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Why Target-Date Funds Might Not Be The Best Retirement Planning Option for You

Author: Martha C. White I Editor: Jill Cornfield
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Target-date funds are incredibly popular, but in an era of pronounced market volatility, some employers are rethinking their commitment to these funds. Should you?

"Mindless." "No-brainer." Financial planners use terms like these to describe **target-date funds**. That's not necessarily an insult — not exactly, anyway. Pros say target-date funds play a valuable role in helping people diversify their retirement portfolio, especially since they often are the default option in an **employer's retirement plan**. A report from investing giant **Vanguard** found that a whopping 98% of plans with an **automatic enrollment feature** put those employees' contributions into a target-date fund.

Target-date funds are investment vehicles — generally comprising a mix of U.S. and international stocks, bonds and other investments — that are structured to gradually shift from a more aggressive to a more conservative allocation, with **less invested in stocks**, and more in bonds and government securities or cash as the target retirement year draws closer. The funds are designed to be the only investment an investor uses, since they're meant to take someone's assets safely to retirement age.

And they're incredibly common: Vanguard found that 95% of retirement plans offered target-date funds at year-end 2021, up from 84% in 2012. Nearly all Vanguard participants (99%) were in plans that offer target-date funds. Eighty-two percent of participants with access to target-date funds used them, and 69% of the people owning target-date funds used only a single target-date fund.

How many people still use target-date funds?

About two-thirds of employers think target-date funds are good for their workers' retirement goals, according to investment and insurance provider **TIAA**. That's a solid majority, but it's a drop of 12 percentage points from a survey in 2020. Then, 78% of employers felt confident that target-date funds would help their workers retire comfortably.

No coincidence, but that same time period encompassed a roaring return of the pre-pandemic bull market, followed by a virtual roller coaster as inflation has pressured household balance sheets and corporate profits.

In theory, the automatic rebalancing helps ensure that investors don't approach retirement with a nest egg that could be wiped out if the market tanks. In practice, it doesn't always work out that way. Even among funds with the same target year, there are big differences in performance and risk exposure, a 2017 Department of Labor report found. "Adjusted for risk, we find large differences in rates of return, which are only partially explained by **funds' expense ratios**," the report said.

Target-date funds have some drawbacks

Part of the challenge is that **as people live longer**, the timeline for these funds to provide adequate income for their living expenses lengthens. An ultra risk-averse approach to investing, especially in an environment of high inflation, could mean falling short of necessary money to pay for people's basic needs in their later years. Financial pros say that even those nearing or already in retirement need to **retain some exposure to stocks**, which provide growth but also introduce risk.

Clark Kendall, president and CEO of Kendall Capital, says the primary limitation of target-date funds is that they don’t capture nuances about your personal financial circumstances. “They’re the default options for many retirement accounts, [but] the disadvantage of them is it's based upon just one factor of your financial profile. It’s based on your birthdate,” he says.

In fact, your income needs in retirement could vary greatly based on where you plan to live, other income streams you will have, other financial obligations you anticipate — such as helping children or grandchildren pay for their education — and so on.

Target-date funds are best for younger retirement planners

Should you invest or skip target-date funds? Broadly speaking, financial planners say target-date funds are a better idea for younger workers just beginning their retirement-savings journey.

“Target-date funds can be a fine way to get started, but most people should not look at these funds as the same as a personally crafted portfolio,”says Robert Schmansky, founder of Clear Financial Advisors.

“The good thing about target date funds is it does allow for a more ‘set it and forget it’ type of mindset,” says Ben Koval, president and founder of SoundPath Retirement Strategies. “For someone a couple of decades away from retirement, it gives them an opportunity to have a diversified portfolio but not have to manage it.”

George Kiraly, founder and chief investment officer at LodeStar Advisory Group, advises looking under the hood of any target-date fund you choose. “Research and monitor the holdings that make up your specific fund,” he says. “Make sure they are appropriate given your risk tolerance and that there are no poorly performing investments being added or held over time.” Even target-date funds that track the performance of a major index can hold stock of different companies within that index.

How to use target-date funds as you near retirement

The closer you get to retiring, the more likely you are to want investments oriented more to your specific circumstances — the kind of fine-tuning you won’t get with a target date fund.

“It doesn't work very well as you get within five years of retirement,” Koval says. “When you get within about five years out, you need to look at more specific investments,” because target-date funds have pre-set allocations that might not conform to your retirement goals.

They also aren’t responsive to market performance, which is why a portfolio composed mostly or entirely of target-date fund investments could leave you exposed to too much risk if your retirement coincides with a bear market.

“They offer little or no protection from downside volatility, which is important to most investors approaching, or in retirement,” Kiraly says. “Your portfolio should offer flexibility in order to adapt to changes in personal circumstances as well as changes in market conditions.”

For people planning to retire in the next several years who don’t have the time or wherewithal to take an active hand in managing their retirement account, Koval suggests hiring a financial planner who will charge by the hour to look over your portfolio and help you optimize your allocations.

“It's more about how to increase stability,” he says. “There's a false sense of security with some of these target-date funds.”