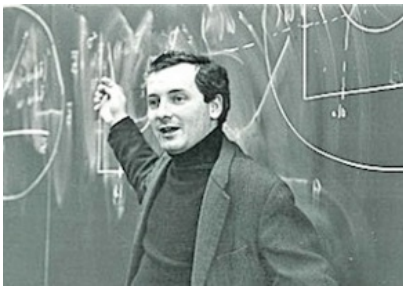
TIPS for the Long Run?

By Kerry Pechter Thu, Nov 5, 2015

Whether you'd prefer the new Dimensional Target Date Retirement Income Funds over one of the "big three" TDFs might depend on whether you share Robert Merton and Zvi Bodie's belief that stocks aren't necessarily safe in the long run. (Photo: Merton explaining the Black-Scholes-Merton options pricing model in 1977.)



To Robert Merton, the Nobel economist, Treasury Inflation-Protected Securities, or TIPS, have long seemed like the right foundation for any defined contribution account whose goal, at retirement, is to produce safe, adequate, predictable post-employment income for the next 25 years or so.

Merton's efforts to monetize this idea—to create a product that puts a "defined benefit" back into DC plans, and to reposition DC plans as personal pension in the minds of participants—started as long ago as 2001, when he, Zvi Bodie, and former JPMorgan executives Peter Hancock and Roberto Mendoza formed a partnership called Integrated Finance Limited. In 2007, they were granted a **patent** on their savings-to-income process, which they called SmartNest.

Their idea is now back in the news. Its latest incarnation appeared this week with the announcement of a new series of low-cost Target Date Retirement Income Funds, managed by Dimensional Fund Advisors, which acquired the SmartNest patent in 2014. (For background on how SmartNest came to be owned by DFA, click **here** and **here**.)

Like other TDFs, the DFA funds use a dynamic asset allocation or "glidepath" that gradually makes the portfolio more conservative over time. DFA's TDF allocation starts as risky as any other TDF (95% equities for a 30-year-old) but ends much more conservative than most (75% short-, medium- and long-term TIPS) at retirement. The annual cost is 21 to 29 basis points, depending on the vintage.

Asset Allocation Glide Paths, Dimensional Target Date Retirement Income Funds			
Years to Retirement	Global equities	Global bonds	TIPS
>25	95%	5%	0%
25	92	8	0
20	79	21	0
15	65	16	19
10	52	11	38
5	38	5	56
0-10 yrs after	25	0	75
15+ yrs after	20	0	80
Source: Dimensional.com			

The funds do not promise a certain level of income in retirement (that depends on the participant's savings rate) or guarantee that the income will last a lifetime (that depends on the withdrawal rate). But if the participant sticks to a recommended spending rate, DFA expects that the stream will last a lifetime (with something left over) and maintain its anticipated purchasing power. If the participants have done their part and saved the recommended amount, income from the 401(k) account (and from Social Security and perhaps —as Merton emphasized at a recent symposium in Boston—from the proceeds of a reverse mortgage on their homes) would be expected to cover their basic expenses in retirement.

"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. (See interview with O'Reilly in today's *RIJ*.)

Deja vu all over again

If you're getting a sense of deja vu, it's because the DFA TDFs are a revival of a fizzled 2012 DFA product called Dimensional ManagedDC, which was also based on SmartNest and was also aimed at gathering assets in the DC channel. All three initiatives have been built on a backbone of target date funds.

The TDFs "use many of the same concepts and ideas on which ManagedDC was built," DFA told *RIJ* in an email this week. "ManagedDC used the same risk framework as the funds. The target date funds are a commingled solution, a series of 40-Act mutual funds, which allows scalability, portability and low costs. Similar to Managed DC, the funds employ an LDI [liability-driven investing] strategy, using a duration-matched TIPS strategy to manage in-retirement income risks, so that estimates of affordable income or consumption in retirement are less volatile."

The huge and growing market for TDFs has attracted a lot of entrants, even though it is dominated by Fidelity Investments, Vanguard and T.Rowe Price. Those fund companies, which are also large full-service retirement plan providers, share a TDF philosophy that is very different from DFA's, as the chart below shows.

The TDFs of the big three have much larger ending equity allocations than DFA's, and significantly higher costs. They differ from DFAs in theory too. The glidepaths of the big three assume that stocks pay off if you hold them long enough, and that bonds don't provide enough upside to sustain a portfolio over a 30-year retirement. The DFA/Merton TDF is predicated on the idea that the perceived long-run safety of stocks is a statistical illusion that masks the wide diversity of outcomes for equity investors. (They do include a 20% allocation to risky assets throughout retirement.)

One fund manager whose beliefs overlap with, but also differ from, DFA's, is Ron Surz, president of Target Date Solutions in San Clemente, CA. He has long been trying to popularize his own TDF series, which uses his patented Safe Landing Glide Path formula.

Current Asset Allocations of Six 2020 Target Date Funds-of-Funds

	Dimensional 2020 Target Date 2020 Retirement Income Fund†	Fidelity Freedom 2020 Fund	Vanguard Target Retirement 2020 Fund	T. Rowe Price Retirement 2020 Fund	BlackRock LifePath 2020 Fund	Surz SMART TDF 2020
Cost/yr	23 bps	66 bps	16 bps	66 bps	108 bps	38 bps
Equities	20-45%	63%	60%	61.6%	48%	23.53%
Bonds	55-80%	33%	40%	36.2%	50%	67.71%
Other*	—	4%	—	2.2%	2%	9%

Sources: DFA fund prospectus; Fidelity, Vanguard, T. Rowe Price websites; private communication (Surz). †New.
*E.g., cash, precious metals, real estate, commodities, credit default swaps, preferred or convertible stock.

As the chart shows, the Surz 2020 TDF Builder holds almost 68% bonds (including allocations of 32% to TIPS and 22% to T-bills). But, unlike the DFA product, Surz' TDFs are so-called "To" rather than "Through" funds. They're designed only to be held until retirement, a decision he believes is justified by participant behavior.

"I don't expect folks to stay in my funds when they reach the target date, so SMART Funds end at the target date," Surz told *RIJ*. "They end in safe money—57% TIPS, 38% T-bills, and 5% US stocks. In 2012 we lowered the TIP duration to less than three years. We'll increase it again when the Fed is through manipulating. Of course, I can't stop folks from staying in SMART, but the fact sheets clearly tell them that it's very conservative, and not intended as a retirement investment. We say it's a true "To" fund."

Surz thinks it's inappropriate for TDF manufacturers to represent their funds as protection against longevity risk, in part because the rate at which people save is the biggest determinant of their retirement income security. He also expects most most participants to liquidate their shares in their TDFs, which are "Qualified Default Investment Alternatives" into which plan sponsors can default auto-enrolled participants into, after they leave their plans.

"I think of the fund companies who market their TDFs as managing longevity risk are being disingenuous, for two reasons: Saving enough is the key for this objective, and attempts to serve people beyond the target date are thwarted because most people withdraw," Surz said. "I'd recommend that they acknowledge reality."

Calculate this!

To help plan participants set income goals, decide how much to save, track their progress toward sustainable income and then draw down that income in retirement, DFA provides a **calculator** (during the accumulation period) and an automatic payment plan (during the income period) that helps retirees save and spend at a sustainable rate. The maturing TIPS in the fund ensure that the payments maintain their purchasing power.

"A retiree in our target date funds would own shares of a mutual fund," DFA said in a statement. "They would use distributions and/or sell these shares to consume in retirement. The value of a share is expected to move like the cost of in-retirement consumption.

"We decided not to have a pay-out schedule as investors can set up automatic redemptions in their accounts at their desired frequency—we prefer to give that flexibility to the investors in the funds. Those automatic redemption can fund a retiree's consumption from retirement until their last days in retirement. As mentioned above, our target date funds are designed to manage uncertainty of affordable in-retirement consumption. We expect this to provide a "smoother" and more certain level of consumption for retirees. We feel managing this risk is critical for retirees, not only for investors saving for retirement."

Someone long familiar with the Merton-Bodie approach to retirement security is Francois Gadenne, founder of the Retirement Income Industry Association. RIIA sponsors the Retirement Management Analyst designation, whose curriculum also focuses on the twin needs of safe income, from bonds or annuities, and upside potential from risky assets.

Gadenne told *RIJ* that the DFA approach is one way to skin the retirement income cat, but that the right income tool depends on each client's specific needs.

"This new product offering by DFA seems to fall in the category of products that wrap a bond ladder, as a risk management device to move the client discussion from an asset focus to an income focus," he said. "Other categories of products that seek to move the client discussion from an asset focus to an income focus include products that 'wrap the mortality credit' and use annuities instead of TIPS.

"In a Zero Interest Rate Policy environment, there are different cost/benefit advantages to these various categories of products. We think the results of The Client Diagnostic Kit, which is the first signpost in our RMA curriculum, should drive the appropriate choice of a specific product for a specific client." With 10-year TIPS currently yielding a real 0.65%, it might be hard to make a case for them.