Target-date Funds: Innovation Challenges

BY JERRY BRAMLETT

Exploring some of the criticisms of TDFs helps to create a framework for focusing on future innovations.

Target-date funds (TDFs), though far from perfect, represent a big step forward from the first couple of decades of the 401(k) market (1982-2002) when, in many (if not most) cases, participants were forced to essentially fend for themselves.

While a few TDFs predate 2002 (BlackRock invented the first TDF in 1993), these vehicles did not begin to become mainstream until about 10 years ago. At the end of 2008, TDFs represented $160 billion in assets; currently, the number stands at $1 trillion and is set to double by 2018 (*Barron's, 2014*).

In spite of their dramatic growth, TDFs have their critics, as is evident from some of the titles of recent articles: "The False Promise of Target Date Funds" (*Journal of Indexes, 2013*), "The Trouble with Target Date Mutual Funds" (*Forbes, 2013*) and "A Popular 401(k) Choice [TDF] is Still Badly Broken" (*Fortune, 2014*). Finally, there is a recent article, "The Conventional Money Wisdom [investing in TDFs] that Millennials Should Ignore" (*Money, 2014*), which takes the position that younger participants should forgo TDFs altogether. Exploring some of the criticisms of the press helps to create a framework for focusing on future innovations.

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High Equity Allocations

The dominant view of the major TDF providers is that DC investors should have significant exposure to U.S. equities when they are young, with this weighting being steadily reduced as the participant nears retirement. The slope of this decline in equity exposure — the glide path — differs from TDF provider to TDF provider. However, among the three largest providers (Vanguard, Fidelity and T. Rowe Price), a heavy weighting toward equities is consistent across these money managers. In fact, the trend lately has been to increase equity exposure as, "several major fund companies are increasing the stock allocation of their target-date funds ... employees who are in

their 40s now find themselves in funds that are 94 percent allocated to stocks, up more than 10 percentage points." (*Reuters, 2014*)

The rationale for these large equity holdings is being challenged on a couple of fronts:

- Given that a large percentage of DC contributions are withdrawn before retirement, the "retirement date" as a time horizon is a poor guide to how much equity risk participants should assume.
- As one historical study has shown, participants can achieve better final outcomes *if equity exposure is increased over time* (an inverse glide path). This same study also demonstrated that an improvement over the dominant downward sloping glide path can also be achieved by maintaining a steady mix of 50/50 equity/bond exposure throughout the entire retirement accumulation phase. (*Arnott, Sherrerd, and Wu, 2013*)

At this stage in the TDF world, a glide path that tilts heavily towards equity in the early years and decreases over time is the standard practice across all of the major TDF providers. Nonetheless, one can expect that glide paths in general will increasingly come under scrutiny as these constructs continue to be experienced and researched.

Single Risk Factor

TDFs require that DC investors essentially answer one question: When do you plan to retire? Or, if the participant is being defaulted, when were you born? There is no doubt that time is the most important risk factor in investing. The investment period for a DC participant, however, is not always simply a matter of age-to-retirement.

A recent study (*Fidelity, 2014*) found that in the 20-to-30 age group, 44% of all DC participants are cashing out after leaving employment. If financial hardships and subsequent cash outs from rollovers into DC plans and IRA accounts were included in the study, the amount of leakage would be much higher. Unfortunately, the age group with the greatest leakage is also the same group that has the highest allocation to equities in a typical TDF glide path.

While TDFs are often criticized for not taking into consideration outside assets and other risk factors, the bigger issue is cashing out of stocks due to an early withdrawal event. These "cashing out" statistics, prompted *Money (2014)* to take the position that:

> *Many 401(k) plans automatically default young savers into stock-heavy target date funds, but they could just as easily start with a more traditional balanced fund, which holds a steady 60% in stocks and 40% in bonds. Perhaps higher risk strategies should be left as a conscious choice, for people who not only have a lot of time, but also a bit more market knowledge and a stable financial picture outside of their 401(k).*

> "No doubt, there is another test out there in the (maybe not so distant) future."

Managing Volatility

One way to rationalize higher equity valuations is by reducing volatility through diversification, which, unfortunately, is becoming increasingly difficult to accomplish when utilizing mostly long-only asset classes. Consider a recent post on CNBC:

> *The turmoil around the globe currently haunting the markets has raised another nasty specter: The days of widely correlated assets that make portfolio diversification a massive headache. (CNBC, 2014)*

Diversification is a good thing most of the time. However, it tends to not provide much protection when it is needed the most, such as during the financial crisis when everything was getting hammered all at once — large and small stocks, value and growth and domestic and foreign. As many investors observed during the financial crisis, it felt like all equity investments had a "perfect positive correlation of 1."

One response to the increasingly higher correlation of long-only equities is to add alternatives. In 2012, *Investment News* published an article, "Target Date Funds Lack Alternatives," expressing a view that is as true today as it is was two years ago.

TDF providers are increasingly adding alternatives to their asset mixes. However, many predict that it will not have much of a stabilizing impact during the market's next fat tail or black swan event. According to one article regarding the use of alternatives: "It's a matter of diversifying rather than dabbling: Adding a few percentage points is not doing anything." (*Investment News, 2014*)

In the somewhat benign environment that has characterized the equity markets since the financial crisis, there has been a sense that the Fed would do whatever is necessary to keep asset prices up. Of course, with real rates close to zero for as far as the eye can see and with such a large, growing deficit, the Fed will be much more limited in the future in terms of what it can do to provide a backstop if the market were to, once again, suddenly go south.

TDF providers face two challenges as it relates to the extensive use of alternatives. Compared to long-only equity funds, alternatives are expensive and drive up the overall cost of TDFs. Portfolios that are highly defensive (*i.e.*, lots of alternatives) tend to underperform relative to other TDFs — that is, unless there is a major correction or market crash.

Valuation Sensitivity

It is generally the case that, regardless of whether or not the S&P 500 is trading at 45 times (as in 2000) or seven times (as in 1982) normalized earnings, the participant's retirement date is matched up with a time-appropriate TDF. That is, more often than not, the end of the process.

In referencing the valuation extremes referred to above, a research paper stated that it "is the height of folly" to assume that both scenarios "can achieve similar return … let alone the expected returns of any reasonable glide path." (*Inker and Tarlie, 2014*)

Here is the issue in a nutshell: Should TDF providers make adjustments to their asset allocation based on market valuations? It is known that most of the largest TDF providers do not adjust holdings based on market valuations. The challenge is that, although valuations are predictive

of future returns, it sometimes takes years for the correlation between current valuations and future returns to become apparent. "The correlation between valuation and subsequent stock market returns [increases] as the time horizon lengthens from 1 to 20 years." (*Inker and Tarlie, 2014*)

The fact that it may take one to 20 years to manifest a strong correlation between current valuations and future returns does not provide TDF providers with much incentive to promote "valuation aware" portfolios. It is a safer option to adhere to the dominant trends in glide path management so as to not get booted from a fund lineup due to poor (mostly recent) relative *performance*.

Choice Architecture

Good choice architecture should make it clear to DC investors that a TDF is an all-inclusive investment program and not just another asset class in the fund lineup. Unfortunately, it is all too often the case that TDFs are experienced by participants as just another investment option. This is why many of them end up with allocations in multiple TDFs, as well as mixing pure asset class funds with asset allocation funds.

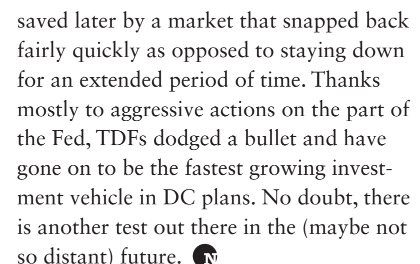
Though the TDF provider typically does not drive the structure of the choice architecture, the plan advisor and record keeper often can have a strong bearing as it relates to helping DC investors understand the implications of utilizing more than one TDF and/or mixing TDFs with other non-asset allocation funds.

> "Should TDF providers make adjustments to their asset allocation based on market valuations?"

Conclusion

In retrospect, looking back to when the first 401(k) plans began to emerge in 1982, it seems rather absurd that DC investors were all of a sudden supposed to become expert asset allocators. We now know that participants made their allocation in one of four primary ways: stay safe in a stable value fund, chase the higher returning fund(s) options, copy their neighbor participant or simply guess using a symmetrical allocation (*Benartzi and Thaler, 2001*). TDFs represented a much-needed innovation.

Target-date glide paths experienced their first stress test in the 2007-2009 Great Recession. Many failed the test only to be saved later by a market that snapped back fairly quickly as opposed to staying down for an extended period of time. Thanks mostly to aggressive actions on the part of the Fed, TDFs dodged a bullet and have gone on to be the fastest growing investment vehicle in DC plans. No doubt, there is another test out there in the (maybe not so distant) future.



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