
MUTUAL FUNDS

# Target-Date Funds Can Pose Complexities

By TIM GRAY JAN. 9, 2015

Deborah L. Lemmerman, vice president for human resources at Hebrew SeniorLife in Boston, believes in the benefits of target-date retirement funds. Over the last 15 years, in her current post and in previous ones, she has seen employees embrace these investments.

At Hebrew SeniorLife, a nonprofit organization providing housing and health care for the elderly, about 30 percent of the assets in its retirement plan are invested in such funds. Ms. Lemmerman also invests in target-date funds herself.

The reason for this popularity? Simplicity, she said.

Employees just pick a fund based on their expected retirement year; typically, the funds are offered in five- or 10-year increments: 2015, 2020, 2025 and so forth. The fund's manager then adjusts the underlying investments as that year approaches, typically decreasing the portion of stocks and increasing the portion of bonds and other kinds of investments.

As an adage in the mutual fund industry goes, a shareholder in a target-date fund can just set it and forget it.

But while the ease is appealing, it can obscure complexities and risks, investment experts say. Target-date funds can allocate their customers' retirement savings to a sometimes bewildering array of securities and use a variety of investing strategies and glide paths, as the gradual asset allocations are known. Overlooking that diversity is like ignoring the differences among a beagle, a bloodhound and a bull mastiff.

"Target-date funds are conceptually simple, but there are few constraints on how they have to be designed, so you end up with lots of different approaches," said Jonathan M. Reuter, a finance professor at Boston College's Carroll School of Management. "There has been a movement, for example, by firms to broaden what it means to invest in equities. Some companies' definitions have expanded to include commodities as well as real estate and emerging-market equities. And managers, in taking that broader view, are often adding risk to the portfolios."

In a recent study of target-date funds, or T.D.F.s, Professor Reuter and another Boston College professor, Pierluigi Balduzzi, documented a wide range of returns and risks across funds intended for people retiring the same year.

In 2008, for example, when the Standard & Poor's 500-stock index fell by 38.5 percent, an Oppenheimer fund designed for 2010 retirees fell by 41 percent, while a 2010 Wells Fargo fund lost only 11 percent. (Full disclosure: I'm a part-time adjunct professor at Boston College.)

The professors attributed their findings partly to efforts by newer funds to distinguish themselves in a crowded market. Some funds bet more heavily on riskier fare, such as investments in stocks of small-capitalization companies and emerging markets, they said.

"If regulators had assumed that T.D.F.s with the same target date would provide investors with the same exposure to risk, they were mistaken," the scholars wrote.

Target-date funds can be hard for nonprofessionals to evaluate, Professor Reuter said. Typically, one would be structured as a fund of funds — that is, a fund that invests in a group of underlying funds. So, to assess one, you also have to examine its component funds.

In general, T.D.F.s based on index funds, rather than actively managed funds, are less risky, he said. Likewise, cheaper funds also tend to be have lower risk. "More expensive T.D.F.s tend to invest in more expensive underlying active funds, which tend to focus on riskier asset classes," he said.

Consumers certainly have plenty of options — and plenty of investment approaches — to choose among. A recent Morningstar report on the sector included 36 fund companies.

Some target-date funds, like those offered by Vanguard, invest passively, trying to replicate the broad stock and bond markets' returns. Others, like those offered by T. Rowe Price and American Funds, invest actively

Some funds stick mostly with stocks, bonds and cash. Others include more exotic offerings like commodities, hedge funds, private equity and direct investments in real estate.

The diversity of T.D.F. investment approaches reflects differences in philosophies among investment companies, said Christopher L. Jones, chief investment officer at Financial Engines, a company in Sunnyvale, Calif., that advises participants in 401(k) plans and similar retirement accounts. (Financial Engines is retained both by employers and investment companies that administer retirement plans. Its clients include Fidelity, T. Rowe Price and Vanguard.)

A greater variety of securities isn't necessarily better, Mr. Jones cautioned. "Most individuals don't need additional exposure to commodities and real estate," he said. A "lot of these more esoteric investments just add cost without adding significant benefits."

Managers of funds that invest in less-common sorts of securities offer a different view. Their reasoning tends to boil down to a single word: diversification. By spreading their bets more broadly, they say, they better insulate their funds from losses in any particular asset class.

Vineer Bhansali, a managing director at Pimco who oversees the company's target-date funds, said his company includes commodities in its T.D.F.s because they tend to perform well during periods of high inflation, while stocks and bonds don't. Thus the Pimco RealRetirement 2015 fund had invested 2 percent of its assets in commodities at midyear 2014 and can invest as much as 10 percent in them.

Pimco's funds also typically include smaller allocations of stocks and bigger ones of bonds than the typical target-date fund, according to Mr. Bhansali. Many funds invest too much in stocks and so expose their customers to the possibility of big losses when the stock market sinks, he said.

"We're trying to provide protection against shocks and high inflation," he said. Over the three years through 2014, Pimco's 2015 fund returned an annualized average of 4.55 percent, compared with an annualized average of 7.54 percent for its average Morningstar peer.

The managers at Manning & Napier can use an even more unusual security: single-stock options, a kind of derivative. They do this to try to earn extra return for their shareholders, said Jeffrey S. Coons, the company's president and co-director of research.

If you're investing in stocks, as the fund managers at Manning & Napier also do, you have to determine prices at which you're willing to buy and sell, he said. Incorporating stock options is similar: You're just selling someone else the right to buy a stock from you, or sell it to you, at a particular price. When an option pays off, "you're earning an additional premium to something you'd be doing anyway," he said.

At the end of November 2014, alternative strategies like options writing accounted for about 4 percent of the assets invested in Manning & Napier Target 2015 Series fund. The K shares of the fund, which began in 2012, returned 3.54 percent last year, compared with 4.89 percent for its average Morningstar peer.

Even more varied in their investment approaches are T.D.F.s offered by Principal Funds. Their managers' menu of choices includes timber, infrastructure, master limited partnerships that invest in oil drillers and transporters, and long-short strategies. Such a big tool kit gives the potential for protection in a greater variety of market and economic environments, said Jeffrey R. Tyler, a Principal vice president and portfolio manager.

As people get close to retirement, for example, they tend to worry more about inflation eating away at their savings. "So you want to manage against inflation risk, and we use real assets like timber to provide that," Mr. Tyler said.

More complicated approaches, however, tend to bring higher costs. The retail share classes of Pimco's, Manning & Napier's and Principal's target-date funds carry expense ratios above 1 percent; by comparison, the Fidelity Freedom Index funds have a ratio of just 0.16 percent, The average asset-weighted expense ratio in Morningstar's recent report was 0.84 percent.

"Generally, the rule is cheaper is better," said Janet Yang, Morningstar's director of multiasset strategies. "Fees are the aspect of your performance that you can control."

In 2006, Congress passed a law that enabled target-date funds to become default investment options in employee-directed retirement accounts like 401(k) plans. The funds have surged in popularity since. Morningstar's report found that in 2013, T.D.F.s accounted for a third of new assets flowing into the mutual funds of companies offering them.

Fidelity, T. Rowe Price and Vanguard together control three-quarters of the assets in target-date funds, Morningstar said.

The offerings range from Vanguard's straight-ahead simplicity — its T.D.F.s invest in five of its index funds — to Fidelity's host of options. Fidelity T.D.F.s can invest in more than 20 Fidelity funds, including commodity and emerging-market debt offerings.

In 2012, Vallapuzha Sandhya wrote her dissertation at Georgia State University on target-date funds. Today, she follows them as a researcher for

Financial Engines. She said she feared that the default rule, combined with the set-it-and-forget-it nature of T.D.F.s, might have made investing in them too easy and lulled people into ignoring the risks.

"A T.D.F. can do a lot of work for you," Ms. Sandhya said, "but you can't rely on it blindly."

MS. LEMMERMAN at Hebrew SeniorLife agreed but said that, at least in retirement plans, investors should be getting help from their employers. A plan sponsor is supposed to vet any investment before making it one of its retirement-plan options.

She also said she had seen an unexpected benefit of target-date funds through her own investing: Her Vanguard funds had helped her to become more patient with her retirement money, particularly during the stock market's plunge in 2008.

"I didn't touch my target-date funds then," she said. "I knew that I was in them for the long run and that professionals were deciding how to invest for me. Where I do give more input, with my other investments, I was more concerned. I stopped putting money into equities for a while, but I left the target-date funds alone."

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