smart column

Target date mutual funds

by Stephen J. Scott, CFP®

A target date mutual fund (TDF) is a single investment composed of other investments, usually other mutual funds, to form a single diversified investment. The goal of this type of mutual fund is to reduce the amount of risk as the investor nears retirement. One of the defining characteristics of TDFs is that the asset mix within the fund changes and becomes more conservative over time. As the current year nears, (and surpasses) the stated year on the TDF, the investments in the fund will change to become more focused on income and stability. For example, currently 2040 TDFs have approximately 85% of the investments in stocks (more risky) and 15% in fixed income or bonds (less risky). Conversely, a TDF with a date of 2015 would have 50% in stocks and 50% in bonds. Most 529 college savings plans use a similar type of investment strategy in their age-based investment choices.

The Pension Protection Act of 2006 allows for the use of TDFs as the default option for 401(k) retirement plans for participants who do not wish to choose their own investments. As a result, TDFs have become very popular in recent years even though they have been around since the early 1990s. Recent studies have shown that assets in TDFs have increased five-fold since 2005. In fact, Vanguard has indicated that 25% of current retirement plan participants and over 60% of new participants are invested in a target date fund as the sole investment of their plan.

The advantages and disadvantages of target date funds

Picking investment allocations can be daunting. TDFs allow the investor to take a "set it and forget it" approach making the simplicity of these funds their biggest advantage. TDFs are a great choice for investors who do not want to spend time researching their own investments and do not understand how to construct a properly diversified portfolio. The level of diversification within a TDF may also be an advantage because a retirement plan participant may gain access to asset classes that are not otherwise available.

Unfortunately, one size does not necessarily fit all investors. For instance, investors who have assets outside of their retirement plans may want to pick specific investments rather than pick randomly from a diversified bucket to complete their portfolio allocations. TDFs have recently also garnered criticism for taking more risks than necessary in the years nearing retirement dates, made worse by the 2008 market. The average decline for 2010 TDFs was 37% from the 2007 market peak to the bottom of the market in 2009 was difficult hard for someone who is only a year or two from retirement.

Another disadvantage is the potential for conflicts of interest to arise for the fund companies and managers. Companies receive more revenue from funds that are invested in stocks versus bonds, and some investors will look solely at historical returns on investment to decide which fund is best for them in any given retirement year. This is an incentive for managers to take extra or unnecessary risks close to the indicated retirement date that could be detrimental to the investor with little to no consequences for the fund companies and managers.

What to look for in a target date fund

Several factors should be considered when thinking of investing in a TDF. As always, the first consideration should be expenses and whether you would like a fund that uses active management or a passive indexing strategy.

While all target funds have the same underlying objectives to reduce portfolio risk as the investor gets closer to retirement, not all TDFs are created equal. The allocations for the same retirement year may vary across mutual fund providers—and sometimes by a very meaningful amount. For example, The Alliancebernstein fund with a target date of 2040 has 95% of funds allocated to equities, whereas another company had the least allocation of 38%. The average allocation was 87% across all fund companies. The lesson to be learned is to refrain from choosing a fund company that has an allocation on an extreme. Additionally, not all investors have the same tolerance for risk. Therefore, it is important for an investor to choose a fund with allocations that will achieve their financial goals and let them sleep at night.

Finally, TDFs are not a guarantee of retirement success. Retirement plan sponsors are obligated to educate their participants concerning investment-associated risks. A recent study by Alliancebernstein suggested that 50% of surveyed workers "mistakenly believed that using [TDFs] will guarantee that their retirement income needs will be met," a misconception that can easily be rectified with proper client education.

Overall, TDFs are popular and advantageous investment choices for participants desiring a simple investment strategy. With proper education about TDFs, many investors can have some peace of mind about their retirement funds.

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