In Praise of Target-Date Funds

To critics of target-date funds: Are you seeing what I'm seeing?

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People love to hate target-date funds.

They're "one size fits none." They only feature the house brand of funds. They can be expensive. And on and on.

Whenever I see those critiques, my first response is to assess motive. Oftentimes, target-date critics are selling some type of investment advice themselves; they may not admit it, but they view target-date funds as competition.

My second thought when I see target-date funds coming in for criticism is to wonder: Are you seeing what I'm seeing? Because from where I sit, target-date funds have been nothing short of the biggest positive development for investors since the index fund.

The reasons are several. Target-date funds take asset allocation and investment selection wholly out of investors' hands--not just at a single point in time but at least until retirement. They provide an element of inexpensive, quite reasonable investment advice for people who might not otherwise be able to afford it and might otherwise be making kooky choices. And most important of all, they have delivered positive outcomes for investors who own them. Target-date funds ought to be celebrated, not denigrated, and they deserve broader adoption outside of company retirement plans.

They Allow Investors to Be Truly Hands-Off (Which They're Good At!)

You may have seen stories about day-trading 401(k) investors. But as a group, investors in company retirement plans tend to be incredibly inert. They make their investment choices (if they do that--many are auto-enrolled) and then they basically do nothing. In Vanguard's report entitled, "How America Saves," which examines the behavior of 5 million participants in defined-contribution plans managed by the firm, just 7% of participants did any trading at all in 2019.

The genius of target-date funds is that they harness that natural tendency toward inertia but they do so for the good. They invest in an age-appropriate asset mix and they gradually become more conservative as the investor gets closer to needing his or her money. They also rebalance back to the target allocation on an ongoing basis, something that investors might not be inclined to do on their own--not just because they're hands-off, but because such trading can be psychologically difficult. In 2020, for example, an investor in a 60% equity/40% bond portfolio would have had his equity allocation knocked down to just 53% in the space of little more than a month. Left to their own devices, few investors would be likely to top equities back up during such a volatile period--not to mention a stretch of time that was as personally stressful and busy as the beginning of the pandemic was for most of us. But that's exactly what target-date managers were doing on behalf of their fundholders during that period, and on an ongoing basis. In upward-trending markets, target-date fund managers are taking risk out of the portfolio and selling stock--also something that investors are disinclined to do when their balances are enlarged and stocks are logging new highs daily.

They Provide Cost-Effective Advice

Here's another thing that target-date funds get right: They provide their investors with an element of advice, and they do so at a very low cost. The critics are correct that target-date funds are certainly not bespoke: They use a single data point--expected retirement age--to determine the portfolio's asset allocation. A good-quality financial advisor or managed-account service can create a plan that considers the investor's other assets and personal risk tolerance and risk capacity.

But do target-date funds help investors who are unaware of the basics of investing find their way to a sane investment mix given their life stage? A thousand times yes. Prior to the advent of target-date funds, it wasn't unusual for investors to select investments in their 401(k) lineups based on which ones had the highest returns or star ratings, or to put 10% weightings into each of the 10 holdings in the lineup. By embedding some basic asset-allocation advice and ongoing oversight, target-date funds serve people who don't have investment backgrounds incredibly well.

Moreover, most target-date funds don't charge an additional fee for that advice. In the early days of target-date funds, it wasn't uncommon for the funds to levy an additional management fee, above and beyond what the underlying funds charge. But most such fees have ebbed away, and the underlying fund fees have dropped, too. In 2020, the average asset-weighted fee for target-date funds was just 0.52%, down from 0.73% five years ago and almost half of what it was a decade earlier. That's an all-in fee, reflecting the asset-allocation advice as well as the fund expenses. Not only have fees come down, but the bulk of inflows into target-date series have gone to the cheapest funds. As discussed in Morningstar's "2021 Target-Date Strategy Landscape" report, the cheapest 20% of target-date funds saw $40 billion in new inflows in 2020, whereas all other expense groupings saw outflows.

They Contribute to Good Outcomes

Finally, and most significantly, target-date funds are associated with good outcomes for their investors. While no investment can address the fact that most Americans are undersaved for retirement relative to where they should be, target-date funds have helped ensure that the investors who have purchased them have enjoyed a healthy share of their funds' returns.

In a 2020 research report, my colleague Amy Arnott examined what Morningstar calls investor returns--dollar-weighted returns that factor in the timing of investors' purchases and sales. Allocation funds, which bundle together stocks and bonds into a single fund and which encompass target-date vehicles, fared the best of any major asset grouping. Thanks to positive timing decisions (they didn't buy high and sell low), the owners of allocation funds actually enjoyed slightly better returns than the funds' total returns.

Of course, it's highly possible that target-date funds' dollar-weighted returns look so strong because the vast majority of assets reside in 401(k) plans, which benefit from automatic contributions and 401(k) investors' natural tendency toward inertia, as discussed above. But given that non-target-date allocation funds also generated strong investor returns, it's also possible--even likely--that target-date funds are easy to own. Because investors can't see the performance of their constituent holdings, they're less inclined to be bothered by the dramatic performance gyrations that stand-alone equity funds can sometimes experience. Target-date fund investors stay put.

A Step Further

Taking into account all of these pluses, my view is that target-date funds are underutilized outside of 401(k)s; they could serve investors just as well in their IRAs, too.

Moreover, retired investors would benefit from a similar product that helps them with the logistics of decumulating their assets. There are retirement-income funds on the market, but few have reckoned with the idea that in an era of very low yields but dramatic appreciation in the equity market, a retiree's own capital will need to compose part of the retiree's cash flows. Managed-payout-type funds struggled to gather assets and were criticized for returning capital as a component of their distributions, but such products were very much on the right track in thinking holistically about cash flows rather than just income. Retired workers need help with decumulation, and the simplicity and effectiveness of target-date funds provide a good model for what that might look like.

EXPLANATORY NOTES—ARTICLE REPRINT

Morningstar, "In Praise of Target-Date Funds," April 23, 2021

When considering mutual funds, investors should look beyond historical performance. They should consider factors such as the fund's investment objective, the types of securities in which it invests, and its level of risk compared with other types of investments. There are inherent risks associated with investing in the stock market, including possible loss of principal.

The principal value of target date funds is not guaranteed at any time, including at or after the target date, which is the approximate year an investor plans to retire. These funds typically invest in a broad range of underlying mutual funds that include stocks, bonds, and short-term investments and are subject to the risks of different areas of the market. In addition, the objectives of target date funds typically change over time to become more conservative.

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