Inexperienced investors should take advantage of 'auto-pilot investing'

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For inexperienced investors with little knowledge about the investment process, it may be important to invest in funds that do not require much maintenance. Now, a researcher at the University of Missouri has found that investors with less investment knowledge are more likely to invest in target-date funds (TDFs). Michael Guillemette, an assistant professor of personal financial planning in the MU College of Human Environmental Sciences, says this is a positive trend which will help inexperienced investors invest safely without risking significant losses based on their lack of knowledge.

'If a potential investor without experience or knowledge is looking to invest in the stock market in order to build retirement wealth, it is not advisable for them to jump in and start investing in individual stocks, since they will be more likely to make investment mistakes,' Guillemette said. 'Target-date funds allow these unsophisticated investors to enter the investment world in a way that minimizes the opportunities for them to make mistakes.'

Target-date funds, which were endorsed by Congress in the Pension Protection Act of 2006, are also known as life-cycle funds. This means that TDFs change their asset mix of stocks and bonds based on the age of the investor. An investor simply begins putting money into the fund at a certain age, and as that person ages, the TDF invests in a greater percentage of bonds to better suit that person's stage of life as they approach retirement. Guillemette says this is a safe, middle-of-the-road option for people who want to save and invest for retirement but lack knowledge of the investment world.

'TDFs are sound strategy for unsophisticated investors because they basically put the investing on auto-pilot,' said Guillemette, who also is a certified financial planner. 'As a person advances in their career and gets closer to retirement, they will want to begin to take less risk with their retirement funds. TDFs do this automatically so that investors do not have to worry about making those changes themselves.'

For his study, published in The *Journal of Retirement*, Guillemette, Terrance Martin, an assistant professor at the University of Texas-Pan American, and Philip Gibson, an assistant professor at Winthrop University, examined data from the National Financial Capability Study, which was commissioned by the Financial Industry Regulatory Authority, and found that 'unsophisticated investors,' or investors who lack investment knowledge, were 22 percent more likely to invest in TDFs than sophisticated investors.

'The average investor, who lacks a strong understanding of best practices for investing, is going to make a host of investment mistakes,' Guillemette said. 'TDFs help minimize those mistakes by doing the legwork for the investors, so this trend we identified is great news, especially for those who have already been investing in TDFs for several years.'

Guillemette says that TDFs are not optimal in terms of maximizing potential investment returns and recommends that both inexperienced and experienced investors should seek advice from a certified financial planner who is held to a fiduciary standard, in order to protect themselves from behavioral biases. He says the next best alternative is probably TDFs, especially for unsophisticated investors.

Provided by University of Missouri-Columbia