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New Research from EBRI:

Target-Date Fund Users Holding Other Funds May Have Unintended Allocations and Risks

WASHINGTON—Some investors in target-date funds, a rapidly growing option in 401(k) retirement plans, apparently do not understand the purpose of the funds and could end up with a potentially inferior portfolio in terms of risk/return tradeoff, according to a study published today by the nonpartisan Employee Benefit Research Institute (EBRI).

The study, in the December *EBRI Notes*, reports that at year-end 2008, nearly 7 percent of 401(k) assets were invested in target-date funds (TDFs), according to the EBRI/ICI 401(k) database, the largest of its kind. Among participants in their 20s, 15 percent of their 401(k) assets were invested in target-date funds, while among participants in their 60s, almost 6 percent of their 401(k) assets were invested in the funds.

This growth is the result of recent legislative and regulatory inducements—notably the U.S. Labor Department's approval of target-date funds as a qualified default investment alternative in 401(k) retirement savings plans, according to the study, available at www.ebri.org

Because target-date funds were designed to be "all-in-one" portfolios that diversify asset allocations and rebalance over time based on a defined target-date horizon, participants who lack financial literacy or desire to use institutional expertise in asset allocation and portfolio rebalancing may benefit from investing in these funds, the study notes.

"However, holding TDFs with other funds could lead to an unexpected result of ending up with a potentially inferior portfolio in terms of risk/return tradeoff from more assets allocated to some sectors than the designers of the target date funds had planned," the study adds.

The study finds that as target-date funds are offered to plan participants (on either a default or voluntary basis), a new class of investors is emerging: TDF users who hold the funds in combination with other funds in their 401(k) plan menu. Target-date fund users holding other funds, referred to as "mixed" TDF investors, are likely to be middle-income and middle-wealth participants. Mixed target-date fund users accounted for about 55 percent of the participants holding TDFs in their accounts as of the end of year 2007.

Those investing only in target-date funds are referred to as "pure" TDF investors. They are more likely to be younger or lower-salary participants who are automatically enrolled into target-date funds.

Overall, the study says, some mixed target date fund investors "apparently fail to understand" that a TDF is designed as an "all-in-one" portfolio solution. For instance, mixed target date fund users are more likely to hold multiple TDFs than are pure users who invest only in TDFs, and low-level mixed target-date fund users (who invest less than half of their account balances in the funds) are more likely to use two or more TDFs than are high-level mixed users (who invest more than half their balance in the funds).

In addition, mixed users holding relatively aggressive target-date funds for their age group (such as someone in their 50s investing in 2050 funds) are more likely to actively invest in equity funds than those following the age-specific investment rule.

The study uses a sample from the 2008 EBRI/ICI 401(k) database looking at plans having at least 10 participants and offering any target-date funds in 2008. The sample includes participants between ages 20–69 with an account balance of between $10,000 and $250,000 as of year-end 2008.

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