Target Date Funds

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Special Interest Articles

Notable note:

Get comfortable with the underlying mix of stocks and bonds in target funds, and know that a greater allocation to stocks means higher highs but also lower dips.

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Do You Know What's in Yours?

The popular retirement plan investments called 'target-date' funds have come under a barrage of criticism recently due to their poor performance during the recent bear market. Target-date funds hold a blend of asset classes such as stocks and bonds, and fund managers automatically shift the asset allocation to a more conservative portfolio as the 'target' date is approached. These funds are often the default choice for many 401(k) plans, and are quite popular with investors as they make retirement investing easy; the fund does all the work of allocating the money, picking the investments, and rebalancing the portfolio. The funds usually have a name with a year in it such as the Fidelity Freedom Fund 2025.

The criticism has come after target-date funds designed for those near retirement were hit with significant losses last year. According Morningstar, funds with 2010 as the target date suffered losses ranging from 3% to 41% in 2008. Many of the funds were aggressively invested in stocks and other highly volatile asset classes, which may or may not be appropriate for each investor. Other criticisms stem from the fact that some fund companies layer target-date fees on top of the mutual fund fees, which can take a sizable bite out of the portfolio return.

Are Target Funds for You?

Target-date funds are generally cheaper than stand-alone stock and bond funds. The median expense ratio of target-date funds is 0.68 percent, slightly lower than the median of 0.71 percent for equity funds.

So target-date funds should be a great option for retirement plans, and they are off to a good start, at least in terms of growth. They are not without problems, though. Congress passed the Pension Protection Act of 2006, which encourages employers to automatically enroll new workers in 401(k) plans. Unless they opt out, companies that offer retirement saving plans almost always provide a target-date fund as the default option. The Employee Benefit Research Institute (EBRI) found that 7 percent of all 401(k) assets in 2007 were held in target-date funds, and that percentage has increased since then.

Fund industry representatives have defended the funds saying they generally performed as expected and are not risk-free funds, nor are they guaranteed to produce a certain level of income. However, many investors have major misconceptions concerning these funds. According to a survey conducted by Behavioral Research Associates LLC, most people who were shown target-date fund marketing material came to the conclusion that the funds offered some sort of promise, a guaranteed retirement date, or a guaranteed rate of return.

Fund Allocations

There may be no perfect 2015 target-date fund, but you should at least be sure that you're getting somewhere close to the industry average and not an allocation that another fund family would use for its 2025 target-date fund. And if it turns out that your 401(k) plan offers the most aggressive target funds, consider dialing back your target date a notch by choosing the 2015 fund instead of the 2020.

What to Look For

If you are investing in a target-date fund through your retirement plan take a look under the hood. Review the mix of stocks, bonds, and other asset classes within the fund, how this mix changes over time, and ensure it is consistent with your risk tolerance. If it isn't, consider creating your own portfolio using individual funds in the plan, or choosing a more or less aggressive target-date fund that is more suitable for you.

Some fund managers tinker with the glide path. For instance, the managers of Charles Schwab target-date funds, among others, significantly shifted stock exposure downward this year, which may or may not be in line with your personal risk tolerance. You can find a fund's allocation in its shareholder reports, which are updated twice a year.

Similarly, Vanguard notes that less than half of its plan participants who use target-date funds invest all their savings in a single fund. But one target fund is designed to be the only investment you need. Combining different years will skew your allocation and the result might not be appropriate for you.

Michael Drew, a professor at the Griffith Business School said that the typical glide path is actually wrong, and savers should increase (or not lower as much) stock holdings as they near retirement. His rationale is that savers are giving up tremendous upside potential and only guarding against the most pessimistic of scenarios.

How Peak Financial Can Help

We will examine how the target funds you have, or the ones you are being offered, fit into your overall retirement strategy. We also look at the underlying holding of the target fund to see if that mix fits into your overall risk comfort zone.

Our advisors are able to see if a mix of mutual funds outside the target funds would be more appropriate and better aligned to your goals.

We base your portfolio on income need, not financial theory. A sample case: An investor who needs $40,000 in income from his investments should have $40,000 times 10 years ($400,000) in bonds. Everything else should be in stocks. The bond allocation would allow the client to ride out even a severe downturn in the stock market without jeopardizing his income.

You're much better off with a simple strategy and a hands-on approach. You don't need to send your money off to be handled by the sages in the hope that what they return on your target date is enough to get the job done.

It is possible to be put into such a fund by your broker or others offering financial advice. But you should ask yourself this question: Why pay for financial advice from someone who is hands off and leaving your financial future to other advisers instead of selecting suitable individual funds?

Call **1-614-542-7242** or email info@ peakfinancialpartners.com to book an appointment or request a call back.

We can explain whether target funds are right for your portfolio.