Target Date Funds: A QDIA That's DOA?

By Editor Test *Mon, Jun 22, 2009*

Last week, federal officials tried to locate the blame for 2008 TDF losses: Was it marketing hype by TDF makers, a flawed concept, Americans' weak financial literacy, regulatory lapses, or merely the caprice of the markets?

Back in 2006, when the stock market was ramping up and Congress blessed target-date funds (TDFs) as a qualified default investment alternative (QDIA) for 401(k) plans, TDFs seemed to relieve the problem of incoherent or overly-conservative savings habits among plan participants.

These "point-and-shoot" funds-of-funds, whose names always include the approximate year when the participant would retire—2015, for instance—automatically evolved to a higher bond-to-stock ratio over time. A single TDF was said to be all a participant ever needed.

In reality, the solution wasn't so neat. Some TDFs held high equity allocations well into retirement. Some TDF fund managers drifted from their investment styles. Many participants bought several funds in addition to a TDF, diluting the intended effect.

Worst of all, as a behavioral finance expert told U.S. officials in a hearing last week, many participants mistakenly assumed that a TDF would "magically" allow them to retire comfortably on their target date—no matter how much or how little they saved before then.

The 2008 market crash shattered that illusion, of course. Many 63-year-olds with money in "2010" funds took big losses. Last week, federal officials tried to locate the blame: Was it marketing hype by TDF makers, flawed TDF designs, America's low financial literacy rate, regulatory lapses-or merely the caprice of the markets?

Judging by testimony from a parade of experts at the joint SEC-Department of Labor hearing/webcast on June 18, the culprit was "all of the above."

Unintelligent design?

The TDF experts were divided into roughly two camps: those who saw them as a glass half full and those who saw them as a glass half empty. TDF advocates said the funds were based on sound principles and answered a gaping need in fund plans for a point-and-clink investment technology for average plan participants.

But TDF detractors said the assumption underlying TDFs-that asset allocation could be based entirely on a hypothetical retirement date-was a gimmick that over-simplified and distorted the investment process. "Age-based rules are unreliable and often perverse," said Richard O. Michaud of Boston-based New Frontier Investors LLC.

Others agreed the using a single criterion such as age to solve a complicated problem like investing over a lifetime makes no sense. "To say that it is false is an understatement," said Louis S. Harvey of Dalbar Inc.

As for the lack of standardization among TDFs with the same target date, some experts viewed that as a flaw and others as a virtue. In practice, every TDF has a different "glide path," with some reaching their lowest equity allocation in the retirement year (thus minimizing investment risk) and some not reaching it until several years into retirement (thus minimizing longevity risk by maintaining growth potential). For instance, 2015 funds today contain equity exposures ranging from 43% to 83%, according to Standard & Poor's.

That sort of disparity has been a cause of confusion among investors but also a sign of innovation among manufacturers. "Variety is a virtue," said Lori Lucas of Callan Associates.

Because there were no standards, TDF managers could pursue better returns by over-weighing equities and taking on more risk. While this form of style-drift might have looked like a smart strategy and a competitive advantage when stock values were rising, it back-fired when the market tanked.

Financial illiteracy?

Sixty-one percent of plan participants who owned TDFs thought the funds contained an implied guarantee of principal or returns, said Jodi DiCenzo of Behavioral Research Associations in Evanston, Ill., who surveyed plan participants last March.

How to Make TDFs Better

Several who testified before an SEC-Department of Labor panel in mid-June recommended the following alterations in target-date funds to protect investors.

- **Practice truth-in-labeling.** Clearly identify TDFs as either retirement funds that reach their highest bond allocation at the retirement date or as lifetime funds that still hold a high level of equities in retirement.
- **Create income-oriented statements.** On participants' statements, show the monthly retirement income their account value could purchase, rather than the current account balance or "the number" they need to save before retiring.
- **Approve "absolute return" funds as QDIAs.** These are diversified, actively managed bonds with low volatility, but whose managers may use many types of assets in search of returns above the risk-free rate.
- **Default to "target-risk," not "target-date" funds.** Before TDFs, there were "lifestyle funds" whose stock/bond/cash ratios were based on varying levels of risk tolerance. Some people recommend those over TDFs as QDIAs.
- **Ban "exit fees."** Some fund managers are said to be assessing penalties for early departures from their TDFs, in violation of federal regulations.
- **Put a cap on the equity allocation at retirement.** Some experts advise the SEC to limit equity allocations to as little as 28% at retirement, or revoke the fund's QDIA status.
- **Disclose the date a TDF reaches its highest bond allocation.** To make it easier for investors to compare TDFs, some suggest prominent disclosure of the date when a TDF reaches its lowest equity allocation.

"They believed in 'TDF magic.' Many thought they would be able to retire on the target date. A significant percentage thought the TDFs offer a guaranteed return ," she said, asserting that the TDF label contained "implicit advice."

Participants assumed an implied guarantee for three likely reasons, DiCenzo said, including "excessive optimism" on the part of plan participants, "framing effects" that positioned TDFs as an alternative to riskier solutions, and a "focus on simplicity" that suggested that TDFs did more than simply adjusted asset allocation over time.

DiCenzo seemed to scold the financial services industry for hyping TDFs as a shortcut to success, and for not making their limitations clear in marketing materials.. "There's no magic in TDFs," she said. "You can't invest your way to a secure retirement. You must save."

Another panelist observed that investors in TDFs also bought other funds, overlooking the idea that a TDF alone was meant to offer adequate diversification and missing the concept that the TDF effect-evolution toward a low-risk asset allocation-would be diluted by the purchase of other funds. "Participants don't realized that TDFs are funds-of-funds," said Anne Tuttle of Financial Engines.

Marketing hype and weak regulation?

Fund companies pushed TDFs not because they were good for plan participants, said Richard Michaud, but because they gave investors a reason not to switch funds. Plan record keepers like TDFs, he added, because they were relatively easy to keep track of.

"TDFs simply sales while encouraging people to stay in the same fund until retirement," he said.

Many TDFs are non-compliant with the regulations of the QDIA, said Dalbar's Harvey. TDFs do nothing to limit investor losses, although that is a requirement of a QDIA, and many TDFs charge a fee if an investor exits the fund within 90 days, although that's not permitted under existing regulations, he said.

One retirement plan advisor faulted regulators for not making sure that plan participants were aware of TDF shortcomings. "These hearing should have been held five years ago, before the horse was out of the barn," said David A. Krasnow, of Pension Advisors.

"We have steered our clients away from the TDF concept," he said. "It was put out to the masses before it was properly researched. Inadequate oversight has jeopardized Americans' financial security. People may never be able to retire because they trusted the government."

It's unlikely that TDFs will vanish, because their footprint in the defined contribution world has become too large. Invented in 1993 by Barclays Global Investors, they are now manufactured by dozens of fund companies.

More than 60% of employers now use them as a default contribution option. Through Q3 2008, assets in this sector were US$187 billion, up from US$ 115 billion in 2006, according to Standard & Poor's. Cerulli Associates Inc. recently predicted that TDFs could gather up to $1 trillion in assets by 2012.