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Should You Invest in a Target Date Fund?

By Leigh Bivings, Ph.D., CFP®

One of the fastest-growing products in the retirement investment arena is the so-called target-date fund (a.k.a. lifecycle fund). Interest in target-date funds has grown tremendously in recent years, as have the assets flowing into these all-in-one retirement-savings vehicles. At the end of 2013, more than $600 billion was invested in target-date funds, more than double the amount just four years earlier.

In this note, we seek to explain what target-date funds are, what to look for, and how best to use them. We also provide our viewpoint as to when and under what circumstances we believe they are a suitable investment choice.

Definition

A target-date fund is almost always a fund-of funds. In other words, a target-date fund is made up of other, more specialized funds. For example a target-date fund might own a domestic stock fund, an international stock fund, and a bond fund, allocating assets in what makes the most sense given the investor's age or years to retirement. The rate at which a target-date fund adjusts its allocation to equities and fixed income over time is known as its glide path. Those allocations get more conservative as an investor glides towards a financial goal such as retirement or saving for a child's college education.

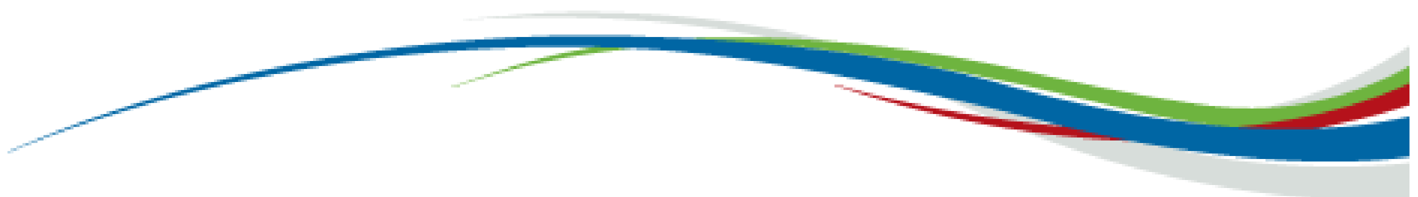
Target-date funds have grown in popularity in large part because they are increasingly the default option in company-sponsored retirement plans. They are also growing in popularity because investors see the benefit of gaining broad diversification across asset classes in a single fund and automatic rebalancing aligned to their selected timeframe, allowing them to "set it and forget it."

What to Look For

The first thing to understand is that target-date funds are not a homogeneous investment type. Depending on the glide path philosophy, the asset classes used, the nature and quality of the underlying investments, and a host of other factors, target-date funds can display markedly different risk and return characteristics, even when they have the same retirement date. In short, you need to look under the hood at a particular fund to make sure it reflects your risk profile.

One also needs to pay attention to the glide path. For example, some target-date funds are designed to invest to retirement, while other are designed to help you invest through retirement. The "to" retirement funds generally leave portfolios very conservative at the moment of retirement transition, while the "through" funds often have more aggressive portfolios at retirement but then become more conservative steadily throughout retirement.

Expenses are also worth comparing. While they have been coming down recently, many target date funds are no bargain. A fee of one percent of assets per



year is fairly typical today. Yet as with any fund-of funds, one is paying for the packaging and allocation features. And, of course, if it means that you can do away with hiring a financial advisor, the expense doesn't look so high.

How to Use Them

Unfortunately, a great deal of confusion exists about how to use target-date funds. The data suggest that very few investors seem to understand that target-date funds are designed to be the only investment vehicle in the portfolio and shouldn't be used together with other funds in the same portfolio. Doing so skews the asset allocation and the dynamic adjustment path the investor intended when they picked the target-date fund, and so defeats the purpose. Worse still is that the investor can easily end up with an overall allocation that is inconsistent with their long-term financial needs and tolerance for risk.

The problem is that many investors do have other assets in other accounts. If these are substantial and the investor wants to use target-date funds, the best option is to use the same or similar target-date funds exclusively in all of the accounts to avoid a skewed allocation. If the investor doesn't want to do this, the best they can do is to take into account the dynamic nature of their target-date fund and periodically adjust their other assets such that the entire allocation remains consistent with their needs and goals.

Recent Glide Path Research

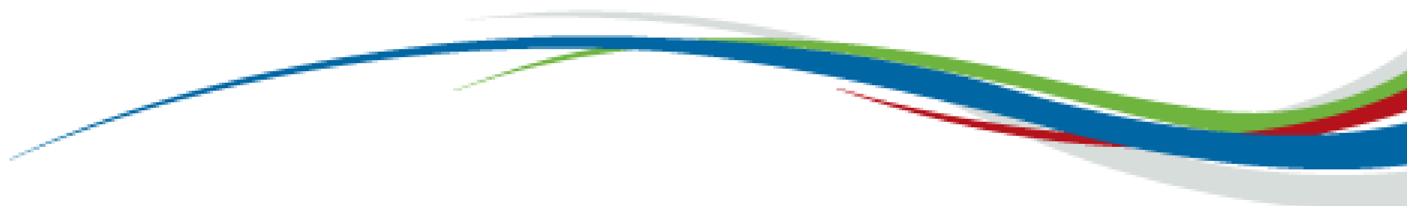
Looking ahead, I strongly suspect we are going to see a lot of new product innovation in target-date funds stemming from a plethora of new research on the 'optimal' glide path. One study suggests that the conventional wisdom that investors should steadily decrease their equity exposure throughout retirement may not, in fact, be the optimal glide path for minimizing both the probability of failure and the magnitude of loss in a retirement portfolio.[1] The study's results show that rising equity glide paths from a conservative starting point at retirement can achieve superior result. For instance, a retirement portfolio that starts at 30 percent equities at the time of retirement and finishes at 60 percent equities outperforms one held at a static 60 percent equities throughout retirement or one starting at 60 percent declining to 30 percent over time.

The principal reason for these results is that beginning retirement with a lower equity allocation and increasing it steadily over time reduces what is called the sequence-of-returns risk. This is the risk of poor market returns early in the retirement withdrawal phase when the nest egg is large, forcing one to sell at just the wrong time. In contrast, if the market performs poorly later in retirement, the damage to the portfolio is far less severe because the money had several decent years to grow (and the years it needs to last are fewer). In other words, the sequence of returns matters, especially in retirement.

Other new research points to the value of taking asset class valuation into account in designing not only the amount of equity to have in the target-date fund, but how much and when to adjust the allocation over time.[2] The basic problem, according to the study's

[1] Phau, Wade D. and Michael Kitces. "Reducing Retirement Risk with a Rising Equity Glide Path." *Journal of Financial Planning,* January 2014.

[2] Inker, Ben and Martin Tarlie, "Investing for Retirement: The Defined Contribution Challenge." GMO White Paper, April 2014.



authors, is that the current target-date fund approach implicitly assumes that returns from asset classes are constant over time -- which is simply not the case if history is any guide. These authors favor a target-date fund approach that incorporates dynamic asset allocation based on measuring how cheap or how expensive assets are at a given time, and demonstrate that doing so can reduce the chances a retiree will run out of money.

Bottom Line:

I like target-date funds, but they are not for everyone. Target-date funds are best-suited to folks with modest savings who have limited time and interest to spend on their investments. Target-date funds provide a simple and affordable way to manage their assets. And they are a lot better than the choices investors often make, including placing their entire portfolio in cash or in their employer's shares, for example.

But one-size-fits-all approaches are rarely, if ever, perfect. They can't take into account what other income sources you have in retirement, such as a private pension or guaranteed annuity, or even how much Social Security you are going to receive relative to your total needs. These guaranteed income streams, if combined with a typical target-date fund, can leave you underinvested in equities and at greater risk of a retirement shortfall. For those who need customized allocation advice, a financial advisor can develop an optimal investment portfolio and retirement strategy.

Artemis Financial Advisors
54 Chandler Street
Boston, MA 02116

617-542-2420

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