# Target Date Funds: Don't Fall In Love!

By Donna M. St.Amant, MBA
Portfolio Manager
Point View Wealth Management, Inc.
June 26, 2014

Target Date Funds have been increasing in popularity and are now offered broadly within 401k and 529 plans. Money flow into these funds has continued to soar, primarily due to the ease and simplicity they offer investors who may be unsure of where to direct funds within these plans.

The name Target Date Fund (TDF) is based on the idea that money is invested with a **target date** in mind when an investor will need access to the funds. For 401ks this is typically the year of retirement or for 529s, the year a child goes to college. Investors who choose these plans do not have to select specific investments or determine asset allocation. They do not have to continually rebalance. The target date fund invests in various mutual funds with percentages dedicated to equity and fixed income that gradually shift as the fund approaches the target date. The shift from stocks to bonds over time is called the target date fund's *glide path*. The equity is typically high in the early stages when the target date is far away. The fund then automatically shifts the allocation to favor fixed income and cash, so that funds are more conservatively invested as the target date approaches.

This autopilot approach simplifies investing and eliminates the need for continuous monitoring and rebalancing. The good news is that TDFs have redirected investors, who typically stayed in low-yielding money market funds, to venture into the market and to do so with an allocation framework in place. Alternatively, investors who may have put everything in the stock market with little caution, now have a more disciplined methodology. In both scenarios, TDFs offer a more balanced approach and sounder risk management.

Though there are inherent benefits, TDFs are not a perfect solution. There are some drawbacks of which investors need to be mindful, and they may need to be modified to adapt to changes in an investor's financial position.

***TDFs follow the one-size-fits all approach***. TDFs can be a good fit when retirement is far-off, but there are many factors to consider along the way: total value of nest egg, financial commitments and medical issues to name a few. As investors approach retirement the financial picture becomes more complicated and they are more likely to need customized financial management.

***Inconsistency of Returns***. Investors will see varying returns for funds with the same target date. This is because the underlying asset mix varies greatly from one fund manager to another. As mentioned, most funds start out with a high equity allocation, but as the target date nears, the disparities among TDF glide paths become great. Some TDFs will take the equity allocation down to 20% over time while others will only lower it to 60%.

***No Guarantee***. There is no guarantee that investors won't lose money just because this critical end date is near. Performance is particularly varied during extreme market conditions. In 2008 many funds that were close to their target date took large losses when in theory they should have been invested very conservatively with a percentage of the money held in cash. In some cases there were investors holding a 2010 target date fund in a 529 plan, and after suffering 2008 stock market losses, found that 20-30% of the money needed for tuition in 2010 was gone. Investors need to dig deeper to uncover the allocation in the last few years and determine if it is the right mix for them.

***Overall Asset Allocation***. Asset allocation within the TDF is continually changing. Not only does it shift according to the fund's stated glide path, but the manager can also make adjustments to that glide path and to the underlying investments. Transparency is lacking and it can be difficult to determine the specific exposure a fund has to riskier assets. A high allocation to fixed income doesn't always mean the fund is conservatively invested. These holdings could be emerging market or high yield bond funds which have a high correlation to stocks. Furthermore, as years pass and assets grow, investors are likely to hold assets outside of the TDF. As a result it becomes burdensome to manage overall allocation prudently.

***Use of Mutual Funds.*** Another drawback of using a target date fund is that the underlying investments are mutual funds as opposed to direct holdings of stocks and bonds. From a tax perspective this gives an investor little control. Holders of mutual funds inherit the tax basis of the fund. For example if the fund purchased IBM at $95 in 2009 and sells it today at $180, your capital gain is the full $85, even though you may have purchased the mutual fund six months ago when IBM was trading at $190. When using a customized portfolio of direct holdings, the investor controls the fund turnover. Gains and losses are realized at a time that is most beneficial to the investor's unique tax situation. Portfolios are likely to have duplication of positions particularly when you hold funds in a TDF in addition to holding mutual funds in other accounts. Portfolios become over diversified and lack focus.

***Assessing Performance***. It can be difficult to assess performance against a benchmark. Funds with similar target dates on Morningstar can be used for comparison, but keep in mind the allocation of the fund under review may differ significantly from the fund on Morningstar with the same target date.

***Restricted to One Fund Manager.*** Within 401k or 529 plans, the target date funds offered are offered by a single institution or fund manager. As a result, the underlying mutual funds selected in the TDF will be from that institution. It is unlikely that all funds from one manager are strong across all asset classes. If self-selecting, it is possible to select the best funds with the lowest expense ratios, and cherry-pick from different managers.

***Fees***. Fortunately fees have come down on TDFs since they were first introduced. However, they can still vary greatly from one plan to another. Funds that use only index funds in the underlying investments can be very low cost, some below a .20% expense ratio. Others that use actively managed funds may have fees exceeding 1%. Most importantly, some managers will charge more for a fund that is part of a target date portfolio versus purchasing that same mutual fund outright. Typical 401k or 529 plans will offer TDFs, but will also offer single mutual funds outside of the TDF. Investors are advised to consider the fees for each to determine whether the TDF truly makes sense.