The Pros and Cons of Target Date Funds

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Most 401k plans offer target date funds as an easy way for participants to start investing. A target date fund is a mutual fund that is composed of several other mutual funds and ETFs. These funds include domestic and international stock funds and fixed income funds. The target date represents the date when the investor plans to retire. The allocation changes over time as you get older. The allocation is more aggressive when you are younger and becomes more conservative as you age.

Target date funds are good for novice investors or individuals who do not want to spend a lot of time researching and selecting investment options. Simplicity is one of the biggest advantages of target date funds. You can select a fund based on when you plan to retire, and your money will be allocated in a manner deemed appropriate for your retirement plans. You don't need to analyze, select, and monitor individual funds. It will automatically rebalance your portfolio as the market fluctuates and it will adjust your allocation to become more conservative as you get older.

This type of fund keeps you diversified across different investment categories and encourages participation from those who are reluctant to contribute to their retirement plan. It also helps investors avoid market timing and extreme investment behavior.

Conceptually, target date funds work well for many investors. Participants like the hands-off approach where you can set it up and forget about it. However, this also presents one of the biggest downfalls. People select a fund and forget about it without understanding the asset allocation and how it will change over time. When you begin investing, the allocation may be appropriate but as you approach retirement, target date funds can become too conservative.

It is common for target date funds to use an allocation of 50% in stock and 50% in fixed income upon retirement and gradually transition to over 75% in fixed income. This is a very conservative allocation for many retirees who anticipate spending 20 to 30 years in retirement. Monitor and understand the asset allocation of your fund to be sure it meets your investment goals.

Target date funds are not customized to your situation, everyone is treated the same based on age. The allocation of the fund does not take into consideration other financial considerations in your life and your tolerance for risk.

Some additional disadvantages to target date funds include potentially higher investment expenses. With a target fund you pay the investment fee for the fund itself as well as fees for the underlying mutual funds held within the fund. Target date funds are generally concentrated in one fund family, providing less diversification and there may be tax inefficiencies if used in a non-retirement account. Do not use target date funds for Roth accounts which should generally be invested more heavily in equities.