



## Target-date funds under the microscope

Regulators to examine funds' pitfalls -- of which there are many, some experts say

By [Robert Powell](#), MarketWatch  
Jun 4, 2009, 11:57 a.m. EST

**BOSTON (MarketWatch) -- Target-date funds, once considered the be-all, end-all mutual-fund product for investors who don't have the time or inclination to build their own retirement portfolios, are about to be scrutinized by federal regulators. Given the rising popularity of these funds and their dismal performance last year, that's a good thing.**

The witnesses, who must submit requests to testify by June 5, will address how target-date fund managers determine asset allocation; how they select and monitor underlying investments; the extent to which risks are disclosed to investors and the adequacy of that disclosure; and the approaches or factors to compare and evaluate target-date funds.

In short, EBSA and the SEC want to learn what's working with these funds, what's not and what, if anything, needs to be changed. They want to figure out what new regulations or laws might be needed to protect investors who think they're buying one thing -- safe asset allocation -- but get something entirely different -- volatile funds that declined in value anywhere from 4% to 41% last year.

Target-date funds are mutual funds that invest in a pre-arranged mix of stock, bond, and money-market mutual funds, usually from the same fund family. Target-date fund managers typically use time horizon rather than risk tolerance or investment objective to determine the fund's asset allocation. Typically, the longer the target date, the more the manager invests in stock funds. As the fund gets closer to its target date, managers adjust downward -- based on a pre-arranged "glide path" -- the percent invested in stock funds.

But what do the experts who will likely testify at the upcoming hearing have to say about target-date funds? Some say it's too soon to say anything conclusive about these products. Others say the funds' overall performance proves a one-size-fits-all product simply won't work, and still others say a nip here and a tuck there could make these funds work. Read comments on Labor Department site from those who are requesting time to testify at the hearing.

### What's working?

Under the Pension Protection Act of 2006, 401(k) plan sponsors -- that is, employers -- can automatically enroll employees into qualified default investment alternatives or QDIAs, including target-date funds. For those workers who weren't contributing to their 401(k), automatic enrollment and contributions to target-date funds are better than not investing, say some experts.

Ditto for older workers who invest in target-date funds of their own volition. Before target-date funds came along, many plan participants, especially those within 10 years of retirement, typically invested too much of their money in stock, said Jack VanDerhei, research director at the Employee Benefit Research Institute.

In fact, VanDerhei said some studies showed older plan participants investing anywhere from 70% to 90% of their money in equities. By contrast, the average 2010 target-date fund today might have about 50% invested in stocks, a much more prudent allocation for someone on the cusp of retirement, he said.

"Target-date funds seem to do a good job of taking plan participants away from extreme equity positions, of having either too little or too much invested in stocks," he said.

Others agree. "Target date funds improve the performance grade of most investors from an 'F' to a 'C,'" said Aaron Skloff, a chartered financial analyst and chief executive of Skloff Financial Group.

Still, he and others said much is not working when it comes to these funds.

### **Perception is not reality**

One big problem with target-date funds: You typically buy a fund whose target date most closely matches your projected year of retirement. If you plan to retire in 10 years, you would buy a fund with 2020 in its name. But even though these funds might have the same date in their name, few fund managers take the same approach when it comes to asset allocation and glide path. One fund might have 20% in stocks while another with the same target date might have 40%.

That problem came home to roost last year. Folks on the cusp of retirement who purchased 2010 funds apparently assumed that such funds would have little or no assets invested in stocks, but they got a rude awakening: The average 2010 fund fell 23% in 2008, according to Ibbotson Associates, and things haven't been much better this year, with the average 2010 fund losing 4.7% in the first quarter.

"The market's recent upheaval is a potent reminder that target-date funds for retirees or near-retirees are neither risk-free nor a guaranteed source of income, no matter how conservatively they may be positioned," Morningstar analyst Michael Herbst wrote in a recent report.

Others say that many target-date funds, not solely those dated 2010, are investing far too much in stocks because underlying investment theories are flawed.

"The 2008 failure is primarily attributable to the flawed investment theories much more so than failure of asset allocation," Louis Harvey of Dalbar wrote in a report that he plans to submit to EBSA.

### **Mediocre funds**

Another problem, Skloff said, is that "many mutual fund companies load their target-date funds with mediocre offerings," he said. "Something they might not like you to know is [their] lack of need to place their best-performing mutual funds inside of a target-date fund, as the best-performing funds are already attracting plenty of assets. The mediocre funds need to attract assets to make them more profitable."

The list of things that are wrong with target-date funds is much, much longer.

But experts also say there are ways to change things for the better.

### **More education required**

VanDerhei suggests that much more education is needed for plan participants who invest in target-date funds. According to VanDerhei, plan participants seem to getting much of their information from co-workers rather than fund managers.

### **Customized funds**

Ideally, Skloff said, plan sponsors should be customizing target-date funds so that plan participants can use the best-of-breed funds from many different fund families. "This would avoid the conflict of interest the mutual-fund company would have in loading its TDF with mediocre, proprietary selections," he said.

### **Managed accounts**

Jason C. Roberts, a partner with Reish Luftman Reicher & Cohen, said one-size-fits-all funds serve no one well. "We have come a long way to come back to what we knew at the start," he said. "Investment decisions require a great deal of unique input."

Roberts is calling for the increased use of what he calls independent "asset allocators," advisers who can custom-build 401(k) and IRA portfolios to the unique needs of each person.

On June 18, watch a live Webcast of the hearing at this site.

*Robert Powell has been a journalist covering personal finance issues for more than 20 years, writing and editing for publications such as The Wall Street Journal, the Financial Times, and Mutual Fund Market News.*