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The Good, Bad And Ugly Of Target-Date Funds

SEPTEMBER 13, 2024 • BEN MATTLIN

Many 401(k)s put members into target-date funds, often by default. These professionally managed funds automatically start savers in equity-heavy portfolios and increasingly reallocate assets to bonds and other less risky securities as account holders age.

The underlying philosophy is sound, experts say. Clients should take less risk as they near retirement, moving more and more of their savings from growth stocks, perhaps, to less volatile, dividend-paying securities, as well as bonds. But this approach doesn't suit all comers. Many retirement-age clients simply don't want to sit back and collect dividends, advisors say, especially when they see equity markets soaring to new heights. At the same time, many younger workers fear market volatility and prefer the security of dividends.

What do advisors think of target-date funds? And what do they tell their clients who reject the one-size-fits-all approach?

"I've never made a direct recommendation to one of my clients to invest in a target-date fund, but they do serve a very specific purpose and fill a very important gap," said Chad Bates of Signature Estate and Investment Advisors in Los Angeles.

Target-date funds, which hold trillions of dollars and represent some 64% of all 401(k) money, as measured by Vanguard, do "a fantastic job" of rebalancing portfolios, Bates acknowledged, especially for "novice investors." These are people who may not have a financial professional to assist them with "crafting an investment strategy customized to their individual needs, risk tolerance, and time line," he said. The funds allow these savers to set their strategy once and forget about it, he said.

On the other hand, he added, many people would be better off working with an advisor. Advisors empower investors to adapt to changing needs and goals, not to mention shifting market conditions. "Good financial advisors help their clients identify and plan for both short- and long-term goals [and] take advantage of different account types and investment vehicles," he said.

Some advisors hold that clients can have target-date funds and still receive financial advice. They might have separate assets outside of the 401(k)'s target-date fund, for instance, or they might need guidance to choose the right target date fund, if their employer offers options.

"Many people don't realize that advisors can help clients choose the target allocation that aligns with their personal goals," said Elizabeth Wolleben Yoder at Dependent Financial Planning in Edgewater, Md. For example, the target date could be age 65, she said, or it could be at any other point the client wants. "It could be 10 years before or after their retirement," she said.

Some advisors, however, flatly do not recommend target-date funds. "Finances should be personal," said Jasmine Renae Ball at Bamboo Financial Partners in Tulsa, Okla. The set-it-and-forget-it approach of target date funds just isn't appropriate for clients with complex situations, she said, which is most of them.

Moreover, relying on automatic rebalancing can actually backfire and obstruct an advisor's ability to provide a dynamic and personalized strategy, she said. "It's important to have a plan that considers the entire financial picture, not just an arbitrary target date," she said.

In addition, clients might not fully understand how their target-date funds work, critics caution, particularly if they're not working with an advisor. "Individuals investing in these think the fund adjusts for current market disruptions," which they don't, said Jason Bottenfield of the Park Cities Group at Steward Partners in Dallas.

They only adjust according to a schedule that "someone else determined," he said. "If a financial advisor is using these funds in their clients' accounts, they should not be paid to do so."

What's more, he said, target-date funds can be expensive. According to MorningStar, they cost 0.68% a year on average, much more than the average index fund. "They have an overlap on fees," Bottenfield said, "investing in other funds that have transaction costs internally." He said he would prefer that young savers put their money in an S&P 500 index fund and "not look back for a few years, until balances get over $50,000," he said.

Many target-date funds are also "heavily invested in international markets, which have lagged domestic markets for more than 20 years," he added. "Clients do not understand why their target-date fund is down so much, [but] in many cases it's due to the high international stock allocations."

To be sure, there are exceptions, industry watchers say—situations in which a target-date fund makes sense. For example, for clients who "have a very long time horizon and are automatic savers," said J.J. Burns, an advisor in Melville, N.Y. For them, these funds can be "a great way to get a diversified allocation."

But if clients start withdrawing funds frequently, perhaps because of life changes like a new baby or an illness, a more personalized approach would almost certainly be better, he said.

“For most of our clients, a one-stop investment is insufficient to accommodate the many changes that occur in their lives over time,” he said, citing early or delayed retirement, job fluctuations, the need to save for specific goals such as a new house or child/grandchild, or an unexpected inheritance. “Life isn’t always straightforward, and flexibility in a portfolio is very important.”

Even clients with a target-date fund, perhaps through their employer, should not overlook financial advice, he said. “Not all target-date funds are created equal,” he said. “Due diligence should not be ignored simply because these funds have a convenient wrapper.”

A good example is the client whose target-date fund happens to reallocate assets from stocks to bonds during a market downturn. “The automatic downshift in risk happens at the worst time, and can be damaging [to the client’s long-term retirement security],” said Mark McCarron, chief investment officer at Wescott Financial Advisory Group in Philadelphia. “Having an experienced advisor working directly with clients to adjust portfolio exposures to capture an eventual market recovery can be invaluable.”

Nevertheless, even those who do not recommend target-date funds for retirement accounts do find them appropriate for 529 college savings accounts. “After all, you very likely have a fixed period of four years, starting at a specific time, when you will need the proceeds to pay for college. You can plan for that,” said Andrew Gardener, president of Tanglewood Legacy Advisors in Houston. “I don’t think that same logic applies to retirement planning.”

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