

# Are Automated Retirement Plan Investment Strategies Simply Too Good to Be True?

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Innovation has long been a hallmark of the financial services industry as new financial products are continually developed to anticipate and meet the perceived needs of savers and investors. However, some of these developments miss the mark by offering oversimplified strategies to very complex investor needs, which can create a false sense of security. Over the years, we've seen many examples of this in the defined contribution plan marketplace.

During the past 30+ years, the 401(k) industry has undergone tremendous change and ushered in significant advancements in the areas of technology, education, and investments with a singular goal: to make these important savings plans more effective for participants pursuing their desired retirement outcomes.

Defined benefit plans once dominated the retirement landscape as the primary benefit provided to employees. The beauty of these plans was that they required no effort and little knowledge on the part of employees, except to remain employed long enough to be fully vested in the plan.

Gone the way of the dinosaur, defined benefit plans have been largely replaced by 401(k) and similar defined contribution plans which shift responsibility onto plan participants to adopt prudent savings and investing behaviors. They place an equally ominous fiduciary responsibility on plan sponsors to provide the tools and education to help them succeed.

Yet, despite increased access to investment tools and education, many



participants still failed to meet their desired retirement goals. Often, the reason had more to do with participant behaviors, rather than long-term market performance, such as:

- Chasing returns
- Emotional decision-making
- Apathy - not paying attention to their accounts and failing to rebalance allocations over time
- Changing investment objectives and asset allocations based on market conditions instead of long-term goals

As a result, the mutual fund industry recognized an opportunity that could potentially make the investing process easier and more effective for plan participants while increasing their own assets under management by attracting more dollars into proprietary funds.

In their first attempt to help make investing easier for participants, the mutual fund industry introduced **Lifestyle funds**. A Lifestyle fund is a preset mix of various mutual funds (often from the same mutual fund family) based on a level of risk determined by the overall allocation of equities, bonds, and/or alternative investment funds within the portfolio. Lifestyle funds with a greater concentration of equity funds would be more growth oriented and carry potentially higher risk due to market volatility. A Lifestyle portfolio with a larger concentration in bond funds would be more income driven and thus offer potentially lower risk of volatility.

A primary benefit was that a participant only had to pick one Lifestyle fund aligned with their risk tolerance. If a participant's investment objectives changed at a later date, they could select a different Lifestyle fund that was more in line with their goals. A secondary benefit offered by many mutual fund companies is periodic portfolio rebalancing to ensure the portfolio adheres to the pre-determined risk level as stated in the Lifestyle fund's prospectus. This helps the portfolio from becoming too conservative or too aggressive.

However, neither of these benefits removed the burden on participants saddled with determining the appropriate risk/reward scenario for the retirement outcome they desired, as well as recognizing when to make

changes. Theoretically, younger participants would invest in a more aggressive Lifestyle fund to better position themselves to reap the potential long-term benefits of a more volatile, growth-oriented portfolio. As they neared retirement, they would move to a Lifestyle fund offering less risk and greater income potential. However, this approach does not factor in two important retirement risks: increased longevity and the impact of inflation. For many plan participants, moving an entire portfolio to a seemingly “safer” option prior to or at retirement—when the income that portfolio generates needs to potentially support them for another 25 or 30 years in retirement—can actually be detrimental to achieving the goal of income for life.

As a result, some investors may find Lifestyle funds to be an oversimplified solution to a very complex challenge.

To solve for X, the mutual fund industry introduced **Target Date funds**. Target Date funds were lauded as the next generation of pre-packaged managed funds designed to help eliminate the need for participants to recognize and then adjust their portfolios based on risk tolerance. This would now be done by professionals managing the portfolio.

The Target Date approach to portfolio management is similar to that of Lifestyle funds and typically consists of multiple sub-account managers overseeing various equity, bond, and/or alternative investment sectors. However, in the case of Target Date funds, the mutual fund portfolio manager seeks to lower portfolio risk over time by reducing exposure to equities and increasing exposure to bonds as the participants move closer to retirement age. The target date of a fund is the approximate date when investors plan to start withdrawing their money.

#### However, Target Date funds make two potentially false assumptions:

1. A participant’s age is the sole determinant of risk tolerance. This assumes that all 20-somethings are okay with the level of portfolio volatility inherent in the more aggressive, higher risk equity-driven Target Date funds created for participants in their 20s. Likewise, Target Date funds assume that as investors age, they’re okay with increasingly lower returns as a result of an increasingly more conservative strategy.
2. As participants age, their exposure to equity investments should decrease over time. Target Date funds are managed to reduce equity exposure and increase bond exposure to help lower volatility as participants near retirement age. However, the flip side is that expected performance will also be reduced and lower returns can have a significant impact on a future retiree’s retirement income projections.

These assumptions can unknowingly create problems for participants. First, participants may select Target Date funds based on their age that do not align with their individual risk tolerance and comfort level. Therefore, when fund performance vacillates, participants may become unnerved and prematurely abandon the strategy, which can impact their ability to pursue their long-term goals.

Second, participants may be encouraged to use retirement plan calculators to select what they feel is the correct average annual rate of return needed to achieve their retirement goals. However, what is seldom made clear to participants is that Target Date funds do not seek to achieve a consistent average annual rate of return over time. Instead, they seek to achieve lower rates of return commensurate with the lower risk in the portfolio as participants move closer to retirement age. Participants who fail to understand this concept could find themselves earning a lower rate of return than required to achieve their retirement goals, based on their unique needs and circumstances that are not accounted for in the Target Date strategy.

Lastly, mutual funds typically use portfolio managers from their own stable of fund managers which can create fund bias and potential conflicts of interest. Mutual fund bias is often the result of using the same (typically in-house) resource for both market research and underlying investment selection. This can lead to a lack of objectivity and makes it difficult for plan participants to determine if investment decisions are truly being made in their best interests or in the best interests of the fund company.

While Lifestyle and Target Date funds were introduced to help reduce the burden placed on plan participants in managing their retirement plan investment portfolios, for many, these strategies may simply be too good to be true. It’s important for participants to understand that “hands off” isn’t synonymous with “risk free,” before handing over full control of their retirement plan portfolio to a mutual fund family. In this case, the risk is one that plan participants can’t live with for long—the potential that they will outlive their income in retirement.

To learn more about ways to simplify complex financial challenges and pursue the Return on Life® you and your family desire, contact the Return on Life Wealth Partners team at 440.740.0130 or visit us online.

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