this article was ghost-written, based off an interview with Vijay Vaidyanathan

Plan Sponsors Are In Love With Target-Date Funds. For Participants, It's Complicated

By Vijay Vaidyanathan, Ph. D. and CEO of Optimal Asset Management

Target-date funds have grown as a popular retirement plan over the past decade. Despite the target-date fund crash in 2008, employers have still abused 401(k) plans, defaulting their employees into target-date funds.

The ramifications of target-date funds have not received the mainstream attention they deserve. Though target-date funds are currently a popular choice for a retirement fund option, the outcomes for employees are less than ideal.

Love at first sight

Employers love target-date funds because, simply; they are easy. Target-date funds have become embedded in 401(k) plans. This is a form of a defined-contribution (DC) plan, removing the employer's attention on the account's performance after the funds are deposited. DC structure is an easy, hands-off approach.

Employers have a habit of searching for plans that require little work and remove risk. They rely far too much on consultants for their 401(k) plans, and those consultants bear most of the blame. They have proven to be poor innovators and have done little to improve the options available to employees. Much of the target-date fund mess can be directly traced back to consultants, and it is a shame to let them and their overly-cozy relationship with exchange-traded fund (ETF) distributors off the hook.

However, consultants are not solely to blame as employers do not recognize the negative impact of target-date funds on their employees. They made a huge error when they threw employees en-masse into DC plans with no training, background, skills or tools to replicate what defined-benefit (DB) plans were previously doing for them.

DC plans involve having employees blindly put their own money into their retirement fund. This plan also depends on the current market, which could be trending down. On the other hand, DB plans guarantee a retirement benefit amount and remove investment risks from the employee. Employers ended their collective underwriting of the downside risk of their employees' retirement by killing off DB plans.

Employees share the romance…until they realize what it really means

Though there is no doubt employers and consultants take the blame, investors have become complacent. The surprise they faced in 2010 is a good indication of their carelessness.

Target-date funds are attractive to employees for some of the same reason their employers love them. They select one mutual fund that is managed for them and do not worry about it until they retire. The ease of a set-it-and-forget-it plan is too attractive to pass up.

Lionel Martellini, Professor of Finance at EDHEC Business School and the Director of EDHEC-Risk Institute, recognizes the original motivation behind target-date funds, “Embedding the life-cycle allocation decisions within a one-stop decision is a valuable attempt at providing added-value to unsophisticated investors, who otherwise will likely make sub-optimal decisions.”

According to Jeff Brown of the Wall Street Journal, the investors who assumed their target-date fund investments were safe based on 2008 statistics were surprised in 2010 when their portfolio losses went into double-digit territory. A table created by Morningstar highlights target-date funds and their transition from 2008 to 2010. For example, Oppenheimer Transition 2010, a target-date fund in 2010, had a -41.17% rate of return in 2008. However, their 2010 equity allocation was 70%.

What should employees look for?

When looking at target-date funds, there are aspects to avoid when choosing between target-date funds from various organizations. Martellini argues, “Broadly speaking these funds can be blamed for using inappropriate building blocks within inappropriate allocation strategies.”

One of the inappropriate building blocks Martellini recognizes involves interest rate risk exposure, “interest rate risk exposure is poorly managed in most existing target date funds.” In the context of designing a proper liability-hedging portfolio, the use of a constant maturity bond index is not appropriate.

An important allocation strategy issue is the lack of accounting for risk-aversion. “In other works, life-style investing funds (balanced funds) focusing purely on differences in risk-aversion across investors, have been replaced by life-cycle funds (target-date funds) focusing purely on the differences in time-horizon across investors,” says Martellini, “One needs to encompass both dimensions in the design of a family of funds to address a wide range of investor needs.”

Though there are target-date fund aspects investors should avoid, there are a decent amount to look for. There are obvious ones such as fees, turnover and transaction costs. Along with those is the question of what the fund uses for equity components. Something inexpensive, systematic and rules-based is ideal.

Finally, investors must look for something that attempts to immunize the bond component from changes in interest rates. Duration Matching is easy to do, and even being 100% in a generic bond portfolio is a bad idea if the bond value falls when you need it.

All hope is not lost

Employees can replicate target-date advantages using ordinary index funds; the trick is being disciplined enough to spend 15 minutes a year to update their ETF weights. On January 1 of each year, investors can sell a fraction of their stock ETF and buy a bond ETF, implementing the “glidepath” themselves.

However, it is understandable many people do not do this for one reason or another, meaning they have to take different actions. One of the first steps is understanding the difference between “through funds” and “to funds.” Martellini found this complication to be prevalent, “Indeed the distinction between “through funds” and “to funds” is not clear to many investors.” A “through fund” automatically reallocates a fund’s holding to a different mix of assets, after the investor retires. It contrasts a “to fund,” which works similarly to a target-date fund.

The final tactic relies on investors’ understanding of what a target-date fund is. Though they are sold as a “safe” instrument, target-date funds have no built-in method to try and secure any degree of certainty in terms of wealth after retirement. “This is a serious problem,” Martellini commented, “Target-date funds are not suitable retirement solutions even though many investors have been misled into thinking they are.”

The industry demands change

Investors and employers can only do so much to improve investors’ financial safety after retiring. It begins with the industry correcting misconceptions investors had before the crash. Along with creating awareness, a call for ETF vendors to improve disclosures and transparency has been made. They are getting better, but there is a long way to go.

Employers have become too dependent on consultants, who have proven to be poor innovators, and have done little to improve the options available to employees. It is true employers had little choice when they ended their use of DB plans. However, they should make more of an effort to offer better retirement solutions within the DC structure, rather than letting employees take the fall.

There is no doubt employees face a difficult decision when deciding whether to go with target-date funds or not. The complication comes from the ease of implementing target-date funds versus their lack of reliability. Employers, on the other hand, completely embrace target-date funds and their simplicity. There are aspirations that remove the negative aspects of target-date funds by creating an automated system that adjusts the stock-bond mix for investors, but this has yet to be seen.

Investors, remember the complicated situation can be made less confusing with a little effort and research. Employers, put aside your infatuation and help your employees retire with financial security.

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