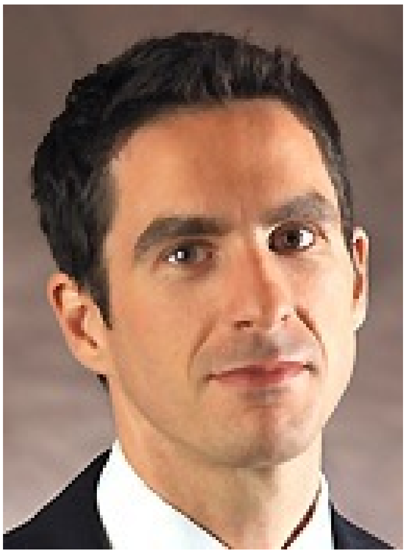
DFA’s Gerard O’Reilly Explains His Firm’s New TDFs

By Kerry Pechter *Thu, Nov 5, 2015*

Dimensional Fund Advisors calls its new target date funds "Retirement Income" funds. How does DFA justify that ambitious title? O'Reilly, DFA's co-Chief Investment Officer and head of research, explains.



Dimensional Fund Advisors, the 30-year-old, $376 billion asset management based in Austin, Texas, launched a series of 13 target dates funds this week. DFA co-Chief Investment Officer and research director Gerard O’Reilly explained how the funds work. (For more on the new TDF series, see today’s *RIJ* cover story, “TIPS for the Long Run?”)

“Each fund matches the duration of a stream of cash flows starting at retirement and lasting for life expectancy plus a buffer,” said Gerard O’Reilly, the TDF investment manager and an 11-year DFA executive who, like DFA CEO Eduardo Repetto, has a PhD in aeronautical engineering from Cal-Tech. “These are ’40 Act’ funds, and each fund is fund of funds. The investments are in U.S., developed countries and emerging markets equities, in global investment grade fixed income, and in three underlying TIPS funds—long-duration, medium-duration and short-duration.

“When you consider a participant’s economic lifecycle, there are multiple phases. You have a period of accumulation in early working life, and then in the last 15 or 20 years before retirement, a need develops for greater clarity about retirement consumption, and consumption of savings. Your own balance sheet looks different at different parts of the life cycle. At the beginning you have lots of human capital, and as you get closer to retirement you have less human capital and more financial capital, and finally at retirement you have only financial capital. When you think about why people save, the goal is to have a smooth transition into retirement. In the future, more and more people will rely on their own savings to provide income to life expectancy, with some buffer.”

“If you held this fund, you could set up automatic redemptions, and we’d manage it behind the scenes. You have complete control over how you spend your assets. We think these funds represent the ‘next generation’ in terms of target date funds, because they’re reducing the uncertainty regarding how much you can spend in retirement. Because that is the focus, we have a different way of managing risk. That's a game changer. It allows you to take your defined contribution savings and turn it into a low-cost source of retirement income. We're solving the right problem. We're managing the right risks. We're saying, 'Here's an estimate of how much retirement income you can afford."

"For example, imagine that you know you will need \$100 ten years from now. Ten-year Treasury rates are about 2.2% right now. You could buy a 10-year zero-coupon Treasury today for about \$80, and eliminate interest rate risk, or you could invest over and over in one-month Treasuries," and leave interest rate risk and inflation risk on the table." What about income estimates? "We've been in communication with recordkeepers about that. They can provide income estimates in their reports to participants. They can say, 'Here's an income estimate given your current balance.'

"But that's a communication question, and I'm a money manager. The funds manage the uncertainty about how much a given balance can afford. But DFA isn't the right person to be telling them that. We're providing an integrated solution across the life cycle. It's low cost—21 bps to 29 bps per year—and very transparent. It enables plan sponsors, advisors and recordkeepers to communicate more meaningfully about how much retirement income each participants' balance can afford."