Participants better off in TDFs: The Principal

By Editor Test *Wed, Aug 29, 2012*

TDFs are better because they offer wide diversification, automatic rebalancing, and age-appropriate asset allocations, says this TDF marketer. But should all young people have high equity allocations?

In analyzing a subset of 2.4 million defined contribution accounts, The Principal Financial Group, marketer of LifeTime target-date funds, recently compared participants who use a TDF (the “do it for me” crowd) with participants who select their own allocation and services (the do-it-myself” group).

The Principal research showed that do-it-myself participants tended to be less diversified than participants who use one TDF option. The former used an average of two to four investment options across the board, compared to the average 15-20 underlying investment options in the typical target date portfolio.

“We believe a minimum of five asset classes should be used with a broad selection of investment options to provide adequate diversification for the typical retirement plan participant,” said Jeff Tyler, portfolio manager, Principal LifeTime Funds. “The research shows that many do-it-myself investors aren’t meeting that mark.”

The Principal took the orthodox position that TDFs for younger investors should have higher equity positions because those investors have a long time horizon. The assumption of higher risk-tolerance by young investors is not universally accepted, however.

Zvi Bodie of Boston University has claimed that there’s no evidence that time diversification works for equity holders. In addition, the directors of NEST, Britain’s public option defined contribution plan, believe that losses of principal in early life can turn young investors away from equity investments permanently.

Principal found that, on average, do-it-myself participants born after 1987 had nearly 30 percentage points less equity exposure (54.7%) in their portfolios than the 83.95% within a target date investment option for that age.

There’s less controversy over the beneficial effects of regular portfolio rebalancing—a typical built-in feature of TDFs. The Principal found that only two percent of do-it-myself investors elected an automatic rebalancing service.

“We found that do-it-myself investors are rarely taking the important step of selecting auto-rebalancing services to keep their portfolios at the risk tolerance level they selected based on their time horizon. Auto-rebalancing is another step to take the emotion out of investing, to avoid negatively reacting to volatile markets,” Tyler said in a release.

The Principal’s research was based on a survey of participants of defined contribution (DC) retirement plans serviced through The Principal, and considered only their plan assets.

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