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Forget Target-Date Funds

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Target-date funds are on the march. These increasingly popular retirement vehicles adjust their portfolios over time, so they are stock-heavy for the young and move more into bonds as investors age. There are problems with them, though, that few understand.

These instruments focus on growing your assets early and shifting to a safer mix by your retirement – the target year when you quit working. Target-date funds are getting a lot of notice.

A July 9 article in the *Wall Street Journal* described how different target-date issuers, ranging from T. Rowe Price to Fidelity Investments, make the transition from equities to bonds at different rates. That move is called the “glide path” in mutual fund-speak. At your retirement year, some leave you with more stocks than others do.

Here are two of the key points, quoted from the WSJ piece:

[M]oney is flowing into target-date funds at a brisk pace. Their assets now total around $400 billion, more than five times the amount at the end of 2005, according to Morningstar.

In 10 years, target-date funds could represent half of all the assets in U.S. 401(k) plans and other defined-contribution plans, says David Bauer, a partner at asset-management consultant Casey, Quirk & Associates, Darien, Conn.

The idea makes sense on the surface: Older investors closer to withdrawing 401(k) money can't afford to sustain large losses so target-date funds naturally get more "conservative" at their stage in life. However, in practice this doesn't work for a number of reasons:

1. Life expectancy is too long for you to trust a target-date fund as the panacea to your retirement financing. If I retire at 65 and have all my

money invested "conservatively," I could still live another 30 to 40 years. Add inflation into the mix and this is a recipe to run out of money.

2. What is conservative? Is investing a bunch of money into bonds at these yields conservative? I don't think so. Long-term interest rates can't go much lower but they can go a lot higher. And they inevitably will. When rates climb, bond prices go down much more. So that conservative, bond portion of your 401(k) will shrink in value.

3. Nobody should subject their portfolio to large losses, at age 65 or 20. That is why, for the average investor, nothing significant ever happens with their money. They get good returns in the up years, then give it all back and then some in the down years.

4. The market doesn't care how old you are. Moving money based on your age makes no sense. You should move it based on market dynamics. In a period like 1995 through 1999, when making money in the market was easy, a 65-year-old had just as much a right to earn 30% a year as a 30-year-old did. During the 2000-2002 and 2008 downturns, a 30-year-old had just as much right to be protective as a 65-year-old.

The better answer is to arrange your portfolio so it has good assets that are appreciating. If they are ascendant, buy them. When they flag, sell them and buy the new winners. This is called Tactical Asset Allocation, which I have written about. You can do this yourself, or with the help of a good financial advisor. You don’t need a target-date fund to do to for you.

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