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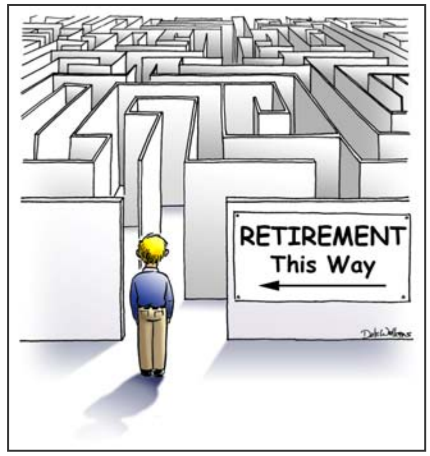
Target Date Funds: Is Yours Missing the Mark?

Navigating the Retirement Maze



Congress did employees a favor for when it passed the Pension Protection Act of 2006. The act allows 401(k) plan administrators to designate a "qualified default investment alternative" (QDIA) for employees who do not make specific fund selections for their retirement plan. The QDIAs used by most 401(k) plans are Target Date Funds (TDFs), also called "life cycle funds."

TDFs, which have been around since 1993 and currently account for over $300 billion in retirement assets, were created as "one-stop shopping" for individuals who preferred to leave the allocation of their retirement savings to someone else. In theory, investing in TDFs consists of two steps: 1) Select your target retirement date; and 2) Invest regularly. TDFs provide asset diversification within one fund –equities and bonds, both domestic and international – and the asset mix is automatically adjusted each year, with the risk level decreasing as retirement approaches. Thus, a 30-year-old's TDF would hold mostly equities, whereas a near-retiree would own more bonds in order to reduce volatility.

2008: A Wake-Up Call

For TDF owners who assumed that their investments were on "autopilot," it came as a shock when they received their 2008 year-end statements and discovered how much they had lost the previous year. While younger employees may have been upset about their diminished balances, many close to retirement were even more distressed, as some TDFs lost 40%. So much for "select and forget."

A 2010 Morningstar study highlighted one of the problems with TDFs: every fund family has a different approach to risk management. There are two types of risk that funds try to mitigate: losses due to market downturns, and outliving one's assets. The former is what gets the most attention, including that of Congress, which held hearings on TDFs in 2009 as a result of the prior year's carnage.

However, the stealth risk is longevity. While more equities (i.e., stocks) means potentially greater loss during a market downturn; fewer equities means your assets might grow too slowly to adequately fund your retirement.

Because of these conflicting objectives, there is a wide range of equity/bond ratios among funds with identical target retirement years. Morningstar found that the percentage of equities in "Year 2015" TDFs ranged from 36% to 84%.

One Size Fits… Well… Some

Target date funds are a good alternative for people who rely primarily on their 401(k)s to finance retirement, but don't want to be bothered with managing it. That said, there are situations where

TDFs may not be the best option, or where particular TDFs aren't an appropriate fit for an investor:

- Where a TDF comprises only a fraction of overall assets, the combination may not constitute a well balanced portfolio. Allocating the assets together may make more sense.
- For those with considerable after-tax investments, allocating assets according to tax strategy – income-producing assets in tax-deferred accounts, and growth assets outside of them – can yield tax benefits.
- For the overly risk-averse, or those who have saved enough such that they can afford to take fewer risks with their portfolio, a TDF may be more volatile than either desired or needed.

In these cases, a mix of mutual funds may be a better option. Most retirement plans offer individual funds along with TDFs, and more companies are now providing employees access to advisors who can help them craft a fund strategy that better meets their particular needs.

Caveat Investor

Finally, it is worth mentioning that not all TDFs are of equal quality. Before deciding to invest in one, it's worth peeking under the hood to look at:

- Asset allocations – Is it really diversified? Are you comfortable with the asset mix? Are the component funds well rated?
- Fees – Are they reasonable compared to other TDF families? Morningstar found a fee range of 0.19% to 1.82%.
- Ratings – Is this particular fund family's TDFs well regarded by independent evaluators?

To the latter point, Morningstar's *Target-Date Fund Series Ratings* and S&P's *Target Date Scorecard* provide information with which to evaluate the quality of different TDF offerings.

Target date funds have benefitted the average retirement saver. If your situation isn't "average", though, you may want to explore other options.

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