

# Easy Does It. Or Easy Doesn't Do It?

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Examining the Effectiveness of Target Date Funds



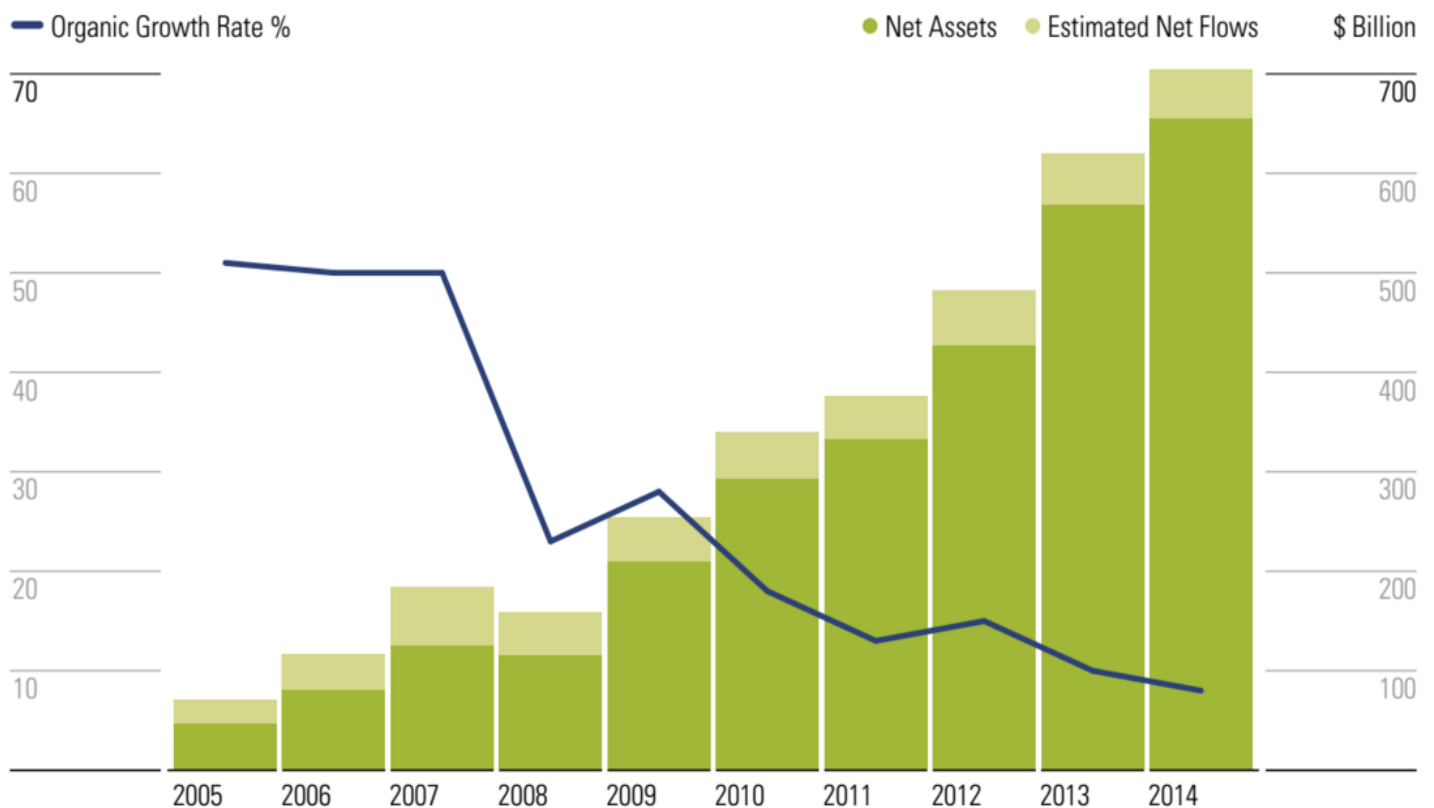
It's fair to say that most people like when complicated concepts or difficult tasks are 'made easy'.

It's also fair to say that the two biggest innovations in managed financial products over the last two decades are exchange traded products (ETPs) and target date funds. Little surprise there.

But how have some of these 'made easy' products delivered upon their expectations over time?

According to Morningstar's "2015 Target-Date Landscape" report, there is an estimated \$700bn of assets under management in target date funds, up from \$100bn a decade before. In addition, there is an estimated \$300bn in collective investment trusts (CITs) that are invested along the same lines as target date funds. This adds up to **\$1 trillion of assets and some experts expect that number to double to \$2trn within the next several years**<sup>1</sup>.

**Exhibit 2** Net Assets, Estimated Net Flow, and Organic Growth Rates of U.S. Target-Date Mutual Funds, 2005-14



Source: Morningstar, Inc. Data as of 12-31-2014.

<sup>1</sup> "Target Date Funds Take Over", Barron's, July 5, 2014, Andrew Bary

## Retirement Investing ‘Made Easy’

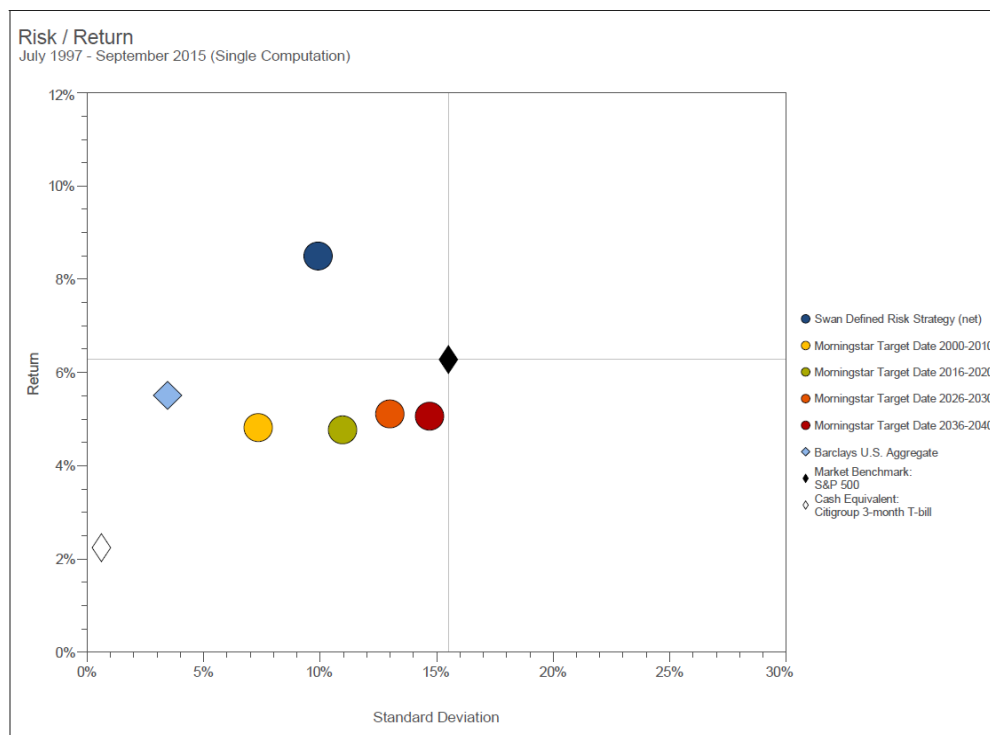
Certainly having a “one-click solution” for defined contribution plan participants offers a lot of advantages. According to a May 2015 report from the Government Accountability Office<sup>2</sup>, 52% of households over the age of 55 have no 401(k) or IRA savings, and of the 48% who do the median value is only \$109,000. Given the widespread financial illiteracy and low savings rates of the average American, making the process of saving for retirement as easy and painless as possible is an attractive proposition.

The concern, however, is that by utilizing a “painless” solution at the outset, investors are setting themselves up for pain in the future.

- Can target date funds deliver enough growth to fund an average investor’s retirement?
- How well have target date funds protected capital?

## ‘Made Easy’ Products May Make Retirement ‘Not So Easy’

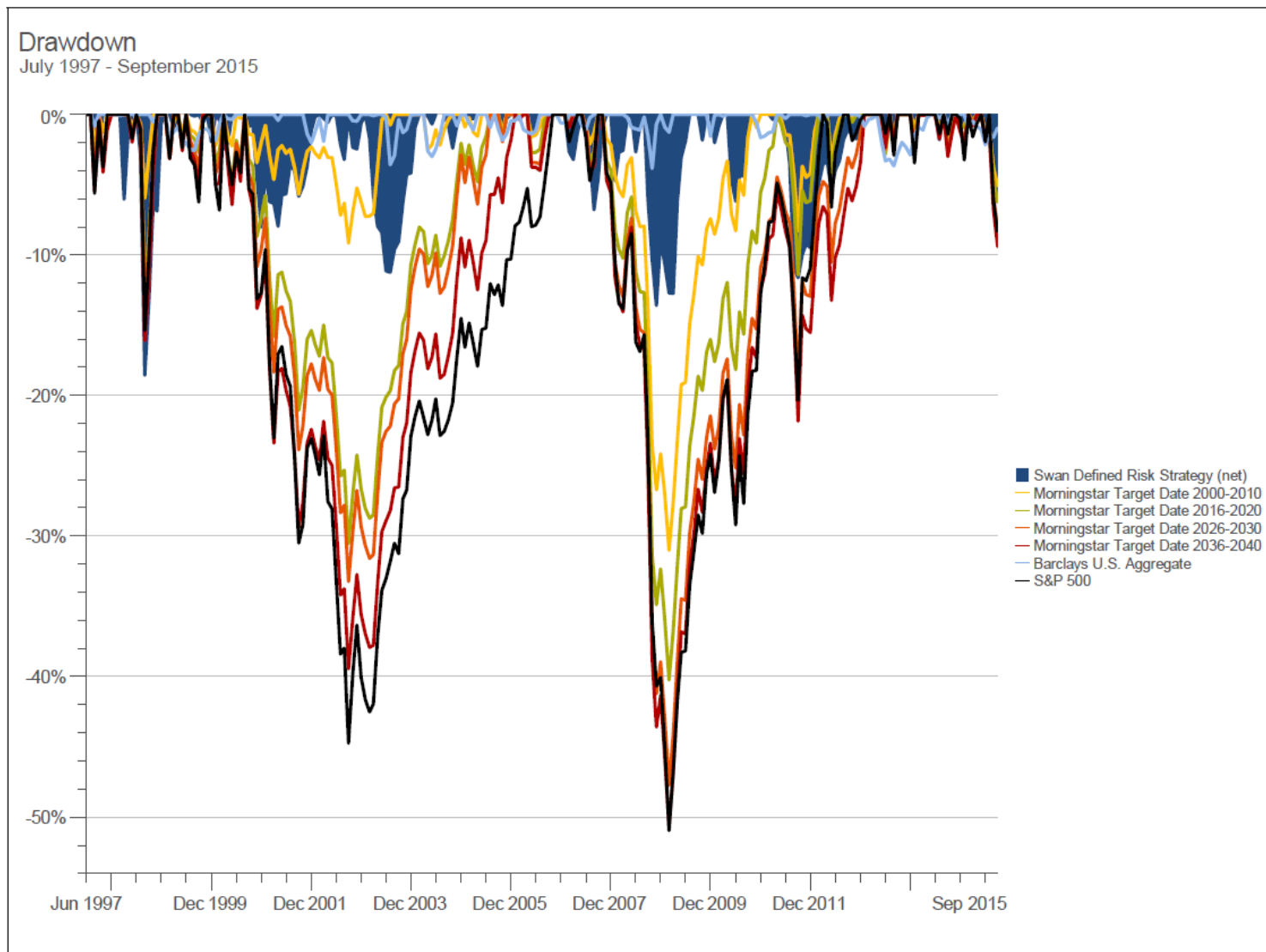
Unfortunately, the track record of the average target date fund has been underwhelming. The graph below shows the risks and returns across several “vintages” of Morningstar category average target date funds, versus the DRS.



Source: Zephyr StyleADVISOR, Swan Global Investments

<sup>2</sup> “Retirement Security: Most Households Approaching Retirement Have Low Savings”

Certainly, the risk has increased across the spectrum as one moves from conservative to aggressive. But what has been lacking is a corresponding increase in returns. It is unlikely that returns in the 5% range were what investors in these products were anticipating. However, what is perhaps more concerning is how target date funds performed during the big equity bear markets.



Source: Zephyr StyleADVISOR, Swan Global Investments

The above chart details the peak-to-trough losses of the average target date funds over the last 18 years, versus the DRS.

Of particular concern is the performance of the average Morningstar Target Date 2000-2010 fund during the 2007-08 correction. These portfolios were some of the most conservative target date funds available, positioned as appropriate for someone who was planning on retiring sometime between the year 2000 and

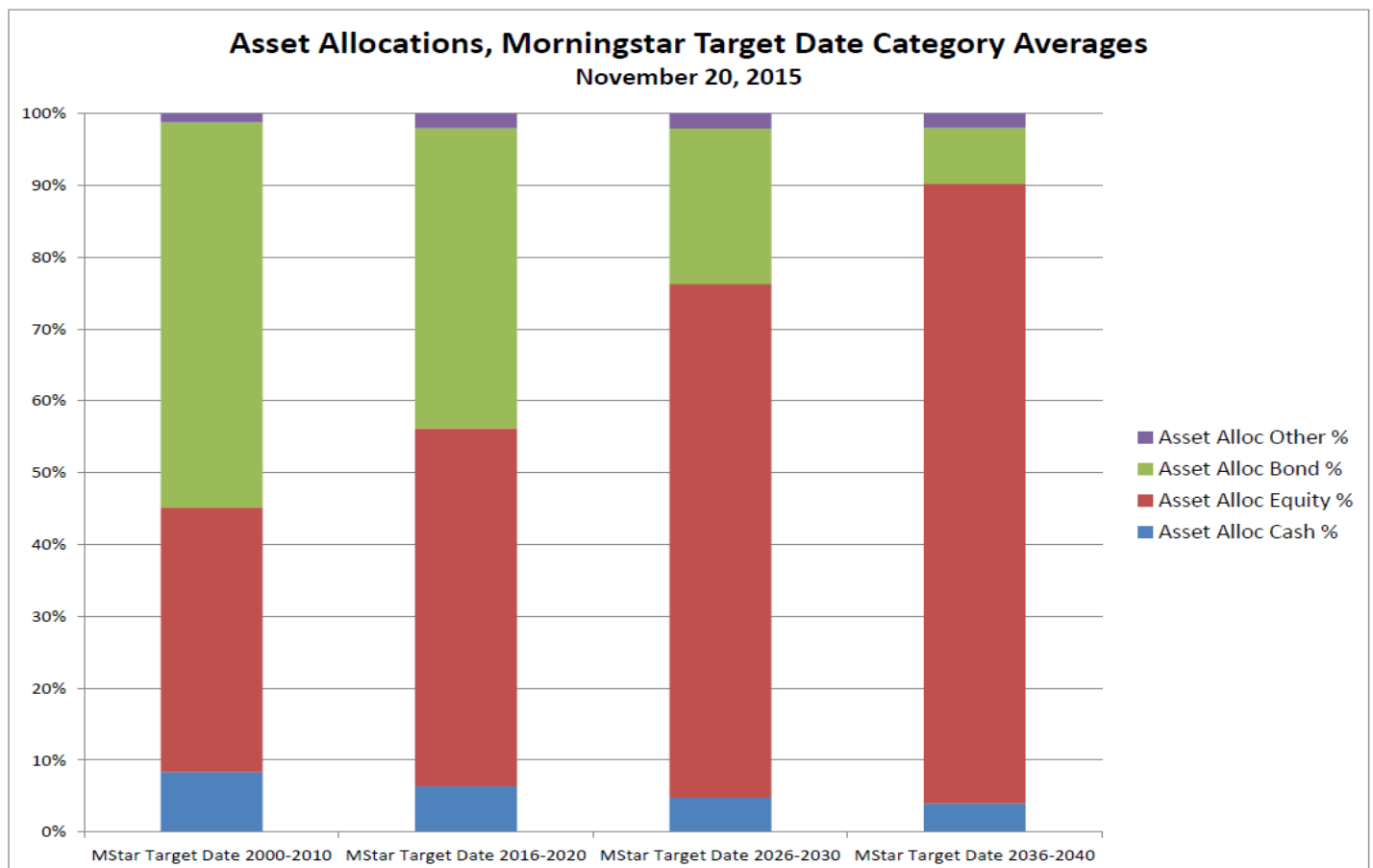
2010. And yet when the credit crisis hit in 2007-08 these funds lost an average of 31.03%. They spent a full three years underwater before recovering their losses. Many Americans were hit doubly hard during this period, where their investment losses were paired with unemployment, stagnant wages, falling home values, or other financial challenges.

## Another Way to ‘Make It’

The poor performance of the target date funds, especially during the two major bear markets since 2000, highlights one of the core tenets of Swan Global Investments’ philosophy.

We believe that traditional asset allocation and diversification fails to sufficiently protect wealth during periods of severe market downturns.

After all, the textbook [descriptions of asset allocation](#) often state that market risk, or systematic risk, simply cannot be diversified away. The vast majority of target date funds seem to passively accept this risk by holding the vast majority of their assets in simple stock-bond combination.



Source: Morningstar Direct

The Defined Risk Strategy differs from this passive approach. The DRS takes an active role in confronting market risk and does so via clever hedging strategies. Our distinct investment approach has been applied to a range of asset classes in a [suite of DRS mutual funds](#). Originally applied to U.S. large cap stocks in 1997, the DRS is now available on U.S. small cap stocks, foreign developed market equities, and emerging market stocks.

Moreover, Swan Global Investments in conjunction with Gordon Asset Management has recently unveiled a family of [collective investment trusts \(CITs\) utilizing the DRS](#). Given target date funds' poor performance based upon traditional asset allocation described previously, we believe the DRS addresses the biggest shortcoming in an otherwise practical idea.

The myriad of problems facing baby boomers as they enter retirement are explored further in the Swan white paper, "[The Retirement Conundrum: Untying the Gordian Knot](#)."

Feel free to review more information on the Defined Risk Strategy [performance](#), or its [components](#), call 970.382.8901.

**About the Author:**



Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly Marc was the Director of Research for 11 years at Zephyr Associates.

**Important Notes and Disclosures:**

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