# TARGET-DATE FUNDS MISS THE MARK

## EXAMINING THE PERILS OF THIS POPULAR "SET IT AND FORGET IT" INVESTMENT

SAM


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> “I can't believe that the great mass of investors are going to be satisfied with receiving just average returns.”[1]

This was the thinking of Fidelity Chairman and billionaire investor Edward Johnson when the first index mutual fund was launched with little fanfare in 1976. He was not alone. Plenty of other notable investors over the years have predicted that such a product was doomed to failure. History has thus far proven otherwise.

It’s no secret that investment capital has flooded into “passive” investment vehicles. It’s not a fad. It’s a well-established trend. Index funds already account for more than half of the equity investments in the United States.[2]

Frankly, that’s fine by us. The stronger the “trend toward mindless investing” (as legendary hedge fund manager Seth Klarman called it)[3], the more inefficient the markets become. That means greater mispricing and more opportunities for active managers like us at Stansberry Asset Management (“SAM”).

But while today is passive investing’s moment in the sun, there is one variety of actively managed funds that has seen exponential growth over the past decade. Ironically, they can be some of the worst funds for investors. We’re talking about target-date funds.

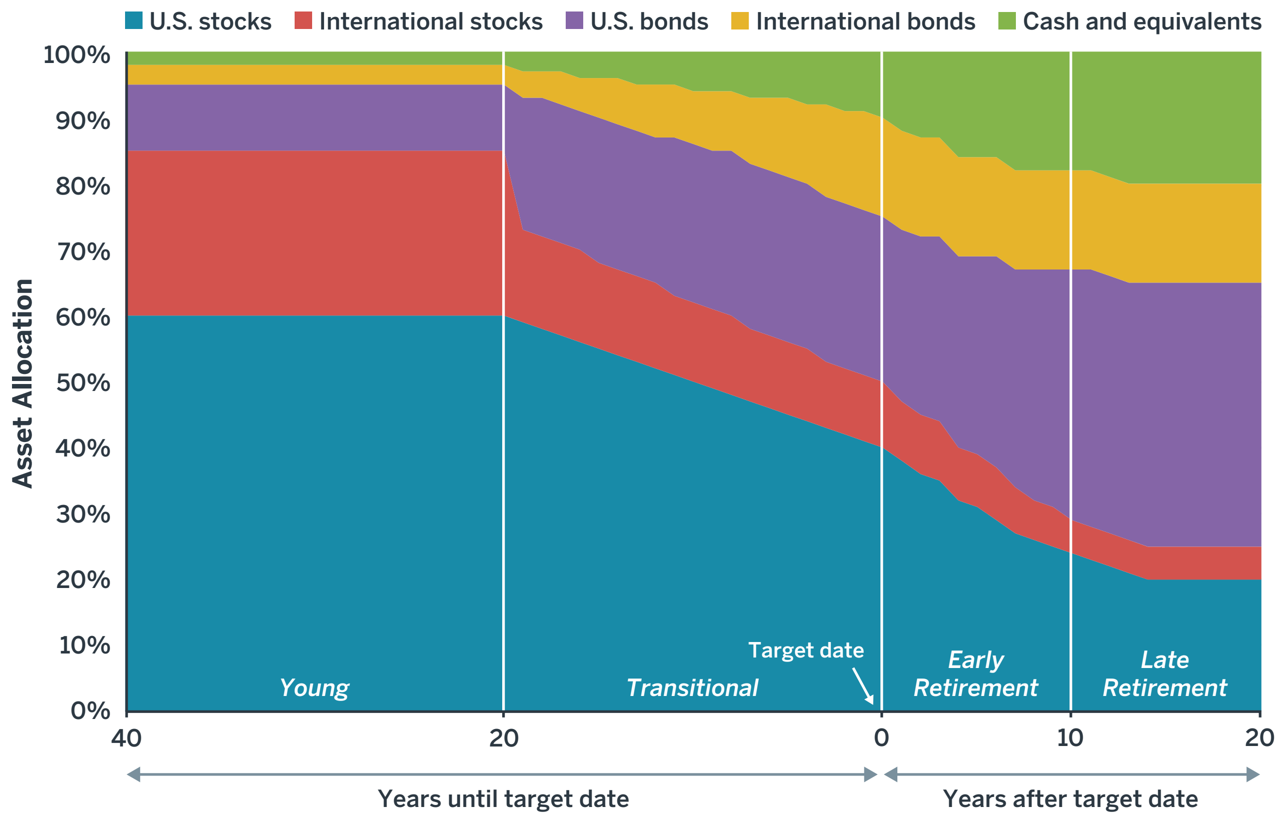
## What is a target-date fund?

A target-date fund (sometimes marketed as a lifecycle or dynamic-risk fund) is a mutual fund with a mix of assets—typically stocks and bonds—that is meant to become more conservative as investors get closer to the target year. That year typically coincides with retirement age.

For example, a target-date fund structured for an investor retiring in 2050 will be more aggressive and generally have a higher allocation to equities than a fund with a 2030 target date.

If you spend any time exploring the target-date fund universe, you’ll likely hear about the “glide path”. This refers to the expected asset allocation mix of the fund over time. Even funds with the same target year may have very different glide paths. Some shift to a dramatically more conservative allocation just a few years before the target date is reached. Others take a more gradual approach.

## Hypothetical Glide Path




Source: Stansberry Asset Management. The Hypothetical Glide Path is not indicative of any particular target-date fund.

On the surface, this all sounds pretty good, right? You don't have to worry about asset allocation. The fund does the work for you. It's an easy way to "set it and forget it" with respect to your investments.

Yet, as we'll soon reveal, these funds often operate in ways you wouldn't expect. "Forget it" is probably not the best investment strategy if you value your retirement savings.

Target-date funds have exploded in popularity in recent years. As the following chart demonstrates, hopeful retirees are increasingly placing their trust in the hands of target-date funds.

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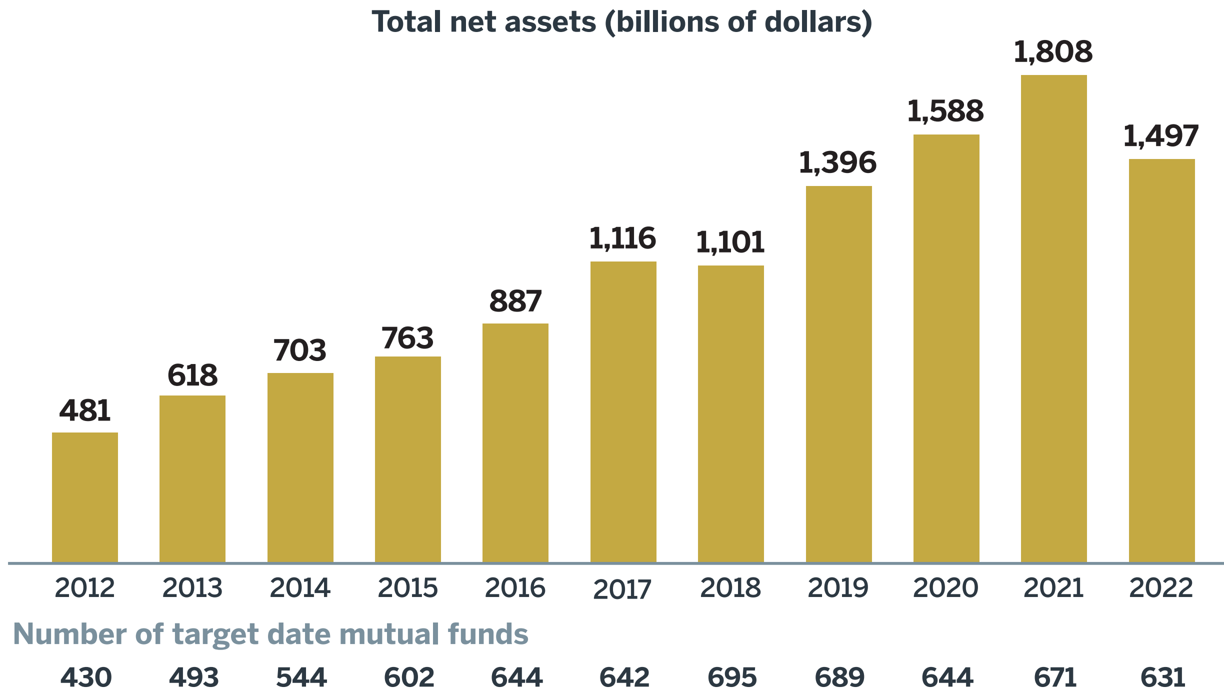
Target-Date Mutual Funds Have Grown Dramatically Over the Past Decade




Source: Investment Company Institute[4]

The rapid ascent of target-date funds has been largely driven by employers offering them to workers as part of their investment plans. While target-date funds have existed since the early 1990s, they became a staple in U.S. retirement investing thanks to the auto-enrollment legislation of the Pension Protection Act of 2006. According to the Plan Sponsor Council of America, 80% of 401(k) plans now offer a target-date fund.[5]

## What's the problem with target-date funds?

After all, doesn't it make sense to sell some of your "risky" stocks and to have more invested in "safe" bonds as you get closer to retirement?

Maybe. But like many Wall Street products, what sounds like a great deal on the surface is often not what it's cracked up to be.

### One size does not fit all

Target-date funds masquerade as a customized product, tailored for you as you get older. In reality, these funds are a generic, one-size-fits-few solution. If you invest all your capital in these funds you are putting your life-savings in the hands of a fund manager who you've in all likelihood never spoken to, who doesn't know you, and certainly has no idea about your financial situation and goals.

**Ask yourself one question: Should two individuals with different levels of risk tolerance, income, net worth, and living expenses be invested in identical strategies... simply because they're the same age?**

Of course they shouldn't.

There are many variables besides retirement age that should impact the allocation decision. As a simple example, let's consider two investors in the workforce, Dave and Jenny, who both expect to retire in the next few years. They have both invested in the same 2030 target-date fund.

Dave suffers from multiple chronic diseases and does not expect to live long into retirement. His time horizon is perhaps 10 years. He has no other assets besides his retirement plan. He expects significant medical expenses during this time.

On the other hand, Jenny has acquired an extensive real estate portfolio over the years that now generates more cash flow than she could hope to spend. She is healthy and her family history is notable for longevity. She expects to outlive her spouse. Jenny wants to grow her retirement as much as possible to leave a sizeable inheritance for her daughter after she dies. Actuarial life tables suggest this may be in 25 years, though she expects to be around longer than average.

Clearly, although we have just scratched the surface with these scenarios, the logic behind target-date funds already appears flawed. Someone like Dave does not expect to have much time to ride out the volatility of the stock market. Furthermore, he is dependent on generating income from his retirement plan, so stability and predictability are of key importance. On the other hand, the same target-date fund is likely to be overly-conservative for someone like Jenny who is not dependent on her retirement funds and has prioritized growth.

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## Illusion of Safety

You've been working hard your whole life. You've made the right financial decisions—living below your means, investing your money into the target-date fund offered by your employer. Now retirement is finally within view—just two years away. You'd think being that close to retirement, the fund would resemble a bomb-shelter. After all, it was supposed to get increasingly conservative over time. There's no way a volatile market is going to shatter your plans for retirement when you're this close to finally escaping the rat race...right?

***Consider what happened during the Financial Crisis...***

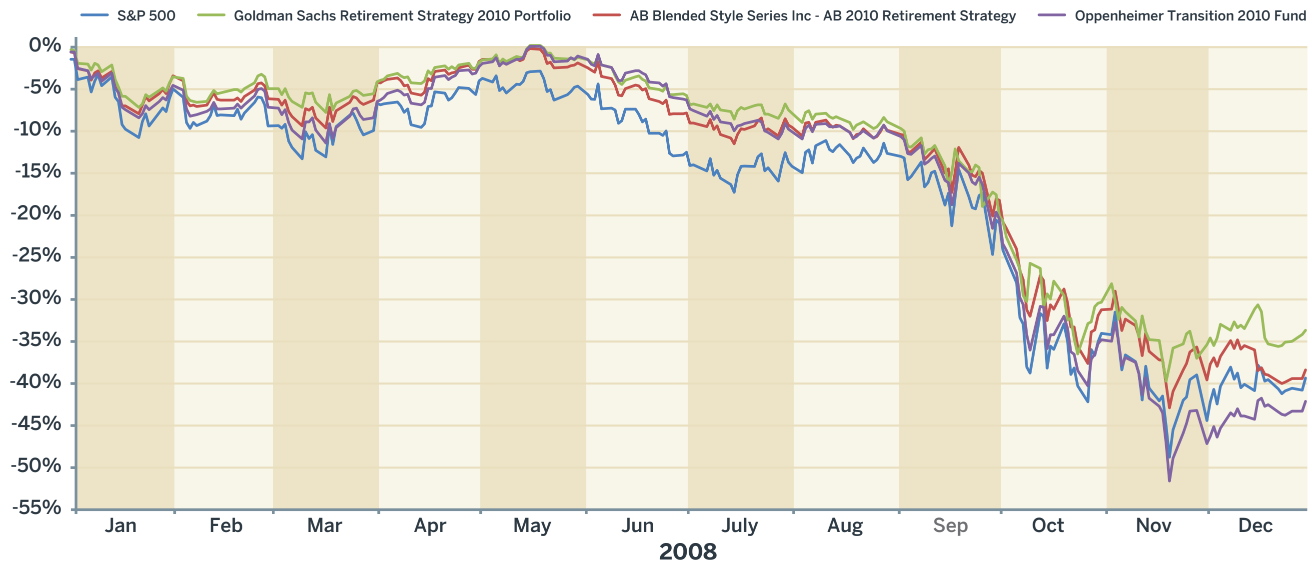
According to research firm Target Date Analytics, the average 2010 target-date fund was more than 45% invested in stocks in 2008. Some, like AllianceBernstein's 2010 Retirement Strategy (LTDAX) portfolio, were more than 55% invested in stocks that year before the downturn.[6]

Remember, back in 2008, that 2010 fund was intended for folks who were about to retire in just two years. Those investors must have assumed their nest eggs were safe and secure.

But when the market sold off, many target-date funds got hammered as badly as the stock market. As of the end of the 2008 fiscal year, the AllianceBernstein 2010 portfolio had lost 33%, almost as bad as the S&P 500 Index's 37% fall.[7] Goldman Sach's Retirement Strategy 2010 Fund (GRCAX) lost 31%.[8] Oppenheimer's Transition 2010 fund (OTTAX) fell 41%.[9]

It would be nice to think that Wall Street learned their lesson after the Financial Crisis. But just a year later, Bloomberg reported that six of the nine largest U.S. target-date fund providers had junk bonds in their 2010 portfolios. Yes, target-date funds were buying junk bonds for folks expected to retire in one year. In 2009, John Hancock's Lifecycle 2010 fund had 35% of its debt holdings in junk bonds.[10]

**Many 2010 Target-Date Funds Resembled the Plunging S&P 500 in 2008**




Source: Bloomberg

## Conflicts of interest

Many investors don't realize that the target-date fund they own is not investing in solid blue-chip companies or investment grade corporate bonds. Not directly, anyway. Instead, they are often investing in other mutual funds!

Yes, the manager of your target-date fund is likely farming out the actual investment management to other fund managers. Recall that earlier, we made the assumption that if you own a target-date fund, the manager of that fund doesn't know you from Adam. As it turns out, it wouldn't make a difference if they did. That is unless that fund manager is going to tell the dozen or so other fund managers that are actually managing the investments about your unique situation. And then in turn, those dozen or so fund managers should be speaking with each other to make sure everyone is on the same page about your investment goals, preferences, and financial situation.

Okay, so we've already established that you sacrifice any hope of being treated as a unique individual when you invest in target-date funds. There is no customization. No consideration for your preferences, goals, health, or financial situation. But what do all these faceless managers have to do with conflicts of interest?

The fact is that many companies that offer target-date funds are delegating management to their own family of mutual funds. Now, it would be some coincidence if the very best fund managers in the world to grow and protect your retirement assets all happened to work at the same company, don't you think?

Well, that's exactly how many target-date funds are being allocated.  Nearly 90% of target-date funds invest in affiliated "family funds".[11]

To figure out how much an investor pays in management fees to these underlying funds, you have to dig through the prospectus until you come to a line item called acquired fund fees and expenses. This became a mandatory line item in 2007 in order to add transparency to the more complex and layered fee structures that come with fund of funds products like the typical target-date mutual fund.[12]

What you may find once you start looking under the hood of these funds is that a large chunk of their operating expenses are due to outsourcing investments to other fund managers. Again, these fund managers often work for the same company. With these layers of fees, it's no wonder that a Senate Committee on Aging report showed that target-date funds had internal fees 10-25% higher than other funds offered in 401(k) plans.[13]

These layers of fees add up over time. A recent study shows that the average investor holding a target-date fund for 50 years would experience a cumulative return loss of 21% thanks to direct and indirect costs associated with them.[14] The "set it and forget it" mentality can come with a hefty price tag.

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# The SAM Approach

Clearly, we don't believe that target-date funds are an optimal choice for most investors. So how do we at SAM do things differently?

## We treat you like an individual

We don't believe in one-size-fits-all investing. Our clients have different priorities when it comes to growing their wealth, preserving their capital, and generating income. That's why at SAM, we offer multiple strategies with varying investment objectives. We take into account your unique situation, time horizon, goals and preferences. And we allow for customization that you'll never find in a target-date fund.

## We don't use simplistic allocation formulas

Target-date funds rely on increasing their bond allocation to make the fund more conservative. This belies the simple truth that it is not always a good time to invest in bonds. The same is true of stocks.

What if both stocks and bonds are unattractive investment options? At SAM, we take a more thoughtful and dynamic approach that you aren't going to find with target-date funds. We don't buy stocks or bonds simply because of your age. And we diversify across broad asset categories such as gold, commodities, and real estate.

## We operate with transparency

As a registered investment adviser with a duty to its clients, SAM doesn't stuff your account full of outsourced mutual funds, resulting in layers of fees. We have a simple and transparent fee structure that is based on assets under management, aligning our incentive with our clients' best interests. In other words, when your portfolio grows, so does our revenue.

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## Interested in Learning More?

A SAM colleague would be more than happy to walk you through how we help clients achieve their long-term financial goals every day.

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As Chief Investment Officer, Austin is responsible for the development and management of investment strategies across all SAM portfolios. Prior to joining SAM, Austin was the Director of Research at Stansberry Research and the portfolio manager for the company's flagship portfolio products, Stansberry Portfolio Solutions.

Austin co-founded and ran North Oak Capital, a New York-based hedge fund that received a strategic investment from Julian Robertson and Tiger Management. He also held senior investment positions at SAC Capital Advisors and Soros Fund Management. Austin began his career at the Blackstone Group.

Austin has experience investing across asset classes, including public equities, derivatives, venture capital, private equity, real estate, and fixed-income securities.

He earned an MBA from Stanford Graduate School of Business, and a BS in Commerce from the University of Virginia. Austin lives in Maryland with his wife and three children.

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Michael is a Portfolio Manager and Deputy Chief Investment Officer at SAM. His duties include sourcing investment opportunities and conducting ongoing due diligence across SAM's portfolios. Michael co-manages our Income and Tactical Select strategies.

Prior to joining SAM, Michael worked with high-net-worth private clients for the largest independent wealth management firm in the United States. He was also a senior analyst for one of the largest investment-grade bond managers in America. Michael joined SAM in 2017.

Michael's investment thinking has been featured in publications including Fortune, Advisor Perspectives, and the Stansberry Digest. He has also been a featured speaker at the annual Stansberry Conference, the Legacy Investment Summit, and the Titan Investors Conference.

Michael holds an MBA from the University of California, Davis and a BA from San Francisco State University where he majored in History. He earned the Chartered Financial Analyst (CFA) charter in 2017.

Michael currently resides in Arizona with his wife and two children. He serves as a Board Member for Copper State Credit Union, an Advisory Board Member for the Arizona Council on Economic Education, and is a member of the Practice Analysis Working Body of the CFA Institute.

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**Endnotes**

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