Target Date Funds: What’s Under the Hood?

By Editorial Staff *Thu, Feb 2, 2017*

TDF investment returns, on average, fall short of their benchmark indices but perform about the same as all other mutual funds, say the authors of a new brief from the Center for Retirement Research at Boston College.

Target date funds (TDFs) have steadily gained usage since the Pension Protection Act of 2006 made them QDIAs—qualified default investment alternatives—in 401(k) plans with auto-enrollment features. In 2006, 28% of new 401(k) participants bought a TDF; by 2014, that figure was 59%, according to EBRI.

In a new policy brief from the Center for Retirement Research at Boston College, a quartet of academics examine the underlying funds, costs, performance and management of TDFs and find that:

- TDFs often invest in specialized assets, as well as conventional stocks and bonds. The typical TDF invests in 17 funds on average. These holdings include emerging markets, real estate, and commodities. The prevalence of these specialized assets has increased over time.
- TDF fees are only modestly higher than if an investor assembled a similar portfolio on his own. To avoid overlay fees, an investor might consider replicating the TDF portfolio on his own, but the analysis found little benefit from this “do-it-yourself” approach.
- TDF investment returns, on average, fall short of their benchmark indices but perform about the same as all other mutual funds, the authors found. “When [the overlay or funds-of-funds wrap fee] fee—roughly 50 basis points on average—is added, the total alpha is roughly minus-70 basis points. This value approximates the average alpha for mutual funds in general.”
- TDF managers’ decisions, in terms of marketing timing and fund additions, sometimes hurt performance. “Three types of fund family objectives can adversely affect TDF returns. First, TDF managers tended to favor start-up funds, which had substantially lower returns over the next three years than the alternatives within their fund family,” the authors found.

The four authors of the brief were Edward J. Elton and Martin J. Gruber, professors emeriti and scholars in residence at New York University’s (NYU) Stern School of Business; Andre de Souza, visiting assistant professor of finance at the Stern School; the late Christopher R. Blake, formerly Joseph Keating, S.J. Distinguished Professor at Fordham University.