Why Target-Date Funds **Fall Short**

The case for dynamic risk management and strategic diversification

As a busy plan sponsor, you've probably been offered target-date funds as the solution for constructing retirement portfolios that offer risk management and diversification. We disagree. We believe target-date funds represent an old-fashioned, auto-pilot-like approach to investing that just can't withstand the volatility of the financial markets.

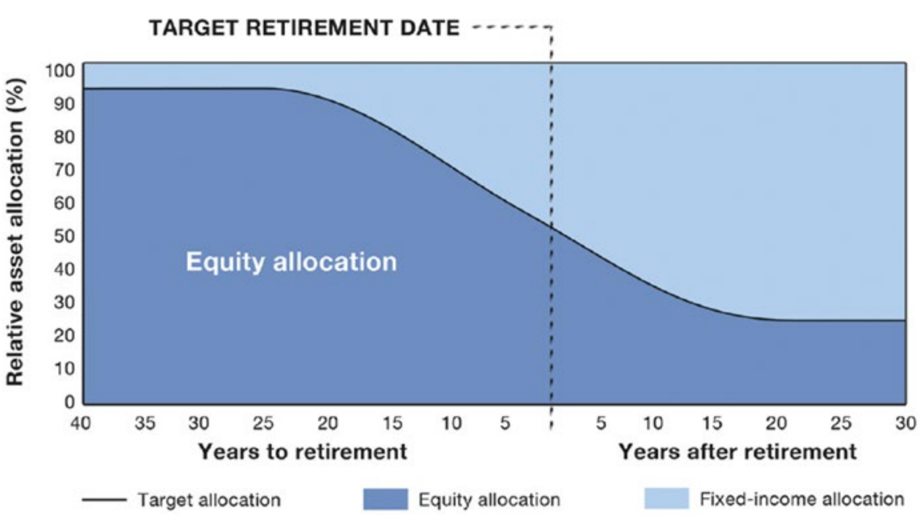
The idea behind target-date funds is that as people age their investment needs change, and so their retirement portfolios need to adjust appropriately. While this idea is noteworthy, we've noticed a glaring omission in the execution: target-date funds have no mechanism to respond to an ever-changing market—bull or bear. This is because the asset allocations within a target-date fund are fixed for a specific amount of time. If the market goes down during that time, so will a participant's portfolio.

The chart below illustrates how a model target-date fund works. This type of fund tries to attain an ideal equity-bond allocation based on a participant's age. For example, an employee in their 20s might be invested 70% in equity mutual fund holdings and 30% in bond fund holdings. As the participant nears retirement, the allocation becomes increasingly more conservative, decreasing the percentage of higher-risk investments such as equities and increasing the percentage of lower-risk investments such as fixed-income bond funds.

A target-date fund assumes the best-case scenario and has no mechanism to shift allocations if the market experiences any kind of swing up or down. In contrast, dynamic risk management that focuses on strategic diversification can respond to shifting market environments in real time, helping investors avoid market extremes. Flexible Plan Investments (FPI) offers strategies that are dynamically risk managedand are both age- and suitability-appropriate.

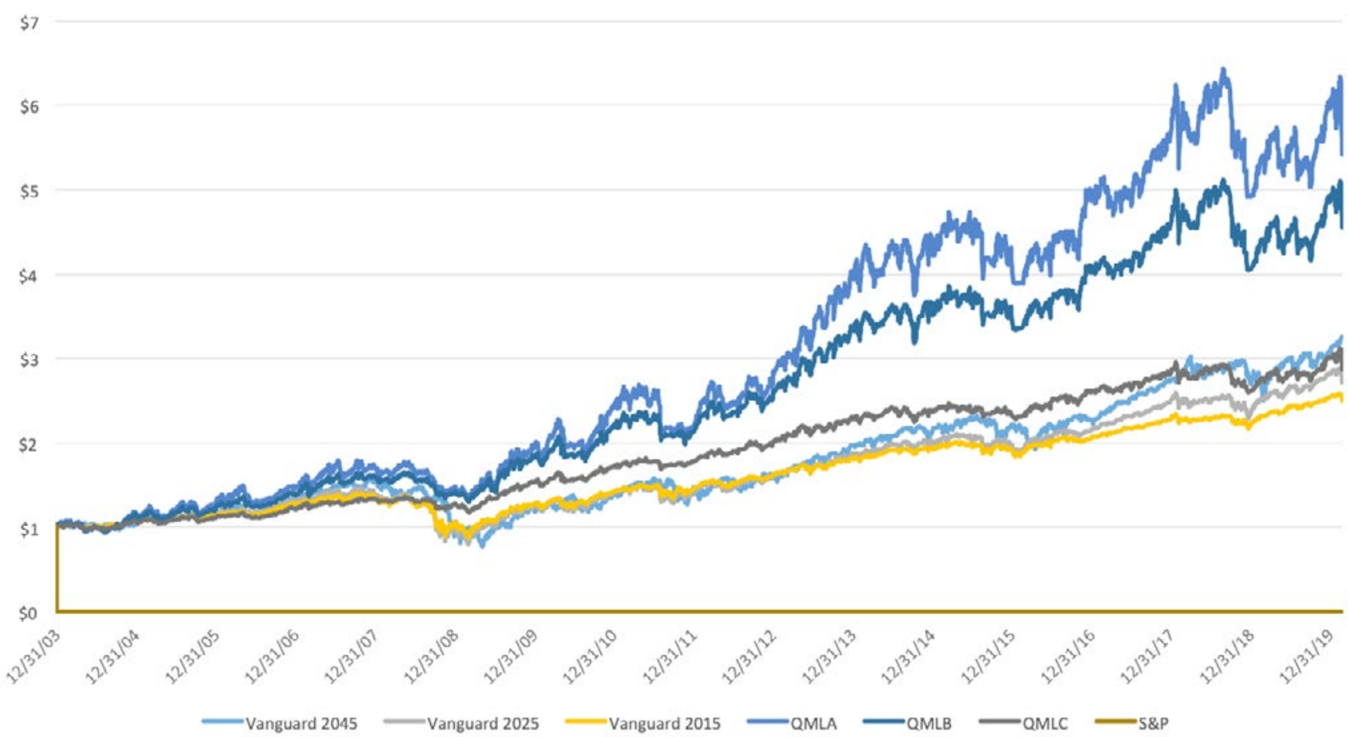
This means that the allocations can change in response to market conditions, helping investors progress toward their retirement investment goals with less volatility. In contrast to a one-size-fits-all approach with age being the only determinant, FPI's dynamic, risk-managed core offerings are customized, geared to the participant's answers to our suitability questionnaire.

Morningstar ran an in-depth test of the performance of target-date funds and found that the average fund with a target date of 2010 lost 23% in 2008, though returns varied widely. The best performer lost 3.6% and the worst lost 41.8%, even worse than the S&P 500's 37% loss. Learning from the 2008 crisis, managers of target-date funds made changes, increasing and decreasing allocations to bonds and equities. However, during the most recent market swing in March 2020, many target-date funds still saw returns as low as -10%, according to data from Morningstar Direct.



Source: Consumer Reports

Dynamic, Risk-Managed Portfolios vs. Target-Date Funds



Source: Flexible Plan Investments Hypothetical Research Report (1/1/2004-2/28/2020). Strategy returns are shown after a 2.25% advisory fee less any available fee credits.

A better solution: Dynamic, risk-managed portfolios

Let's look at an illustration of an account of a participant whose employer selects FPI's QFC Market Leaders strategy, a dynamic, risk-managed strategy that seeks growth by investing in the top-performing international and domestic asset classes plus the leading sectors. We'll compare the relative performance of the different risk profiles of the QFC Market Leaders strategy to the more fixed-allocation approach of the Vanguard Target Retirement Funds.

With the QFC Market Leaders strategy, the participant benefits from periodic allocation shifts that can help mitigate unnecessary risk. The strategy offers two levels of dynamic risk management: (1) within the Quantified Funds (subadvised by FPI) and (2) the allocation/rebalancing between the equity and bond funds.

Additionally, the strategy draws upon a larger pool of investment options to take advantage of opportunities. This key component—strategic diversification (diversifying not only by asset class, but also by investment methodology, strategy, and time line)—is a cornerstone of our investment methodology.

With FPI's dynamic, risk-managed investment approach, even those nearing retirement can benefit from the upside potential of exposure to stocks that some target-date funds do not provide. We seek to take advantage of opportunities in any market environment.

As Morningstar discovered, target-date funds perform well in a perfect world. However, in reality, participants need to capture upside potential and avoid downside risk. Additionally, research has shown that as employees get closer to retirement, they can benefit from additional equity exposure to help achieve a retirement they can afford.

This can be especially advantageous when someone is providing dynamic risk management in the event of a turn to the downside just before, or during, retirement.