

Grading Target Date Funds from a Fiduciary Perspective

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I'm tired of seeing high risk get good grades.

Target date funds (TDFs) are the biggest deal in 401(k) land so there is great demand for a scoring system. Morningstar has become the recognized TDF rating authority, but much of their rating is based on investment performance. Not surprisingly, funds with high U.S. stock allocations receive high marks because U.S. stocks have skyrocketed in the past 5 years, leaving other asset classes in the dust. But winning the performance horserace over this time period is more of a warning than it is a triumph. U.S. stocks are risky, and someday the U.S. stock market will correct.

Fiduciary Considerations

The fiduciary duty of care mandates protection of the vulnerable from foreseeable harm. It's like our obligation to protect our children – it's a moral imperative as well as a legal responsibility. At the same time, fiduciaries strive to earn reasonable returns on assets in TDFs. So how is a fiduciary supposed to reconcile these conflicting mandates? The beauty of a TDF is its changing emphasis through time, moving from aggressiveness for young participants to protection for those nearing retirement. This argues for a fiduciary score that focuses on the endpoints, as summarized in the graph on the right, showing various TDF glide paths.

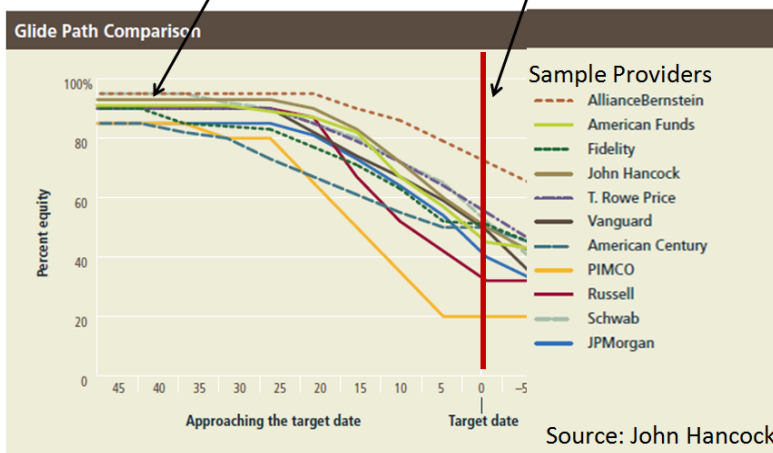
Looking to the left of the graph at long terms to target date, we see consensus in high equity allocation – the lines cluster. The differentiator at long dates is diversification. Theory states, and evidence confirms, that diversification improves the risk-reward profile of a

(1) **Fees:** Less than 50 bps all-in

(2) **Diversification:**
Global Stocks, Global Bonds,
Global Real Estate, Commodities, Natural
Resources, etc

(3) **Defend at Target Date:**

No Risk



portfolio. Greater diversification leads to higher returns per unit of risk.

Looking to the right of the graph, near the target date, you see great disagreement, with equity allocations at target date ranging from a high of 70% to a low of 20%. The better fiduciary choice is safety at the target date, or low equity allocation. Here are some of the reasons:

Incontrovertible Imperatives for Zero Risk at the Target Date

1. There is no fiduciary upside to taking risk at the target date. Only downside. The next 2008 will bring class action lawsuits.
2. There is a “risk zone” spanning the 5 years preceding and following retirement during which lifestyles are at stake. Account balances are at their highest and a participant’s ability to work longer and/or save more is limited. You only get to do this once; no do-overs.
3. Most participants withdraw their accounts at the target date, so “target death” (i.e., “Through”) funds are absurd, and built for profit.
4. Save and protect. The best individual course of action is to save enough and avoid capital losses. Employers should educate employees about the importance of saving, and report on saving adequacy.
5. Prior to the Pension Protection Act of 2006, default investments were cash. Has the Act changed the risk appetite of those nearing retirement? Surveys say no.
6. Ignoring the past (especially 2008) and hoping it’s different the next time is not an option, and it’s certainly not an enlightened view of risk management.

A Fiduciary Score

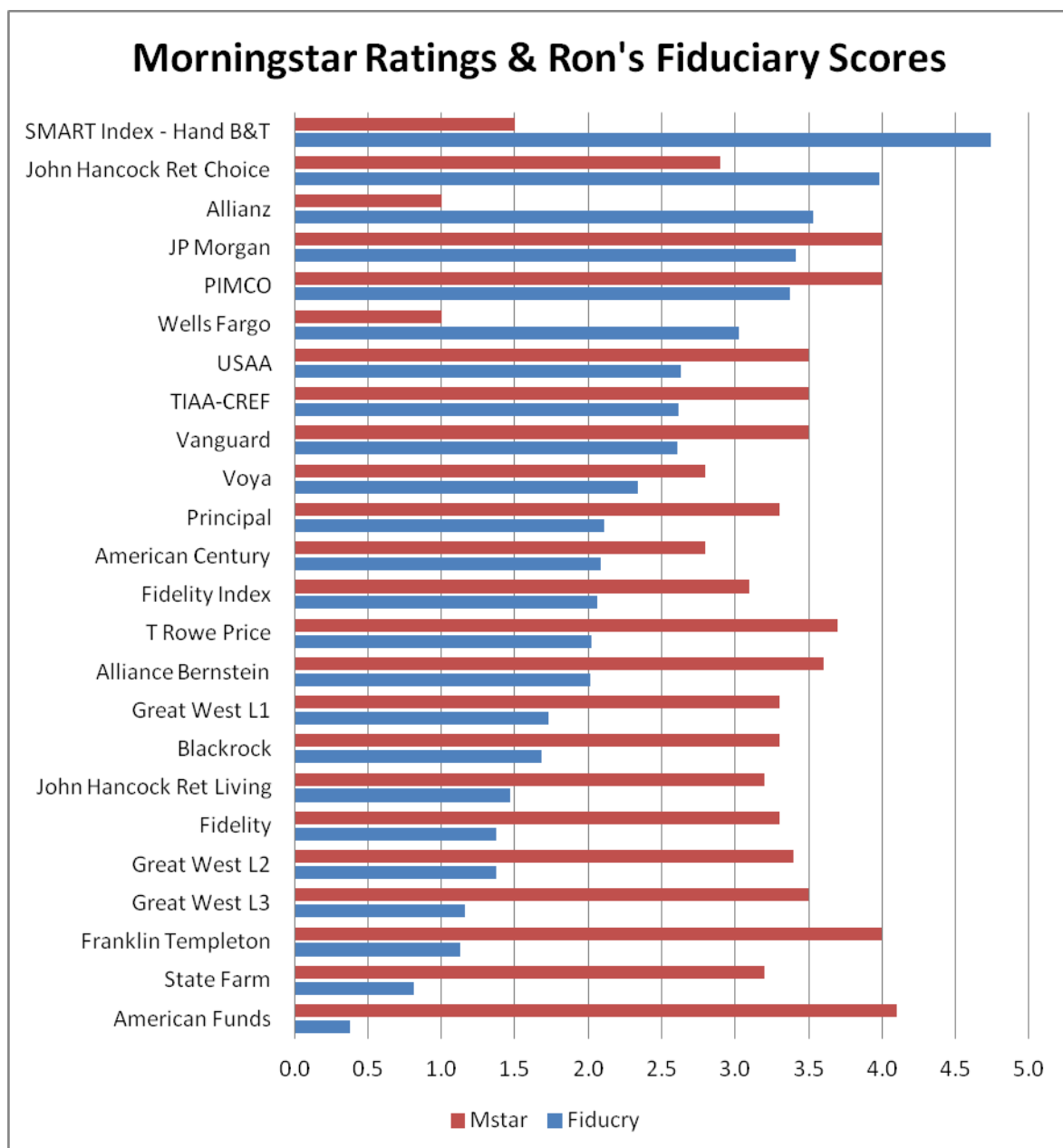
These considerations argue for a new grading system that focuses on these key differentiators:

- Who has the broadest diversification at the long dates when risk is being taken for younger participants? Broad diversification includes global stocks, global bonds, global real estate, commodities, natural resources, etc. The equity

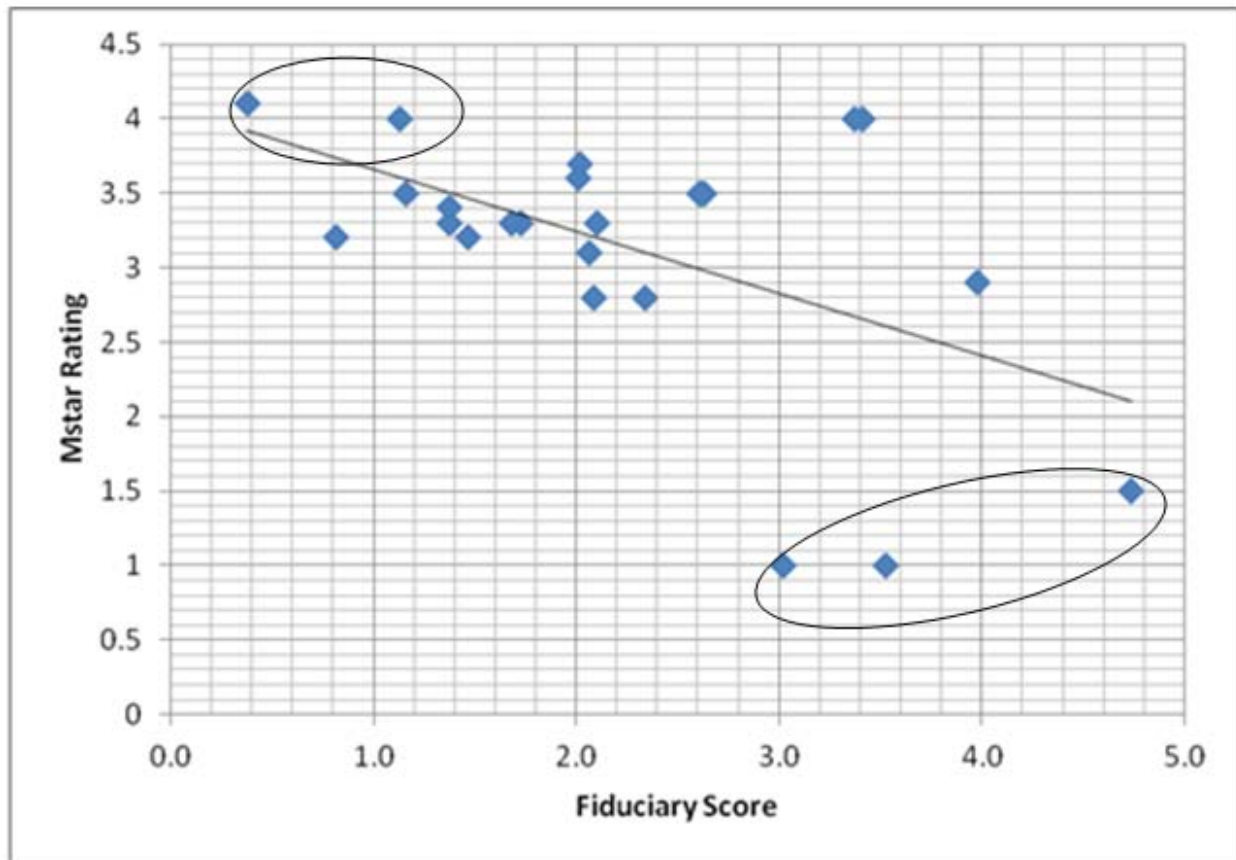
allocations of most TDFs are similar at long dates. The differentiator is diversification.

- Who defends best at the target date? Who has the least amount of risk? There is a wide dispersion of equity allocations across TDFs at the target date. The differentiator is safety, i.e. lowest risk.
- Are the fees reasonable?

I created a score that uses these three fiduciary considerations. See the Appendix for the details. The contrasts of my Fiduciary Score results to Morningstar Ratings are revealing, as shown in the following 2 graphs.



3 of the top 6 Fiduciary Scores have low Morningstar Ratings, & 2 of the 4 high Morningstar Ratings have low Fiduciary Scores.



Conclusion

Fiduciaries now have a choice between TDF rating systems that are quite different. You can choose between Prudence and Performance. I hope you find my Fiduciary Scores helpful.



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[Target Date Solutions](#) developed the [patented the Safe Landing Glide Path®](#), the basis for [the SMART Funds® Target Date Index](#) collective investment funds on Hand Benefit & Trust, Houston, the only investable target date fund index. Ron is co-author of the [Fiduciary Handbook for Understanding and Selecting Target Date Funds](#).

Appendix: Constructing Fiduciary Scores

The Fiduciary Score is not very quantitative, & much simpler than the Morningstar ratings. It uses only 3 pieces of information that I literally obtained from each fund's prospectus (by hand, over 2 full days):

1. Fees: I used average fees across all funds
2. # of diversifying risky assets at long dates: I counted these, & excluded allocations that are less than 1%. Some funds have meaningless allocations to commodities for example.
3. Safety at target date: % allocation to cash & other safe assets, like short term bonds & TIPS.

Here's the table I filled out by hand:

Company	Fee (bps)	# Risky	% Safe
SMART Index - Hand B&T	34	6	90
John Hancock Ret Choice	69	5	40
Allianz	117	6	40
JP Morgan	82	6	30
PIMCO	85	6	30
Wells Fargo	53	4	25
USAA	80	4	25
TIAA-CREF	21	3	15
Vanguard	17	4	10
Voya	113	6	20
Principal	86	6	10
American Century	96	4	20
Fidelity Index	16	3	5
T Rowe Price	79	4	15
Alliance Bernstein	101	4	20
Great West L1	99	4	15
Blackrock	98	5	10
John Hancock Ret Living	91	5	5
Fidelity	63	3	5
Great West L2	102	4	10
Great West L3	95	4	5
Franklin Templeton	110	4	8
State Farm	119	4	5
American Funds	93	2	0

The next step is a little quantitative. I made up some rules for the importance of each factor:

- Safety got the highest importance. I adjusted the “% safe” allocations so the safest got a score of 25
- Fees are 2nd in importance. I weighted them at 15.
- Diversification gets a max score of 10

Then I add the 3 scores for each & divide this sum by 10, so the highest composite score is 5: $(25 + 15 + 10)/10$

The 1st table is totally verifiable. We can discuss the weighting scheme in the following 2nd table:

Company	Fiduciary Score			
	Fee (15)	Divers(10)	Protect(25)	Fiducry
SMART Index - Hand B&T	12.4	10	25.0	4.7
John Hancock Ret Choice	7.3	7.5	25.0	4.0
Allianz	0.3	10	25.0	3.5
JP Morgan	5.4	10	18.8	3.4
PIMCO	5.0	10	18.8	3.4
Wells Fargo	9.6	5	15.6	3.0
USAA	5.7	5	15.6	2.6
TIAA-CREF	14.3	2.5	9.4	2.6
Vanguard	14.9	5	6.3	2.6
Voya	0.9	10	12.5	2.3
Principal	4.8	10	6.3	2.1
American Century	3.3	5	12.5	2.1
Fidelity Index	15.0	2.5	3.1	2.1
T Rowe Price	5.8	5	9.4	2.0
Alliance Bernstein	2.6	5	12.5	2.0
Great West L1	2.9	5	9.4	1.7
Blackrock	3.1	7.5	6.3	1.7
John Hancock Ret Living	4.1	7.5	3.1	1.5
Fidelity	8.2	2.5	3.1	1.4
Great West L2	2.5	5	6.3	1.4
Great West L3	3.5	5	3.1	1.2
Franklin Templeton	1.3	5	5.0	1.1
State Farm	0.0	5	3.1	0.8
American Funds	3.8	0	0.0	0.4