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FOCUSED ON WHAT MATTERS MOST.

It Pays to Know What's Under the Target-Date Fund Hood

As a concept, "retirement-date", "target-date" or "age-based" investments seem like a good idea. Most people believe that as you approach financial goals like retirement or college, you should take fewer risks with your investments as you have less time to recover from any loss, which is the primary feature of target-date investments: they get more conservative over time. Sure, you may be reducing your opportunities for growth, but the increased safety that comes with a more conservative portfolio is worth it, because as that goal draws near, the extra return you may give up is more than made up for with the decreased possibility of suffering a big loss and having to either push your goal off or to reduce your goal. Any investment that promises to automatically get more conservative as the goal approaches does seem good in theory, but unfortunately the reality is much more of a mixed bag.

A trend in company 401(k)s and other retirement plans is to either automatically enroll employees in a target-date investment within their retirement plan, or at least to strongly encourage the use of target-date funds. From an employer's point of view, it does make sense to offer people who do not have any special expertise in investing an easy to understand tool that requires they only choose one investment that promises to be targeted to their needs. After all, it is a lot easier to pick one investment than to come up with your own properly-diversified portfolio of multiple funds, and it also means you don't have to think about how aggressive or conservative to be as the investment itself does that for you. You basically pick the investment that has a timeframe that corresponds with when you want to retire and you let the mutual fund family do the rest of the work.

We do believe that, in general, if target-date investing results in an investor allocating his or her savings into a more risk-appropriate portfolio than he or she would have otherwise, then using that target-date investment as opposed to the other investments may not be inappropriate. Additionally, if target-date investing seems to reduce the complexity of the process for an investor such that he or she ends up saving more as a result, then that too may help lead to a better investment outcome for the investor.

Unfortunately, the same things that make target-date funds easy to use also make them easy to mis-use. When something is simple and clear, why suspect it is

anything but, and why look under the hood if it promises you it will get you where you need to go? Though target-date investing seems simple and appropriate, investors still need to understand how much risk they are exposing themselves to, especially at this point in time. But even before looking all that deep into this type of investing, we would like to point something out that should be obvious but seems to get ignored relative to target-date investing:

No Single Investment Is Appropriate for Everyone Just Because Their Timeframes Match.

Is the Vanguard Retirement 2020 Fund really appropriate for every single American who is going to retire next year? Of course it's not, and that's the first shortcoming of target-date investing: it only takes into account your timeframe, completely ignoring how much you have saved, how much your goal is going to cost, and, most importantly, your tolerance and ability to recover from a loss. There is absolutely no guarantee that a target-date fund will earn an appropriate return before and during retirement by just focusing on a timeframe.

Target-Date Funds Create a False Sense of Security.

Looking one level deeper, consider how target-date investing fills an investor with a false sense of security. Calling something the "retirement 2020 fund" allows anyone to define what that investment will do for them, namely be perfectly allocated to meet their specific investment needs regardless of where the markets go. Think about it; doesn't the naming of it, the "retirement 2020 fund", lead you to naturally assume that were you going to retire next year and invest in that fund, it will adequately protect you from a big market crash? Because everybody knows, if you're going to retire next year, you shouldn't expose yourself to large financial risks. As a result, the 2020 fund is assumed to have next year's retirees adequately protected from losses that would derail their retirement, and therefore few investors really look at how that 2020 fund is allocated, but that's where really looking under the hood on these things begins to pay dividends, because:

Target-Date Funds Are Probably More Aggressively Allocated Than You Would Assume.

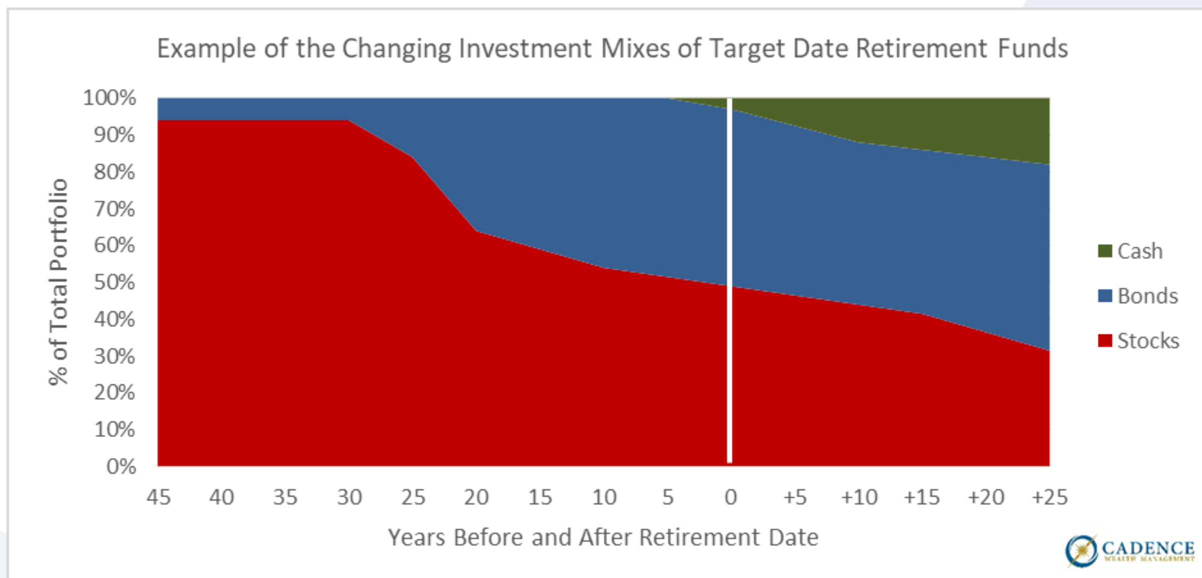
The retirement 2020 funds from the 5 best families identified by Kiplinger, an 80 year old business forecast and personal financial advice company, have an average stock allocation of 48.3%. Those companies are T. Rowe Price, Vanguard, Fidelity, American Funds, and JP Morgan. Although a nearly 50% allocation to stock, and some of these funds actually get closer to 60%, may have been appropriate to many new retirees at certain points in history, funds with allocations like these would have lost between an estimated -26% and -33% during the Financial Crisis of 2007-2009. Keep in mind, that's an average: most of those funds from the five companies named above would have actually lost more than that estimate. How many of the people retiring next year could recover from a -33% loss? How appropriate does a 2020 fund seem now for someone about to retire? Signs are pointing toward global stock markets having the potential to lose at least as much as they did during the 2007-2009 crash, so although a 50% stock, 50% bond portfolio may have worked out for many new retirees over the years, now is probably not the time to be taking risks this large. This points to another problem with target-date funds:

They Have the Potential to Be Either Too Aggressive to Start, Too Conservative Later on, or Both.

These companies create their target-date allocations based on long-term average returns for the different asset classes. The problem with that is that you almost never actually earn the long-term average in a given year; you earn

more or less, and sometimes quite a bit more or quite a bit less. During market crashes, aggressive allocations tend to lose more than conservative allocations, but during the recovery phase those same aggressive allocations may have the potential to grow back from their large drops, as we have seen many times in the past. Unfortunately with target-date funds, a retiree would be withdrawing money to cover expenses when their investments are down more than they had wanted because they were too aggressive initially, and then over time the investments would be automatically getting more conservative, making it harder to grow back from the downturn.

The decreasing level of risk in target-date funds is commonly called their "glide path". As you can see, the first 15 years or so of these funds' lives has their stock allocations at 80-90%. Over time, they have less stock and more bonds and cash:

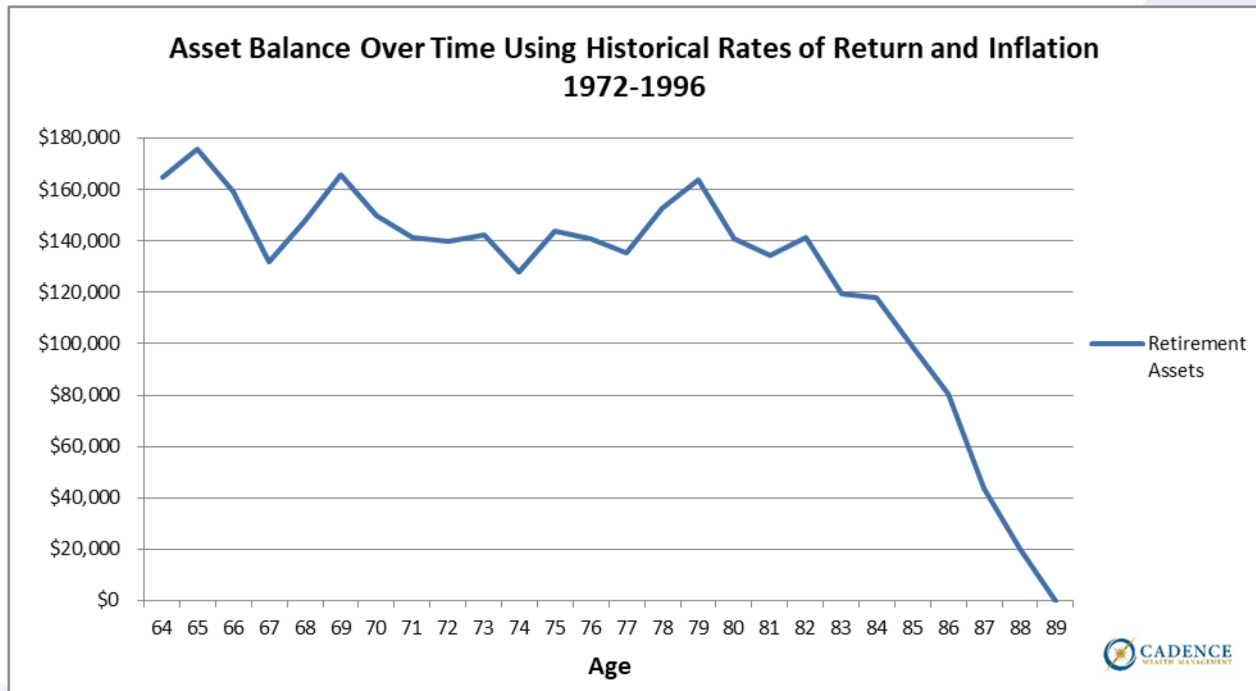


In general, an investment that gets more conservative as an investor approaches, achieves, and then continues past a financial goal is not necessarily inappropriate, however the automatic nature of target-date investing does not allow for an investor to assess whether he or she should be more or less aggressive given the risks or opportunities currently present in the financial markets. Also, not everyone of a certain age has the same tolerance for loss as most other people their age. There are time periods, like today, where it makes sense to be even more cautious than you normally would be, and there are time periods, like after major market crashes, where it makes sense to increase your exposure to risky assets. Unfortunately, the "set it and forget it" nature of target-based investing does not allow for short-term tactical moves to reduce or increase risk. The investments are just going to be automatically changing allocations regardless of what is happening in the real world.

How Could These Shortcomings Ruin Retirement Finances?

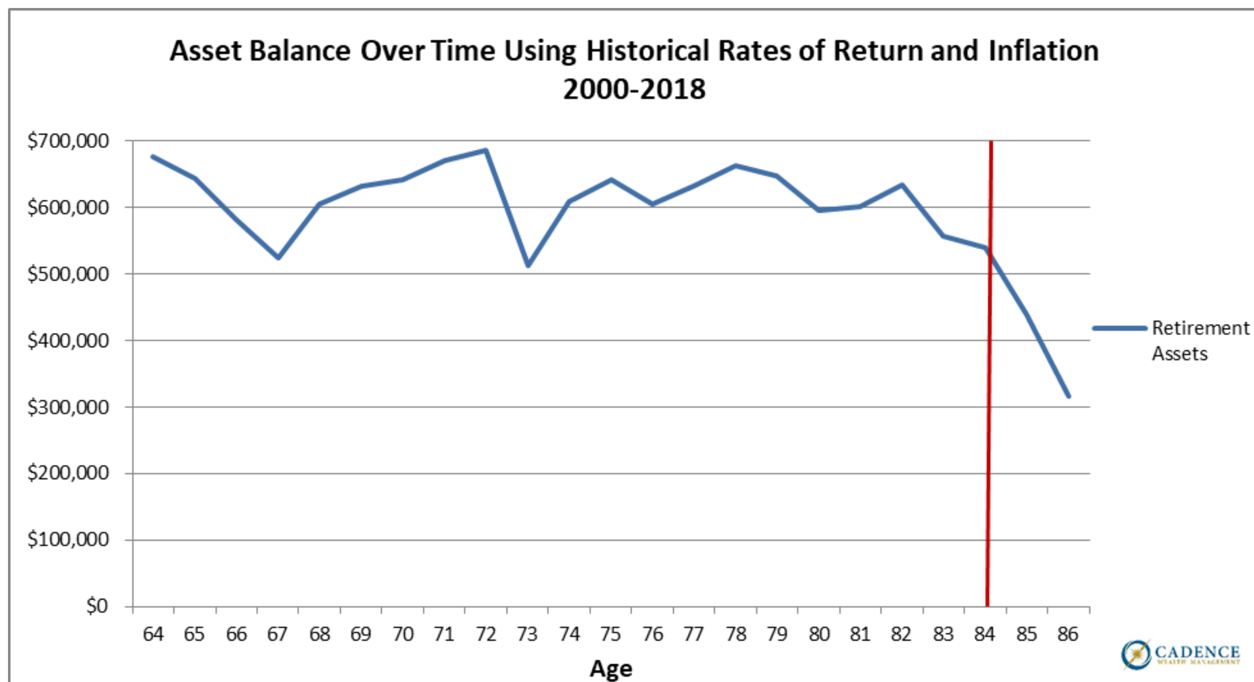
To illustrate how these shortcomings could work against a retiree, we went back in time and looked at actual financial data and calculated what could have happened to an investor using a target-date fund over the life of his or her retirement. In this case, a person retires in 1972 with an investment mix similar to many of the 2020 funds investors are using today. The investor has $165,000 in retirement assets, which is equivalent to a little over $1M today, he or she starts with an annual fixed income of $6,500, which is equivalent to around $40,000 today, and he or she has annual expenses of around $13,500, or about $82,500 today. We looked at numbers that are not uncommon to see today relative to income, expenses, and savings. In order to pay for the gap between fixed income and expenses, the

investor will have to withdraw an amount the first year that represents around 4% of the total retirement assets. As the years go on, the investor's retirement assets will continue getting more conservative like target-date funds do, and the investment returns are consistent with what a retiree would have earned starting in the early 1970's with these investment mixes. Lastly, the annual income will increase by the social security raises that occurred during those years, and the expenses will increase consistent with the historical rates of inflation.



As you can see, if this retiree does not alter his or her spending, and/or lives into his or her late 80's, the risk of running out of money looks to be quite high. What might have happened? For starters, years 2 and 3 produced negative returns large enough to cause problems. 1973 and 1974 were bad years for the US stock market, with a cumulative drop of over -40% in the S&P 500. Compounding that, inflation was remarkably high from 1973 – 1981, which meant a higher and higher percentage of the assets were liquidated to cover expenses. And then finally, the investments were getting more conservative, as target-date funds automatically do, reducing the portfolio's growth over time. Even with all that, had this person lived to average life expectancy, there would still be money left over. However, if this person were to live into his or her late 80's, and this isn't counting on expenses increasing due to healthcare costs, then the investments would have eventually depleted rapidly and completely.

The 70's and 80's were known for their high inflation, so we did consider that perhaps the failure in this scenario was the high historical inflation rates and not necessarily the performance of the target-date fund. We decided to perform the same analysis using the same current day dollar values, actual historical returns, and actual inflation and social security raises, but this time modeled someone retiring in 2000 instead of 1972. Like the early 1970's, the early 2000's also started off with low to negative investment returns, but inflation was lower than average this time. Despite the favorable average annual inflation since 2000, it looks like the pattern of bad early returns and investments getting automatically more conservative when they could have been getting higher returns yielded potentially the same results:



Similar to the first example, this retiree looks in deceptively decent shape until age 84, despite taking investment losses the first three years of retirement and then again during the financial crisis from ages 72-73. By using an investment getting automatically more and more conservative over time, and by withdrawing money every year to cover expenses, this person's retirement assets were not able to grow enough after the 2007-2009 crash to make up for the previous losses. By age 84 at the end of 2018, noted by the red line, this retiree cannot afford overly large losses, but with 40% of the target-date fund still invested in stock as it would be today, there is the potential for too large of a loss going forward. In this example, the target date fund loses -25% over the following two years, which a 40% stock investment could easily achieve at this point in time. It would have probably worked better for this investor to be more conservative during the dangerous times right before the Tech Bubble and the Financial Crisis, as it would for him or her now.

Despite all this, we do not think target-date funds are always bad investments. They make it simple and easy for investors to save for retirement, they may be helping investors be more conservative nearing retirement than they would have been otherwise, and depending on the time period in which they are used, they may work out just fine. But when using these types of investments, investors cannot just assume that because the names of these target-date funds happen to match a timeframe that applies to them they are therefore perfectly allocated to meet their needs. Any situation may call for an investor to be more or less conservative than a date-specific investment happens to be, so when it comes to using target-date funds, it pays to still know how aggressively or conservatively they are allocated, especially right now.

If you are investing in a target-date fund, or multiple target-date funds, don't panic! However, it would benefit you to know just how your fund or funds are allocated before they have a chance to behave in a way you did not expect. Review materials you might have access to, and as always, you can contact your Cadence advisor for help.

Stocks Resume Their Downtrend

Volatility works both ways. Sharp upward moves often lead to equally sharp downward moves and vice versa. This most recent bounce from the December lows was no exception to this rule. Most cap weighted indexes – where the large companies carry more weight – managed to bounce all the way back beyond their prior highs, while the broader and more equally-weighted indexes didn't quite get there. Some fell a good deal short. All however have resumed their downward trend over the last few weeks, which increases the likelihood that what we've witnessed since December 26 of last year was in fact a huge bear market bounce.

When we take a step back and look at the equally-weighted S&P 500 index (below), what is very clear is that it peaked three times at roughly the same level. First in January 2018, next in September of last year, and again a few weeks ago. Over the last 16 months, despite all the excitement, the market as represented by this index has gone nowhere. This is not unusual for phase transitions from up markets to down markets.

For additional context we can look at the stock market for the rest of the world represented on the next page by the MSCI World index. What we can see quite clearly is that the peak for the rest of the world was January 2018. No confusion, no ambiguity, no debate. The rest of the world on balance has seen a series of lower highs and lower lows in price, which is the textbook definition of a downtrend. This also more accurately reflects the economic fundamentals we've been witnessing over the same period of time – slowing growth within the global economy. Whether in corporate earnings, global trade, or housing activity, things have slowed in most corners of the world and markedly. In our opinion, a triple peak in some U.S. stock indexes in no way reflects that reality. We very likely have some "catching-down" to do with the rest of the world.

Investors continue to be best served over the longer term focusing on asset categories that are more defensive in nature and/or just plain cheap from a valuation perspective. If you're a client of ours, you know which these are. If not, please don't hesitate to ask. As we've written about relentlessly, we're most likely at a generational turning point in markets. Getting this larger story right (and over time) will probably be the most impactful piece of your retirement planning. If you don't think so, just ask investors in Japan or Europe among other places in the world who didn't expect down markets for long periods of time in their home countries. Just because it hasn't happened yet, doesn't mean it won't. In the end, it's just math. Make sure your retirement portfolio and broader planning is on the right side of it.

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