REBUILDING TARGET-DATE INVESTMENT OPTIONS

Meridian Wealth Management & SST Benefits Consulting

telephone: 949.916.6238 • fax: 831.300.3028 • www.meridianwealth.com

http://themeridian.blogspot.com

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Introduction

Target-date mutual funds have come under a lot of scrutiny lately. The Securities and Exchange Commission and Department of Labor are about to hold hearings and everyone is wondering what or if new legislation will affect these unique offerings. Personally, I've never been a fan of the target-date mutual fund. Though I admired the concept, I just felt it was flawed. This paper will explore some of those flaws and make recommendations on how to fix them. It is not my hope that target-date mutual funds go away, simply that they evolve.

The Flaws of Target-Date Mutual Funds

Does it make sense that if you and your co-worker are the same age that you both have the same need or ability to take investment risk?

Does it make sense that a target-date mutual fund that targets 2010 as the retirement date would have an allocation to stocks of 60%?

Does it make sense that one fund family would have the best funds for all asset classes?

Does it make sense that most target-date mutual funds use the age of 65 to determine the appropriate glide-path when many individuals retirements start earlier?

Does it make sense that target-date mutual funds invest in Passive-Only or Active-Only strategies?

The above questions are on the minds of a lot of people these days and apparently the target-date mutual fund managers believe the answers to all of the above questions is "Yes." This answer is the reason why target-date mutual funds in their current incarnation are not appropriate investments for most people.

What is a Target-Date Mutual Fund?

A target-date mutual fund is quite simply a mutual fund that invests in a diversified portfolio of stocks, bonds and cash with the aim to get more conservative in the allocation to stocks the closer it gets to a predetermined date (deemed to be your retirement date). For example, an individual who is fifty years old today might purchase a target-date mutual

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fund that targets the year 2025, the portfolio might have a current allocation of 75% to stocks with a goal of hitting 50% by the target-date.

The goal is to provide a one stop, diversified and simple choice for a participants retirement money, simply "set it and forget it."

A Short History

According to www.tdbench.com, the first target-date mutual fund was introduced by Wells Fargo and Barclays Capital in 1994, though the earliest funds that most people remember were created by Fidelity in 1996 under the Fidelity Freedom brand, all of which were slow to catch on.

Target-date mutual funds began to grow in popularity after the 2000-2002 bear market and by 2007 most major mutual fund companies offered a series of target-date mutual funds. The biggest target-date providers according to Morningstar are Fidelity, Vanguard and T. Rowe Price. Target-date mutual funds began to gain even more steam when they became an official Qualified Default Investment Alternative (QDIA) under Department of Labor Guidelines (issued October 26, 2007) through the Pension Protection Act legislation of 2006. This guidance basically provided that if six conditions are met, the fiduciary of the plan will not be held liable for investment losses related to Qualified Default Investment Alternatives.

With what appeared to be the blessing of Congress and the Department of Labor, target-date mutual funds soared in popularity and it is estimated they are now present in 72%[1] of all defined contribution plans. A recent study[2] found that "in 2008 target-date funds made up 9.3% of all DC plan assets, which represents a 16% growth rate from 2007." However "from 2006 to 2007 target-date funds grew by 31%. And from 2005 to 2006, the funds grew 45%." According to the mutual-fund trade group the Investment Company Institute[3] assets soared to $164 billion by the end of 2008 from $71 billion just three years earlier. But while assets in these funds were soaring, returns were souring. According to Ibbotson, the average 2010 target-date mutual fund fell 23% in 2008[4].

The Securities and Exchange Commission (SEC) and Department Of Labor (DOL) are scheduled to hold hearings regarding target-date mutual funds on June 18, 2009 as these funds have in a short period of time come full circle from being endorsed (at least in concept) to being investigated, all by the same entities.

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What is the Solution?

The concept of the target-date mutual fund is not a bad one, it is just not complete. In order to be relevant and meaningful going forward they need to evolve. In many cases target-date funds, even evolved ones will not be the solution, instead custom target-date solutions will need to be created and managed. I believe that at a minimum target-date mutual funds need to evolve into funds that take into account risk as well as one's retirement date. I call these Risk-Based Target-Date Funds and in fact at least one mutual fund company has adopted the concept[5] and Morningstar has created a set of target-date benchmarks that take into account individual risk tolerance[6]. I also believe that larger defined contribution plans should seriously consider creating a fully customized set of target-date portfolios that are specific to their participant population as Intel, Deluxe, the NY City Deferred Compensation Plan and the California State Teacher Retirement System have done (in different ways)[7].

I propose three solutions, one for mutual funds and two for defined contribution plans that are large enough to mitigate the extra costs.

Risk Based Target-Date Funds

In 2005, as target-date mutual funds began to gain a lot of steam I found myself thinking that these funds seemed like a good idea, but were missing something. That something was risk. These funds were plenty risky, but they assumed everyone had the same risk profile just because they shared a common retirement date. The other flaws started becoming obvious as well, but the one that really stood out for me was risk. Most target-date mutual funds at that point in time had a high allocation to stocks and it seemed like fund companies were trying to outdo each other in their stock allocations. It got to the point where I wouldn't have been surprised to see the first levered double the S & P 500 target-date mutual fund! It seemed that asset managers believed that higher stock allocations led to higher returns and that higher returns would attract more assets, but they didn't account for the severity of a bear market.

My biggest fear for investors was that they would get close to retirement and experience a

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significant market downturn and have to delay retirement. I also feared that target-date mutual funds would ruin stock investing for younger individuals who would potentially experience a large drop in their assets and abandon stocks for good (behavior is an important aspect of long term return). The large allocation to stocks rather than being a boost to retirement could instead act as an anchor keeping employees in jobs they could have retired from had they not experienced such dramatic negative returns so close to retirement. Unfortunately, 2008 proved me right. The good news is that while target-date mutual funds have grown to $164 billion in assets as of December 31, 2008 they represent only a fraction of the $3.5 trillion in nationwide defined contribution assets[8]. In other words, there is still a chance to get this right.

Adding Dimension

My fears led me to thinking, what if target-date mutual funds had just one additional dimension added to them, a risk profile? What if I combined Lifestyle type funds (those that target risk) and Lifecycle type funds (those that target a retirement date) and created a risk-based target-date fund? What if for each target retirement date offered a participant they were allowed to choose a risk profile as well: conservative, moderate or aggressive? The funds would then have an equity allocation appropriate for each risk profile and a glide path based on that risk profile.

There are usually two criticisms to this idea; the first is that participants simply don't know enough to choose among the three risk profiles, and second, that adding this second dimension will do nothing but confuse the participant. The first criticism may have some merit, but in my experience most people do have the ability to discern the difference between the terms conservative, moderate and aggressive. A good education program can further increase their ability to make a good decision. As far as the second criticism I've developed a very simple two question model that usually gets the participant right where they need to be, as follows:

About when do you plan on retiring? (choose the target-date closest to your retirement)

Do you consider yourself a Conservative, Moderate or Aggressive investor?

I realize the questions are not a substitute for a financial planning questionnaire (We are not using target-dates to create a financial plan), but they lead the participant into the correct

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portfolio without them having to choose from a bunch of different target-date options. It is not perfect, but it is much better than the current system that completely ignores participant risk profiles. For those plans that default a participant into an option, the plan sponsor makes the decision which risk profile fits their participant population best.

Risk-based target-date mutual funds would not be difficult to develop or manage and would help to solve one of the fundamental flaws of target-date mutual funds. I strongly encourage mutual fund companies to begin building these products.

Custom Target-Date Portfolios

A few enterprising plan sponsors over the past few years have begun creating their own target-date portfolios for their participants: Intel, Deluxe and the NY City Deferred Compensation Program to name just a few and, of course, the behemoth Thrift Savings Plan and their L Funds. I believe these customized target-date portfolios can solve a lot of the fundamental flaws of target-date mutual funds. Specifically, a custom target-date portfolio can be built for the participant population taking into account other retirement plan options, human capital and the normal retirement age of the participants. A better glide-path could also be designed given the additional information known. Instead of utilizing just one fund family for all the underlying asset classes or utilizing only active or only passive strategies, a combination of fund families and strategies can be utilized to create a diversified low-cost portfolio. Given that the plan sponsor would have greater ability to control the investment options they would also have a greater ability to control fees by choosing better share classes or creating Collective Investment Trusts and negotiating fees with investment managers. The custom target-date portfolios would be made up of the funds already chosen for the plan participants as these funds represent the best thinking of the fiduciaries of the plan.

If a plan sponsor didn't want to assume so much responsibility they could design their own glide-path and determine their own population's normal retirement date and simply pair an existing target-date mutual fund with a stable value (or any appropriate fixed income option) to fit that glide-path.

I believe the custom target-date portfolio is a step in the right direction and helps to solve many of the problems inherent in target-date

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mutual funds, however in our opinion it still falls short because it fails to address the participant's risk profile.

Custom Risk-Based Target-Date Portfolios

My idea about creating a risk-based target-date mutual fund option was not exactly on the radar of mutual fund companies several years ago and it still may not be today. I decided that the best way to implement my solution was to build a customized risk-based target-date portfolio. In November of 2006, I was working with the California State Teachers Retirement System and was getting ready to assist them in taking their 403(b) plan out to bid. At that point they had recently added Vanguard target-date mutual funds (a fund company I respect and admire). I presented my idea and asked if I could include in their bid the ability to create and manage a set of customized risk-based target-date portfolios to replace the Vanguard funds, which I felt had too high of an allocation to stocks. Thinking the concept a novel idea they allowed it to go out in the bid and to our delight the winning bidder agreed to help us create these portfolios, which were later termed "Easy Choice."

The portfolio's building blocks started by taking a close look at the population CalSTRS would be targeting - for the most part, teachers. The statistics showed that the median age of retirement was about 61 (not 65 as most target-dates assume). Using this and other data we designed and created a target-date portfolio and glide-path for the following target years:

Retired

2020

2030

2040

2050

For each of these years (retired encompassing those who are retired or about to retire in the next few years) we created a Conservative, Moderate and Aggressive portfolio utilizing the core investment options of the 403(b) plan.

By creating this customized solution CalSTRS was able to better fit the glide-path to the participant population, control the investment options and choose from a wide range of mutual fund managers and strategies (including active and passive), better control expenses and most importantly provide the participant with a target-date solution that better fits their

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risk profile. They need only identify the target-date portfolio closest to their retirement year and then choose whether they are a conservative, moderate or aggressive investor.

The results so far have been very positive. Participants, when explained the concept understand it. The portfolios started officially in November 2007, just in time for the greatest market crash since the Great Depression. While all the portfolios were negative, those who were in the conservative or moderate portfolios experienced much less fluctuation than the typical target-date, which was the goal in the first place.

Conclusion

None of these solutions will solve our current and future retirement crisis, but hopefully it will improve long term returns, behavior and allow participants to feel a little more comfortable with their retirement investing. In no way does a target-date mutual fund or portfolio replace a well thought out financial plan, but in the absence of one a customized risk-based target-date solution makes sense.

I believe that target-date mutual funds represent a great idea, though in order to be a great product for retirement plans they need to evolve. I hope the ideas presented in this paper provide a road map to that evolution.

About the Author

Scott Dauenhauer, CFP(r), MSFP, AIF(r) is the co-author of “The 403b Wise Guide” and a recognized national speaker on retirement topics for government DC retirement plans. In addition, he works as a consultant to government defined contributions plans through his Registered Investment Advisory firm, Meridian Wealth Management and via a partnership with SST Benefits Consulting out of El Dorado Hills, CA.

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