Target Date Funds: Too Good To Be True?

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Read the Ads. Target Date Funds reign supreme -- the answer to everyone's retirement woes. Every financial services firm, from mutual fund companies to banks, are promoting their Target Date Funds. Trust us, make regular contributions over your 30 year career, and we'll provide you with a retirement fit for a king. My own simple experiment, however, using common sense, and forgoing complicated analytical tools, has led to a simple conclusion. Target Date Funds -- The emperor has no clothes.

A few years ago I set up an IRA with the minimum contribution and decided that I would try a target date retirement fund. Why not? Seemed to be an easy way to invest the money. A single investment decision would relieve me of the necessity of evaluating my investment decisions on a regular basis. As a professional woman with work and family demands, I like "easy" decisions. Furthermore, I suspect that my decision making process was similar to many, if not most, plan participants. Who doesn't like an easy decision? Life is so complicated …. we jump at easy.

In retrospect, however, although the decision may have been easy, it might not have been so smart. I guess I really didn't fit the model of an ideal investor for this fund. But, I do probably fit the model of the typical investor in Target Date Funds. That is the problem.

I realized that I made a critical mistake. I used the Target Date Fund as a convenient place to park the money while I took some time to think about a better allocation for my investment. What I thought was going to be a short term investment still continues 6 years later. Even when we intend to revisit these decisions, somehow we don't. Life gets in the way. We are all very busy.

From an investment perspective, however, Target Date Funds are not at all designed to meet short term investment needs. It's the exact opposite. In order to derive the full benefit of the asset allocation decisions, assets need to be invested over the entire length of the fund. My short term investment is nothing short of a disaster. That is, I have experienced probably the riskiest years of the fund, without enjoying the benefits of the later years.

Recent data shows that only 22% of participants in a plan today will still participate in the plan post retirement. For the Target Date Fund to "work", the participant really needs to stay in the fund through retirement, otherwise the investment assumptions of the target fund do not work.

Investing in Target Date Funds also requires a participant to pick a "retirement date" 20-30 years in the future. So, here's the dilemma — participants who want to make "no decision" about their retirement are "defaulted" into Target Date Funds. But, they must pick a "retirement date". What even is a retirement date? The concept of retiring is elusive. What might have appeared like a sound decision in my 20's could seem questionable by my 40's and ridiculous by my 60's.

If we have learned nothing else over the past decade, the concept of work and careers is fluid and evolving. Long-term employment is elusive and possibly an anachronism … a relic of long gone economy. Again, if I look at my own life experiences, I jumped ship from a comfortable corporate life to the exciting turbulence of a start-up firm. And yet, my Target Date Fund is not designed to respond to these fundamental life changes.

Fortunately, my investment in a Target Dated Fund represents a very small portion of my investment portfolio. But, imagine a good corporate soldier who nonetheless ends up with their entire 401(k) plan invested in a Target Dated Fund. (And, remember, this participant probably is not participating in traditional pension plan either). Then, due to no fault of his or her own, their job is eliminated. Assume for a moment that they are 48 years old.

Their entire financial world has changed. Do they leave the money in the Target Date Fund? What are the implications of taking the money out? Can they even afford to continue contributions to the fund? Is it even possible to make additional contributions? And, what advice, if any, will the plan sponsor give the terminated employee?

The questions and complications are dizzying. And, again, all for an investment which the participant "defaulted into".

Target Dated Funds are amazing investment products …..for the firms that sponsor them. Once on a 401(k) platform, money will just pour in month after month as the default option. By definition, the assets are "sticky" — even if they do not remain in the funds for 30 years, they will likely be invested for a longer investment horizon than is typically the case. The annual fees generated by these funds will compensate financial firms for decades.

I have spent most of my career building similar types of products. I understand the motivations of financial firms. Now, however, at Harrison Fiduciary Group, we have the obligation to undertake actions which are in the best interest of participants. We are not selling products. Plus, my own small experiment with my own investment funds has taught me a valuable lesson. And, think of it, I'm a CFA. I should have known better.

The allure of a single investment decision is very enticing. However, as a prudent investment fiduciary, I know that as the allure and excitement grow around a particular product, it probably makes sense to dig deeper. Dig behind the marketing campaigns and test whether or not the emperor is wearing any clothes.

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