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Improving life cycle funds

Pensions

Target date strategies should be reassessed, write **Lionel Martellini** and **Vincent Milhau**

The shift from defined benefit to defined contribution pension plans in most developed countries raises serious concerns. It means employees must increasingly rely on their own investment decisions to fund their retirement but typically lack the expertise to make them. In response, the asset management industry has started to offer products that provide solutions for investors' long-term investment needs.

One key innovation is the development of life cycle, or target date, funds that reduce the exposure to equities over a period leading up to the target date.

This is a good attempt at providing added value to unsophisticated investors. However, the question remains whether existing life cycle funds make sense in their current format.

There is an intuitive justification to the advocated decrease in equity allocation. The fact that equity returns tend to revert to the mean (come back to their long-run average values) supports the view that equities are less risky over the long term. It also justifies reducing the allocation to equities as the target date approaches, to guard against the risk of a short-term decline in equity markets just before retirement.

On the other hand, it hardly seems plausible that an allocation strategy depending purely on time horizon could be optimal.

It is possible to show that when equity prices are mean-reverting, the optimal strategy does involve a higher allocation to equities for the young investor compared with the investor who is close to retirement date, which is consistent with the standard forms of target date funds.

But the optimal strategy also displays an element of dependence on the state of the economy. This suggests the allocation to equities should be increased when equities have become cheap and decreased when they have become expensive, as measured through a proxy like the dividend yield or price-earning ratios.

Preliminary results from research, carried out with the support of UFG, suggest that omitting to take the state of the economy, and therefore the financial markets, into account leads to underperformance. Life cycle strategies that adjust the allocation to equities according to relative cheapness of equity markets, as well as over time, dominate the standard approaches by avoiding buying too high and selling too low.

Implementing this approach to target date funds in a delegated money management context is a challenge. It requires a narrower classification of plan participants based on factors other than age.

Subjective factors include age, risk aversion and funding status, while objective ones are the current (estimated) risk premium provided by equities, and the levels of interest rates and volatility.

Financial innovation is needed to design better target date funds that take markets into account.

There is ample room for added value between one-(allocation)-size-fits-all (investors with same age) solutions and do-it-yourself approaches to long-term investment decisions.

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