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The Stevens Advisor

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TARGET DATE RETIREMENT FUNDS

Over the last 30 years, the landscape of retirement savings options offered by employers has shifted drastically. In the early 1980’s, nearly 60% of private sector workers in the US were offered a defined benefit plan (commonly a pension) as the only retirement account option. Today, that has dwindled to less than 5%. Defined contribution plans (most commonly 401(k) plans) now overwhelmingly dominate as the primary retirement account option offered to private sector workers.

Defined contribution plans put a much larger share of the responsibility on the individual participant rather than the employer to properly fund and allocate the account for retirement. Many participants don’t have the expertise or time to adequately monitor and implement the strategy best suited to help them meet their retirement goals.

Congress passed the Pension Protection Act of 2006 as part of a broader effort to ease automatic enrollment in retirement plans. The bill forced all defined contribution plans to have a qualified default investment alternative (QDIA) as the primary investment vehicle for retirement plan contributions in the absence of direction from the plan participant. Twelve years later, target date funds have become the principal QDIA option for over 80% of defined contribution plans. These are the funds listed in your plan as Fidelity Freedom, Vanguard Target Retirement, American Century One Choice, etc., all including an assumed retirement year (e.g., Vanguard Target Retirement 2025, JPMorgan SmartRetirement 2030, etc.)

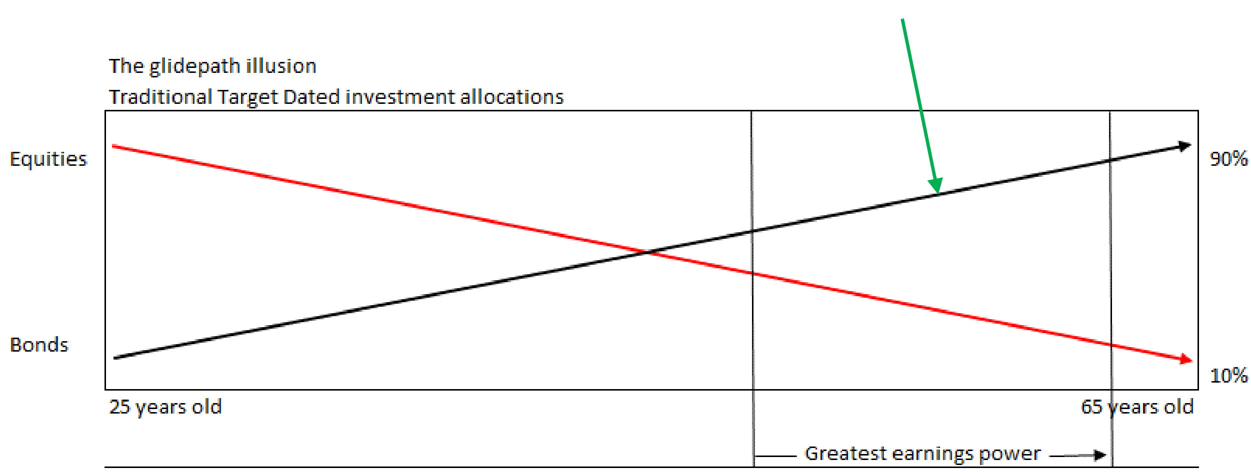
What are Target Date Funds?

Target date funds are broadly diversified investment vehicles that are automatically adjusted to help build capital in early working years and preserve savings as the target date for retirement approaches. Accordingly, this means a higher ratio of equities to bonds early in a participant's career, which then transitions to a higher ratio of bonds to equities as the retirement date gets closer (see illustration below). The simplicity that target date funds provide for participants has led to the flow of over $1 trillion of capital into those types of funds, with over 70% of plan participants voicing positive support for their auto-enrollment features. The youngest participants of current plans are putting more money in target date funds than any other generation before them.

Our View on Target Date Funds

Given the widespread and increasing use of target date funds within defined contributions plans (sometimes unknowingly), it is important to understand why target date funds may not always be the best option for plan participants. Investors face a number of risks including market risk, interest rate risk, and inflation. Target date funds have been proven to navigate these risks less efficiently than other methods of long-term retirement investing, potentially leaving the participant with less money than if they had allocated their retirement account amongst a variety of fund options.

Target date, i.e. "glidepath", funds fail to recognize the fact that wage earnings over the course of a person's career are rarely static or linear. Most data points to the highest income earning years being concentrated towards the end of a given career. It would be logical to tactically shift a portfolio to mirror this fact, keeping it more equity-centric for longer; not to ignore it as many target date funds do. Shown in the illustration below is the most common "glidepath" for target date funds. By the time a person is at his or her greatest earnings power, a majority of the target date fund resides in bond investments. It is probable that this will leave them with less wealth when they retire.



How does Stevens Foster help you manage your 401(k)?

No two target date funds have exactly the same "glidepath", but our research indicates that most adhere to the flawed strategy described above. We believe it is in our clients' best interests to allocate away from target date funds and into a diverse mix of the other fund options available in their defined contribution plan. This strategy allows for the allocation to be tactically shifted over time to better take advantage of the highest wage earning years. Stevens Foster, in conjunction with our proprietary fund rating platform, offers allocation recommendations for our clients' defined contribution plans. Using the options in your plan, we design the right allocation that mirrors the investment objective of your entire balance sheet and periodically review it to recommend adjustments when necessary.

Defined contribution plans are often a substantial portion of an individual's net worth, yet they are seldom reviewed thoroughly. A nine year bull market, combined with a changing interest rate environment, warrants visiting or revisiting the allocation of your plan. Should you wish to discuss how Stevens Foster can help you more effectively manage your defined contribution plan, don't hesitate to contact your Client Account Manager with questions.

Sources: CNN Money, American Century Investments, Fidelity, Research Affiliates