The Target Date Emperor Has No Clothes

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Target date fund (TDF) companies would have us believe that their 2008 performance failure was a passing hiccup that will go away. The 20%-plus loss in near-dated funds is acceptable because the target date is simply a speed bump in the highway of life.

Don't believe them. And don't believe it when they tell us they are managing mortality risk or that TDFs should be designed to last from the cradle to the grave.

The fund companies have yet to identify and acknowledge the real problems in their offerings. The emperor has no clothes.

The 2008 global financial crisis reveals that TDFs are not all that they're cracked up to be. The typical 2010 TDF lost more than 20% in 2008. Some current retirees are invested in 2010 funds because of the practice of bracketing the target date by five years, so 2010 funds are for those retiring between 2005 and 2015.

The media has expressed disappointment in the 2008 results but has not uncovered the real problems because it has allowed the TDF companies to hide behind their pat speed bump explanation. Truth cannot emerge from interviews with the culprits.

The truth is that the target date industry entered into a performance race in 2006 and 2007, raising equity allocations and justifying the increase based on longer life expectancies, as though we all suddenly decided to live longer. The timing of course was awful, but even more shameful is the cover-up and unwillingness to correct an obvious mistake. TDFs should not be managing mortality risk, as explained in detail below.

Target date funds (TDFs) have been gaining in popularity, in part because the Pension Protection Act of 2006 made them Qualified Default Investment Alternatives (QDIAs) for defined contribution pension plans. TDFs have been the preferred QDIA because they are "set it and forget it," and they should improve upon decisions that are typically made by participants. Now it's time for the target date industry to deliver on its hype.

The faulty speed bump rationalization is not the only flaw in TDFs. The designs of every single target date fund family are flawed in ways that can and should be corrected. Every fund family suffers from the following shortcomings:

Problems with Target Date Funds

- **Poor risk controls**. The average 2010 fund had a 45% equity allocation at the end of 2008. The typical TDF holds 35% in equities at the target date.
- **Inbreeding.** Most target date families are comprised exclusively of funds managed by the fund company. Even though the active-passive debate rages on, most would agree that closed architecture limits the potential for active rewards.
- **Lack of diversification**. Most are predominantly US stocks and bonds.
- **Haphazard glide paths**. Glide paths are generally *ad hoc*, with arbitrary decreases in equity allocations through time. A better approach is to model a glide path that offers reasonable likelihoods of achieving agreed-upon objectives.

Some fund families suffer more than others in each area, but all have serious problems in all four areas. Statements like "XYZ lost 'only' 20% in its 2010 fund" are crazy – no large loss is acceptable in these near-dated funds.

Target Date Analytics LLC has created standards that address all of these shortcomings, described at http://www.tdbench.com/Downloads/OTI-Description.pdf. The beauty of these standards is that they are completely and readily investable. The SMART Fund® Collective Trusts, offered by Hand Benefits & Trust of Houston, track the performance of the target date indexes developed by Target Date Analytics.

To keep this brief I'll deal here with just one important aspect of the problem: risk control and the crying need to end the glide path at the target date entirely in safe inflation-protected assets. No target date fund currently ends its glide path at the target date, other than of course the SMART Fund® Collective Trusts. It would be so simple to make things right but the fund companies are unwilling to admit their mistake. It's a shame.

With all due respect to David Letterman, I present the Top 10 reasons that TDFs should end at the stated target date.

The top 10 reasons for the target date glide path to end at the target date with no risk (zero equities).

10. It's how the Europeans do it. The European practice is to end in cash at the target date and roll into annuities.

9. It's an important part of delivering on the promise to protect the purchasing power of accumulated contributions.

8. Target date funds should stick to just the accumulation phase, and leave the distribution phase to vehicles designed for this purpose, like annuities and guaranteed funds.

7. The majority of participants cash out all or most of their savings at retirement. Participant behavior makes it impossible to manage retirement assets beyond the target date, let alone to death.

6. Truth in advertising dictates relabeling target <u>death</u> funds. For example a 2010 fund that is designed for investors who remain 30 years beyond target date should be re-labeled "2010-to-2040", or simply "2040 Target Death Fund."

5. Participants perceive that they are protected at target date. How would you feel losing more than a fourth of your savings at age 65?

4. The Pension Protection Act has the word "Protection" in it, suggesting that protection is the intent of Qualified Default Investment Alternatives. Good chance participants who are defaulted into target date funds think their money is safe. They don't need someone else to make mistakes for them.

3. Academics recommend a glide path that is only in risky assets if and when a standard of living is secured, which for most is never, so the recommendation is TIPS forever.

2. The idea is not that the participant remains in safe assets after the target date, but rather that he or she makes an important decision at the target date. Employers see their responsibility ending at retirement, so the participant is on his or her own, and needs to act.

And the number one reason to end the target date glide path at the target date:

1. IT's THE RIGHT THING TO DO.

The time for change is now. As Buddha says:
"Impermanence is eternal"