

# THE PORTFOLIO

## 2010, A Fund Odyssey

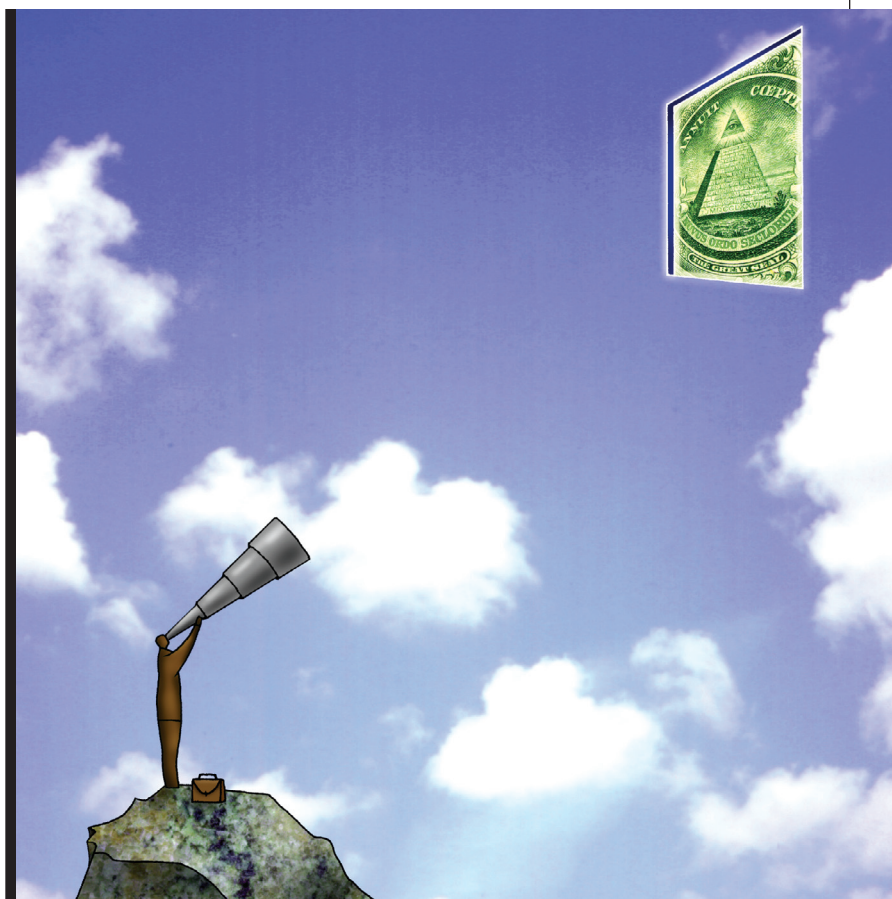
WITH 2010 JUST AROUND THE CORNER, HAVE THE FIRST TARGET-DATE FUNDS ADEQUATELY PROTECTED THE ASSETS OF SOON-TO-RETIRE INVESTORS? BY CRAIG L. ISRAELSEN

IN THE MID-1970S, I SAW THE MOVIE *2001, A Space Odyssey*. Everything from large monoliths to ape femurs. I didn't understand it then, and I still haven't figured it out now. What I do vividly recall, however, is thinking just how far off the year 2001 seemed at the time.

But alas, 2001 has come and gone. Space travel, which seemed so amazing then, is taken for granted today. Movie buffs will remember a space jet flying into the center of the wheel-shaped space station in an early scene that was labeled Pan Am. The passage of time certainly has not been kind to Pan Am.

But let's segue from space travel to target-date funds. The first target-date funds were introduced in 1994. Back then, a target date of 2010—the first major target date—seemed extremely far away. But here we are, just 14 months from 2010. Other target dates that may still seem “so far away” include 2015, 2020 and 2025. Yet, of course, just like 2010, they too will come around before we know it.

A large cohort of investors is scheduled to retire in 2010. Basically, these are the folks who were born in the mid-1940s. You will recall that the baby boom is defined as the 18-year time period spanning from 1946 to 1964. Therefore, much of the money invested in 2010 funds



belongs to the leading-edge baby boomers, who are now ready to move into the next phase of their lives.

As of late 2008, approximately \$26 billion was invested in 2010 target-date funds. As a point of reference, roughly \$192 billion was invested in all retail target-date

funds. Target-date funds linked to the year 2020 have the single largest asset base, with around \$42 billion.

### SERIOUS FLAWS

So, with the year 2010 right around the corner, it makes sense to ask how 2010 funds are faring in this ugly

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equity environment. Are target-date funds protecting investors' assets as they approach their retirement date? Have the funds hunkered down primarily in bonds and cash and largely sidestepped the equity market avalanche that began in June 2007 and has yet to let up?

Not exactly. In fact, shareholders are in for a big shock. The four largest 2010 target-date funds (which collectively hold about 90% of all the assets invested in 2010 funds) have each experienced quite significant losses in 2008 (see "Target Pain," at right). Fidelity Freedom 2010 was down 13% year to date through Sept. 30, 2008; T. Rowe Price Retirement 2010 lost 14%; Vanguard Target Retirement 2010 dropped 11.2%; and Principal LifeTime 2010 plummeted 16.7%.

On average, these four 2010 funds lost 13.7% year to date through Sept. 30, 2008. Consider what a loss of that type of magnitude translates into for a 63-year-old baby boomer

## TARGET PAIN

The four biggest 2010 target-date funds allocated about half of their assets to equities, which hurt them when the stock market imploded this year. Plansponsor's On Target 2010 Index followed a much more conservative glidepath. With a mere 8.2% of its assets in equities, the Index only lost 0.8% in the first nine months of 2008.

Four Largest 2010 Target-Date Funds (as of 9/30/08)	Total % Equity Allocation in Portfolio	Year-to-Date % Return as of 9/30/2008	Impact of YTD Performance on \$500,000 Account
Fidelity Freedom 2010	49.1	-12.95	-\$64,750
T. Rowe Price Retirement 2010	58.6	-14.00	-\$70,000
Vanguard Target Retirement 2010	53.6	-11.23	-\$56,150
Principal LifeTime 2010	47.6	-16.72	-\$83,600
S&P 500 Index	100.0	-19.29	-\$96,450
Plansponsor On Target 2010 Index	8.2	-0.82	-\$4,100

Source: Morningstar and Target Date Analytics

19.3% year to date through Sept. 30, 2008. Many of these 2010 funds, which supposedly have a diversified portfolio and a risk-attenuating glidepath, just barely outperformed a 100% equity portfolio. Results like that point to both a design problem as well as a failure to manage risk

performance in 2008 sets a standard for how a 2010 fund should behave as it closes in on its target date. The reason is clear: The On Target 2010 Index had an equity allocation of about 8%, compared with the 52.2% average equity allocation maintained by the four largest 2010 target-date funds.

## A target-date fund that is within five years of its end date should not be running on high-octane equity fuel.

who has a \$500,000 account balance in the "average" 2010 fund on Jan. 1, 2008. By Sept. 30, the account value in his or her fund had dropped by \$68,500.

These funds are nearly one year from reaching their target date. What would happen if investors intended to withdraw their money at the target date and purchase annuities? Isn't it true that the glidepath (the dynamic asset allocation model that governs the portfolio from inception to the target date and beyond) is supposed to guard against exactly this sort of meltdown?

This is a rhetorical question, of course, to which the answer is, "Yes." The reality is quite different.

Consider that the S&P 500 (with its 100% equity allocation) lost

properly within the fund. A stated desire to factor in boomers' increased longevity led product manufacturers to err on the side of growth rather than on asset preservation.

### TOO MUCH EQUITY

So what happened? Well, let's take a look at the equity allocation patterns shown in "Target Pain." (Equity allocation is defined as the sum of U.S. equity and non-U.S. equity.) The average equity allocation of the four largest 2010 target-date funds was 52.2%.

Compare this with the equity allocation and performance of the Plansponsor On Target 2010 Index, a target-date index designed and maintained by Target Date Analytics. (Full disclosure: I am a principal of Target Date Analytics.) On Target's per-

Clearly, the On Target 2010 Index has a far more conservative glidepath. Through Sept. 30, 2008, the index lost only 0.8%. This prudent approach produced a year-to-date loss of only \$4,100 in an account that had a \$500,000 balance at the beginning of 2008. Remember that an S&P 500 account lost \$96,450, while the top four 2010 target date funds dropped \$68,500 on average.

Target-date funds are qualified default investment alternatives (QDIA) within the provisions of the 2006 Pension Protection Act. A "default" investment vehicle should take a more conservative approach to protect investors.

Of the more than 30 2010 target-date funds in existence right now, nearly all of them are too aggressive as they approach their target dates.

A target-date fund that is within five years of its end date should not be running primarily on high-octane equity fuel.

### TIMING IS EVERYTHING

Caution comes at a price, of course. The first nine months could have looked quite a bit differently from the mess that has played out before us. If that time period had produced a 15% return for equities, the On Target 2010 Index would have underperformed the average 2010 fund. Not fully capturing the upside is always the price of avoiding the downside. And while maybe I'm just being cautious, that certainly seems like a reasonable approach for a 63-year-old.

Luckily, being conservative does not necessarily mean that performance will be inferior over the long run. The whole point of a glidepath is to take appropriate amounts of risk at the right time, providing investors with the right results.

As shown in "Winning the Race," at right, the Plansponsor On Target 2010 Index performed as well as the average 2010 target-date fund over the past three-, five- and 10-year time periods, as of Dec. 31, 2007. But it was not because the Index had any big upside years. Instead, it was due to the fact that the Index succeeded at avoiding any big losses. If there is a secret to investing, that truly is it.

This comparison is confined to 1998 to 2007 to remove the impact of 2008, which would obviously provide an advantage to the equity-light On Target Index. But, as its performance so far in 2008 shows, the On Target Index became more defensive at the right time—as it approaches its target date. Thus, the primary goal should be asset protection, so that investors can arrive safely at the target date and then make needed plans for the retirement income distribution phase.

It is naïve and clearly dangerous for mutual fund companies to assume a target-date fund is the ideal product

## WINNING THE RACE

To be successful, a target-date fund must take the appropriate amount of risk at the right time. The Plansponsor On Target 2010 Index kept pace with the average 2010 fund over the three-, five- and 10-year time periods ending Dec. 31, 2007.

Annual Returns 1998-2007	Average 2010 Fund (%)	Plansponsor On Target 2010 Index (%)	S&P 500 Index (%)
1998	17.04	9.66	28.58
1999	10.69	11.93	21.04
2000	1.50	1.88	-9.11
2001	-0.61	-2.84	-11.88
2002	-5.96	0.71	-22.10
2003	17.00	16.28	28.68
2004	8.03	9.45	10.88
2005	4.62	4.79	4.91
2006	10.45	6.56	15.80
2007	6.36	9.00	5.49
Annualized % Return			
3-Year	7.12	6.77	8.62
5-Year	9.21	9.15	12.83
10-Year	6.68	6.60	5.91

Source: Morningstar and Target Date Analytics

during the post-retirement years. The stated target date is an ending, not the beginning of a new long-term retirement period in the same fund. Investors should not have to stay in the same fund in order to recover the losses they sustained during the two years prior to the target date. If the target date is truly an ending, the asset allocation glidepath must be more conservative. In other words, it should look more like the On Target Index.

Being cautious with other people's money should be the mantra when designing a target-date fund or target-date index—particularly when that person is over 60 years old. The Plansponsor On Target 2010 Index did exactly that. Despite seeming so far away a few years ago, we really are on the doorstep of 2010. A 63-year-old's portfolio should not go the way of Pan Am.

A target-date fund that fails to attenuate risk near its target date has

failed in its primary purpose. Given that premise, nearly all 2010 target-date funds are failing right now. Even worse, virtually all of the target-date funds coming down the pike (2015 funds, 2020 funds, etc.) are cut from the same cloth and will likewise experience big losses near their target dates if the equity markets decline.

To fix the problem, fund companies must retool the target-fund glidepath to take less equity risk as the target date approaches. Beyond that, broader diversification will help a lot as well. But that's a topic for another article. **FP**

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