SET IT

AND FORGET IT?

By David Tobenkin

TSP's Lifecycle Funds Make Asset Allocation Automatic. But They May Not Be for Everyone.

WHEN JON COOK, A FINANCIAL COUNSELOR AT THE U.S. ARMY'S ROCK ISLAND ARSENAL in Illinois, converted from being a contractor to a federal employee in 2008, he took the advice he had been giving other federal employees for years – "Join the Thrift Savings Plan (TSP) and invest in its Lifecycle (L) Funds" – and put his money where his mouth was.

"I could not wait to join the TSP and invest in the L Funds," says Cook, who retired in May and responded to a *narfe* magazine reader survey on the L Funds. "As the money coach at the installation, I was well aware of the advantages of the TSP and the L Funds. What could be better than

Illustration by Bill Pragluski, Critical Stages, LLC

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investing in a set of index funds that automatically adjusts quarterly based upon my age? It was perfect. And since I joined the L 2030 Fund in 2008, the beginning of the Great Recession, and retired in 2014, I got to buy low and sell high!" says Cook.

The Smart Savings Act, signed into law on December 18 by President Obama, makes the L Funds the default funds for federal contributions to new federal employees' TSP accounts, beginning in October. By doing so, the number of participants in the funds, which automatically adjust investors' holdings over the years from a high-growth, higher-risk investment portfolio to a more conservative one as retirement approaches, will dramatically increase.

The Federal Retirement Thrift Investment Board (FRTIB) – which operates the TSP – and many employee and retiree advocates, including NARFE, have long been concerned that too many federal employees park their retirement savings in the existing default TSP fund, the G Fund, which is made up of government securities. The G Fund's low growth potential may not be appropriate for federal employees looking to accumulate wealth over the long term, they reasoned.

So, should all federal employees follow suit? Just invest new dollars or transfer existing TSP money into one or more of the L Funds and, essentially, set it and forget it?

Not necessarily, say investment experts and many *narfe* magazine readers. The L Funds offer a number of financial advantages, such as low costs and a disciplined, measured and professional asset allocation approach that will likely save a great number of federal investors from bad investment outcomes. Despite their set-it-and-forget-it nature, however, such funds still require periodic financial planning oversight, particularly as retirement approaches and in post-retirement.

The L Funds are only one TSP investment option and may not be the best choice for a considerable number of federal employees and retirees, say financial experts and survey respondents.

"We are trying to educate people to understand that asset allocation is important, but are we telling them that they should be in the L Funds? No, that's not the message," says Tracey Ray, chief investment officer for the TSP at the FRTIB. "They should make smart decisions. In communications with federal employees, we tell them that if they are not comfortable making allocations to different funds, the L Funds are there to help them do that. But we can't recommend a particular fund because we don't have access to individual investors' financial and life details. They might have access to outside investments, marital income or payments from former jobs. In some cases, that could mean being entirely in the G Fund could be rational for them."

THE BASIC IDEA

The L Funds allow investors to pick the date they plan to begin withdrawing their retirement savings and invest in a fund that automatically adjusts relative amounts of holdings in the five primary TSP funds. The objective is to allow high growth and risk in early years and stabil-

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The L Funds do not include any exotic ingredients. Rather, they are mixes of the TSP's five main funds, which are, themselves, index funds that track specific categories of investments: the C Fund, a stock fund, tracks the S&P 500, an index that includes medium- to large-size companies; the S Fund, a small-cap stock fund, tracks smaller companies; the I Fund tracks an index of international companies' stock; the F Fund, a fixed-income fund, tracks an index of bonds, a generally less volatile investment than stocks, with correspondingly lower returns except in periods of rapid inflation or deflation; and the G Fund, which includes government securities, a class of investments that are the safest but have the lowest returns over longer periods.

The L Funds debuted in August 2005 with five funds. When each fund matures, the money is shifted into the L Income Fund, the most conservative of the L Funds, which includes 74 percent in the G (government securities) Fund, 20 percent in the three stock funds and 6 percent in the F (bond) Fund. Five L Funds are currently open: the L Income Fund; the L 2020 fund, which matures in 2020; the L 2030 fund; the L 2040 fund; and the L 2050 fund. The progressions from a more risky growth orientation to conservative can be seen by comparing the L 2020 fund, which in October 2014 had 51.12 percent in stocks, with the L 2050 Fund, which had 85.75 percent in stocks. The funds' target maturity date is the date that the participant expects to begin withdrawing money from his or her account, which may be later than an employee's retirement date.

The funds are specifically designed around the assumption that an employee's TSP holdings are only one of the three legs of the Federal Employees Retirement System (FERS) retirement-plan stool. They assume that retirees should receive 72 percent of their pre-retirement income in retirement, including roughly 53 to 54 percent from TSP payments, 24 percent from the FERS annuity and 22 to 23 percent from Social Security benefits.

The L Funds have proven to be popular. Approximately 17 percent of total TSP participant balances are invested in them. More than 980,000 participants have all or part of their account balance invested in the L Funds as of November 2014.

FEDERAL SUPPORT OF LIFECYCLE FUNDS

The bill recently signed into law was supported by the FRTIB and its stakeholders, including NARFE, which is a member of the Employee Thrift Advisory Council, a group of 15 organizations representing civilian employees and retirees and a representative of the uniformed services. The new law changes the default investment for the 3 percent of salary automatically committed to the TSP for new hires from the G Fund to the L Fund most appropriate for the individual. It establishes this default only for new enrollees; others who were automatically enrolled in the TSP and have not made their own allocation would continue to have their funds invested in the G Fund. If a TSP participant makes his or her own asset allocation choice, the bill would not affect them.

"We're not going to sweep people in the G Fund into the L Fund. We didn't ask for that authority," says the FRTIB's Ray. "But I think you can assume that when the L Fund becomes the default, that will give it an extra oomph of desirability in the eyes of others. We also will probably do a communications effort to G Fund investors to the effect that, 'You are in

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the G Fund – you may want to consider switching to the L Fund' after the bill is passed and implemented."

KEY ADVANTAGES AND WHAT THE EXPERTS SAY

The L Funds offer investors a number of advantages besides simplicity. One key advantage of the L Funds, like all the TSP funds, is their remarkable low cost compared to private-sector alternatives. That is particularly the case for the L Funds, given that they involve a degree of portfolio management. "The TSP target-date fund has a cost of less than 3 cents per every $100 invested, whereas the industry average for target-date funds is 84 cents per $100, and even a low-cost, target-date fund such as Vanguard's averages 17 cents, which is an amazing difference," says Janet Yang, an analyst at Chicago-based investment research provider Morningstar. That is important because investment management costs, unlike returns of particular investments, are one of the few things that an investor can control, Yang notes.

Then there are the advantages that the L Funds share with all target-date funds, that is their promise to automatically adjust the funds' asset allocations to reduce the danger that an investor will make several common investing mistakes. These include: improperly allocating funds at a given point in time, such as investing too much in funds that are too conservative to provide growth, such as the G Fund, in early years; over-investing in funds that have too high a risk profile as retirement nears or when a large drop in stock prices could severely compromise retirement savings; or shifting funds out of stock funds or not investing in them after a stock market plunge, as occurred for many investors after the 2008 financial crisis. Such a reaction to events caused investors to miss out on the subsequent rebound in stock prices that followed.

"For do-it-yourself employee investors, the L Fund is a valuable tool," says Mark Atherton, president of the Reston, VA, financial planning firm Ticknor Atherton & Associates, who says that more than half his clients are federal employees. "With our clients, we focus on diversification, cost minimization and tax efficiency, and the L Funds have all of those attributes."

"The vast majority of federal investors should invest in the Lifecycle Funds," says Jon Stein, chief executive and founder at Betterment.com, an Internet-based money management service in New York City that provides investors with customized investment plans. "They will make fund allocation decisions in a systematic fashion that investors would otherwise have to impose upon themselves."

COMMON CAVEATS

The most common criticisms of the Lifecycle Funds are ones common to many target-date funds: first, that they are insufficiently tailored to individual investors; and second, that they encourage investor complacency and passivity.

"For a person currently working, the Lifecycle Funds are not bad investment vehicles, but they are one-size-fits-all," says Michael Falk, a partner at Focus Consulting Group in Long Grove, IL, who no longer advises individual investors but researches and lectures on retirement planning issues. "It presumes that you have saved like the majority of people over your career and that you have similar outside investment interests to the majority of federal investors, which are dangerous assumptions."

"I like to build out portfolios specific to what's going on with investors, and, as a result, I rarely recommend using the L Funds," says Mark Keen, a financial planner at Keen & Pocock in Fairfax, VA, and columnist for *narfe* magazine.

"I think, generally speaking, that the Lifecycle Funds can add a lot of value to investors who aren't as diligent as they should be in rebalanc-

ing and becoming more conservative over time," says Benjamin Muchler, managing partner of wealth management company Boston Research & Management, Inc., in Manchester-by-the-Sea, MA. "But if someone came to us with $1 million to invest, it's highly unlikely we'd be considering Lifecycle Funds. You simply have more investment tools outside of the plan than in it."

Falk and other critics are also concerned about the general tone in employer literature for potential investors regarding target-date funds. They fear that descriptions of the funds' automatic, set-it-and-forget-it allocation nature may lead investors to assume that they are a sound choice for most employees based upon inherent design, even if, as noted earlier, they are inappropriate for a particular federal employee.

Some investors also may choose to be in other TSP funds for a variety of reasons. The G Fund, for example, has the unique advantage of being based on U.S. Treasury bonds and pays current interest rates with no downside risk. Those attributes have led Chris Mezines, a retired Internal Revenue Service manager, and many others to park a portion of their funds in that fund rather than the L Funds.

THE END OF THE LIFE CYCLE

The challenges of a one-size-fits-all approach become more significant as the L Fund target date is reached. As with a novel or a movie, designing a good ending for a target-date fund is no easy task. As noted, the funds transition into the conservative L Income Fund as they mature. But many federal employees who retire early may have 30 years of retirement ahead of them. In such cases, the L Income Fund may not produce adequate growth for these employees.

"One-size-fits-all is absolutely not OK when investors retire," Falk says. "Retirees should do a budget-versus-spending analysis to determine how much to hold in bond or stock investments. A Lifecycle Fund will not do that for them."

Given the very conservative L Income Fund portfolio, many placed in it may want to reallocate at least some portion of that fund to a more aggressive set of TSP funds. So what is the ideal retirement asset allocation? While Falk says it will differ for each investor, for many it will include more in equity than the L Income

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Fund provides. "I would start on the basis of 50 percent equity [stock], 50 percent in bonds and government securities," says Falk.

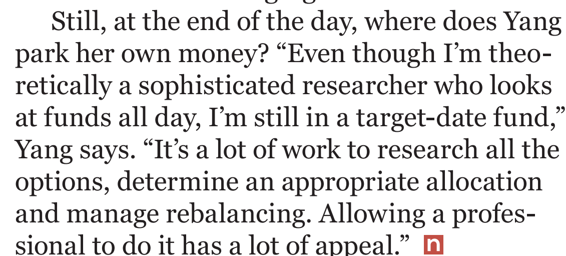
"What I suggest to retirees is that they take the total amount they spend and split it into a budget for needs and a spending plan for their wants," says Falk. "Once you have that two-piece puzzle, you look at Social Security and pension payments to see how those guaranteed payments contrast with their budget. If these two annuities cover the budget, you could actually have the rest of your money in equities."

And it is here that the danger of passivity rears its head. To reallocate their assets, L Fund participants may have to overcome a lengthy period of inaction to muster the will to examine their holdings – essentially having to master a new skill at crunch time.

THE LARGER ISSUE

Some financial services experts also criticize aspects of the L Funds' design. Some say the funds are too conservative; others point out that they contain fewer funds than some target-date funds.

Despite the L Funds' relatively more conservative and less diversified nature, Morningstar's Yang notes that the biggest factor in whether retirement savings will meet the needs of retirees is how much they invested, not whether the L Funds had marginally more in equities or had an allocation to emerging markets.



Still, at the end of the day, where does Yang park her own money? "Even though I'm theoretically a sophisticated researcher who looks at funds all day, I'm still in a target-date fund," Yang says. "It's a lot of work to research all the options, determine an appropriate allocation and manage rebalancing. Allowing a professional to do it has a lot of appeal." n

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