A Much Simpler Design for Target Date Funds

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Everything should be made as simple as possible, but not simpler. Einstein

A recent survey on sponsor attitudes toward target date funds indicates a slowing interest and increased concern about potential liability, much of it attributable to a lack of understanding. With all of the confusion and regulatory concern surrounding target date funds I thought it would be helpful to simplify these important investment vehicles. Simple is good. So here is a straightforward approach to simplifying target date funds. It begins with a description of the complexities with current approaches and then describes a much simpler alternative.

Getting Started – Current Target Date Fund Objectives

The key to getting started is deciding on objectives – what are our goals for our target date funds. We have a couple of choices. We can agree with the objectives put forward by fund companies, or we can give consideration to alternative objectives that are more in line with fiduciary responsibilities and what is practical in a one-size-fits-all vehicle. Let's start with the current fund company objectives. Most target date funds have two objectives: replace a desired amount of final pay in retirement, and avoid outliving your assets. We'll call these the "pay replacement" and "longevity risk" objectives. To achieve these objectives we'll need to make some assumptions so we can design investment policies. These assumptions come in two forms: behavioral and capital market. Behavioral assumptions describe participant savings (working life) and spending (retirement) through time. Since target date funds are one-size-fits-all, these behavioral assumptions can only apply to the "typical" or "aggregated" participant, whatever that means – we need to decide. Capital market assumptions are the bread and butter of financial planners and advisors, so these are commonplace.

Setting Assumptions for Current Objectives

<u>Savings for the Typical Participant (Pay Replacement Objective)</u>

- Current savings
- Other sources of retirement income
- Desired pay replacement at retirement
- Current pay and projected pay increases
- Savings pattern through time, employee plus employer

Spending for the Typical Participant in Retirement (Longevity Risk Objective)

- Spending discipline, perhaps as a fixed percent of current market value
- Other assets, like Social Security
- Life expectancy
- Life events, like medical costs, college funding, whatever … stuff happens

Capital Markets

- Asset classes: stocks, bonds, …
- Sub-asset classes: styles, countries, alternatives
- Risk & return & correlations
- Glide path shape: linear, geometric, step, Mobius strip

Setting Policies

As you can see, these assumptions are extensive and complex. That's why the Department of Labor has proposed that fund companies disclose them. The real magic is in developing the all-important "glide path." Asset allocation matters most. All of the other aspects are just annoying noise: active/passive, open/closed, to/through, bundled/investment only, etc. Investment policy should match up the right blend of assets through time with the savings and spending assumptions above. It would be good fiduciary practice to document these objectives, assumptions and policies, taking the view that risk is the possibility of not achieving objectives.

Now that you see the complexity implied by current offerings it's no wonder that fiduciaries are leery of target date funds. They should be. But target date funds don't have to be complex. Simpler objectives make for simpler design and understanding. You may want to consider the following alternative approach.

An alternative simpler approach

Target date funds can and should be much simpler. It all begins with rational objectives that apply only to accumulation, and not retirement, because most participants, especially those defaulted into target date funds, withdraw their accounts at retirement. Before fiduciaries sign on for pay replacement and longevity risk objectives they should give consideration to what is practical in a one-size-fits-all-set-it-and-forget-it vehicle. For example, the following objectives can be realistically achieved by a target date fund designed for these purposes:

1. Deliver at least accumulated contributions plus inflation at the target date. Strive to achieve this objective with high conviction (i.e. low risk). In other words, don't lose employee money.
2. Grow assets as much as possible without jeopardizing the primary preservation objective. Focus on this objective when the horizon (term to target date) is long, but sacrifice growth for safety as the target date nears.

Please note that there are absolutely no saving or spending assumptions required to achieve these objectives; they are indifferent to individual participant behavior. The investment policies for achieving these objectives stand far apart from current industry practices. Critically, the preservation objective demands a real[*] "to" (accumulation only) fund that ends at the target date entirely in inflation-protected assets, like TIPS and T-bills. By contrast, the TDF industry offers 20-70% in equities at the target date. Even 20% in equities is too risky when preservation is the objective – preserve and protect at the target date.

Conclusion

So now you have it: differentiate product from solution. Pick your objectives, and the distinction is clear. Have you settled for product-based objectives of pay replacement and longevity risk? Is your bundled service provider your TDF manager; if so, why? Is your employee protected near the target date? Don't forget to document your decisions because it's what fiduciaries do.

[*] The target date fund industry has defined "to" as "flat equity allocation beyond the target date." Anything with the word "beyond" in it cannot be a real "to" fund since "end" and "beyond" do not play well together. Flat 100% equity is a "to" fund by this definition.