The Deficiencies of Target Date Funds

By Robert Pozen

 The hottest product in the retirement space is the target date fund -- sometimes called the target timeline or lifestyle fund.  The assets in these funds have grown from $70 billion in 2006 to $330 billion today.

 Target date funds are typically offered in a series based on the expect retirement date -- usually at age 60 -- of a cohort of workers, such as Target Date 2010, Target Date 2020, etc.  When these workers are young, the target date funds are invested primarily in stocks; as the workers age, these funds switch to more and more bonds than stocks.

 Target date funds have recently become popular as the default option in defined contribution plans with an opt-out enrollment procedure.  In an opt-out plan, all workers at the sponsoring company are automatically enrolled as plan participants -- unless they expressly choose not to contribute to the plan.

 The Pension Protection Act of 2006 authorized the widespread use of opt-out plans since they significantly increased the participation rate in defined contribution plans, especially for low-income and minority workers. In traditional opt-in plans, by contrast, many workers said they wanted to participate but never got around to filling out the applications forms.

In the rising number of opt-out plans, the default find option is critical; it is the sole investment of plan participant who does not make a choice.  Target date funds have become the favorite default option because they are allegedly designed to match the needs of most workers -- growing assets though equities in the early years and preserving assets through a shift to bonds in the later years.

In my view, however, lifecycle funds are inferior as default options to a balanced fund with 60% of its assets in stocks and 40% in bonds (rebalanced each year). First, the net returns of a balanced fund are likely to be higher than those of a lifestyle fund. It is impossible to predict over the 20 to 40 years of a worker's career when equity markets will do well. Thus, on an *ex ante* basis, the expected returns of a balanced fund are roughly the same as the expected returns of a lifestyle fund. Yet the expenses of the lifestyle fund are always higher – in most cases, from 15 to 30 bp higher per year – so its net returns are likely to be lower than those of a balanced fund.

Second, many participants in 401(k) plans do not understand the risks involved with their lifestyle funds. Some participants believe that lifestyle funds are guaranteed not to lose money in the decade before they reach 60. In 2008, such lifestyle funds incurred significant losses with a wide dispersion of negative results – as much as 10% in that one year. This dispersion is due to the significant differences among fund managers in the equity portion held by their lifestyle funds as they approach the normal retirement age of their investors.

By contrast, investors in a balanced fund know what they are getting – 60% stocks and 40% bonds. To avoid a sharp downturn in the equity markets during the last decade of their working years, many participants may intelligently decide to move some assets from the balanced fund. But this decision will be based on their own investment objectives, time horizon and appetite for risk.

This brings us to the third problem with lifestyle funds as the default option in a retirement plan – they assume that everyone born in the same year will have the same investment needs when he or she reaches 60. Of course, this is not true. Some workers will need current income so they will want to hold mainly bonds. Other workers will have other sources of monthly income and hope to build up assets for their grandchildren, so they will want to hold mainly stocks.

When workers come close to retirement, the robotic quality of lifestyle funds works against prudent decision-making. At that time, workers should not assume that their retirement needs will be satisfied by a lifestyle fund; they should make a considered investment decision that makes sense for them. This type of individualized financial plan is more consistent with a balanced fund as the default option. Workers are not likely to believe that a balanced fund will automatically take care of all of their retirement needs.

In short, the target date fund is too robotic; it lulls plan participants into thinking that all their retirement needs are being satisfied by the fund.  In fact, participants at age 60 have a broad range of retirement needs and different time horizons for investing.  We need a default option that will be diversified and automatically rebalance during the accumulation phase, but will encourage plan participants to make a considered and customized decision when they approach retirement.   These dual objectives are best met by having a balanced fund as the default investment option in opt-out plans.

*Robert Pozen is a senior lecturer at Harvard Business School and chairman emeritus of MFS Investment Management. Together with Theresa Hamacher, CFA, president of fund industry association NICSA, he co-authored, Fund Industry: How Your Money is Managed, published by Wiley in January 2011.*

originally published on ignites.com, March 2011