What risks are lurking in your Target Date Funds?

The acceptance and growth of target date funds has been impressive, and is fueled by the ease in which an individual chooses an investment based on a future retirement date. There are challenges that target date funds have, including its lack of adaptability to changing market conditions and not eliminating risk. Adding the Innovator Defined Outcome ETFs to a retirement income fund can allow investors to continue to participate on the upside with the market, but also have a built-in buffer of 9%, 15%, or 30% against downside losses.

Over the past decade, target date funds have gained prominence as a one-stop product that simplifies investing and provides a glide path method to asset allocation changes and investment across asset types. As investors approach retirement, target date funds broadly change their allocation between equities and fixed income along a glide path, generally a more aggressive asset allocation the further out from retirement (represented by higher equity weightings), and a more conservative one the closer to retirement (represented by higher bond weightings).

Some financial experts have noted that the funds can be a good way to save for both retirement and college. Investors seem to agree. According to a Pension & Investments survey done in mid-2019, out of $3.19 trillion in proprietary mutual fund assets in U.S. defined contribution plans, more than a quarter — $877.2 billion — was invested in target-date mutual funds, whose assets grew 13.9% over the past year and 101% over the past five years.

However, Innovator believes target date funds do face some unique challenges, including whether the one-size-fits-all approach to investing is suitable for all investors. Because target date funds are tied to retirement dates, it can limit flexibility in responding to changing market conditions. An investor could be exposed to higher than anticipated risk on the downside or face limitations to potential upside. For example, a 60-year old may be invested in a highly concentrated portfolio of low-yielding bonds with limited upside, just as the market is entering a bull run.

Further, while target date funds are meant to simplify investing, they do not necessarily eliminate risk. For instance, during the financial crisis, many pre-retirees invested in a 2010 retirement fund were surprised to learn that their portfolios still had more than 50% of assets in equities and were thereby facing double-digit negative returns.

The table below summarizes typical allocations an investor might expect to see in various target date funds and describes a typical experience after a target date fund reaches its “end”:

<table>
<thead>
<tr>
<th>PROVIDER NAME</th>
<th>STOCK / BOND / SHORT-TERM DEBT &amp; NET OTHER ASSETS / CASH (EXPLICITLY STATED) MIX</th>
<th>WHAT HAPPENS TO THE FUND ON THE LISTED TARGET DATE AND AFTERWARDS?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sample Retirement 2020 Fund A</td>
<td>55% / 45% / 0% / 0%</td>
<td>Within 7 years after their designated retirement dates, move to Sample Retirement Income Fund A (30% stocks/70% bonds)</td>
</tr>
<tr>
<td>Sample Retirement 2020 Fund B</td>
<td>56% / 36% / 8%</td>
<td>Allocation strategy adjusts over time until it reaches an allocation similar to that of the Sample Retirement Income Fund B, to which this fund may be folded, approximately 10 to 19 years after the target year (19% stocks / 81% bonds)</td>
</tr>
<tr>
<td>Sample Retirement 2020 Fund C</td>
<td>45% / 48% / 7%</td>
<td>After expiration, investors can go to the sample Sample Retirement Income Fund C (range of portfolios from Conservative to Enhanced, designed to accommodate retirees’ withdrawals during retirement)</td>
</tr>
</tbody>
</table>

1 Figures may not add up to 100% due to rounding errors and/or cash balances. For illustrative purposes only. Does not represent an actual investment.

The 2020 Target Date Funds above provide reasonable stock/bond mixes, with a healthy portion still allocated to equities even at the listed target date. We find this approach highly appropriate given that longer life expectancies must factor into the gliding path asset allocation; even if a client retires next year, he/she still may have another twenty years to live. The problem we would like to highlight, however, is the far-right column which describes what happens to the fund on the listed target date and thereafter. Listed target date funds are often rolled into Income portfolios, wherein over time, the allocation mix changes significantly to a more dominant bond allocation. We offer another potential solution that can be instituted at any point, to maintain more equity exposure but still have a buffer against losses on the downside.

The Funds have characteristics unlike many other traditional investment products and may not be suitable for all investors. For more information regarding whether an investment in the Fund is right for you, please see “Investor Suitability” in the prospectus.
As an example, suppose a client will be retiring next year (2020) at age 65 and is currently invested in the Sample Retirement 2020 Fund A. By 2027, and likely well before that, the company will transition the client’s assets from this target date fund to the Sample Retirement Income Fund A, which holds a 30% equities/70% bonds allocation.

PROPOSED FUTURE ALLOCATION

- Sample Retirement Income Fund A 70%
- Innovator S&P 500 Defined Outcome ETF 30%

Assume this client is now 72. As of 2019, the Organisation for Economic Co-operation and Development (OECD) has calculated male and female life expectancy in the US at roughly 76.1 and 81.1 years respectively. This female client may still have another (at least) nine years to live. The more conservative allocation of the Sample Retirement Income Fund A may not provide a client’s money the chance to grow much above the rate of inflation. In this relatively common situation, we believe redeploying 30% of the assets from the Sample Retirement Income Fund A into the Innovator Defined Outcome ETF as a complement to an investment portfolio could be an attractive alternative. This option allows increased exposure to the potential upside of the equity market, while also providing a buffer against downside losses.

WHAT ARE DEFINED OUTCOME ETFS?

Innovator Defined Outcome ETFs seek to provide a defined exposure to a broad market index (such as the S&P 500, Nasdaq 100, Russell 2000, MSCI EAFE, and MSCI EM) where the downside buffer level, upside growth potential to a cap, and outcome period are all known, prior to investing.

Innovator issues the S&P 500 series’ monthly and offers varying levels for the downside buffer (9%, 15%, and 30%). The ETFs reset annually and can be held indefinitely. Further, unlike other options-based strategies available in mutual funds or other less efficient vehicles, Innovator helped pioneer a rule change which allows options based ETFs to trade-in-kind, allowing for greater tax efficiency.

Innovator is committed to helping investors better control their financial outcomes by providing investment opportunities they never considered or thought possible.

For additional information, please visit www.innovatoretfs.com.