TARGET DATE ANALYTICS LLC

RECOVERY IN TARGET DATE FUNDS?

by Joseph C. Nagengast, February 2010

AFTER THE DEVASTATING PERFORMANCE OF 2010 FUNDS IN 2008 SOME COMMENTATORS CLAIMED INVESTORS WHO HAD BEEN IN THE MORE AGGRESSIVE VERSIONS OF TARGET DATE FUNDS WOULD HAVE BEEN BETTER OFF EVEN AFTER THE LOSSES. NOW THAT THE MARKET HAS REBOUNDED SOMEWHAT IN 2009, AN INCREASING NUMBER OF COMMENTATORS ARE CLAIMING THE ALARMS RAISED AFTER 2008 WERE JUST THOSE OF A BUNCH OF CHICKEN LITTLES; AND THAT INVESTORS WHO STUCK IT OUT FOR "THE LONG TERM" WOULD BE BETTER OFF. WE EXAMINE BOTH CLAIMS.

Target Date Funds have been much discussed. Even before the market meltdown of late 2007 through early 2009, hardly a day passed in which there wasn't an article in some trade paper about target date funds (tdfs). When the bottom fell out of the market and participants about to retire saw devastating losses when they were expecting protection, and in some cases intending to take lump sum distributions, the regulatory bodies and popular press started paying attention. Nothing like a good old market crash to get people's attention!

At their core and inception, tdfs were fairly simple propositions—funds which were designed to answer the problem of defined contribution plan participants willing or not, being charged with managing their own portfolios. The solution offered by tdfs was to conceptually aggregate all participants by years to retirement and then build a portfolio which became steadily more conservative as time passed and the date approached. When the target date was reached the assets were rolled into a preservation fund, often called, somewhat optimistically, an income fund.

However, most managers have since taken a more aggressive approach. In spite of behavioral evidence that most participants withdraw all of their money at or shortly after the target date*, these managers claim that they must maintain high levels of equity and risk because they believe their mandate is to manage the assets until participants' death rather than just to their retirement date. These aggressive managers have high-jacked participants accounts by refusing to adhere to a basic tenet of target date investing, the need to substantially and rapidly reduce risk as the target date approaches. For many investors this change had the effect of a bait-and-switch, which promised a target retirement date strategy but provided something entirely different. The aggressive managers justify their actions by claiming they address "longevity risk," but all they really do is add market risk to longevity risk. Participants (especially those hoping to retire in 2008 and 2009) were badly burned by this strategy. The managers forsook principle preservation at the target date in favor of a simplistic, long-term, risky portfolio strategy.

What makes a fund a target date fund?

While the strategy of attempting to address longevity risk is an admirable goal, it is in conflict with the objective of a glidepath-based strategy for managing participant assets prudently through the accumulation phase, and when undertaken late in the glidepath, it misleads investors who believe the date in the name of the fund indicates a focus on principal preservation at that date. Managers must choose. If they continue to focus on growth in the last years before the target date, they abandon the traditional target date approach of substantially and rapidly reducing risk in anticipation of the approaching liquidity date. They cannot do both. Those managers who think this strategy is appropriate for default investing must acknowledge the evidence that approximately 80% of participants withdraw all of their assets within a few years of the target date. Clearly for these investors, the longevity risk strategy is inappropriate. These managers should earn their QDIA status honestly and independently, on the merits of their longevity risk strategy, not on the backs of the fundamental target date strategies that they have abandoned.

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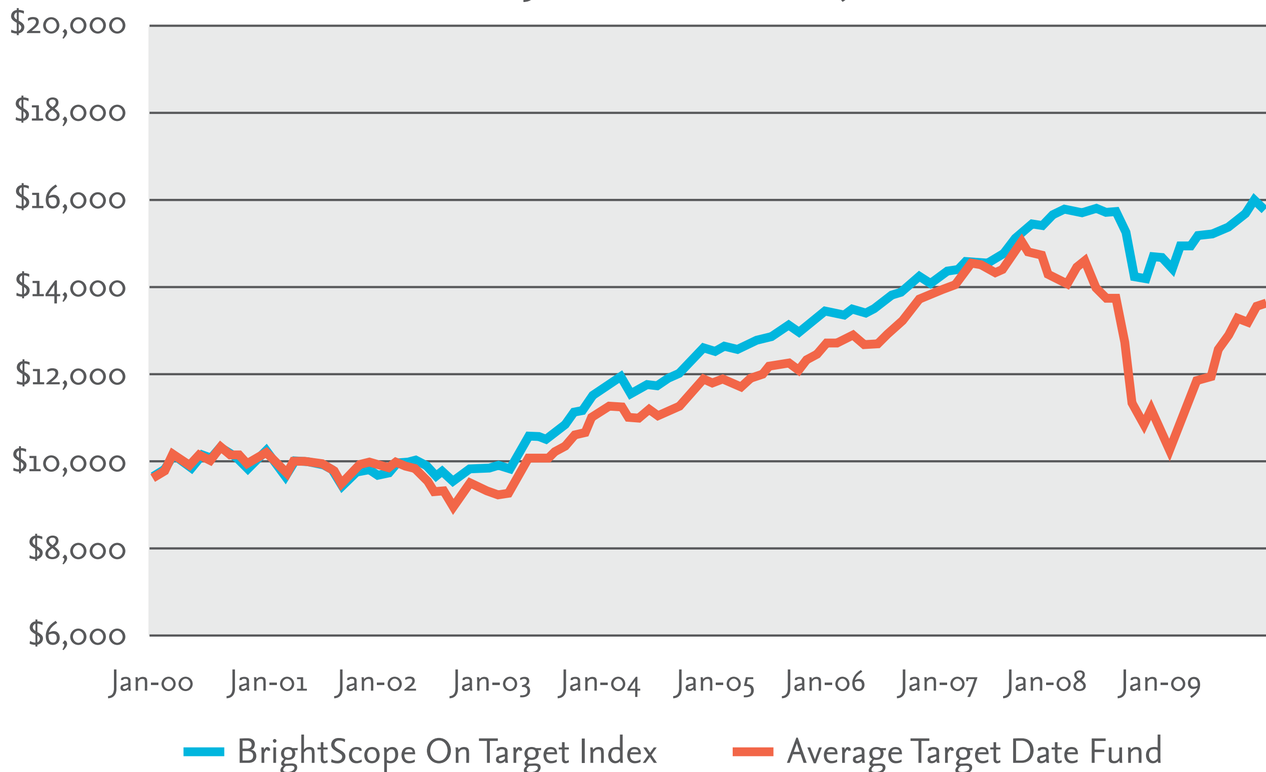

Now this aggressive and market-dominant form of target date funds has its defenders. Two sibling defenses** which we will address here are:

1. If a participant had been invested in a more aggressive 2010 fund over several years, the losses incurred in 2008 would not have erased all the gains participant enjoyed relative to a more conservative fund; and,
2. A participant in an aggressive 2010 fund who remained invested after 2008 would have recovered all his or her losses and then some because of the terrific gains in the market from its lows in the first quarter of 2009 until now.

The above chart will help us to examine the validity of both of these claims.

In this figure we chart the growth of $10,000 as managed by our index, The BrightScope On Target 2010 Index[1] (blue line), and the average 2010 target date fund[2] (red line), for the last 10 years, from January 1, 2000 until December 31, 2009. This is a particularly useful 10 years for measuring funds, covering a growth period followed by a sustained downturn, a sustained up market, a sharp drop and a final, 9-month upturn.

Please note that BrightScope On Target Index is representative of a fundamental target date strategy. We use this index because, of the major target date indices, it is the only one that retains the core strategy of rapidly and substantially reducing risk as the target date approaches. It is the only target date index that maintains a “to” the target date approach, as opposed to a “through” the target date approach. For that reason it offers an excellent benchmark against which to measure the consequences of ignoring the target date.

Also note that we use the average 2010 fund here because most target date funds, including most 2010 funds, are of the more aggressive form described above, funds which have sacrificed protection at the target date in favor of continued risk and chance of growth.

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Growth of $10,000 in 2010 Funds

Average 2010 fund vs BrightScope 2010 On Target Index Ending Values

3 Years Starting Jan 1 2007		5 Years Starting Jan 1 2005		10 Years Starting Jan 1 2000	
Avg 2010 Fd	OTI 2010 Idx	Avg 2010 Fd	OTI 2010 Idx	Avg 2010 Fd	OTI 2010 Idx
$9,907	$11,139	$11,447	$12,438	$13,728	$15,776

So let's examine the first defense of the more aggressive target date funds:

1. If a participant had been invested in a more aggressive 2010 fund over several years, the losses incurred in 2008 would not have erased all the gains participant enjoyed relative to a more conservative fund.

Well, anyone making that claim could be expected to quickly give it up after seeing the evidence presented in this chart. They will have to find other cover for their folly. There is simply no starting point in the entire eight year span prior to the market collapse in October 2007, from which an investment in the more aggressive model would have resulted in a higher balance than the index, that is, the more conservative, fundamental target date model.

For example, if two participants both started on January 1, 2000 with $10,000 invested and made no contributions or withdrawals, the participant in the aggressive target date fund (as represented by the red line) would have an ending value of $13,728 at December 31, 2009. The participant in the fund which emphasizes increasing preservation as the target date approaches (as represented by the blue line) would have an ending value of $15,776.

Consider the result if both investors started 5 years ago, instead of 10 years ago; that is, investing a single lump sum of $10,000 at January 1, 2005. The participant in the aggressive target date fund (as represented by the red line) would have an ending value of $11,447 at December 31, 2009. The participant in the fund which emphasizes increasing preservation as the target date approaches (as represented by the blue line) would have an ending value of $12,438.

And consider the result if both investors started 3 years ago, instead of 10 years ago; that is, investing a single lump sum of $10,000 at January 1, 2007. The participant in the aggressive target date fund (as represented by the red line) would have an ending value of $9,907 at December 31, 2009. The participant in the fund which emphasizes increasing preservation as the target date approaches (as represented by the blue line) would have an ending value of $11,139.

Let's examine the second claim:

2. A participant in an aggressive 2010 who remained invested after 2008 would have recovered all his or her losses and then some because of the terrific gains in the market from its lows in the first quarter of 2009 until now.

The most casual glance at the chart (Figure 1) reveals the gross inaccuracy of this claim. By September 30, 2007, our $10,000 one-time investment in the average 2010 target date fund had reached its highmark of $16,232. Seventeen months later, February 28, 2009, the portfolio had crashed 31.7% to $11,086. While its return in the following ten months, moving back up from its $11,086 trough to $13,728, at an annualized rate of return of 28.60%, is impressive, it is far short of the $16,232 required for full recovery, which would have required an annualized rate of return of 38.7% to make back its losses.

Moreover, while the BrightScope On Target 2010 Index (an index which adheres to fundamental target date strategies rather than sacrificing them in favor of amatuerish strategies to achieve questionable goals) also suffered a loss over the same period (Oct. 2007 through Feb. 2009), its loss was much less (from 16,380 to 15,534, or -5.2%). And while its rate of recovery (1.6% absolute or 1.3% annualized) did not match that of the average 2010 fund, the BrightScope On Target 2010 Index did not need to take such risks, since it had performed its primary task (which investors expected) of preserving principle as it approached the target date.

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This second issue clearly illustrates a fundamental difference in strategies. The BrightScope On Target 2010 Index follows the fundamentals of target date investment management; that is growth early in the glidepath and preservation as the target date arrives. More aggressive funds, represented by the average in our illustrations abandoned target date fundamentals in favor of the folly of using a glidepath to manage for "longevity risk." No portfolio strategy can simultaneously manage to two different dates and these managers chose the later date; but that is not target date investing, which features a focus on principle preservation as the target date nears.

And to make matters worse, the managers of the more aggressive funds ignore the harsh reality of participant and retiree behavior, which is that of lump sum withdrawal at retirement. Repeated studies find that approximately 80% of participants withdraw all of their money at or shortly after their retirement date.* So after losing in excess of 30% of their investors' retirement assets, these managers have the arrogance and insensitvity to scold the investors for withdrawing their money. Because investors withdraw their money at the target date they would never have benefited from the managers' after-the-fact defense that they would have recovered their losses had they stayed in.

CONCLUSION

Thus far, across up and down markets, the aggressive strategy has only resulted in poor long term returns.The claims that investors would have been better off had they been in the aggressive versions of target date funds before the market collapse, or if they had stayed in after the collapse, are both false.

The evidence clearly supports our contention that target date fund managers should stick to their core mandate, prudently managing participant assets during the accumulation phase, and give up the unsupportable claim that they must manage to participant death. That claim is becoming increasingly transparent as a thinly disguised justification for trying to hold on to participant assets.

ERISA Fiduciaries

Perhaps if the mutual fund managers were legally responsible as ERISA fiduciaries to their investors (mutual fund managers currently enjoy an exemption from the requirement that managers of QDIAs serve as fiduciaries, as defined in ERISA) they would take a more prudent approach to their charge. Efforts are currently underway to revoke the mutual fund exemption and much has been said about the conflict of interest inherent in "advising" a fund-of-fund structure in which all of the underlying funds are proprietary. We would like to add to the argument in favor of requiring mutual fund managers, like other managers of QDIAs, to serve as ERISA fiduciaries, by pointing out that the allocation and glidepath decisions have even more impact on the outcome than the selection of the underlying funds.

Footnotes

1. The BrightScope On Target 2010 Index is an index used to track the performance and risk of 2010 target date funds. This index is co-sponsored by BrightScope, Inc. and Target Date Analytics LLC. It is based on fundamental investment principles, focusing on the liability at the target date and is constructed of purchasable underlying funds, predominantly passive index funds. Its reported performance is net of the fees of the underlying component funds. The BrightScope On Target Index adheres to the core target date strategy of rapidly reducing market exposure(risk) as the target date approaches.
2. The "average 2010 target date fund" is simply all commercially available 2010 funds and their average performance history. The average target date fund is indicative of the latter day strategy of ignoring the date in the name of the fund, promising a target date strategy but maintaining a very high level of market exposure (risk) well beyond the target date.

Acknowledgements

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References

*For studies indicating that most participants withdraw all of their money from the plan (and the fund) at or shortly after retirement, see the following:

Lester, Anne and Santiago, Katherine, "Ready! Fire! Aim?," 2009, JP Morgan and Company

Mottola, Gary R. and Utkus, Stephen P., "Spending the nest egg: Retirement income decisions among older investors," 2008, Vanguard Center for Retirement Research, Vol. 35

2009 *Investment Company Fact Book, 49th Edition*, A Review of Trends and Activity in the Investment Company Industry, 2009, Investment Company Institute

**For examples of articles and commentaries expressing the opinion that investors would have been better off in aggressive target date funds if they had been invested either before or after the 2008 debacle, see the following:

Charlson, Josh, "A Much-Maligned Fund Group Bounces Back," FundSpy, December 31, 2009, Morningstar.com

Ackerman, Ruthie, "Are Target-Date Funds On Target?," January 7, 2010, Financial-Planning.com