WALL STREET JOURNAL

THE EXPERTS INVESTING IN FUNDS & ETFS

Two Costly Flaws of Target-Date Funds

WSJ Wealth Management Expert Peter Hecht says target-date funds need to leverage diversification and risk management.

By PETER HECHT
Dec 8, 2016 10:51 am ET

Peter Hecht is a managing director at AQR Capital, a global investment management firm, and a former professor of finance at Harvard Business School.

Target-date funds provide a total portfolio solution for savers—the fund automatically shifts the asset allocation to a more conservative mix as the target (or the investor's retirement) date approaches.

Unfortunately, the typical target-date fund continues to underutilize a couple of key tenets of modern portfolio management: diversification and managing risk. By not fully embracing diversification and risk management, target-date fund providers are making it unnecessarily difficult for savers to achieve a comfortable retirement.

Let me explain.

The typical target-date fund continues to have a "home bias"—focusing too much on U.S. stock and bond exposure and forgoing the diversification benefits associated with global investment opportunities.

In addition to underutilizing non-U.S. assets, most target-date funds contain no-to-low allocations to inflation-protecting assets, such as commodities, and are overly exposed to inflation risk.

Prudent investing not only requires holding the right assets, but holding them in the right proportions to balance risk. The typical target-date fund violates this principle by continuing to over-allocate to stocks. The focus on "dollars invested in each asset class" instead of "risk allocated to each asset class" has given savers the illusion of diversification. A portfolio comprised of 50% stocks and 50% bonds, for example, is "dollar diversified" but far from "risk diversified" since stocks are roughly four times as risky as bonds. In fact, stocks account for approximately 90% of the risk in a 50/50 portfolio.

Additionally, markets themselves are not equally risky at all points in time, but the asset allocation of target-date funds does not recognize this. Consider the risk of a 50/50 stock and bond portfolio during the height of the 2008 financial crisis. Clearly, this portfolio became more risky during 2008, but target-date funds ignore this time-varying risk phenomenon. In contrast, a risk-managed portfolio would have reduced the stock allocation during 2008 to counteract the fact that stocks were becoming even more risky and added them back when times returned to normal.

In theory, diversification and risk management sound great, but do they move the dial for retirement savers in practice? Yes! Let's put some real dollars and cents on these foundational investment concepts.

Assume the typical individual 1) saves and invests for 40 years, 2) has a starting annual savings rate of $1,000 (inflation-adjusted), and 3) increases the annual savings amount by 2.8% per year. Under this scenario (as documented in this research), the typical target-date fund participant would have accumulated $253,000 in wealth at the time of retirement.

By including global stocks and bonds, including commodities as inflation protection, allocating across assets in a risk-diversified manner, and managing risk through time, the typical saver's retirement nest egg materially increases to $427,000 — a 69% improvement!

So, the bottom line is that future retirees need to demand (and asset managers need to produce) better target-date funds—funds that fully leverage the benefits of diversification and risk management. They will have a material positive impact on your retirement strategy and quality of life.