ALLOCATIONS AT RETIREMENT

Looking to Target Date Funds to Determine Appropriate Equity/Fixed Income Allocations at Retirement

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INTRODUCTION:

It is nearly universally accepted that retirement accounts should consist mostly of equity securities if the investor has an extended time before retirement. Then gradually, investors should add fixed income instruments to their accounts in order to reduce volatility and generate additional portfolio income. In recent years, this idea has been captured in investment products known as target date funds (also known as lifecycle funds).

The reasoning behind this portfolio composition is straightforward. During the accumulation phase of a retirement portfolio (pre-retirement), portfolio returns are complemented by contributions. At the investor's retirement date, contributions will cease and the investor will begin to distribute the assets in the portfolio. Over time, we have seen higher returns and higher volatility associated with equities, relative to bonds. When investors have a longer period to invest, prior to retirement, they can afford more risk in their accounts. This means that younger investors can, on average, afford to take more risk than older investors because they have more time to recover from potential losses. However, as older investors near retirement, there is less time to recoup large losses in a portfolio. As such, a downturn in financial markets is far more detrimental to the finances of an investor who is near retirement than to an investor with decades left to build his/her portfolio.

Given the recent level of growth in target date mutual funds, it is apparent that many investors and financial advisors have bought into this idea. Target date funds allow investors to choose a particular retirement date, and the fund then automatically takes care of the asset allocation adjustments over time. Target date funds are designed to simplify the entire retirement saving process by automatically reducing the fund's equity exposure as the retirement date gets closer. The defined change in a fund's allocation over time is known as its glidepath.

In this document, we attempt to determine the most appropriate asset allocations for an investor at the time of his or her retirement. We use the allocations of target date funds in order to measure which allocations have been most popular.

KEY POINTS:

- Target Date Funds are products that are made up of a combination of investments and implicit investment advice.
- Funds have taken vastly different positions as to the most appropriate investment allocations as of an investor's retirement date. Allocations range from equity allocations of only 20% to as much as 65%.
- The target date fund universe is dominated by three major complexes (Fidelity, Vanguard, and T. Rowe Price). These three fund complexes account for more than 80% of industry assets.
- The majority of target date fund complexes, thorough their asset allocation strategies prescribe an allocation close to 50%/50% equity/fixed income for investors at retirement.
- There are no complexes that suggest that investors do not need any equity exposure upon reaching retirement. Similarly, there are no complexes that suggest that a 100% equity allocation is ideal.
- While target date funds provide a good benchmark for measuring typical allocations, each investor's individual financial picture should be examined independently.

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TARGET DATE FUNDS

TARGET DATE FUNDS CAN BE VIEWED FROM TWO DISTINCT PERSPECTIVES:

First, like other mutual funds, they can be examined as investments, themselves. They generate returns and perform similar to other funds in the marketplace. Most of these vehicles utilize a fund of funds structure, whereby instead of investing directly in individual securities in an attempt to accomplish their investment goals, they invest in other funds (underlying funds). These underlying funds are often actively managed investment portfolios that may also be evaluated as individual investments. The target date fund, itself, typically makes investments in terms of the asset allocation among the underlying funds.

Second, the funds can be viewed as packaged investment advice. Buying a particular target date fund is similar in some respects to choosing a trusted financial advisor. Two advisors might have completely different views on asset allocation and offer vastly different investment advice. In this document, we examine target date funds primarily for their role as packaged investment advice, rather than their role as investments.

In order for an investor to successfully reach his or her retirement savings goals, three components of a retirement plan must be individually achieved. These three components are:

1. Contribution/Savings rate: No retirement plan will be successful if it is not funded.
2. Investment Performance: Are the investments doing what they are designed to do? How do they compare against similar peers?
3. Investment Allocation: A poor combination of good investments might still lead to retirement savings failure. How much should be allocated to various assets classes at different times during the glidepath is critical.

There is a startling lack of consensus, however, as to the proper asset allocation at the retirement date. Currently, 37 distinct fund complexes offer a series of target date funds. These complexes often have vastly different options as to how much equity exposure, relative to fixed income exposure, a fund should have upon retirement. Lipper reviewed the most recent prospectus for each of the complexes to determine an estimated allocation between the two asset classes at the target date of each fund. Please note that for many complexes the allocation does not become fixed upon reaching the target date, but continues to adjust going forward. The American Funds Target Date Retirement Funds Series, for example, continues to make adjustments to the fund's glidepath until 30 years after the target retirement date. Other fund complexes have a "fold-in" policy whereby a target date fund folds into a retirement income fund shortly after reaching its target date.

The fund complex with the most conservative allocation at the retirement date is MFS. The MFS Lifetime Funds prescribe an investment strategy whereby the fund has only 20% of its assets invested in equity as of the retirement date. At the other side of the spectrum, however, are the American Funds Target Date Retirement Funds, the AllianceBernstein Retirement Strategies Funds, and the Seligman TargetHorizon ETF Portfolios, which expect to have 65% of their assets allocated to equity investments as of the retirement date.

WHY FUNDS MAY DIFFER

How can these fund complexes develop retirement asset-accumulation models that calculate such vastly different allocations at the date of retirement? And which allocation is best? We next examine a very simplistic development of an asset-allocation model to help explain how these types of discrepancies arise.

Just as two different financial advisors would make different asset-allocation decisions for their clients, we have found that discrepancies among fund complexes arise in a similar manner. There are two principle reasons for these discrepancies:

1. Different assumptions as to the risk/return profiles of different investments. These types of discrepancies arise on the investment side of the client/advisor relationship.
2. Different client preferences/tolerances. Some clients may be more willing to take on risk than others. These discrepancies arise on the client side of the client/advisor relationship.

We start by describing how differences might arise in relation to the first reason listed:

It would be nice if, when developing an asset-allocation model, the future returns of various asset classes could be known with some degree of certainty. This, unfortunately, is not the case for most investments. Since the future returns of these various asset classes are largely unknown, we are forced to estimate future returns using the available data on the historical returns for these types of assets. However, using different historical return series might lead to vastly different investment allocation decisions. We mean by this that it is difficult to determine the best historical period to use for estimating possible future returns.

If we use relatively short periods, we may only be picking up pieces of market cycles, rather than the cycles in their entirety. Over the one-year period ended October 31, 2008, the S&P 500 returned about -35%. We would not expect anyone to build an asset-allocation model assuming that equities are likely to lose 35% per year. The question is whether we should use five-year returns, ten-year returns, or even longer. On the one hand, the longer the return series that we use, the more likely we are to capture entire market cycles. However, if we choose a return series that is too long, we end up capturing market conditions that clearly no longer exist. Given the rise in availability of investment information and tools over the past decade, we would not expect equity markets today to act exactly like equity markets that existed several decades ago.

The decision concerning which historical periods to use has a profound impact on how our model will expect certain asset classes to perform over time. In our over simplified example, we have eight asset classes available for investment. Tables 1, 2, and 3 display the average returns and standard deviation of all mutual funds in the asset class on an annualized basis for the 5-, 10-, and 20-year periods ended October 31, 2008.

Again, for the sake of simplicity, we assume that this is the only data available to us when developing a target date model. We have the returns and standard deviations (volatility) for eight distinct asset classes. When looking at the five- and ten-year periods, we see that large-cap funds have generated a relatively high level of risk, but a very small level of return. However, in the 20-year period, returns for large-cap funds are much more proportional to their level of risk. Based on these numbers, we might be tempted to include less large-cap domestic equity in our glidepath due to its relatively high risk and low returns in recent periods. This could then result in a more conservative glidepath, relative to a model that puts more emphasis on 20-year data, which might lead us to a more aggressive asset allocation.

The second reason for the discrepancy between complexes with respect to equity/fixed income allocations is more straightforward. Different firms may have different types of clients. The glidepath that a fund complex chooses is not designed to serve the needs of all clients. Rather, it is designed to serve the needs of the average client. This means that the

TABLE 1 FIVE YEARS

Asset Class	Annualized Return	Standard Deviation (Risk)
Emerging Markets	9.44	24.76
Real Estate	3.19	22.39
International Dvsfd.	2.85	17.28
TIPS	2.18	6.78
Taxable Corp. Bond	1.14	4.37
Small-Cap	0.16	17.18
High Yield	-0.29	9.39
Large-Cap	-0.62	13.51

TABLE 2 TEN YEARS

Asset Class	Annualized Return	Standard Deviation (Risk)
Emerging Markets	10.19	25.19
Real Estate	8.15	18.06
Small-Cap	5.31	21.38
TIPS	5.15	6.26
Taxable Corp. Bond	3.59	4.42
International Dvsfd.	2.81	17.90
High Yield	2.03	9.35
Large-Cap	0.13	16.23

TABLE 3 TWENTY YEARS

Asset Class	Annualized Return	Standard Deviation (Risk)
Small-Cap	9.03	19.06
Real Estate	8.83	14.54
Large-Cap	7.87	15.10
Taxable Corp. Bond	6.14	4.58
International Dvsfd.	5.94	15.97
High Yield	5.26	8.34
Emerging Markets	N/A	N/A
TIPS	N/A	N/A

Tables 1, 2, and 3 reflect the average annualized total returns for all open-end funds in the Lipper database for the period. Standard deviation shown reflects the average standard deviation of monthly returns for the same group of funds. Standard deviation is a measure of return volatility. There were no funds in the emerging markets or Treasury Inflation-Protected Securities (TIPS) asset classes for the 20-year period.

allocations at the retirement date will likely be too aggressive for some, and too conservative for others.

Some investors are clearly more risk-averse than others, but there is more driving the glidepath than risk-aversion. The first piece of retirement planning success that we mentioned previously was contribution rate. Investors that contribute more of their income to their chosen target date fund will have a greater chance of retirement savings success than those investors that save less. However, the typical client might vary greatly from one financial advisor to another. This is also true of shareholders of investment managers.

It might be the case that high-net-worth investors can take more risk than investors with less wealth. Lower-net-worth investors might be more concerned with preserving the level of income that their investments could provide while wealthier investors have less concern over losses in their investments. On the contrary, however, it may also be true that firms with clients with less wealth, on average, might undertake more risk in an effort to help offset their clients' lower contributions.

The investment allocations of a target date fund might change substantially based on the investment manager's typical client profile. Underlying assumptions about a firm's clients likely account for much of the different retirement investment allocations.

TYPICAL ALLOCATIONS

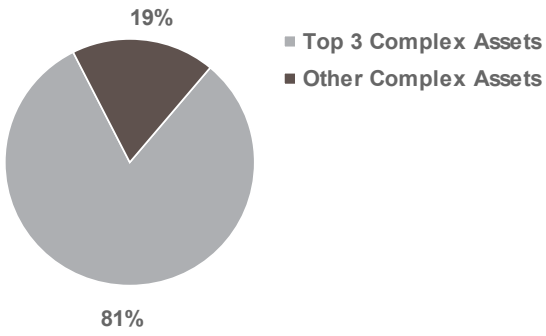
If we examine the glidepaths of the various fund complexes, we note that the allocations range between 20% and 65% of fund assets allocated to equity at the retirement date. The most common allocations, however, fall closer to 50% equity/50% fixed income. Two thirds of target date fund complexes have estimated allocations between 40% and 60% equity/fixed income at their retirement dates.

It is important for us to note that while there are many fund complexes in the target date fund business, the industry is largely dominated by three of the earliest players. Fidelity, Vanguard, and T. Rowe Price account for over 80% of target-date assets (Table 4 and Figure 1). If we weight the estimated retirement allocations by the assets in the complexes' funds, the average mix between equity and fixed income is 47% and 53%, respectively.

TABLE 4 TARGET DATE COMPLEXES*

	Estimated Allocation at Retirement Date		
Fund Complex	Equity	Fixed Income	TD Assets ($Mil)
Fidelity Freedom Funds (Includes Adviser Freedom Funds)	50	50	79,269
Vanguard Target Retirement Funds	30	70	35,255
T. Rowe Price Retirement Funds	55	45	28,704
Top 3 Complex Total			143,228
Total Target Date Fund Assets			175,780

FIGURE 1 TOP THREE COMPLEX ASSETS*



* Assets shown reflect the total net assets in all target date funds for the complex as of September 30, 2008.

CONCLUSION

We have seen that there is little evidence in the target date fund data to suggest that one retirement allocation is preferable to others. While the consensus seems to be close to a 50%/50% split between equity and fixed income investments, there is considerable deviation from this. It is important for advisors to address the needs of each client individually. A target date fund that is appropriate for one client could be entirely inappropriate for another client.

TABLE 5 RETIREMENT ALLOCATIONS OF TARGET DATE COMPLEXES.

Relatively Conservative Allocations ↑

	Estimated Allocation at Retirement Date	
	Equity	Fixed Income
MFS Lifetime Funds	20	80
DWS LifeCompass Funds	25	75
American Independence NestEgg Funds	28	72
RidgeWorth Life Vision Funds (formerly STI Classic Funds)	30	70
Vanguard Target Retirement Funds	30	70
Wells Fargo Dow Jones Target Date Funds	30	70
Russell LifePoints Funds - Target Date Series	32	68
TDAX Independence ETFs	33	67
AIM Independence Funds	38	62
Barclays Global Investors Lifepath Portfolios	40	60
Federated Target ETF Funds	40	60
Franklin Templeton Retirement Target Funds	40	60
State Farm LifePath Funds	40	60
Vantagepoint Milestone Funds	40	60
American Century LiveStrong Funds	45	55
Hartford Target Retirement Funds	45	55
JPMorgan SmartRetirement Funds	45	55
Putnam Retirement Ready Funds	45	55
RiverSource Retirement Plus Series	48	52
BlackRock LifeCycle Prepared Portfolios	50	50
Fidelity Freedom Funds (Includes Adviser Freedom Funds)	50	50
John Hancock Lifecycle Portfolios	50	50
MainStay Retirement Funds	50	50
Payden/Wilshire Longevity Funds	50	50
Schwab Target Funds	50	50
TIAA-CREF Lifecycle Funds	50	50
Goldman Sachs Retirement Strategies Portfolios	55	45
GuideStone MyDestination Funds	55	45
MassMutual Destination Retirement Funds	55	45
Oppenheimer LifeCycle Funds	55	45
T. Rowe Price Retirement Funds	55	45
Nationwide Target Destination Funds	59	41
Principal Lifetime Funds	59	41
Banc of America Retirement Funds (Columbia)	60	40
AllianceBernstein Retirement Strategies	65	35
American Funds Target Date Retirement Series	65	35
Seligman Target*Horizon* ETF Portfolios	65	35

Relatively Aggressive Allocations ↓

The table at the left displays the estimated proportion of each target date complex's assets that are invested in equity and fixed income instruments at the time of retirement. All data is derived from each complex's most recent prospectus. Aggressive and conservative allocations refer specifically to the mix of equity/fixed income at the retirement date. Some types of securities may be considered more aggressive/conservative than others. Equity/fixed income mixes at points on the glidepath other than actual target date were not taken into consideration.