A Second Look at How Target Date Funds Change Their Allocations

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Article Highlights

- Target date funds are designed to evolve their allocation over time to help a person invest for a projected retirement date.
- While these funds' allocations usually become more conservative over time, one target date fund has boosted its exposure to stocks over the past few years.
- The allure of target date funds is that they can be used as a sole investment in a retirement savings account, but investors could create their own diversified portfolios instead.

Target date funds offer the premise of a one-stop solution for investors seeking professional allocation strategies.

They are commonplace in 401(k) and other similar employer-sponsored retirement plans (aka, defined-contribution plans). According to Vanguard, 88% of defined-contribution plan sponsors offer target date funds. Furthermore, four in 10 participants in a defined-contribution plan using Vanguard funds solely owned a target date fund in their workplace retirement account at the end of 2014 ("How America Saves 2015").

The simplicity of target date funds' premise is one reason why. A second significant factor is that these funds are default options in many workplace retirement plans. Many employers use target date funds as the default investment alternative for new defined-contribution plan enrollees. Similar to auto-enrollment (employees are automatically enrolled into the retirement plan, often with a starting default contribution rate equal to 3% of an employee's gross salary) and auto-escalation (the contribution rate is automatically increased each year and/or at the time a raise is given), employees have the ability to choose a different option. Many don't.

Despite this growth, there remains confusion about how to use target date funds. Financial Engines found that 62% of investors who only partially allocate to target date funds do so to "avoid 'putting all their eggs in one basket,'" even though most understood that target date funds were diversified investments ("Not So Simple: Why Target-Date Funds Are Widely Misused by Retirement Investors," March 2016). A survey by Voya Investment Management revealed similar behavior, with 46% of target date fund users listing diversification as a reason they use other investment options in addition to target date funds ("Participant Preferences in Target Date Funds: Fresh Insights," January 2016).

Given this backdrop, it seemed warranted to revisit target date funds and provide an update to my October 2012 article, "Target Date Funds: A Simple Premise, but Underlying Complexities." In doing, some changes came to light.

Target Date Funds: A Brief Explanation

A target date fund is a fund designed to evolve its allocation over time to help a person invest for a projected retirement date, as well as for a period afterward. The targeted retirement date is stated in the fund's name—for example, the Fidelity Freedom 2020 fund (FFFDX) is designed with a target date of 2020. An investor planning to retire in 2020, or within one or two years of that date, would consider investing in this fund. A younger investor—say, someone who is currently in their 30s—may prefer a 2050 or a 2055 fund. These funds' target dates coincide approximately with the time the younger investor will reach the age of 70.

As the projected retirement date moves closer, target date funds change their composition to adjust the level of risk the fund sponsor believes shareholders should be taking. The actual allocation and how often the allocation changes varies from fund to fund. Furthermore, at the target date, a fund can either adopt a final allocation strategy or continue to evolve.

Target date funds are funds of funds. Instead of holding individual securities, they hold shares in other funds in the same family. T. Rowe Price's target date funds, for instance, invest in other T. Rowe Price funds. This allows the target date fund manager to focus on making allocation decisions instead of also having to consider what securities should be held. The downside is that an investor has no control over the funds chosen, is locked into the target fund's family and may experience an inappropriate level of price volatility (either too little or too much, given personal financial needs and emotional tolerances).

The basic premise of target date funds is that the investor does not need to do anything but save for retirement. A single target date fund takes care of all of the allocation and diversification decisions. As such, for an investor who wants a portfolio tailored to an expected retirement date, a single target date fund can do the job. The portfolio is diversified and professionally managed. Plus, no other fund needs to be purchased unless the investor specifically wants more return or more income than the target date fund offers.

Table 1. 2020 Target Date Fund Current Allocations

Fund	Stock (%)	Bond (%)	Other (%)	Cash (%)
Fidelity Freedom 2020 (FFFDX)	65.3	30.4	0.0	4.3
Schwab Target 2020 (SWCRX)	51.4	40.5	0.9	7.3
T. Rowe Price Retirement 2020 (TRRBX)	61.1	36.0	0.4	2.6
USAA Target Retirement 2020 (URTNX)	38.0	59.0	0.0	3.0
Vanguard Target Retirement 2020 Inv (VTWNX)	59.4	40.6	0.0	0.0
Thrift Savings Plan L 2020*	45.5	5.5	49.0	0.0

**Holds a 49% allocation in the G fund, which invests exclusively in a non-marketable, short-term U.S. Treasury security that is specifically issued to the Thrift Savings Plan.*

Source: Mutual fund and Thrift Savings Plan websites. Data as of 4/30/2016, except for Fidelity, which is as of 3/31/2016.

Table 2. 2020 Target Date Fund Final Allocations

Fund	Stock (%)	Bond (%)	Other (%)	Cash (%)
Fidelity Freedom 2020 (FFFDX)	24.0	46.0	—	30.0
Schwab Target 2020 (SWCRX)	25.0	66.0	—	9.0
T. Rowe Price Retirement 2020 (TRRBX)	20.0	80.0	—	—
USAA Target Retirement 2020 (URTNX)	30.0	60.0	—	10.0
Vanguard Target Retirement 2020 Inv (VTWNX)	30.0	70.0	—	—
Thrift Savings Plan L 2020*	20.0	6.0	74.0	0.0

**Will hold a 74% allocation in the G fund, which invests exclusively in a non-marketable, short-term U.S. Treasury security that is specifically issued to the Thrift Savings Plan.*

Source: Mutual fund and Thrift Savings Plan websites.

Allocation Strategies

Target date funds adjust their strategies by maintaining a higher allocation to stocks for longer-dated funds and a smaller allocation to stocks for shorter-dated funds. This can most clearly be seen when comparing target date funds offered by the same fund family. Vanguard Target Retirement 2015 (VTXVX) has 46.9% of its portfolio allocated to stocks and 53.1% allocated to bonds. (In 2012, the mix was 55.8% stocks and 44.2% bonds.) Conversely, Vanguard Target Retirement 2035 (VTTHX) has 80.8% of its portfolio allocated to stocks and 19.2% allocated to bonds. (The previous mix was 86.5% stocks/13.5% bonds.) Notice two fund characteristics in these numbers. First, the 2035 fund has a bigger exposure to stocks, reflecting the longer time period until its target date is reached and therefore the ability of its shareholders to withstand greater price volatility in exchange for potentially higher returns. Second, the allocations of both strategies have become more conservative, in part reflecting a "gliding down" of equity exposure as the respective target dates grow closer. Co-managers William Coleman and Walter Nejman took over both funds in 2013.

Whether the respective exposures to stocks are appropriate is a subject of debate. The less-than-50% allocation to stocks for the 2015 fund could be justified on the basis of the greater need of recent or soon-to-be retirees for income-producing investments. On the other hand, a retiree in good health could conceivably be looking at 30 or more years of life. This increases the need for long-term portfolio growth and, therefore, a bigger exposure to stocks.

The lack of a clear consensus on the proper allocation strategy can be seen in Table 1 and Table 2. These tables show how the current and final allocation strategies vary for 2020 target date funds from various fund families. Each of these assumes a shareholder will retire in 2020. (Typically, target date funds are offered in five-year increments.) The number of funds displayed were largest for this category in 2012, and I have maintained the list to provide comparisons between then and now. I've also included the L 2020 fund from the federal government's Thrift Savings Plan (TSP) due to previous requests from AAII members.

The allocation strategies of target date funds are commonly divided into a "to" or a "through" approach. A "to" approach adjusts the allocation up to a target date, at which time it becomes finalized. A "through" approach continues to adjust the allocation past the target date. The amount of time the fund glides and what its final allocation is varies, however.

Not only do the current and ending allocations matter, but the speed at which each fund reaches its final allocation also matters. The Vanguard fund has a shorter glide period than the Fidelity fund. The Vanguard fund will reach its final allocation by 2027, versus 2030 to 2039 for the Fidelity fund. A shorter glide path and a larger allocation to bonds causes a fund to be more conservative more quickly than its peers. This may be a plus for someone with a shorter expected life span and/or greater cash needs earlier in retirement, but it can be a negative for someone with a longer expected life span and/or less need for cash early in retirement. The ideal strategy provides a person the right amount of money to fully fund retirement and no more beyond what is desired to be bequeathed.

You can find out how the allocation of a target date fund evolves over time and what happens to the allocation at and after the target date by reading the fund's prospectus.

What's Changed?

Allocations Have Evolved

Five of the six funds made changes in alignment with a downward glide path toward a more conservative portfolio mix. Table 3 shows how each fund's allocation has changed between 2012 and 2016.

The USAA fund has had the lowest equity exposure of the group. With a current 38% allocation, it continues to do so. The fund will have a 30%/60%/10% stock/bond/cash allocation by 2020 and is gliding toward that conservative allocation. The Thrift Savings Plan rebalances all of its L funds quarterly, with the rate of change accelerating as the retirement date approaches. Vanguard's prospectus calls for its 2020 fund to reach a 30%/70% stock bond mix by 2027, a sizeable change from its already reduced 59%/41% stock/bond mix.

The one notable exception to the group is Fidelity's Freedom 2020. This fund's equity allocation increased from 48.9% in 2012 to 65.3%. Part of the reason for its comparatively aggressive stance is that Fidelity incorporates financial market forecasts into its allocation strategy. Changes in anticipated 20-year return, risk and correlation (the extent to which different asset classes experience similar or different returns) will alter the firm's allocation strategy for its target date funds. The fund's prospectus also allows a considerable variance in the timing at which the ending allocation will be reached: "approximately 10 to 19 years after the year 2020." In other words, the Fidelity fund can be regarded as following the most tactical strategy of the aforementioned funds. This creates the opportunity for higher returns and the risk of lower returns.

No More Target Date ETFs

One fund discussed in the October 2012 article is no longer in existence: the exchange-traded fund (ETF) iShares Target Date 2020. Blackrock's iShares division liquidated its series of target date ETFs in October 2014. The ETFs never reached the popularity their mutual fund counterparts have.

There are a few reasons why. Workplace retirement plans are intended to be longer-term in nature. Default allocation strategies exist in defined-contribution plans; no such alternative exists in the brokerage accounts. Target date funds are suitable for individuals seeking to hand over control of how their portfolio allocations are managed. Institutional managers, conversely, don't have retirement dates and directly hire one or more managers to make these decisions; hence, they don't share the same need for target date funds.

Annuities Allowed Under Certain Circumstances

In late 2014, the Internal Revenue Service issued guidance allowing the inclusion of annuities in target date funds offered in qualified defined-contribution plans. Such funds must have age restrictions, limiting who can invest in them. This ruling allows a target date fund to transform into a lasting source of cash flow at retirement in the form of an annuity.

This option is only available in specific employer-sponsored plans, however. Those with this option should read the prospectus and plan materials carefully to fully understand the contract terms and what fees may be involved. For more about the ruling, see the Briefly Noted section of the December 2014 *AAII Journal* ("Annuities Now Allowed in Target Date Funds").

Table 3. Changes in 2020 Fund Allocations From 2012

Changes in each fund's allocation between 8/31/2012 and 4/30/2016 (3/31/2016 for Fidelity)

Fund	Stock (%)	Bond (%)	Other (%)	Cash (%)
Fidelity Freedom 2020 (FFFDX)	16.4	(6.1)	(0.8)	(9.4)
Schwab Target 2020 (SWCRX)	(8.9)	6.2	0.1	2.7
T. Rowe Price Retirement 2020 (TRRBX)	(8.4)	11.9	(0.5)	(2.9)
USAA Target Retirement 2020 (URTNX)	(2.7)	10.2	(2.5)	(5.0)
Vanguard Target Retirement 2020 Inv (VTWNX)	(5.4)	10.0	(1.5)	(3.1)
Thrift Savings Plan L 2020*	(9.0)	(1.8)	10.8	0.0

**Holds an allocation in the G fund, which invests exclusively in a non-marketable, short-term U.S. Treasury security that is specifically issued to the Thrift Savings Plan.*

Source: Mutual fund and Thrift Savings Plan websites and "Target Date Funds: A Simple Premise, but Underlying Complexities," AAII Journal, *October 2012.*

How Do You Choose?

Though target date funds simplify the process of investing before and in retirement, there are still decisions that need to be made on the part of the investor. They are: how much volatility is acceptable in the years leading up to and at the retirement date, and the post-retirement allocation that an investor believes will be appropriate.

The intended retirement date will influence the "year" of the target date funds to choose (e.g., 2020, 2025, 2030, etc.). For example, say you plan to retire in 2020. This would make a 2020 fund the seemingly obvious choice. However, if you do not expect to be reliant on your portfolio for retirement income—thanks to a pension or other sources of income—you could choose to go with a 2025 or later-dated fund instead. A later-dated fund will give you a greater allocation to stocks at retirement and thereby more long-term growth. On the flipside, if you don't think you will be able to withstand a bear market near your retirement date, you should consider a shorter-dated fund. Such a fund will have a smaller allocation to stocks on your retirement date, reducing downside risk and providing more portfolio income.

The trade-off for choosing a fund with a date that precedes or occurs after your retirement date is that you are either giving up potential portfolio growth or risking more market volatility by picking a later-dated fund. There are always trade-offs in investing and while target date funds offer the allure of simplicity, they do not negate the tough decisions that an investor has to make.

Once the date for a fund is selected, the next step is to select an allocation glide path if there is a selection of fund families to choose from. As previously shown, each fund family has its own strategy for gliding to the final portfolio allocation. Vanguard evolves to the conservative allocation within seven years of retirement; T. Rowe Price takes 30 years. The Vanguard strategy will give you a more conservative, income-producing strategy sooner in retirement. The T. Rowe Price strategy will give your portfolio more opportunity to grow at a rate faster than inflation during your retirement years.

None of these funds moves out of stocks completely during retirement. Rather, it is the pace at which they reduce the exposure to equities in retirement that differs. It is up to each investor to determine their own comfort level.

Performance and expenses do matter, but both are influenced by the size of the equity allocation. A higher comparative allocation to stocks will give better long-term returns, but will also increase risk. Greater bond exposure can increase costs, but reduce volatility.

Do You Need a Target Date Fund?

Setting aside questions about whether target date funds use the most optimal allocation strategies—beyond the scope of this article—the biggest downside to them is the lack of customization. Shareholders in these funds are locked into specific fund families. They are also locked into allocation ranges based on planned retirement ages.

So-called robo-advisers offer an alternative. These online advisory services provide tailored allocations for a fee. They commonly recommend portfolios composed of exchanged-traded funds. Robo-advisers are relatively new, however, and their long-term success remains to be seen. An extensive overview of these services was provided in the January 2015 *AAII Journal*: "What Exactly Do Online Investment Advisory Services Offer?" These are not an option in employer-sponsored retirement plans, such as 401(k) plans, however.

You could also simply create your own portfolios or securities and adjust your allocations as you see fit. This requires determining the proper allocation and selecting funds or securities that match your needs. Besides control and customization, this method allows investors to choose the best fund or securities for each category, as opposed to relying on a pre-specified set of funds.

Following this approach requires more involvement. Not only must performance be monitored, but you will also need to make allocation decisions regarding the portfolio. A strategy must also be developed for ensuring that enough cash flow is realized by the portfolio to fund retirement withdrawals and living expenses. In addition, when the allocations stray too far from their desired range, you will need to adjust them. Failure to do so can lead to increased volatility. Finally, exposure to stocks must be maintained no matter what the market is doing, something that is often easier said than done.

The answer ultimately depends on whether you want a simplistic but less customized solution or are willing to handle some complexity and extra effort to achieve greater customization. There is no universal right answer. You will need to determine what makes the most sense for your personal situation. ➤

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