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FINANCIAL PLANNING PERSPECTIVES

The Correct Way to Use Lifecycle Mutual Funds

Target-date and target-risk funds have become popular investments among 401(k) plan participants and retirement investors, especially those who have neither the time, knowledge nor inclination to create and manage an investment portfolio.

For instance, recent research by Financial Research Corporation, shows that assets in target-date retirement funds has risen dramatically over the past several years, rising from $14.5 billion in 2002 to $86.7 billion in May, 2006. And assets in lifecycle funds have risen from $54.6 billion in 2002 to $145.9 billion in May, 2006. What's more, FRC is predicting that both target-risk and target-date retirement funds, sometimes referred to as lifecycle or lifestyle funds, will continue to grow dramatically over the next four years, with target-date retirement funds hitting some $30 billion by 2010. **Target-date funds** are mutual funds that base their asset allocation around a specific date, and then rebalance to more conservative allocations as that date approaches, according to FRC. **Target-risk funds** are mutual funds that build their asset allocations around a pre-specified level of risk, and then rebalance to maintain that risk level.

The appeal of such funds, which are designed as a complete solution for investors with similar risk profiles or time horizons, is perhaps obvious. Such funds provide instant diversification and the benefits of disciplined portfolio rebalancing. Technically, a fund of funds, target-date and target-risk funds invest in a variety of mutual funds, typically those offered by the same fund family. For instance, the average 2010 target-date fund invests in 15 funds, according to a recent Brigham Young University study and has 35.5 percent of its assets in U.S. stocks, 8.5 percent in non-U.S. stocks, 45.2 percent in bonds, 10 percent in cash, and 0.8 percent in other types of securities. In addition, the manager of such funds will rebalance the portfolio adjusting the mix of the portfolio to become more conservative as the portfolio nears the target-retirement date.

And most important, such funds are easy to use since investors and financial planners for that matter don't have to search through thousands of mutual funds to create a portfolio. A recent study suggests that three in four financial planners are now recommending target-date and target-risk funds for investors with less than $100,000 to invest.

But recent studies also indicate that both target-date retirement funds, and lifecycle funds, are being misused. Indeed, studies suggest that 401(k) plan participants are mixing such funds with other funds and using them as conservative choices along with several other selections. This, say financial planners, abrogates the purpose of the funds.

For instance, according to Hewitt Associates in June 2006, the average 401(k) plan participant had 6.4 percent of their assets in a target-date or target-risk fund, 21.7 percent in a stable value fund, 22.2 percent in company stock and 20.7 percent in U.S. large-capitalization stocks. According to financial planners, the mix should be almost reversed with the greater percentage in the target-date or target-risk funds and the smaller percentage allocated to investments that don't duplicate the funds or investment objectives in the target-date or target risk funds.

To be fair, a recent Hewitt Associates study did show that more and more 401(k) plan participants seem to be using lifestyle and lifecycle funds correctly, investing their entire plan balance into the funds. Hewitt noted in a May 2006 study that the overall number of employees investing in lifestyle and lifecycle funds has remained constant, but the number of employees using them as turnkey solutions increased. For instance, one in five employees holding a lifestyle or lifecycle fund had their entire 401(k) balance in them in 2005, up from 15 percent in 2004. In addition, nearly half of employees with less than one year of tenure investing in a lifestyle or lifecycle fund invested all of their 401(k) monies in a single lifestyle or lifecycle fund in 2005, an increase from 34 percent in 2004.

So what then is the right way to invest in target-date or target-risk funds? Investors need to get a sense of the time horizon, tolerance for risk and investment goals. In the parlance of professionals, investors need to construct an investment policy statement which outlines, among other things, a target asset allocation or mix between stocks, bonds and cash. Most lifecycle funds are designed to take away all that work, but not all lifecycle funds are created alike, so it’s important that investor find the lifecycle fund that best matches their personal tolerance for risk.

With that an investor can then examine whether it’s better to invest in many different types of funds using the help of a professional or to use target-date or target risk fund that best match their personal goals, time horizon, and tolerance for risk. That’s especially important since target-date and target-risk funds may all sound the same in theory, but are quite different in reality. For instance, the asset allocation of such funds will quite often differ quite dramatically from one fund firm to another. What’s more, the rate at which a target-date retirement fund becomes more conservative over time will differ dramatically. And while these funds often have similar sounding names, the performance and fee associated with these funds will vary greatly too.

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