Reflections on Time and Structure

Part I

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In comparing the registered funds available today against investor needs, two things are glaring by their absence. First, the menu of fund choices, broad as it may be, fails to account adequately for the varying time horizons of individual investors. While target maturity funds were designed to address this need, their results have been mixed and they remain limited in both flexibility and effectiveness. Second, while individual funds cater to disparate levels of risk tolerance, their mechanisms to manage risk are assigned invariably to active managers for implementation – and so, an inexact, unpredictable and unreliable process too often results.

Together, this paper and a Part II to follow posit that much of these twin failures of funds to account appropriately for varying time horizons and differing risk tolerances results from a structural deficiency – intrinsic to the most popular fund vehicles. The two papers challenge whether some of these structural shortcomings might be overcome by employing a different approach to product structuring – one that is more flexible and responsive to investor preferences.

"In all our deeds, the proper value and respect for time determines success or failure."

Malcolm X

In his book *Winning the Losers Game*, Charles Ellis establishes quite eloquently the primacy of an investor's time horizon to her decisionmaking:

> "Time -- the length of time investments will be held and the period of time over which investment results will be measured and judged is the single most powerful factor in any investment program."[1]

Somehow – perhaps because different timing needs do not lend themselves neatly to a "one size fits all" approach – a meaningful discussion of investment horizon often seems beyond the reach of the average investor. And, there is a commercial reality as well – financial products are difficult enough to sell as it is. Further sub-dividing the world by yet another meaningful factor, would only add to the mounting marketing and cost challenges of today's fund industry.[2]

[1] Charles D. Ellis, Winning the loser's game: timeless strategies for successful investing, (2002). *See also, Time or Timing?,* Fleishel Financial Associates (Sep. 15, 2016) available at www.fleishelfinancial.com/blog/time-or-timing ("In investing, that lever is time. The length of time investments will be held, the period of time over which investment results will be measured and judged, is the single most powerful factor in any investment program.").

[2] *See generally* Deloitte, *2015 Mutual Fund Outlook: Accelerating the Quest for Growth* (2014) available at https://www2.deloitte.com/content/dam/Deloitte/am/Documents/financial-services/gx-fsi-2015-mutual-fund-outlook-010714.pdf at 5 ("[w]ith 7,800 US mutual funds and 1,400 ETFs currently in play, and more on the way, there seems a limited amount of room left for managers to get the attention of advisers and investors.").

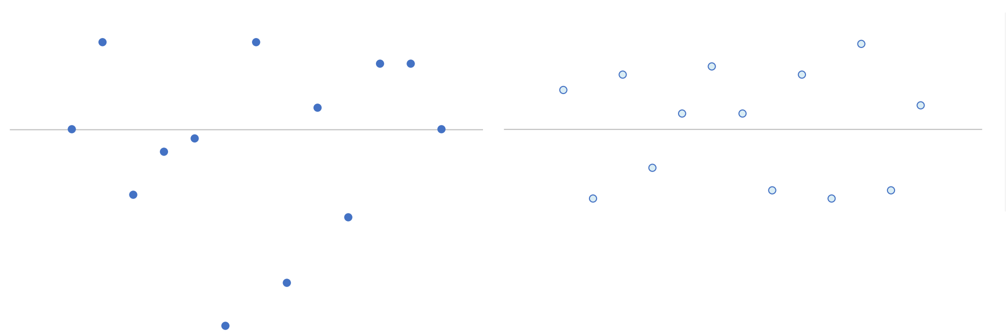
Of course, those with even a modicum of training in financial theory will appreciate Ellis' further observation, that

> "If time is short, the highest return investments - the ones an investor naturally most wants to own - will be undesirable, and the wise investor will avoid them. But if the time period for investing is abundantly long, the wise investor can commit without great anxiety to investments that appear in the short run to be very risky."[3]

An investment horizon describes the length of time for which particular monies will be invested. As such, it is dictated by the planned liquidation date of an investment.[4] And, because "[y]our investment strategy will vary depending on how long you can keep your money invested,"[5] prudent investors match account type with time horizon and choose investments that provide the best expected return over the relevant time period. Squaring an investing time horizon with investment decisions — a relatively simple exercise — can have a weighty effect on an investor's long-term financial prospects.

The passage of time might be said to transform investments along a continuum from least to most attractive. Mathematically speaking, the average expected rate of return remains unaffected by time, but the distribution of actual returns around the expected average is affected dramatically by duration. In essence, the longer investments are held, the closer a portfolio's actual returns will come to matching the expected average. As the two plots at Figure 1 illustrate, there are many different paths to a mathematical mean. As importantly, the path by which such a mean is achieved is of significant consequence to an investor.

Figure 1.



Over shorter time periods, an investor is exposed to the potential for acute loss. And, therefore, responsible investors with shorter time horizons must seek to limit risk. For example, an investor saving for a down payment on a house that

[3] Ellis, *supra* note 1.

[4] *See generally*, Zvi Bodie, Alex Kane and Alan J. Marcus, Investments (4th ed. 1999) at 816.

[5] *See* FINRA, *Set a Time Frame for Your Financial Goal,* available at http://www.finra.org/investors/set-time-frame-your-financial-goals .

he plans to buy in a year or two may choose to save inside of a regular savings account, money market account or a CD maturing in 24 months or less. Here, investment choice is largely dictated by circumstance. With so little time and so close to meeting his investment goal, this investor cannot reasonably risk losing a substantial amount of capital. His portfolio would not have sufficient time to recover should it suffer a short-term loss of any significance. This example illustrates why, as a general rule, investors with shorter time horizons have fewer choices, on the one hand, and larger allocations to less risky assets, on the other. They prefer a plot resembling the right hand side of Figure 1. There is a cost attached to this investment decision, however, as this risk forbearance limits the return the investor might reasonably expect.

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By contrast, with the luxury of an extended time horizon, a wise investor can commit confidently to investments that appear the riskiest, but are most likely to produce the highest rate of return over the long term. With an extended time horizon, an investor can more ably absorb volatile investments, as she can ride out difficult markets and economic cycles. A riskier investment that dips in value over a short period of time would not necessarily frustrate a portfolio's long-term prospects, as the investment has ample chance to recover and appreciate in value with the passage of time. For investors saving for retirement, with 20 years or more until that time, a tax-advantaged account (i.e. 401(k), traditional IRA, or Roth IRA) would represent a better choice than a savings account. Such an investor would typically fund such an account with a portfolio of stocks and bonds, allocated depending on time horizon and other factors including risk tolerance. And, for taking on the additional risk, the expected return of the "risk" portfolio should exceed that of its "conservative" cousin. Accordingly, Figure 1 might be more accurately adjusted to have a midline for the left hand plot that exceeds that of the right hand plot.

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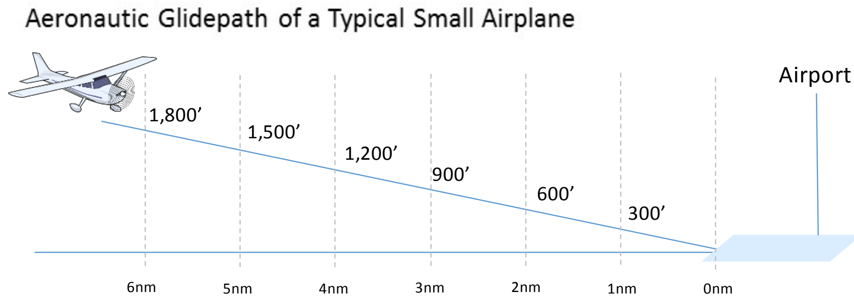
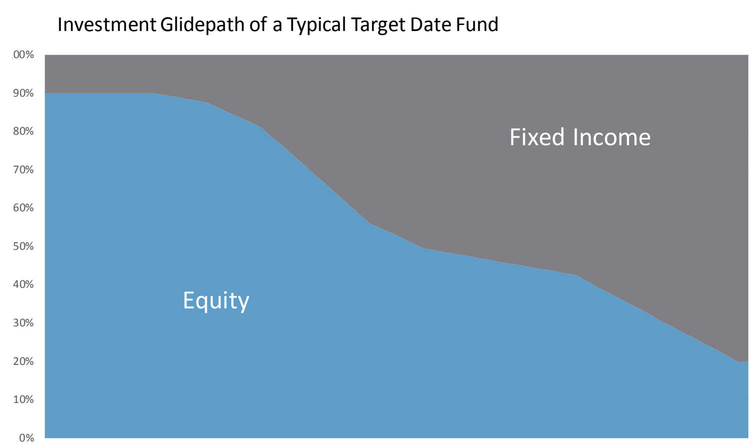
It is important to appreciate that investment horizon is not a static concept. Instead, a dynamic exercise is required to maintain an appropriate time horizon for a portfolio based on the evolving needs and circumstance particular to each investor. For example, as retirement draws nearer, investors regularly adjust their investment mix to account for a shortening investment horizon. And, they generally glide from riskier investments like stocks to safer fixed-income investments. Such adjustments allow investors to keep a toe in the market, on the one hand, yet enjoy appropriate liquidity and capital preservation, on the other. The choices made in defining and implementing this glidepath – an analogy borrowed from aeronautics and describing the process by which an airplane descends to a landing – are personal to each investor and should account for particular needs, circumstances and tolerances. It is not surprising that the details of execution surrounding such a strategy have profound effects on investment return.

Figure 2.



The concept of glidepath (and its attendant adjustments) forms the theoretical underpinning of the target date mutual fund product set. For purposes of this paper, we will consider a target date fund (sometimes, a "lifecycle", "dynamic-risk" or "age-based fund") to be any mutual fund designed to provide a simple investment solution through a portfolio whose asset allocation mix becomes more conservative over time. These funds typically shift their asset mix from return-seeking assets, such as equities, to capital-preservation assets with the passage of time toward the target date (typically retirement). As Figure 3 illustrates, the process for most target date funds remains quite simple: based on a projected, approximate date of retirement, fund managers provide a preset portfolio which gradually increases the proportion of "safer" assets (and, reduces the allocation to "riskier" assets) as the investor ages.

Figure 3.



The appeal of these funds derives from their promise of a lifelong managed investment strategy, according to a generic retirement plan glidepath. The target date fund industry relies on the simple idea that age is the most important determinant in setting an investment strategy. And, for the investor unable or incapable of remaining hands-on and managing his own distinct glidepath, the funds offer an attractive, if not simplistic, default setting.[6] A recent New York Times article describes their appeal quite succinctly:

> "Target-date funds are intended to be all-in-one investing solutions capable of getting you all the way to retirement. They typically don't try to produce market-beating returns, but can provide an approximate mix of stocks and bonds based on your age and planned retirement date."[7]

The growth of target date funds has validated their appeal. According to Morningstar's "2015 Target-Date Landscape" paper, the group now accounts for more than $750 billion in AuM. And, one industry group expects these funds to hold about 35% of total 401(k) assets by 2019, up from 13.5% in 2013.[8]

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However, while target date funds offer a simple and popular solution for the glidepath of retirement planning, it has been widely observed that such products tend to provide a suboptimal strategy for the personal glidepath of a particular individual investor.[9] This deficiency results naturally from the inability of target date funds to account for a number of critical personal considerations such as risk tolerance, employment flexibility and shortfall risk. As a result, target date funds tend to attract an investor base with a lower level of investment sophistication.[10] Investors that seek to optimize their retirement saving throughout the glidepath must employ a more "hands on" approach. As one market pundit observed, target date funds are "just too plain-vanilla and hands-off for the majority of market participants."[11]

While target date funds represent a significant advance in incorporating the concept of time horizon into the investment process for the average investor, the demand for more sophisticated tools is pronounced and growing. As the "Baby Boomers" continue to pour into the retiree demographic, the dearth of investment products tailored to optimize portfolios with shrinking investment horizons is bemoaned by a chorus of money managers and academics alike.[12] At the same time, the immutable shift away from defined benefit pension schemes

[6] *See* Commissioner Luis A. Aguilar, *Advocating for Investors Saving for Retirement* (Feb. 5, 2015) ("These funds offer an appealing and reassuring simplicity for those who lack the time or expertise to plan for their own retirement.").

[7] John F. Wasik, *Target-Date Funds Are Simple, But They Still Require Careful Aim*, N.Y. Times (Apr. 9, 2016); See also Aguilar, *supra* note 7 (referring to these funds as "autopilot investing" because they "allow investors to rely entirely on financial experts to make important decisions about migrating from riskier assets to safer ones as investors approach retirement.").

[8] *See* Chana R. Schoenberger, Fears About 'Target' Funds, Wall St. J. (Mar. 8, 2015) (citing a study by Cerulli Associates, a Boston-based research firm).

[9] *See* Michael A. Guillemette, Terrance K. Martin, and Philip Gibson, Investor Sophistication and Target-Date Fund Investing, Journal of Retirement (Spring 2015).

[10] *Id.* at 22 (concluding that that U.S. investors with low investor sophistication are 22.2% more likely to primarily use target-date funds to save for retirement, compared to highly sophisticated investors).

[11] David Fabian, *Forget Target-Date ETFs -- Consider These Multi-Asset ETFs Instead*, THESTREET.COM (Aug. 21, 2014) available at https://www.thestreet.com/story/12853186/1/forget-target-date-etfs--consider-these-multi-asset-etfs-instead.html.

[12] Darrin DeCosta and Matthew Patterson, *Target Maturity Bond Funds as Retirement Income Tools*, JOURNAL OF INDEXES (Feb. 2014) ("To a large extent, the investment management industry has failed to develop products that help retirees generate income while managing the liquidation of their retirement savings in an orderly fashion.")

across the industrialized world is rapidly transferring the responsibility for the retirement investing of younger generations from institutional money managers to individual investors.[13] And so, the challenge of the optimal retirement glidepath promises to confront generations of investors for years to come.

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Yet, the universe of fund products remains largely oblivious to the notion that investors would have differing time horizons. First, mutual funds, ETFs and closed-end funds are perpetual in nature, with no specified end date. Fixed income funds generally seek to maintain portfolios with constant duration and the majority of equity funds have as their stated objective some version of "long-term capital appreciation". As a result, managers do not manage to a prescribed time horizon. Instead, they are encouraged to cycle positions in and out without any account for the disparate timing needs of the fund's investors. In addition to increasing transaction costs and bringing tax inefficiencies, such turnover recasts fund investors into time-takers, subject to the risk-reward tradeoff that a manager deems most appropriate.

As a result, the optimal glidepath eludes most investors forced to choose between simple and impersonal retirement products or limited allocations to products poorly adapted for such purpose.

Simply put, not all investors have the desire to or the luxury of investing for the long term – where the extended holding period allows for more risk to be taken. The most critical purposes of individual savings and investments – home buying, financing education costs and retirement planning – all require careful attention to time horizon and significant adjustments during the course of the glidepath.

The challenge of building optimal portfolios during critical phases of a glidepath is exacerbated by the scarcity of product designed to facilitate such purpose. An insightful academic recently stated the problem as it relates to retirement planning in succinct terms:

> "Currently available investment options hardly provide a satisfying answer to the retirement investment challenge, and most individuals are left with a choice between, on the one hand, safe strategies with very limited upside potential, which will not allow them to generate the kind of target replacement income they need in retirement and, on the other hand, risky strategies offering no security with respect to minimum levels of replacement income."[14]

At Olden Lane, we challenge "one size fits all" solutions when we find them. And,

[13] Lionel Martellini, *Mass Customization Versus Mass Production – How an Industrial Revolution is About to Take Place in Money Management and Why it Involves a Shift From Investment Products to Investment Solutions*, JOURNAL OF INVESTMENT MANAGEMENT (Feb. 2014).

[14] Id.

In the coming years, we are hopeful that the market will look anew at the timing needs of investors and construct solutions which allow investors to participate in market returns over discrete periods of time and within specific risk parameters

the timing needs of investors represents one of the important factors that has not been given enough attention by an industry that might be too comfortable with the current roster of fund structures. In the coming years, we are hopeful that the market will look anew at the timing needs of investors and construct solutions which allow investors to participate in market returns over discrete periods of time and within specific risk parameters. Funds offering such a combination will contribute substantially to the optimization of investment portfolios with medium to short-term investment horizons. Further, a growing variety of such products will equip investors with practical tools to help navigate a proper glidepath to their own personal investment goals.

ABOUT OLDEN LANE

Olden Lane is an innovative financial services firm that works closely with institutions to structure alternative streams of return within fund wrappers. Established in 2015, Olden Lane is grounded in a culture of high performance, operational excellence, and a spirit of partnership with our clients.

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