge for TDFs is whether greater active participation by the client, based on his or her “funded ratio,” can improve investment outcomes. The funded ratio measures the value of one’s investment portfolio against the present value of one’s projected future liabilities to calculate spending needs. Managing asset allocation with respect to the client’s funded ratio is a clear way for advisors to add value for their clients.

Asset allocation should adjust with respect to how close one is to meeting financial goals. This requires projecting future salary, future savings rates, a planned retirement date, the duration of retirement and the desired retirement spending from financial assets. These considerations can be used to calculate a client’s funded ratio, and the appropriate asset allocation should evolve dynamically in response to a client’s fluctuating funded status. Many Americans without advisors require a simple default solution, but advisors should position clients to move beyond default TDF glidepaths.
The idea of calculating an individual’s funded ratio is to treat personal retirement planning in the same manner as a corporate pension fund. On a lifetime basis, are the assets large enough to meet the liabilities? Assets are the resources available to fund one’s liabilities, while liabilities are the planned expenditures to be made over one’s lifetime. The answer to this question is measured through the funded ratio. A funded ratio of 1 means that a person has just enough assets to meet their liabilities, while overfunded and underfunded individuals have ratios above or below 1, respectively.

An implication of the funded ratio is that optimal asset allocation varies with the funded status. Mathematically, one can show that the optimal allocation to volatile assets like equities follows a U-shaped curve with a minimum equity allocation when the funded ratio is 1 and allocations becoming more aggressive as one moves further away from 1 (in either the up or down direction). This result is demonstrated using dynamic programming techniques in works such as the *Retirement Management Journal* article, Adaptive Investing: A Responsive Approach to Managing Retirement Assets by Sam Pittman and Rod Greenshields, as well as the free AACalc software developed by Gordon Irlam.

But when the funded ratio is less than 1, the mathematical optimization suggesting a higher equity allocation should be accepted with caution. While attempts to make a “Hail Mary pass” to salvage a financial plan may maximize the probability for a plan’s success, it could just as easily backfire, leaving the funded ratio in a more dire condition. Here again, the widening distribution of outcomes, in terms of greater upside and greater downside, resulting from a volatile portfolio means that there is no generally agreed-upon best practice when one is underfunded about whether to take risk or to lock-in what remains with secure assets.

Meanwhile, in fortunate situations in which the funded ratio exceeds 1, the implication is to increase investment risk as the funded status increases. But it is worth thinking more carefully about how to proceed, as options include either leaving the portfolio exposed to volatility or locking in the liabilities with laddered fixed-income assets or income annuities to assure that spending goals will be met. Locking-in eliminates the possibility for further upside, but it also prevents the potential downside tragedy of having achieved a goal and then letting it slip, as some investors in 2008 learned too well. Indeed, locking-in spending goals with safe assets may encourage the client to become even more aggressive with the remaining assets, which can result in a greater legacy even when partially annuitizing assets.

Advisors can add value to their client’s portfolios by moving them away from an ad hoc TDF glidepath to a customized asset allocation accounting for the client’s funded status. By itself, though, this is not an argument against TDFs as a default asset allocation option for savers.

**Other criticisms of target-date funds**

Other criticisms of TDFs suggest increased vigilance on the part of advisors to help evaluate the TDF options their clients may face, particularly in employer plans. Advisors should be aware of these criticisms when evaluating different funds, as there is no standardization among products:

- Not all glidepaths are equal. Some are significantly more aggressive than others.
- It is important to check the holdings and fees of TDFs carefully. Because they are commonly
used by naïve investors, some TDFs have high fees, and TDFs may serve as a type of “garbage dump” for underperforming funds from a family’s suite of offerings.

- Glidepaths can change over time, and there is always going to be temptation to make glidepaths more aggressive when markets are doing well, and vice versa. These are the types of behavioral mistakes that investors wish to avoid in the first place by investing in TDFs.
- Investors may believe it is possible to select active managers who can better time the market, for example by suggesting against automatically shifting the allocation to fixed income when interest rates are at historic lows.

### The bottom line

Though improvements can be made to TDFs, they receive more ridicule than deserved. They are grounded in economic theory and are aimed to serve individuals who are otherwise unwilling or unable to seek better customized solutions. Nonetheless, advisors must consider the arguments against TDFs to better serve their clients.

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