Target Date Funds: A 'Time Bomb' in a Retirement Tool for the Masses?

The GAO will investigate target date funds. What does that mean for the multitrillion-dollar industry?

By Ginger Szala | June 08, 2021

A letter (https://www.help.senate.gov/chair/newsroom/press/murray-scott-ask-government-watchdog-to-review-funds-responsible-for-the-retirement-security-of-millions_-) in early May from the Senate Committee on Health, Education, Labor and Pensions to the Government Accountability Office requesting that it conduct a review of target date funds raised some eyebrows in the retirement industry.

Assets in these funds, a popular qualified default investment alternative for workplace retirement plans, have grown to about $1.5 trillion in roughly 15 years. Some project the number to be as high as $2.5 trillion including private accounts.

The letter, dated May, 7, from Sen. Patty Murray, D-Wash., chair of the HELP Committee, and Rep. Bobby Scott, D-Va., chair of the House Education and Labor Committee, asked the GAO to research and answer 10 detailed questions on TDFs.

And that's not the only recent development in the TDF space. On May 24, one of the largest TDF managers, T. Rowe Price, announced a fee cut (//www.troweprice.com/content/dam/trowecorp/TRP%20TD%20Repositioning%20Final.pdf) across its suite of TDF products. The reduction, effective July 1, averages 6.3 basis points across mutual funds and 4.8 basis points across trusts.

Meanwhile, on June 1, current and former employees of Northern Trust filed an (https://www.thinkadvisor.com/2021/06/02/northern-trust-sued-over-poorly-performing-target-date-funds/) ERISA lawsuit against their firm, accusing it of loading up its retirement plan with proprietary TDFs that underperformed similar offerings from other fund managers.

TDFs have "been an ongoing issue," said Wade Pfau, professor at the American College of Financial Services, who wrote a 2013 paper with Michael Kitces on the topic, Reducing Retirement Risk with a Rising Equity Glidepath (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2324930).

"Different companies end up offering very different target date funds, and it becomes random about whether the target date fund in one's 401(k) is on the conservative side or the aggressive side," Pfau said. "This exact issue came up after the 2008 financial crisis, where some 2010 target date funds lost more than 40% in 2008, and it's not necessarily what people expect with these."

And that's a main reason that the HELP Committee requested the GAO report. In its letter to the GAO, it stated: "The employer-provided retirement system must effectively serve its participants and retirees, and we are concerned certain aspects of TDFs may be placing them at risk.

"TDFs are often billed as 'set it and forget it' investments, yet expenses and risk allocations vary considerably among funds. The millions of families who trust their financial futures to target-date funds need to know these programs are working as advertised and providing the retirement security promised."

Questions and Concerns

Meanwhile, the GAO has responded that it will proceed with the study. That said, one source was told it could take as much as a year and a half.

Several questions in the letter go beyond asking how many plan participants default into TDFs.

For example, they ask "to what extent have participants approaching retirement age who are invested in TDFs been affected by market fluctuations as a result of the COVID-19 pandemic? How much variation is there in the performance of TDFs of the same vintage (i.e., target retirement year), particularly for TDFs at or near the target retirement date? To what extent have TDF providers taken steps to mitigate the volatility of TDF assets?"

The committee also asked about asset allocation and fee structure differentials as well as shifts to more conservative investments as these funds move closer to retirement.

Another question noted a Trump-era change allowing TDFs to include alternative assets such as hedge funds and private equity, seeking to understand the number of funds that use these products and their risk level.

Finally, the committee asked the GAO to recommend what legislative or regulatory options would bolster protection of those nearing retirement but also achieve the "intended goals" of TDFs.

Performance Variation

After the 2008-2009 financial crisis, the GAO studied (//www.gao.gov/assets/gao-11-118.pdf) TDFs and found:

- A large variation in allocation between stocks and bonds closer to retirement date. Some TDFs had dropped stocks to a 35% allocation, while others remained around the 60% range "in the belief that relatively high equity returns will help ensure that retirees do not deplete savings in old age."

- Performance varied significantly. For example, between 2005 and 2009, annualized TDF returns for the largest funds with five years of returns ranged from +28% to -31%. However, the mean rate of return for all individual participants was 4.3%.
- Some plan sponsors faced challenges in the TDF selection and monitoring process.

The Department of Labor and Securities and Exchange Commission took steps to improve TDF disclosures, participant education, and guidance for plan sponsors and participants. One example cited is that regulations were proposed that participants understood there could be investment losses. The SEC also issued new advertising and sales literature disclosure requirements for TDFs.

In 2013, the Labor Department issued a fact sheet on TDFs: Tips for ERISA Plan Fiduciaries. (//www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf)

"Many plan sponsors rely upon these tips, although they are not formal legal guidance," Marcia Wagner of the Wagner Law Group told ThinkAdvisor in an email. "In 2013, the SEC's Investment Advisor Committee recommended that the SEC develop a glide path illustration for [TDFs] based on a standardized measure of risk."

Risk Equation

One issue, seen by both the committee and others, is the risk in the allocation as these funds grow close to the target retirement date. Ron Surz, president of Target Date Solutions and CEO of GlidePath Wealth Management, notes that funds from the big three TDF firms — Vanguard, Fidelity and T. Rowe Price, which he says run about 65% of the money in TDFs — have a high level of portfolio risk at the target date.

"They are about 55% of equity at the target date," he told ThinkAdvisor. "Fifty-five percent is too much for sure, but [now] 35% of bonds are risky, too. So you have 90% of risky assets at the target date. It's just a time bomb waiting to happen."

Instead, he believes these funds should follow the Federal Thrift Savings Plan, which has some $769 billion in assets and 6 million participants. The plan's lifecycle funds allocate 60% of assets to short-term government-backed securities two years before the retirement target date.

Another option would be to warn participants with better designations — fund names would include a low-, moderate- or high-risk addition, and would also help "enlighten" fiduciaries, Surz says. However, some say this isn't necessary as it's already defined when reviewing the fund data.

Pfau notes that although TDFs follow economic theory, one concern is that "there are some people who may think it's almost like a guarantee that if I'm investing in a [TDF], I can successfully retire at my target date. And of course it's just an investment account. All [a TDF] knows is the age of the participant; it doesn't know anything about their risk tolerance."

The Positives

Yet there are those who strongly support TDFs, including Christine Benz, Morningstar's director of personal finance. In a recent column (https://www.morningstar.com/articles/1034854/in-praise-of-target-date-funds), she cited three key reasons these funds work: 1) They allow investors to be truly hands-off, 2) they provide cost-effective advice and 3) they contribute to a good outcome. She believes they are underutilized in 401(k) plans and says they would work just as well in IRAs. (Here's a ranking of the top TDFs (https://www.morningstar.com/articles/1029667/the-best-target-date-funds-for-2021-and-beyond) by Morningstar.)

Benz was backed up further by her colleague John Rekenthaler, vice president of research for Morningstar, who in a May 20 column (https://www.morningstar.com/articles/1040464/the-latest-attack-on-target-date-funds) took to task a study (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3729750) that criticized TDFs. He argued that TDFs are "relatively cheap."

For instance, the median annual expense ratio for a 2035 TDF, including all underlying fees, is 0.65%, while for their closest investment rivals, it's 1.01%. "Across the board, they cost substantially less than does the typical allocation fund," he said.

And the price is getting lower, at least with T. Rowe Price's recent fee cut. The firm responded to ThinkAdvisor that its "recent reduction in fees for Target Date Funds and Trusts was a business decision the firm made unrelated to the [congressional] inquiry.

"Over the past two decades we've made continued strategic enhancements to our target date solutions and this update is a continuation of those efforts," it stated in an email.

But many believe the congressional inquiry is a good one.

Pfau said that "the [HELP] letter made sense." Congress sees that TDFs are growing in popularity, but it wants to know more about their growth, fees and asset allocation.

"The whole idea of the target-date fund is you can have more volatility when you're young, but when you're getting closer to the target date, you want to start locking in with a lower stock allocation and have less volatility," he said.

"And now with some of the new trends towards alternatives and different asset allocation approaches, is that creating more volatility around the target date in a way that users of [TDFs] don't really expect?" Pfau said. "They're expecting that [TDFs are] giving them a safer, less volatile portfolio at the target date."

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