

The Biggest Misunderstanding in Retirement Investing Today

By Brian Regan

When reviewing 401(k) portfolios, one mistake shows up with surprising consistency. Many investors pair a target date fund with additional equity-focused funds, unintentionally undermining the very purpose of the target date strategy. Target date funds are designed to manage risk automatically based on a specific time horizon, gradually adjusting the allocation as retirement approaches. Target date funds may not be perfect, and often you're likely better off building an allocation and excluding that Target fund altogether. However, if going with the target date fund, layering extra equity exposure on top typically increases portfolio risk beyond what the investor intends.

While asking myself why this is so common I came to two conclusions:

- 1) Most people do not understand the nature of a target date fund
- 2) Investors get frustrated that it is not "keeping up" with the other funds

Investors should not expect a target date fund to keep pace with broad equity benchmarks like the S&P 500. By design, a target date fund is not a pure domestic large cap equity portfolio. For example, a 2035 target date fund I recently reviewed held roughly 65% in equities and 35% in fixed income. Of that equity allocation, only about 73% was invested in U.S. stocks, with the remainder spread across international markets. Even within U.S. equities, exposure to market leaders can be meaningfully lower. For example, NVIDIA represented less than 2% of the portfolio, compared with more than 7% in the S&P 500. Given these structural differences, there is no reason to expect similar performance between a target date fund and an all equity index like the S&P 500.

Here is a fact that many retail investors overlook: not every fund is designed to beat the S&P 500. In fact, only a minority of actively managed funds even measure success against that benchmark. Asking whether a fund has "beaten the S&P 500" is meaningless unless you first understand what the fund is trying to accomplish. A target date fund is not designed to outperform an all-equity index; its primary objective is to manage sequence of returns risk. As the target year approaches (2035) the fund intentionally reduces risk and increases diversification to avoid a significant drawdown near or during retirement. A large loss at that stage could permanently impair the investor's long-term balance, which is why the fund's strategy becomes more conservative over time.

Across the 15 major discretionary strategies I manage for clientele, each is intentionally designed to meet a specific risk objective or security type preference. Only one strategy is explicitly built to outperform the S&P 500, and it is also the riskiest offering—a concentrated, actively managed portfolio of roughly 30 individual stocks. That approach is not appropriate for most investors. The majority of our clients are invested in broadly diversified portfolios that include fixed income and maintain a long-term allocation to international equities. One strategy does not include equities at all. In that context, comparing these portfolios to the S&P 500 based solely on performance is neither appropriate nor informative.

A more useful comparison aligns the benchmark with the portfolio's risk profile. For example, conservative investors are typically positioned in a 50/50 portfolio, targeting an equal mix of stocks and fixed income. Evaluating that outcome against a blended benchmark, such as half the S&P 500 and half the aggregate bond index, provides a far more accurate measure of success. Portfolios with lower equity exposure should be expected to deliver lower volatility and more manageable drawdowns, particularly during market stress.

Many funds and assets are misunderstood because they are judged against the wrong expectations. They are not all designed to maximize returns or outperform the S&P 500. The purpose is typically different for each type of fund. For the Target date fund discussed the goal is aligning a portfolio's volatility, diversification, and drawdown profile with an investor's time horizon, particularly as retirement approaches.

Problems arise when investors compare apples to oranges. The result can be frustration, unintended exposure, higher volatility, and greater vulnerability to emotionally driven poor timing and sequence of returns risk.

The more productive approach is understanding what a fund or portfolio is designed to do, evaluate it against an appropriate benchmark, and ensure it fits within the broader allocation rather than duplicating or distorting it. When expectations, benchmarks, and portfolio design are aligned, investors are far more likely to achieve higher returns over years, and a more reliable path to retirement.



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