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Target Date Funds and Your Retirement Planning

Our latest article gives you the facts on target date funds—why have they become so popular and what the advantages and disadvantages of this type of investment vehicle are. To find out what our expert is saying about what characterizes a target date fund and how they can help you, read on.

By Jane Leibbrand

As defined benefit pensions have become a thing of the past, more Americans realize that having a comfortable retirement is going to be their responsibility. The good news is that retirement account balances are now twice as large, on average, as they were a decade ago.

Many savers are choosing target date funds as the primary retirement savings vehicle in their 401(k) accounts. A recent survey notes that for the first time ever, more than half of individuals with funds in 401(k)s have all their retirement money in a target date fund. Furthermore, 69 percent of millennials have selected a target date fund as their sole retirement vehicle, as more and more companies are auto-enrolling individuals into their 401(k) plans.

Kathleen Whitmore, senior retirement counselor, advice and wellness with CAPTRUST, works with 30 companies; she says all of them have a suite of target date funds available for employees. Why have target date funds become so popular, and what are their advantages and disadvantages?

What Characterizes a Target Date Fund?

A target date fund is an investment that contains an appropriate mix of stocks, bonds, and cash based on an individual's current age and anticipated retirement date. The title of the fund always has a target date that signifies when the individual wants to begin to draw down the funds. Target date funds are usually used for retirement purposes. They're often composed of mutual funds, although some have exchange-traded funds (ETFs).

If you're a millennial who's 30 years old and you anticipate retiring at 65, you have 35 years to save. If you've decided on a target date fund, you'd likely select a target date 2055 fund. These funds are offered in five-year increments (e.g., 2025, 2030, etc.).

How Investments in Target Date Funds Change Over Time

A target date fund pursues a long-term investment strategy, using a mix of asset classes (or asset allocation) that the fund provider adjusts to become more conservative over time to account for factors that affect an investor's risk profile. These are things like a shorter time horizon, fewer chances to make contributions to savings, and sensitivity to capital market swings. The asset allocation path that the target date fund follows to become more conservative over time is known as a glide path.

While glide paths differ based on the assumptions and calculations providers use in designing their funds, all target date fund glide paths provide for more exposure to equities for younger investors and more exposure to fixed income and cash for investors near retirement.

According to Whitmore, if you select a 2055 target date fund now, the fund may have an 85–90 percent allocation in stock and 10–15 percent in bonds. By the time you are near retirement, that allocation has shifted significantly, but it's not totally reversed, a fact that many plan participants may not know.

Advantages of a Target Date Fund

Target date funds have psychological as well as financial pluses.

Relieves Stress Over Picking Investments

Whitmore says many clients feel tremendous stress over how to save money for retirement. A lot of worry comes to the surface during appointments: "I don't know where to save my money. How do I know I've picked the best investments? What if they lose money?" are questions financial advisors hear frequently. A recent Northwestern Mutual study found that money is the number one cause of stress for Americans, outranking both personal relationships and work, and worrying about retirement investments is a part of that angst.

A target date fund is one-stop shopping. Instead of picking and trying to manage various funds and individual stocks and bonds and allocating an appropriate percentage to each, the target date fund does all of that for you.

Automatic One-Stop-Shopping Approach

These funds all have a glide path that moves the investments from an aggressive allocation to a conservative one. The change over time is automatic; you don't have to worry about changing your investments periodically because it's done for you. If your busy schedule leaves you with little time to think about your retirement investments, or if you don't know where to start, a target date fund may be a good answer for you.

Age-Appropriate Investing

Funds with dates 30 or 40 years in the future are aggressive, containing a high percentage of stock; the reasoning is that you pick these when you're young and have many years to make up losses when returns are negative. Plus, when prices fall, you're buying that stock much more cheaply. The glide path changes as you age.

Disadvantages of a Target Date Fund

Target date funds aren't the best choice for all investors.

No Consideration of Personal Risk Tolerance

The glide path of target date funds may not be aligned with your personal risk tolerance. If you're 65 and the target date fund you selected is still invested 55 percent in stock, that allocation may be too aggressive for you; you could switch out of the fund at or a couple of years before retirement and select more conservative investments. "If you're losing sleep over your investments, perhaps they don't reflect your risk tolerance, and changes should be made," says Whitmore.

Target Date Funds Aren't All the Same

Different fund companies have their own philosophies guiding their glide paths; therefore, each group is likely to have significant variation in the percentage of stocks versus bonds at various points on the path. In addition, the percentage of domestic versus international stocks may vary considerably. The fund you select may perform better or worse in any given year than other target date fund families you may read about in financial publications.

Higher Fees for Actively Managed Funds

Fees for retirement fund vehicles vary widely. High fees eat into your investment returns, so it's important for you to know what the fees are for the funds you select.

Many companies offer passively managed target date funds because they offer you very low fees. But if your suite of target date funds is actively managed, you pay for professional expertise. Actively managed funds have higher fees—sometimes significantly higher—up to $7 per thousand in the fund. If the fund's performance isn't stellar, your returns may not be as high as they seem when you take the fees into account.

Target date funds are, of course, not your only option for your retirement investments. Your company may have other choices for investment vehicles, including low- or no-cost index funds. A stock index is great if you're 25 and just starting out, but it could suffer a large drop just before retirement, so a stock index fund, unlike a target date fund, is not an "automatic" one-stop vehicle as you grow older.

That's just one example of why it's important to develop a working relationship with a financial advisor you trust. Your advisor explains different investment options and the pros and cons of each. He or she matches the options to the level of risk you're comfortable with and to your circumstances, making sure that they're age appropriate.

You already make appointments with your physician for checkups. Schedule regular appointments with your financial advisor, who can develop a workable financial plan that takes you into retirement and beyond.

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Have questions? Need help? Call the CAPTRUST Advice Desk at 800.967.9948 or schedule an appointment with a retirement counselor today.