Casey Mullooly: Welcome back to the Mullooly Asset podcast. This is episode 378 and I'm your host Casey Mullooly. This is part two of our discussion on whether or not target date funds are right for you. We know a lot of people invest in target date funds through their 401(k) accounts, so we thought that this topic was relevant and important for our listeners. Without further ado, episode 378.

Casey Mullooly: One of the main sticking points was, and Peter's counter arguments was that within 10 years of retirement these funds were not the best. He used a little bit stronger words than that, but I guess as a person's actual retirement date is approaching and getting near, I think he's within 10 years of a retirement date is, is the target date fund something that younger people just entering the workforce should be defaulting into, and then as time goes on, maybe they accumulate more assets in there and they can start working with a financial professional? Are target date funds more targeted for younger people and older people shouldn't be using them, or what's your guys take on that?

Tom Mullooly: I'm not necessarily unhappy when a client is within 10 years of retiring and they show us their 401(k) and it's sitting in a target date fund. I think that's better than not being invested or like Brendan had said, trying to jump in and jump out of the market and do some market timing. I mean, go back to doing what you do best, go back to doing your job, instead of watching the market from your desk. I am not opposed when we see that. Can we do some things around the edges to maybe better tailor a portfolio that's more appropriate for them? Yeah. But we're doing a lot more work before we even get to that step. And so, yeah, I'm happy to see that people are investing and they've a long term approach. That's great. It's the other folks who are trying to get too cute with this money and they...

Tom Mullooly: A lot of times we have conversations. I know you do too, where some of these balances in 401(k)s are getting really large, and people are starting to understand that, hey, if I make a misstep here, it's not only a gigantic amount of money, like a year's pay or more, it's going to really hurt me very soon when I retire. And so I don't necessarily know that I want to take that risk all by myself.

Brendan Mullooly: Yeah. I mean, the stakes are higher when you get towards retirement. I mean, it should be the case, at least you've been accumulating your entire career. You're getting closer to retirement. Ideally, yeah, you have enough assets and the means to pay for help from a financial professional, who can take a look and say, "Hey, is this actually a fit based on what you want to do? Is the approximation of the target date fund you've been using, close enough, or should we be doing something different based on what you want to do over the next 10 years in retirement and transition to it in early stages of it? What other assets do you have? Because that factors into your overall allocation and not necessarily just this account that the target date fund is accounting for."

Brendan Mullooly: Yeah, there's a lot that you can dig into and especially at that point in somebody's career, but also there are tons of people approaching retirement, using things like target date funds that aren't going to work with an advisor. For them, yeah, I would rather see them in a target date fund than trying to time the market or do something crazy because they're worried that the stakes are high and that they have to try harder. I don't necessarily think that's true. I think the target date fund again is most of the way there. I'd also say, because we've seen it come across our desks here, that there's a lot of folks that are invested in target date funds that simply don't understand how things work. Because we'll see some folks that have five different target date funds in their account, in their 401(k). It's not-

Casey Mullooly: Yeah [crosstalk 00:04:34].

Tom Mullooly: I mean, again, that's education.

Casey Mullooly: Right.

Tom Mullooly: But yeah, I mean, this should be. It's an asset allocation approach, which as you were alluding to, Brendan, if you can get the asset allocation right, you're 80% of the way home. Or get it close, just don't be harmful because I know we're joking.

Brendan Mullooly: We've seen people who are diversifying "across their target date funds," but I've also seen way worse DIY not targeted fund allocations where somebody sprinkled random... They have lump sums and they randomly stuck it into like, "Oh, this one had the best five year track record at that time so I put it into that." And then I like both of these small cap values funds [crosstalk 00:05:18].

Brendan Mullooly: They own like six of the 10 large cap funds that the plan offers. That's not valuable either, and in fact, I think leads to maybe a sense of false... It's false diversification. Because at least, I mean, if it's overlapping and it's all in the same asset class, let's say like, oh, I just picked the five best three year track records in my plan and they all happen to be large cap growth funds. And then the person thinks they're diversified and they're not at all. They're actually very undiversified. They own all the same stuff across five different funds that are all doing the same thing. I'd rather see them in five target date funds because at least the target date funds are fund to funds and they're getting an exposure that's like balanced across asset classes, as opposed to just loading up and whatever other way you got to [inaudible 00:06:06].

Brendan Mullooly: I'm not saying people can't do it on their own and come to a sensible conclusion. It's just that I don't think most people really like want to do that. I don't think a lot of people can work with a financial professional to do better than that. And so that's who we're trying to solve for, with the target date funds I think. If you're going to work with a financial advisor and get better advice, then you're going to pay out pocket for that and you'll probably get better advice. Yeah.

Casey Mullooly: But it sounds like target date funds are doing a lot of the intangible work, meaning they're giving people their time back. They're giving people their maybe sense of peace back or peace of mind back by not having to do this stuff themselves and worry about making the calls on their own or what the market's doing. The target date fund, it is a set and forget type approach. I think that that is a huge plus and a huge reason why a lot of people use the target date funds in the first place. I also think it's interesting that we're doing this podcast a couple episodes after talking about the behavior gap, and how investors underperform the funds they own by 1.7%. That was a recent study from Morningstar found that investors underperform the funds that they own, which means that the investors themselves are buying and selling the funds that they own at in opportune times. Which I think telling people to do it themselves and not use the target date funds exposes the investors to that exact thing.

Brendan Mullooly: One really great thing about target date funds is that it forces investors to consider their portfolio as one cohesive unit, despite the fact that underneath the hood in each target date fund, you're going to have large cap stocks, midcap stocks, small cap stocks, international stocks, bonds, international bonds, cash. All of these things, maybe even commodities, it depends on the target date fund we're talking about. But it's balancing all those asset classes and sectors. It's putting them all together into a mix that makes sense, based on the blind age number that's been slapped on at the year, that the person might begin needing the money. But it's one pot of money in the sense that the person then doesn't have to go in each year and say, "Hey, large caps did good this year, we need to sell some of those to bring the portfolio back into target and add to the bonds." Or, "We need to add to the small caps or to the international," or whatever else wasn't working.

Brendan Mullooly: People don't do that because if you had to do that rebalancing on your own, I know because we have to do this for clients and I know the human emotions that go along with that. I don't want to do it. You don't want to do it. And then, so you don't do it and then you end up with a portfolio that is nowhere near your target and can probably end up far riskier than then you otherwise thought. If rebalancing feels good, then it's probably not balancing [crosstalk 00:09:15]. You're probably doing reverse rebalancing then and just trying to like add on to more of whatever's been working lately and that's not keeping a constant risk portfolio. That's an entirely different thing.

Brendan Mullooly: And so we try to get clients to think of the portfolio as one cohesive unit, and it's a lot harder when you can look under the hood and see the parts and be like, hey, this part, what's going on with it? Is it broken? Should we [crosstalk 00:09:41]? Well, no, we allocated to that part for a reason and yeah, over the last 12 months it might have stump, but it doesn't mean we're going to quit on it. You have the opportunity to look at that and to nit pick it. I think that that is a huge benefit of these fund to funds.

Casey Mullooly: There was also an article from the Wall Street Journal, which sparked this discussion in here in the office. They talk about how if doing it yourself, you could save a couple basis points pretty much. But over 10 or so years, it works out to a few percentage points. It was pretty much telling people that to go ahead and remake these target date funds and just do it yourself and save those couple basis points. I just want to read the last two lines of the article. "Of course, the downside to doing it yourself is a desire to time markets and rebalance too often. But if one can control that urge, a do it yourself portfolio can net you a few percentage points in retirement." But if one can just control that urge, it's not that hard.

Brendan Mullooly: If I were you, I would simply control my emotions then and I would be great at investing.

Casey Mullooly: So much easier said than done. I think that human behavior is such a crucial part. We've talked about it on pretty much everywhere. Our videos, podcasts, our blog posts, we talk about it all the time with our clients here in the office. How controlling for that, and taking the emotion as much as you can out of investing, usually works out in the long run in your favor.

Brendan Mullooly: You're taking, the target date fund is taking that whole process out of the equation. Instead of saying that you should learn to corral your emotions, it's saying we're not even going to do that. We're going to opt out of that part. Sometimes the avoidance of opportunities to behave poorly is the best way to make sure that you don't do so because otherwise it's in your hands and our hands to do the right thing, time after time.

Tom Mullooly: Yeah. I mean, I think to piggyback on your last comment, Casey, I think what they were saying was that if you did it yourself, instead of letting this target date fund do it, you would see a boost of more than three percentage points in cumulative returns, over 10 years, not per year, over 10 years. Three points.

Casey Mullooly: Right. I think it was 17 basis points a year.

Brendan Mullooly: I mean, just so insane. Why would you do that? In one hand you have the opportunity for that, which also opens you to the opportunity of under performance versus what you otherwise would've gotten by not having to do it yourself, which one year of that could easily wipe out 3% over a decade. One year of, oh, I don't want to rebalance. [crosstalk 00:12:45] to want to rebalance into that. Yeah. Obviously cost matter and everything else equal in a vacuum. Sure. You would want the lower costs, but the lower costs in this case come with the added responsibility of continuing to do the right thing over a decade to make sure that the cost benefit is not being negated by other decisions that you could choose to make.

Casey Mullooly: Right. I think some of the Vanguard target date funds now are around 15, 12 basis points. It's going to be plan dependent. Vanguard's not in every single 401(k) plan, wish it were. But yeah, obviously lower costs the better, but lower costs at what cost? It's about trade offs.

Casey Mullooly: I think target date funds mostly good. We didn't mean to get on Peter Mallouk too much. A lot of his points were right. I thank you, again, just creating some good discussion amongst the finance community on Twitter. We just wanted to talk about this and share our thoughts on target date funds with our listeners.

Casey Mullooly: That's going to do it for episode 378 of the Mullooly Asset podcast. We talked a lot about target date funds in there, and I hope that there were some applicable tidbits of information and you now have a better grasp of how to use target date funds and what they're for. We will see you on episode 379.

Casey Mullooly: Tom Mullooly is an investment advisor representative with Mullooly Asset Management. All opinions expressed by Tom and his podcast guests are solely their own opinion and do not necessarily reflect the opinions of Mullooly Asset Management. This podcast is for informational purposes only and should not be relied upon as a basis for investment decisions. Clients of Mullooly Asset Management may maintain positions in securities discussed in this podcast.