

Some TIPS for lawmakers

401(k) investors need a 'safe' target-date retirement fund option

By [Robert Powell](#), MarketWatch

Last Update: 7:09 PM ET Mar 8, 2007

BOSTON (MarketWatch) -- Lawmakers in Washington this week met to discuss whether fees for 401(k) plans are too high or aren't transparent enough. The nation's 401(k) plan participants would have been better served had lawmakers discussed what the appropriate default investment options should be for those who will have their nest egg contributions automatically invested into a target-date or target-risk retirement fund. [Read what happened in Washington.](#)

Or so says Zvi Bodie, a professor at the Boston University School of Management and co-author of a just-published report titled "Making Investment Choices as Simple as Possible: An Analysis of Target Date Retirement Funds."

Under the Pension Protection Act, signed into law in late 2006, employers are now able to enroll automatically their workers in a 401(k) plan and, what's more, the employers will be able to deposit automatically their worker's money in what's called a default investment option.

At present, it appears that two of the default options will be target-date retirement funds (TDF) and target-risk funds (TRF). A TDF is a fund of funds that uses an investor's time horizon -- their anticipated date of retirement -- as the basis for how much is invested in stocks and bonds. Typically, a TDF would invest a greater percent in stocks the longer the time horizon and then gradually reduce that percent over time till the retirement target date is reached.

The TRF, by contrast, is a fund of funds that uses the investor's tolerance for risk -- how much volatility the investor is willing to accept -- as the basis for how much is invested in stocks and bonds. Typically, the TRF would invest more in stocks in an "aggressive" fund and less in stocks in a "conservative" fund. Unlike the TDF, the percent invested in stocks doesn't change over time.

But the two types of mutual funds that will soon become the default investment option for millions of Americans come with some drawbacks.

The TDF does not take into account an investor's risk tolerance. And the TRF doesn't take into account an investor's time horizon. And that means 401(k) plan participants are getting an asset allocation based on only one of the three factors used to build a portfolio: Typically prudent investors would consider their investment objective, time horizon and risk tolerance when deciding how much should go into stocks and how much should go into bonds.

Those drawbacks notwithstanding, TRFs and TDFs have become incredibly popular in recent years. Indeed, investors who either don't have the time or the knowledge to build a retirement portfolio are contributing more and more money into these one-size-fits-all solutions.

And on the surface TDFs are a fairly good investment option for many 401(k) plan participants. "Empirical evidence suggests that a simple TDF strategy would be an improvement over the choices currently made by many uninformed plan participants," Bodie wrote in his paper.

Better options

TDFs may be an improvement for many 401(k) plan participants, but those funds are not perfect default option for all workers, Bodie said in an interview. According to Bodie, TDFs would be the optimal strategy for workers who are in the middle to late stages of their career and work in a stable industry, or who can tolerate risk. Those are what he calls "natural" TDF holders.

"But the TDF strategy may be far from optimal for people who -- although of the same age -- differ from the natural TDF holder in their risk aversion or exposure to human-capital risk," Bodie wrote. "To bring such plan participants much closer to their optimal strategy it is enough to add a second simple investment alternative -- a safe fund matched to their time horizon."

According to Bodie, workers who are averse to risk or who are exposed to "human-capital" risk (those in the early stages of their career or in a volatile industry) could benefit from having a different kind of default investment option in their 401(k) -- a Treasury inflation-protected securities or TIPS. TIPS mature in a certain year and pay interest based on the rate of inflation.

"We find that people who are very risk averse and who have a high exposure to market risk through their labor income would experience a substantial gain in welfare from being offered a safe target-date fund rather than a risky one," Bodie said.

Bodie says 401(k) plan participants who invest in TIPS, though not a TIPS fund, would stay ahead of inflation and have a guaranteed sum of money in their retirement account when they reach their target retirement date, not unlike a person with a traditional pension plan.

By having TIPS and TDFs as investment options in a 401(k) plan, Bodie says "participants with the same time horizon could then choose (or be advised to choose) either the TDF or the safe target-date fund depending on their risk aversion and human-capital risk."

According to Bodie, it's important that investors factor in their human-capital risk when deciding which 401(k) investment options make the most sense. "Recent empirical research suggests that human-capital betas change over one's working career," Bodie said. "They are typically quite high during the early years when human capital represents the largest part of total wealth for most people, and they decline with age."

With hope, lawmakers will see the wisdom of Bodie's argument. And if not, perhaps workers and employers will push to add this low-cost, fee-transparent option to 401(k) plans absent a public hearing on Capitol Hill. ■

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