Insights and Strategies
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Are target date funds perfect?

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Executive summary

This brief examines the success of target date funds in the retirement plan marketplace, their advantages and areas in which they may not address crucial aspects of retirement planning. It identifies key risks that confront retirees, and points out that target date fund investors may not fully understand the limitations of these funds.

Introduction

By now everyone in the retirement industry is well aware of the success of target date funds (also known as lifecycle funds). Target date funds are designed to invest based on a participant's age and assumed year of retirement. The target date fund portfolio is adjusted over the years, making it an easy way for participants to help stay on track with their investment strategy, with an appropriate risk/reward balance throughout their lifetimes. However, the value of a target date fund is not guaranteed at any time. The "target date" part of the target date fund represents an approximate date when investors may plan to begin withdrawing from the fund.

But are these funds the ideal solution for retirement investors? Let's take a look at what these funds do well and where they may fall short.

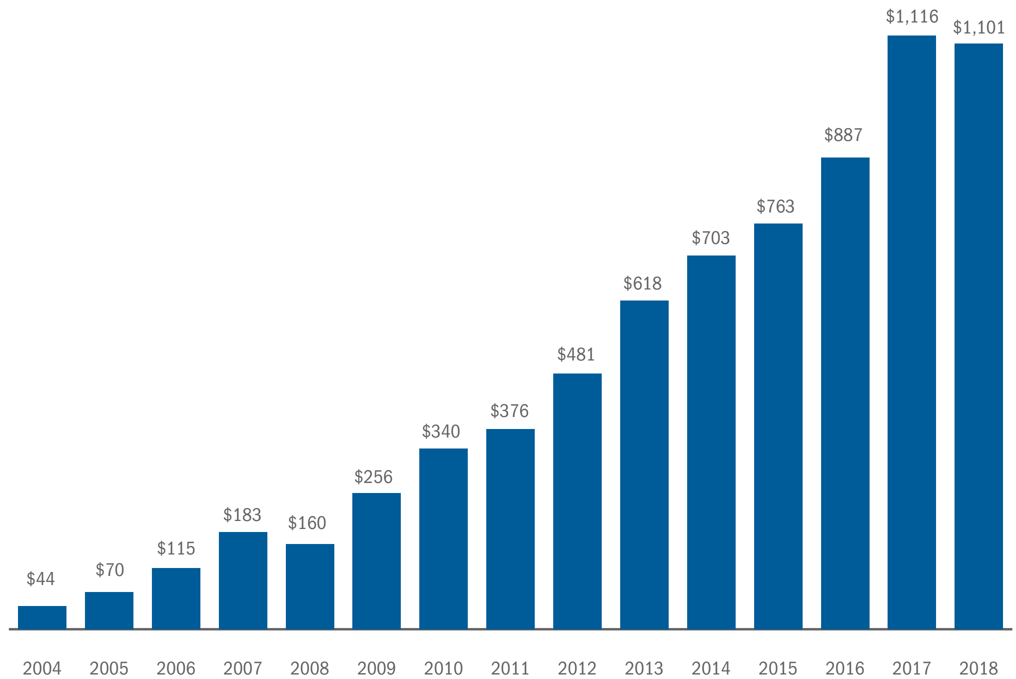
Why are target date funds so popular?

Target date funds have skyrocketed in importance and size over the years, from just $44 billion in assets in 2004 to an astonishing $1.1 trillion at the end of 2018 (see Chart 1.1).

This explosion has clearly been enabled by the Pension Protection Act of 2006 and the designation of these funds as an eligible Qualified Default Investment Alternative (QDIA). QDIAs allow plan sponsors to automatically enroll participants into an investment option if they do not make a decision on their own.

In addition, there is a rather large consensus that this simplified investment product with embedded strategies offers a dramatic improvement for millions of participants who would otherwise struggle to manage their own retirement portfolios. Target date funds can be a viable accumulation vehicle for many individuals, freeing them from the complexities of selecting investment funds, structuring asset allocations and performing periodic portfolio rebalancings.

Chart 1.1 –Target date mutual fund assets (in $ billions)



Source: *Investment Company Institute. 2019 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry. Washington, DC: Investment Company Institute. Available at http://www.icifactbook.org/.*

Are target date funds the perfect solution?

Although target date funds may do a good job while participants are saving for retirement, less closely examined is how well they perform in the retirement phase.

Target date funds are not all similarly designed to address the accumulation phase, and the transition into and through retirement.

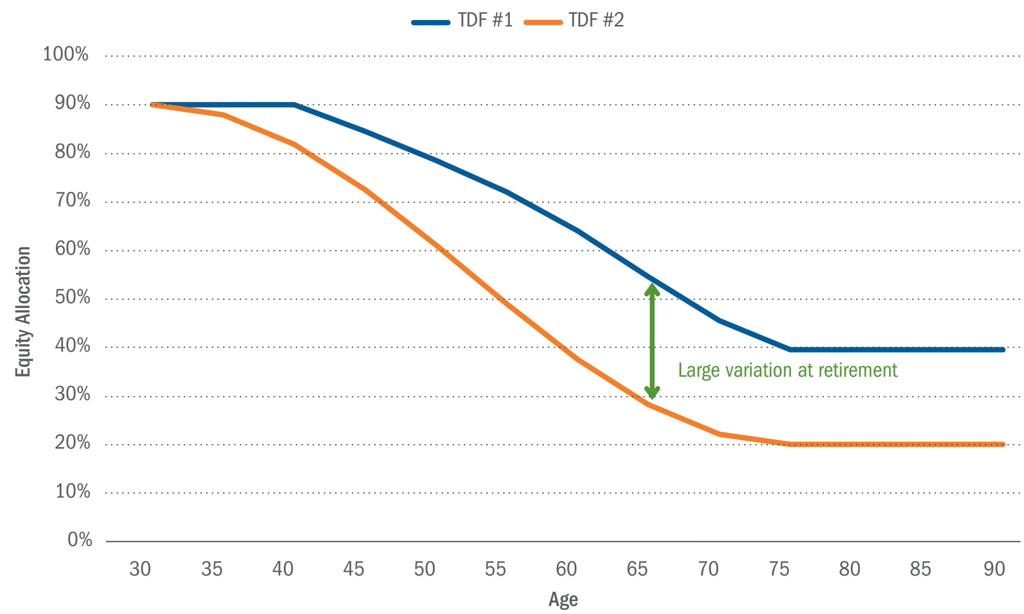
This isn’t always easy to assess. Some target date funds are intended to get participants “to” retirement—attain sufficient accumulation to begin taking income—while others are built for use “through” retirement—providing an investment portfolio that seeks to combine some growth potential, as well as income, during retirement. The “to” versus “through” approach is just one way that these funds differ. Differences among the funds become particularly noteworthy when you compare different glidepaths, or asset allocation adjustments, as participants reach retirement age (see Chart 1.2).

For example, based on a retirement age of 65, the equity allocation in a target date fund can range from about 30% to 55%, depending on the fund. This indicates varying approaches to dealing with the primary risks during retirement[1], such as:

- **Sequence of returns risk**, or the risk of having poor investment returns in the early years for portfolios subject to withdrawals
- **Longevity risk**, the risk of outliving retirement savings
- **Inflation risk**, the risk of income not keeping up with inflation and the resulting loss of purchasing power

Funds that focus on trying to mitigate sequence of returns risk will have a lower equity allocation at retirement, while funds that focus more on longevity and inflation risk will have a higher equity allocation at retirement. In other words, the only mechanism to help mitigate retirement risks is to shift the equity allocation, but reducing one risk may unfortunately increase another.

Chart 1.2 – Illustration of varying equity exposures in target date funds



Where target date funds may fall short

Target date funds are not intended to generate a specific income goal.

Despite their differences in design, the majority of target date funds have one thing in common: They are not built around the idea of providing an ultimate retirement benefit. They are investment vehicles, not retirement strategies, so an investor in a target date fund still has work to do once retirement is reached. For example, target date funds do not provide guaranteed lifetime income similar to that provided by Social Security or by a guaranteed income product. This is news to many who believe (and, to some extent, are led to believe by the term “target date”) that there is a robust retirement solution embedded in these strategies. In the 2019 Lifetime Income Survey that was sponsored by TIAA, when asked whether a target date retirement fund provided guaranteed income in retirement, 64% of all respondents believed target date funds did provide guaranteed income.

This missing element—a guaranteed stream of income—is a feature that many individuals find appealing based on consumer surveys. According to the 2019 TIAA Lifetime Income Survey, 69% of respondents said that receiving a guaranteed monthly “paycheck” in retirement is important to them; and according to the 2019 TIAA Lifetime Income Survey, when asked about the primary goal of a retirement plan, the top response was to provide guaranteed income every month to cover living expenses in retirement. In addition, retirement experts and academic research consistently show that guaranteed income can yield better outcomes and provide peace of mind to participants.

A case study in enhanced plan design by a major university

Implemented a custom default solution as the new Qualified Default Investment Alternative (QDIA)

- Specifically designed by the university and its consultant to meet its plans' specific demographics and preferences
- Target-date approach with three glide paths, built from investments on the plans' core lineups
- Allocations adjust by "considering" individually owned annuity assets in the plan, which form more than half of total plan assets
- Weighted average expense ratios of investments in the models range from 2 to 4 basis points

Streamlined the plan investment lineup

- Reduced 112 options to 11, taking advantage of economies of scale while still providing diversified asset class choices
- Moved to institutionally owned Retirement Choice (RC) and Retirement Choice Plus (RCP) contracts
- Added a new self-directed brokerage account to increase choice for sophisticated investors

Reenrolled 27,000 participants

- Four retirement plans with nearly $6 billion in total plan assets
- Comprehensive educational materials and communications campaigns to promote awareness of plan changes
- Results, two months after the remapping event was completed; as of May 5, 2019:

Still in a model portfolio	Remained in the defaulted model	Personalized model selection[2]
94%	85%	9%

Contact Tim Pitney
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Please note:

A target date fund is a “fund of funds,” primarily invested in shares of other mutual funds. The fund’s investments are adjusted from more aggressive to more conservative over time as the target retirement date approaches. The principal value of a target-date fund isn’t guaranteed at any time, including at the target-date, and will fluctuate with market changes. The target date represents an approximate date when investors may plan to begin withdrawing from the fund. However, you are not required to withdraw the funds at that target date. After the target date has been reached, some of your money may be merged into a fund with more stable asset allocation. Also, please note that the target-date fund is selected for you based on your projected retirement date (assuming a retirement age of 65). Target date funds share the risks associated with the types of securities held by each of the underlying funds in which they invest. In addition to the fees and expenses associated with the target-date funds, there is exposure to the fees and expenses associated with the underlying mutual funds as well.

No strategy can eliminate or anticipate all market risks, and losses can occur.

TIAA

[1] For more information, please refer to the Briefs Supplement: Major risks in retirement.

[2] 1/3 of those who personalized their selection by providing additional information also remained in the defaulted model.

Please note that investments pose risks and you can lose money.

You should consider the investment objectives, risks, charges and expenses carefully before investing. Please call 877-518-9161 or go to TIAA.org/prospectuses for current product and fund prospectuses that contain this and other information. Please read the prospectuses carefully before investing.

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