Target date funds: More than just a fund

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Providing investors with a sophisticated portfolio solution

Target-date funds (TDFs) have increasingly become a very important part of millions of investors' retirement portfolios, whether in their 401(k) plans, IRAs, or other accounts. However, the term "fund" may not fully convey the level of investment sophistication investors actually receive—leaving some investors unclear about the full value and benefits that TDFs provide.

A diversified portfolio solution

Unlike an individual equity or bond fund that serves to fill a specific "sleeve" of an investor's portfolio, a TDF is a diversified portfolio solution offering individuals professional portfolio management that adjusts over time as an investor moves closer to retirement. We believe that this potential portfolio solution is especially important to investors without access to personalized advice. To get a clear sense of the uniqueness and value represented by a TDF, it is important to look at what these products are, as well as what they are not.

First, what they are. TDFs are professionally managed portfolios designed to adjust their allocations over time among asset classes such as stocks, bonds, and cash investments. The target date in the name of a fund is designed to align with a given investor's anticipated year of retirement. The fund is managed accordingly, with allocations adjusting over time. Earlier in the target date fund investor's life, the fund tends to be positioned for growth, typically by holding more stocks. Later in the investor's life, and as the target date approaches, the fund's portfolio shifts, usually placing a greater emphasis on reducing the risk of losses. During this stage, the fund tends to hold more bonds and cash investments, which have historically tended to be less volatile.

This gradual, systematic shift over time from more aggressive to more conservative allocations is commonly called the "glide path." By following this design, TDFs can address one of the most common pitfalls of investing: failing to adjust for changing financial risk tolerance over time.

In addition to the benefits provided by following a glide path and the gradual reduction of risk over time, many TDFs have evolved from their more basic beginnings to become increasingly sophisticated investment solutions.

A diversified portfolio solution *(continued)*

While typical allocations include stocks, bonds, and cash investments, many of today's TDFs also invest in less traditional asset classes with the goal of improving overall diversification. For example, these funds often include allocations to traditionally less common asset classes such as international small cap stocks, emerging market stocks, real estate investment trusts (REITS), commodities, and a variety of fixed income securities.

Today's TDFs have also evolved in their usage of a broader range of underlying strategies to further improve diversification. In fact, many TDFs include over twenty underlying strategies, sometimes even from multiple firms. Furthermore, some TDF's also seek to use both active and passive underlying strategies to further enhance the diversification, as these strategies can behave differently depending on where we are in a market cycle.

With an ever-expanding menu of asset classes and strategies at their disposal, many TDFs now go well beyond managing a traditional glide path where allocations are more simply shifted among stocks, bonds, and cash investments. Increasingly, portfolio managers may further refine a portfolio's risk and return characteristics by also adjusting allocations among a variety of sub-asset classes and different types of underlying strategies. For instance, later in the glide path, allocations to more volatile asset classes such as emerging markets or commodities might be reduced in favor of large-cap domestic stocks.

Creating, monitoring, and adjusting a portfolio with such a wide array of asset classes and underlying strategies would likely be a daunting task for the average individual without access to supporting analyst teams and portfolio software. With a TDF, investors truly gain easy access to experienced, professional managers that are supported by deep resources.

Compelling benefits, often at great value

In terms of cost, TDFs can represent good value, with several actively managed or blend providers offering these products with expense ratios between 0.32% to 1.19% at the end of 2017 according to Morningstar. Larger 401(k) plans may have access to TDF's at lower costs, sometimes at 0.08% or less.

Since this level of expense ratio often covers both managing the TDF itself, as described above, and the cost of the underlying funds, investors are gaining one-stop access to multiple important aspects of portfolio management for a single low fee.

Compared with the time and cost of creating a similar portfolio from scratch, or the higher cost of some traditional managed or wrap account platforms, TDFs bring investors without access to fully customized advice very compelling benefits, often at great value.

What TDFs are not

Now, what TDFs are not. First, unlike, an FDIC insured CD, they are typically not guaranteed. Like many financial vehicles, the value of an investor's portfolio will fluctuate depending on the value of the underlying investments. However, TDFs are very well diversified, which may help smooth returns over market cycles. And, in parallel, equity market exposures and other risks are systematically managed over time.

Second, TDFs are not short-term investment solutions. The asset allocation strategies employed by most TDFs assume that investors will own the funds over the long term and likely through multiple market cycles. As a long-term investment, investors must be prepared to accept a degree of volatility in order for the funds to potentially achieve growth over time. With TDFs, an investor receives professional allocation and rebalancing discipline even through the market extremes—good and bad—so investors have the opportunity to achieve long-term success.

Third, while TDFs are designed to address the retirement needs of the vast majority of investors, they're not currently customizable for each individual's specific situation. For example, TDF design modeling doesn't generally consider whether an investor has significant outside assets apart from their 401(k) or retirement account, or if they plan on retiring at a significantly older or younger age.

However, TDFs are likely to continue evolving to even better address these issues and investor needs. Volatility management, income generation, and combining with insurance-like products are all areas of potential product research and development that we believe is likely to occur in coming years.

Understanding what TDFs are (and are not) is a good place to start in setting expectations and determining how these investment vehicles should be used by clients. It is rare for such a sophisticated financial planning solution to be so easily accessible to investors across various stages in life at such a modest cost, and for various account sizes. Because of these attributes, TDFs have grown in popularity in both personal retirement portfolios and corporate 401(k) plans. TDFs should be viewed not as just funds but as sophisticated portfolio solutions designed and still evolving to help investors meet their retirement savings goals.

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Kevin Bowman is a Director for DCIO Channel Management supporting Charles Schwab Investment Management (CSIM). In this role, he is responsible for initiatives to grow and support CSIM's defined contribution investment-only business.

Mr. Bowman joined Schwab in 1995, serving in a series of large-scale project and product management related positions within the Retirement Plan Services and Investment Management Services organizations. Most recently, he was responsible for the product management of Schwab's Target Date, Target Risk, Balanced and Managed Payout products; as well as other products for the institutional retirement marketplace.

Mr. Bowman earned a Bachelor of Science in Finance from Miami University in Oxford, Ohio. He holds Series 7, 24 and 63 licenses.

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Target date fund asset allocations are subject to change over time. The principal value of the funds is not guaranteed at any time, and will continue to fluctuate up to and after the target date.

There is no guarantee the funds will provide adequate income at or through retirement. The funds are built for investors who expect to start gradual withdrawals of fund assets on the target date, to begin covering expenses in retirement.

The funds are subject to market volatility and risks associated with the underlying investments. Risks include exposure to international and emerging markets, small company and sector equity securities, and fixed income securities subject to changes in inflation, market valuations, liquidity, prepayments, and early redemption.

Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

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