

■ The Circle of Life

Lifecycle funds may streamline retirement planning—or effectively destroy the client-advisor relationship.

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By Alan Gersten

Born in 1994, lifecycle funds stand poised for adolescence as well as controversy. Like many teens, they have grown quickly, jumping 11.2 percent annually since 2004—more than twice the mutual fund industry's 4.5 percent rate. Already, these funds have \$82 billion, and they keep climbing.

But to put things in perspective, lifecycle funds are only a fraction of the \$10 trillion mutual fund industry, and their rapid growth doesn't mean they will become the ultimate retirement fund. In fact, a lot of pundits doubt that these funds are the right answer for retirement investments. Others, however, contend that lifecycle funds and their kin—lifestyle funds—are the painless way to ease into retirement.

"I think right now [these funds] are on a roll," says Joe Nagengast, founder of Turnstone Advisory Group in Marina del Rey, Calif., where he advises financial advisors. Nagengast wrote a manifesto-like report on lifecycle funds. "They have undergone tremendous growth. It's unbelievable," he says.

A top investment officer in San Francisco agrees. "They're so popular because of their ease of use," says David J. Goerz III, senior vice president and chief investment officer for HighMark Capital Management, a wholly owned subsidiary of Union Bank of California. Goerz, who manages a portfolio of \$20 billion in assets, says, "People understand the index market, and that's what makes [these funds] attractive."

But Bill Harris, a financial planner in Duxbury, Mass., feels differently. "This is a communist product. That's because for every investor, it's exactly the same. They jam them all into one."

Communitistic or capitalistic, lifecycle and lifestyle funds are like a "fund of funds," or six to 12 offerings from the same fund family. Each fund is composed of a portfolio of different funds, chosen and allocated as a group, to attain definite levels. Lifecycle funds are concerned with timing. Let us say a 40-year-old investor wants to insure that when he retires in 25 years, he will have enough money to live on for the rest of his life. Lifestyle funds, which are also used for retirement, deal more with risk, automatically adjusting the balances of risk and reward to the investor's desires for the balance of his or her life.

Both funds are suited for individuals who prefer to have a mutual fund that, they hope, ends their retirement worries. "It's one-stop shopping," Nagengast says.

More and more of these funds are shooting into the marketplace. After the Securities and Exchange Commission approved the first, the agency accelerated the process, so hundreds of such funds are now available.

Are these funds the wave of the future? "They're the wave of the present," says Matt Smith, managing director of Russell Retirement Services, a Tacoma, Wash.-based firm that manages \$181 billion in assets.

"People don't want to come up with their own asset allocation plans," Smith says. "They want someone to do it for them. You have do-it-yourselfers, and you have those who want you to 'do-it-for-me.'" Lifecycle funds are do-it-for-me's. These fund managers had better do it for the investors because at Russell, they hire and fire managers to ensure they maneuver investments to get the right return. Russell deals with advisors, not individuals, and typically, these advisors have long-term relationships with Russell.

With lifecycle funds, which are also called target-date funds, investors have two types of capital—their financial holdings and their human capital. The first is their job, house, car and other financial assets, while the second is their ability to earn future paychecks.

But as people get older, their human capital decreases; their ability to earn a paycheck wanes. Consequently, the asset allocation managers modify the equity-bond-cash strategy. Younger investors have a longer time horizon for earning power, so their target-date funds carry more equity. As they get older, the equity portion of their target funds decreases, and their bond portion increases.

For instance, Jane knows that she wants to retire in 2030, so she could select one of the 2030 funds. These funds automatically adjust the asset allocation as Jane nears retirement. The closer to retirement, the more the portfolio switches from stocks to bonds. For example, the Fidelity Freedom 2030 fund could contain 80 percent stocks, 15 percent bonds and 5 percent cash. But the Fidelity Freedom 2010 fund could feature about 50 percent stocks, 35 percent bonds, and 15 percent cash.

Lifestyle funds are actually divided into three investment styles: aggressive, moderate and conservative growth.

Aggressive growth is for younger investors, moderate for the middle-aged and conservative for the older set. An investor could start with an aggressive fund, switch to a moderate one as he ages, and go conservative when retirement nears. For instance, the Russell Life Aggressive fund could invest 74 percent in stocks, while the Russell Life Conservative fund could invest 19 percent in stocks.

All these funds preserve the same level of risk by shifting money from market areas that appear expensive to those that

look cheaper. Hence, with a lifestyle fund, investors don't have to choose and allocate individual stock and bond funds to assemble their portfolio. Instead, that's the job of the investment managers.

Despite their growth, most investors don't know about lifecycle funds, so it is up to financial advisors like Bryan E. Kelly to suggest them. "There has to be a method in the way we plan our future," says Kelly, founder of Kelly Financial Group in Bel Air, Md., with \$105 million in assets under management. "The baby boomers are approaching retirement, and with the bear market we had in the early part of this millennium, you have extreme risk in not being diversified."

Most of Kelly's clients who buy these funds carry 401(k) programs, many with millions of dollars to invest. The Pension Reform Act made lifecycle funds the default investment for 401(k) plans, so if anyone fails to select a fund, they get the lifecycle funds.

In selling these funds, Kelly talks about diversification, the target-date for retiring, and how "no one size fits all."

Personally, he likes the lifecycle funds that Fidelity and T. Rowe Price market. If someone wants to retire in eight years, the 2015 fund is a possibility. These funds could have 10 to 15 different funds with a manager for each. An overlay manager supervises the funds.

With such a fund, someone investing \$1 million at retirement could have an annual income stream of 4 to 4.5 percent, which is \$40,000 to \$45,000. Is that enough for this person's lifestyle? That's what the investor and advisor must work out in advance.

The actuarial underpinnings of these funds are built into the funds' matrix. For example, if someone today is retiring at age 65, he could probably live into his late 80s. Therefore, the fund has to calculate its yield to accommodate that person's lifespan and lifestyle. Since so many of these funds exist, "It's a bit overwhelming," Kelly says.

In the 1980s, financial advisors felt differently, concluding that investors could make their own decisions. Nagengast recalls, "What we were telling ourselves is we could educate participants to be adequate investors. Every individual in the country could be a Citizen CIO (Chief Investment Officer)."

Wrong. Investing is hard. "There were voices in the wilderness saying it will never work," Nagengast explains.

Lifecycle funds appeared 13 years ago when Wells Fargo started them with Barclays Global Investors as sub-advisor.

Later, Barclay's created its own lifestyle funds. However, these funds languished for six years because the stock market was roaring forward to unprecedented highs. Pick any stock, especially with a dot-com name, and it doubled or tripled. Of course, the inevitable crash came in 2000 to 2002.

"We had a bad equity market," Nagengast says. Thus, lifecycle and lifestyle funds received renewed attention. "There was a growing body of research in behavioral finance."

And the focus turned to lifecycle funds whose big advantage is their diversification. An investor doesn't base his whole portfolio on one stock. Without rehashing the collapse of stocks like Enron, everyone gets the point. During the bear run in the early 21st century, a well-positioned bond fund could have ameliorated the equity losses. Within this universe of lifecycle funds, the investor must tell the fund manager what he wants. Of course, that creates another question: Does the investor know what he wants?

"Five or six years ago, I stayed far away from lifecycle funds. I thought part of the value I brought to the table was screening funds for clients," says Derek R. Williams, a certified financial planner and founder of Moseley Investment Management Inc. in Bradenton, Fla., "In my opinion, that's changed. You have the overlay of management handling of these funds, and you get a decent return of around 9 percent," adds Williams, whose firm manages \$100 million.

Sometimes, Williams recommends these funds for high-net-worth individuals. For instance, a couple in their 60s was interested in the Franklin Templeton Funds. Since they have offices in nearby Sarasota, Williams went there to visit with the fund managers. After discussing the situation with his clients, they invested \$9 million in three Templeton Funds that are now yielding 7.5 percent annually. His clients are pleased.

While the yield is less than some other funds, this lifecycle fund provides the slow and steady return this elderly couple craves. What they don't want is to be churned by a broker, buying and selling stocks just to generate commissions, and nickel-and-diming them. With lifecycle funds, investors avoid those problems.

However, an advisor inherits a different problem. Let's say the Standard & Poor's is yielding 14 percent, so the client calls and wants to know why his lifecycle fund is only yielding 7.5 percent? Then the advisor has to explain that these funds are slow and steady as you go. "I sit down with them and explain who these funds are designed for, and what they are for. You don't have the highs and lows. You're in the middle," Williams says.

"Advisors were threatened by these funds, but now they embrace them as a core," says Valerie Corradini, principal in Intermediary Investor Business in San Francisco which markets LifePath brand lifecycle funds to financial advisors. Some funds, like Lifepath, use six assets—domestic stocks, international stocks, bonds, cash, real estate and inflation-linked bonds.

"You need the financial advisor to maintain the dialogue with the investor," Corradini says. "If anything changes with the client's landscape, the advisor must help navigate things like inter-generation planning, estate planning or philanthropy. That's where their value lies. Otherwise, advisors would have been eliminated 20 years ago when we got hand calculators," she quips.

But many financial advisors point out what they consider the funds' flaws.

"These are best suited for unsophisticated investors, not high-net-worth individuals," says Eric Brotman, a financial

planner who founded his own firm, Brotman Financial Group, in Timonium, Md. Well-to-do investors can better customize their portfolios and buy and sell themselves, which is “more efficient for tax reasons,” he says. Sometimes, investors may want to take profits or absorb losses to offset gains elsewhere. With lifecycle funds, the manager—not the individual—decides this. Of course, this means Brotman, who manages \$50 million in assets, can’t manage lifecycle funds for the wealthy. “You can’t represent everyone,” he says.

These funds are only around 1 percent, or \$200 million, of Goerz’s \$20 billion portfolio. “My struggle with target funds is that many investors just look at the retirement date,” Goerz says. Based on that, investors let their advisors or fund managers select the appropriate mix of stocks, bonds and cash and do nothing, so the fund and the investors remain passive until retirement. Goerz warns that such an approach is too simplistic.

Instead, investors should also consider what they want from their investments, how much money they think they need and what kind of lifestyle they expect to lead when they retire. Then they select the target funds they want and have the advisor and manager arrange their stocks, bonds and cash accordingly.

Another issue is management fees, which could be 50 to 80 basis points annually, condemning many of these funds to underperform. But a more actively managed fund could add 100 basis points annually above the expense ratio. Kelly, the Bel Air, Md. advisor, charges 25 to 75 basis points annually, depending on the portfolio, so a \$2 million portfolio would mean a charge of 40 to 50 bp.

Lifecycle funds usually have two costs—one external and the other, internal. The first could be 1 percent annually on the investor’s assets, while the second could be 1.5 percent. That’s the cost the fund managers get for running the portfolios. So, if the overall yield of the fund is 9 percent, the investor may only get 7.5 percent.

“I think many [of these] funds are either packaging the existing funds in the fund family or simply using funds that have another ‘angle’ to them that makes them hard to evaluate from a performance standpoint,” says Eric D. Hess, a CFP with Alpha Financial Advisors in McLean, Va. “We have dealt with them for years and have run hundreds of comparisons against going the lifestyle or balanced route or using an optimized, diversified batch of individual category funds. It can go either way, depending on the retirement account.”

In Hess’ opinion, a conservative, young investor could be unhappy with the downside of a 2030 retirement fund. On the other hand, a well-educated, aggressive investor may be very unhappy with a 2010 fund. “We also have to remember that a person may have 20 or 30 years in retirement where we have to outperform after inflation and taxes. An ultra-conservative fund may be too safe.”

Additionally, Hess says he has seen these lifestyle fund/pre-allocated funds in the Federal Thrift Savings Plan, a retirement savings plan for civilians employed by the U.S. government and members of the uniformed services. Basically, they diversify the five index funds they already have, but he disagrees with the premise that someone’s risk tolerance is totally based on their time horizon. “This is absolutely wrong,” says Hess, whose firm manages \$52 million. “In reality, their risk level is based on the downside loss of account value they can handle until they sell out. Selling out at the bottom is the real risk.”

Harris, who manages \$20 million for W.H. Cornerstone Investments LLC, the Massachusetts firm he founded, expands on his misgivings. “In my opinion, their [lifecycle funds’] basic existence is problematic. These funds are one giant compromise. They have no actuarial underpinnings.”

Some fund managers, Harris says, dump underperforming mutual funds into lifecycle funds to make them look better. Sometimes the fees are too high, and there isn’t enough transparency or enough yield. Thus, Harris expects a “backlash”—say, in 2045—when some people retire and are dissatisfied with the funds’ performance.

To the defense of lifecycle funds comes Kim Daifotis, chief investment officer and Portfolio Manager for Fixed Income at Charles Schwab Investment Management Inc. in San Francisco. “Advisors don’t like these funds because clients go to them to fix their risk and returns,” Daifotis says. Now, these funds can do that. Daifotis notes that Schwab has done “a lot of academic work on these lifecycle funds.” Plus, the Schwab funds do not have an internal charge—only a charge on the overall fund, which varies from 70 to 98 basis points.

Bryan D. Beatty, a financial advisor with Eagan, Berger & Weiner in Vienna, Va., suggests a way to unite advisors and the lifecycle funds. “Have the advisors talk to employees about these funds, explain them, and the employer could compensate the advisor,” he suggests. That way the advisor is a partner.

After all the pros and cons, what’s the future of lifecycle and lifestyle funds?

“Some say the imperfections of these funds are fatal flaws,” Nagengast says. “Others say that they started out not perfect, and they are constantly remaking themselves, changing, incorporating some of the information being generated by critics.”

Love them or hate them, lifecycle funds will continue to grow. “They will be a very popular investment in the future and have significant growth for many years,” Smith concludes.

Alan Gersten, a freelance writer based in Brooklyn, wrote about socially responsible investing in November 2006.