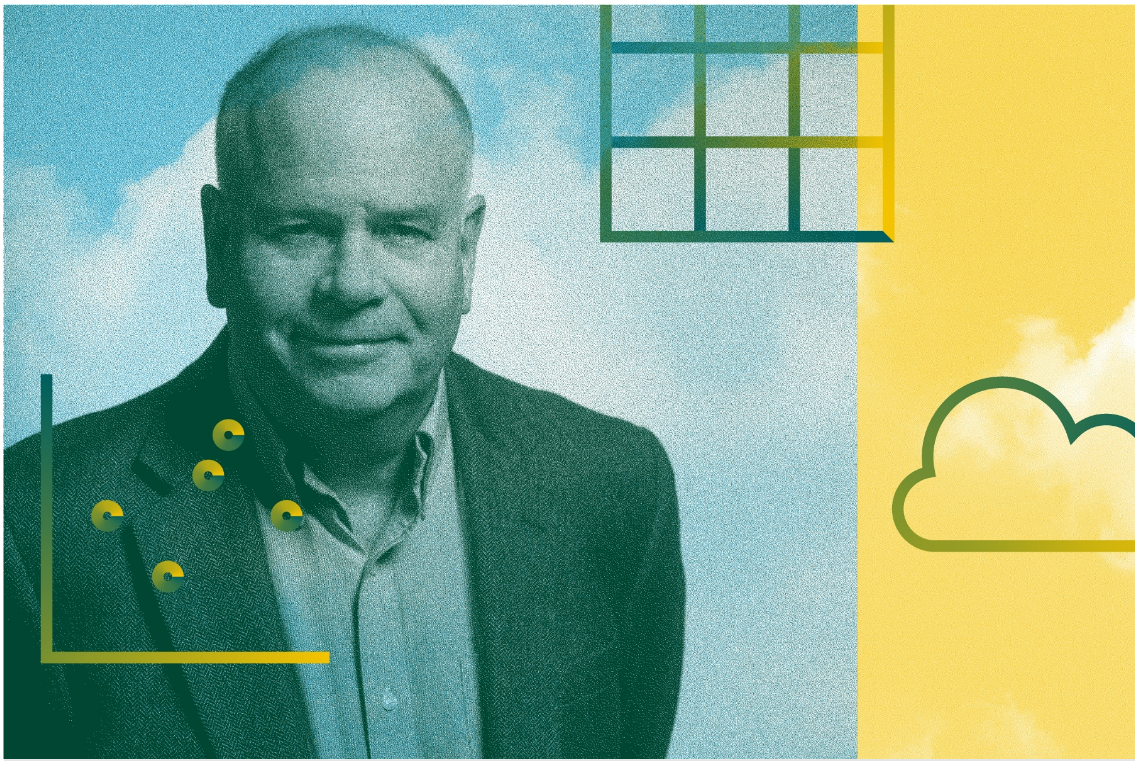
REKENTHALER REPORT

Are Target-Date Funds Flawed?

The research finds room for improvement.



John Rekenthaler
Jan 24, 2022

A New Study

An academic paper entitled "Simple Allocation Rules and Optimal Portfolio Choice Over the Lifecycle," by Victor Duarte, Julia Fonseca, Aaron Goodman, and Jonathan Parker (the first two authors are affiliated with the University of Illinois, the second two with MIT), recently attracted the attention of *The Wall Street Journal*. Its article, "Why Target-Date Funds Might be Inappropriate for Most Investors," by Mark Hulbert, summarized the paper's three main conclusions:

1. *Target-date funds are well-suited for young investors.* On average, target-date funds held by employees who are in their 30s hold 89% of their assets in equities. That figure mirrors the authors' estimates.

2. *For older investors, target-date funds are too conservative.* Target-date 2035 funds, which address 50-year-old investors, are 68% invested in stocks. When target-date funds reach their final date, which presumably occurs when their shareholders reach age 65, they hold an average stock position of 40%. The authors prefer allocations of 80% and 60%, respectively.
3. *The needs of older investors vary more than those of younger investors.*

Young Lives

The first point is straightforward. For most young investors, investment advice for retirement savings is blessedly simple. Save as much as is reasonably possible, while placing those monies into higher-risk, higher-reward investments. Whether such investments should include fashionable assets like cryptocurrencies and NFTs can be debated, but as those can't be owned by mutual funds, the question is moot. Long-dated target-date funds should invest largely in equities.

Such has been the traditional wisdom. Portfolio managers rarely do anything different. The authors do diverge from customary practice by contending that some young investors should place as little as 30% of their retirement assets into stocks. (What makes those workers outliers, and why they should invest more cautiously than their peers, is unclear.) But their advice to the average younger employee is mainstream.

Neither is the third argument surprising. A corollary of the axiom that all young investors are alike is that older investors are not. Their wealth and spending requirements differ greatly, as do their medical conditions and life expectancies. The reason that financial advisors have mostly older clients is not solely because seniors are wealthier. It is also because their financial lives are more complicated.

Too Cautious?

Which leaves the second item: that over time, target-date funds become too timid. This, too, is a familiar assertion. My friend Javier Estrada, finance professor at IESE Business School in Barcelona, is not alone in urging retirees to favor stocks, although admittedly Javier's suggestion of 90% (!) exceeds the norm. Studies of historical U.S. investment returns typically indicate that older investors should be bolder--and so should the target-date funds that serve them.

(The exceptions to the rule generally aren't. For example, Morningstar's recent white paper, "The State of Retirement Income: Safe Withdrawal Rates," advocates that retirees place 30%-60% of their assets in equities. But that paper assumes that future stock returns will be substantially lower than past results. So, too, does this paper from Dimensional Fund Advisors, which relies upon a pessimistic stock forecast to dispute the wisdom of a high equity allocation.)

In short, the authors' verdicts are conventional, although arrived at unusually, through a complex "machine-learning solution algorithm" that eludes my comprehension. (If such approaches existed when I attended business school, they were not taught.) Target-date funds largely work for younger employees. However, they struggle to satisfy older investors. Not only might they be too conservatively positioned, but owing to diverging personal circumstances, the single size they offer no longer comfortably fits all shareholders.

Next Steps

Those edicts seem reasonable. However, adding equities to target-date funds for older investors presents two problems. The first is political. While cautiously positioned funds that trail bull markets annoy their shareholders, they rarely anger them. Not so with aggressive funds that are slammed by bear markets. They cause outrage. Following a public outcry, the U.S. Senate convened hearings on target-date funds in 2009, seeking to punish those funds that were deemed to have been too reckless during the global financial crisis.

The other difficulty is psychological. The 2008 crisis again provides a useful example. Had a 2010 target-date fund invested according to the authors' precepts, it would have lost about 20% of its value. That would not have posed a problem for the fund's upcoming retirees, because stocks rapidly recovered. But such assurance comes only with hindsight. At the time, it was not available to shareholders. They would have legitimately feared for their financial futures.

Thus, while I appreciate the underlying math (if not this paper's details), I don't foresee major changes to target-date allocations. A nudge here, a tweak there.

The authors' other prescription, that target-date funds become "individualized," will eventually occur. Increasingly, 401(k) plans contain retired employees as well as a company's current workers. The current approach for such shareholders is to retain them in their original target-date fund before eventually transferring them to a generic "retirement" fund. That approach is clearly inadequate--a stopgap fix developed for a system that was created to serve workers, not retirees.

That will change. The 401(k) industry has taken its first step toward better addressing the needs of retirees, by providing annuity options. Other innovations will follow. Over the past 40 years, the 401(k) industry has markedly enhanced its blueprint for current workers, by switching from insurance pools to mutual funds, devising the target-date structure, and inventing automatic enrollment. In the future, it will do so for retirees. Among the improvements will be customization.

This process, however, will take decades, partially because an $8 trillion ship can only turn slowly, and partially because the solutions have yet to be discovered. Desiring customization is one thing; knowing how to deliver it without sacrificing the ease of use that has made target-date-funds so appealing is quite another.

John Rekenthaler (john.rekenthaler@morningstar.com) has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.