Skloff Financial Group

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Question of the Month

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Q: My employer automatically enrolled me in a target-date fund in my 401(k) plan. How do target-date funds function and are there any problems with them?

The Problem — Understanding the Problems with Target-Date Funds
A target-date fund is an all-in-one investment portfolio that automatically shifts its asset mix from aggressive to conservative as you approach a specific retirement year. Many 401(k), 403(b) and 457(b) retirement plan participants assume that if an employer automatically places their savings into a target-date fund (TDF) it must be a good investment. Unfortunately, there are several problems with TDFs.

The Solution — Understanding the Top 5 Problems of Target-Date Funds
Although there are more than five problems with TDFs, the top five are examined below.

1. Everyone Is the Same. TDFs assume everyone retiring in the same year has the same financial situation. TDFs ignore your: health, actual expected retirement date, risk tolerance, marital status, spouse's age and health, pension benefits and Social Security benefits. In 2026, the typical retirement plan will automatically place a 40-year-old into a Target 2050 fund – assuming you will retire in approximately 25 years, in 2050. Most TDFs are available in five-year increments.

The problem is you may not plan to retire at 65; you may plan to retire at 55. Furthermore, you may not plan to access those retirement funds until you are required to begin your required minimum distributions (RMDs). Based on your age, your RMDs may not begin until you reach age 75. A TDF does not know or care about your unique situation, it is solely based on your age and its assumption that you will retire at age 65. This can cause a large discrepancy between the current and future risk and expected performance of your investments in comparison to your unique circumstances. Not everyone is the same.

2. Not All Target Date Funds with Same Target Date Have the Same Risk Level or Shift Risk the Same Way. One company's Target 2050 fund may hold 50% U.S. stocks, 40% international stocks and 10% bonds, while another company's Target 2050 may hold 40% U.S. stocks, 30% international stocks and 30% bonds. The first fund may reduce your risk slowly, keeping your relatively high stock exposure higher for longer. The second fund may reduce your relatively low stock exposure quickly, reducing your risk too quickly.

Since neither fund takes into consideration your personal tolerance for risk, both may initially be too conservative or too aggressive, and/or leave you underexposed or overexposed to a risk level you are comfortable retaining. The incorrect risk level could result in less than expected investment performance.

3. Less than Optimal Asset and Sub-Asset Allocations. Should you have 100% of your 401(k) account assets in stocks? Should 100% of those stocks be comprised of only the largest U.S. stocks? Should 50% of your stocks be international stocks? Should your 401(k) assets be divided between 50% stocks and 50% bonds? Should 100% of your bonds be in lower yielding conservative bonds?

Since TDFs are not based on your individual risk tolerance or your return objectives, your allocations (stocks, bonds and cash) and sub-asset allocations (large, middle and small sized stocks; low yield, moderate yield and high yield bonds; and cash or no cash) are pre-determined based on your age. This means your responses to the questions above are ignored, potentially generating less than optimal asset and sub-asset allocations.

4. Target Retirement Income Funds May Be Too Conservative, Causing Longevity Risk. TDFs are often designed to transition to a Target Retirement Income fund when you reach age 65. Many Target Retirement Income funds are very conservative, with as much as 70% of the assets in conservative bonds. If you plan to live another 30 years or even longer, an overly conservative weighting in conservative bonds can lead to "longevity risk" – the risk of outliving your assets because your portfolio isn't growing fast enough to keep up with your withdrawals.

5. False Sense of Security. The 'set-it-and-forget-it' marketing pitch of TDFs can lead to complacency. You may stop checking your savings rate or overall strategy because you feel the funds do everything you need. This can lead to disappointing investment outcomes if the fund's conservative or aggressive nature has not produced the return you expected.

Action Step — Structure a Custom Designed Portfolio Based on Your Personal Situation
Your risk tolerance and return objectives may not be the same as everyone your age now or in the future. Work closely with your Registered Investment Adviser to develop the optimal portfolio based on your personal situation.

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