VOLUME 77 ◆ NUMBER 1

Employee Benefit Plan Review

Warning Signs of Target Date Funds: What's Best for the Future

By Bob Cohen and Don Nordstrom

Retirement assets invested in Target Date Funds (TDFs) continue to grow (estimated at $1.8 trillion as of March 2022 per Morningstar) as defined contribution (DC) plan investors increasingly place their trust in these vehicles to be the solution to their future retirement needs.

Despite this marketing success, it is long overdue to ask a few questions about the suitability and applicability of TDFs and their impact on retirement in the United States.

Specifically, a few general critiques of Target Date Funds include:

- TDF investing encourages participant lethargy when it comes to asset allocation where one size does not fit all;
- The suitability of TDFs is in question as they lack the ability to customize and incorporate all of the age, risk tolerance, retirement and investment needs, and personality factors that are necessary to define success for unique investors;
- TDFs do not consider adequacy risks in terms of whether investors are saving enough and what their future looks like; and
- As highlighted by economic conditions experienced during the first half of 2022, does the investment strategy present in most TDFs provide enough inflation hedge, protection from rising interest rates, and diversification within and across various asset classes and styles? (Some of the nearer-term and purportedly "safer" TDF 2020 vintages underperformed longer-dated vintages of the same TDF family, as shown in the accompanying chart.)

Thus, going back to the initial observations about the rapid growth of TDFs, it is reasonable to ask:

- Is this investor trust misplaced? Have the favorable conditions for a passive, risky allocation such as offered by TDFs run their course?
- Are the risks of this investment option being accurately considered or are there hidden traps that can upend even the most prudently designed retirement plans?
- Are the underlying investments of TDFs properly adapted to the new inflationary economic regime we are seeing?

Especially as the Baby Boomers, the largest generation to enter the retirement phase, fully transition from the workforce, there are serious concerns as well as opportunities related to whether TDFs in their current form are suitable for those entering or already in the spend-down phase of their life.

In addressing these concerns it is important to recognize that everyone has unique and personal financial circumstances, which leads to the question of design, especially as people plan to end the accumulation phase of their working career in preparation to entering retirement.

Inadequate Design?

Target Date Funds are a generalized product that only looks at one factor: When does the investor plan to retire? All investors in a particular TDF vintage get the same allocation regardless of an individual's circumstances.

Another concern is when a TDF's sub-investments are from the same management firm as the TDF issuer. A high concentration of sub-investments across all asset classes used in the TDF being advised by the same firm may not only limit the asset class exposure, but may also result in an unhealthy bias of investment strategy and diversification within the TDF portfolio.

Lack of Customization

A certain level of customization is required to efficiently plan for the future and avoid either under-saving and living below the quality of life the investor was accustomed to, or running out of money and having to scramble to get by for their remaining years.

TDFs do not look at investors' or their spouses' other assets, social security, pension, or most importantly their spending habits and therefore cannot adapt to their needs and develop a well-rounded financial plan and asset allocation that suits their needs.

Paired with the lack of a comprehensive picture of their financial capital, there are gaps left in planning for a financially stable future solely through investing in TDFs.

Present Environment and Warning Signs for the Future?

Entering 2022, TDFs had their largest allocation to equities on record as the seemingly invincible stock market had managers chasing returns in a friendly Federal Reserve environment of easy money and low rates. That was before the specter of inflation started showing up near the end of 2021. Now that the Fed has reversed course, moving to tightening mode in hopes of taming inflation back to their 2% target, TDFs have been revealed as highly exposed to risky assets.

In fact, in some cases, down market returns for the longer-dated 2040-2060 vintage TDFs were better than their presumably more conservative and retiree suitable 2020 counterpart, as can be seen in the accompanying graphic showing returns for Dow Jones Target Date Indices. Each index measures the performance of sub-indices selected and weighted to represent a consensus of the opportunity set available in the U.S. universe of target date funds.[1]

Columns with bold headers exhibit counterintuitive returns for different vintages and risk levels of target date funds. Funds expected to provide more downside protection failed to do so in the first quarter of 2022, and also experienced counterintuitive lower returns relative to the longer vintage indices over a 1-year period. Although this is not the case for every fund family, the index shown is representative of a widespread phenomenon.

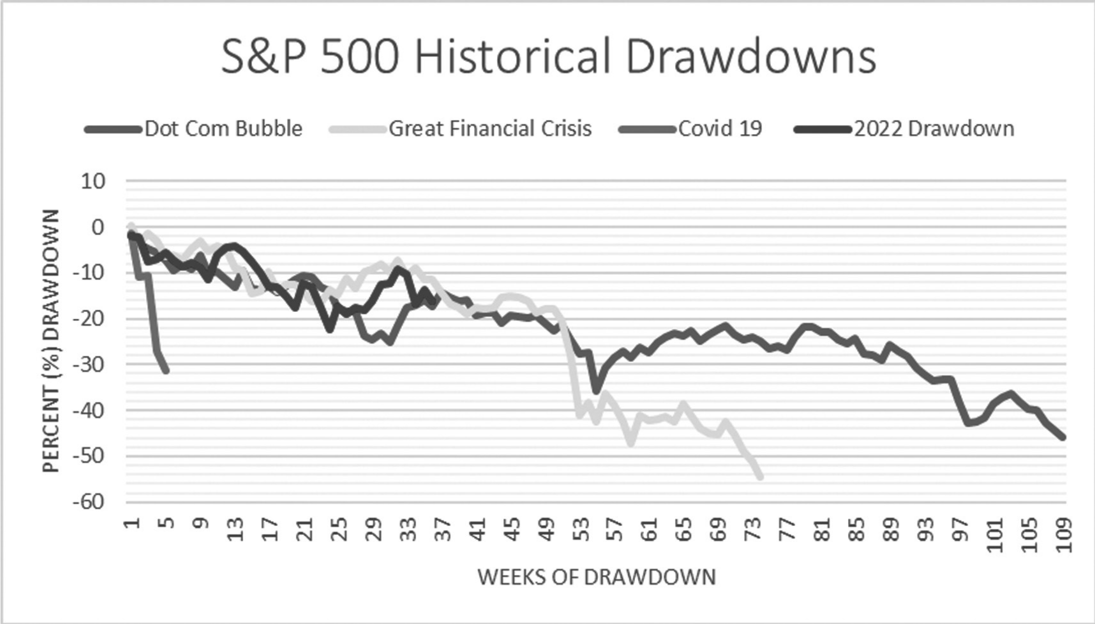
For investors in a near-dated TDF such as a 2020 vintage, the equity percentage generally levels off at around 30%-40%. The question remains: How suitable is this for investors' financial circumstances?

Investing now is different. Investors experienced returns midyear in the rarest of forms: Since 1926 this is the third worst start for a 60/40 portfolio (1932, 1940) and only the third time that stocks and bonds have declined together (1931, 1969). In the previous large stock routs of this century – the Dot Com Bubble crash, Great Financial Crisis, and the COVID-19 pandemic selloff – bonds acted as a buffer to the stock selloff.

This time around, however, bonds did not behave so well. Investor attention to asset allocation has never been more important. After over a decade of complacency built up following the

	2022 Q1	2022 Q2	**Q3 to Date**	**1-Year**
DJ Target 2020 Index	-5.43	-8.07	-1.30	-15.10
DJ Target 2030 index	-5.31	-9.91	-0.05	-14.77
DJ Target 2040 Index	-5.09	-12.23	1.60	-14.49
DJ Target 2050 Index	-4.94	-13.92	2.92	-14.31
DJ Target 2060 Index	-4.91	-14.26	3.19	-14.28

(Data from Morningstar as of 9/14/2022.)



(Data as of market close 9/14/2022.)

lengthy period of market-friendly central bank policy, world economies are faced with the geopolitical risks of the war in Ukraine, fragile economies still seeking to regain their footing following COVID-19 lockdowns, supply chain bottlenecks, and the pivot in central bank policies to higher interest rates and quantitative tightening to combat the effects of inflation and the risk of recession.[2]

After a summer rebound, large cap U.S. stocks dropped ~16% through September 14th, whereas the other 3 large drawdowns in the last 20 years have seen much larger pullbacks.

Given the current macro-economic situation with a real estate crisis beginning in China and potentially the U.S., decreasing currency reserves among emerging market countries and record sovereign debt levels from the pandemic, the pain seen in equities in 2022 may not be the end of the turmoil. The question is are TDFs prepared if the current drawdown resembles previous ones?

Conclusion

As a simple example of why customization is desirable: A retiree who is well-funded for retirement compared to a retiree who is underfunded should likely not be exposed to the same level of risk, return, and investment income expectations. The same is true for the younger investors still saving and accumulating assets for retirement at very different rates and levels of investment success.

Retirement goals can vary greatly. Retirees both present and future should utilize an investment strategy that can look at the big picture and accommodate their unique circumstances with a more personalized solution. Stock and bond performance in 2022 has revealed weaknesses in the investment thesis for TDFs. Target Date Funds do not fit the necessary profile for a successful retirement future. ❂

Notes

1. The methodology can be found here: https://www.spglobal.com/spdji/en/documents/methodologies/methodology-dj-target-date-indices.pdf.
2. Certain information contained in this article has been obtained from third party sources believed to be reliable, and therefore has not been independently verified for accuracy or completeness. Investors cannot invest directly in an index. For this reason, index performance noted herein does not reflect the deduction of advisory fees or other expenses.

Bob Cohen, the chief investment officer of ProManage, LLC, focuses on strategies for improving participant retirement outcomes. Don Nordstrom, a senior investment analyst at the company, specializes in performing mutual fund due diligence, equity research, portfolio analysis, retirement planning and risk management.