

THE PORTFOLIO

Send in the Clones?

TARGET-DATE FUNDS ARE PROLIFERATING, AND THEY'RE ASTONISHINGLY SIMILAR. SADLY, THEY'RE NOT ASTONISHINGLY EXCELLENT. BY CRAIG L. ISRAELSEN

THE NUMBER OF TARGET-DATE FUNDS is multiplying rapidly. Unfortunately, the vast majority of them are clones of one another. The basic concept—a portfolio that evolves over time to match the life cycle of the investor—is sound. But, as we will see, the execution of the concept tends to resemble a cookie-cutter approach.

A SURGE OF NEW PRODUCTS

During the past four years (2003 through 2006), the market has seen a surge in the introduction of target-date funds. As you can see in “Up and Coming” on page 108, roughly 50 new target-date funds were introduced in 2006 alone. As of year-end 2006, there were 168 distinct target-date funds (meaning only one share class of a multiple share class fund is being counted). Moreover, that total only counts target-date funds that have a stated target date in their name. The largest target-date fund asset bases are in the years 2010, 2015, 2020, 2025 and 2030.

This study focuses on target-retirement-date funds (which I will refer to as target-date funds). All the raw data in this study was extracted from Morningstar Principia. The asset totals include all share classes, whereas the headcount and performance comparison include only distinct target-date funds. (See “Targeting the Target-Date Funds,” page 112.)

The assets utilized in target-date funds consist of U.S. equities, non-



U.S. equities, bonds and cash. When the target date is decades away, the portfolio is weighted more heavily in equities; gradually, it evolves toward a more conservative asset allocation

based on a timetable that approximately coincides with the retirement year of the investor.

The prevailing approach is to shift from a stock-heavy portfolio to a

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bond-heavy portfolio over time, i.e., as the fund nears its target date. For example, an investor who is 25 years old in 2007 and is planning to retire in 45 years would look for a fund with a target date around 2050. Once the date is reached, most target-date funds continue along a glide path toward a bond-heavy portfolio, though at varying speeds.

As shown in “Asset Allocation à la Carte” at right, target-date funds with closer retirement dates have a reduced exposure to equities and a larger allocation of their portfolio in bonds and cash. For example, the 13 funds with a 2015 target date have an average bond allocation of about 31%, an average U.S. equity allocation of roughly 43%, an average non-US equity allocation of 12% and an average cash allocation of roughly 11% (with the remaining 3% comprising “other”). By contrast, the 15 funds with a 2040 target date have an average of 9% in bonds, 65% in U.S. equity, 21% in non-U.S. equity and about 4% in cash (with 1% in “other”).

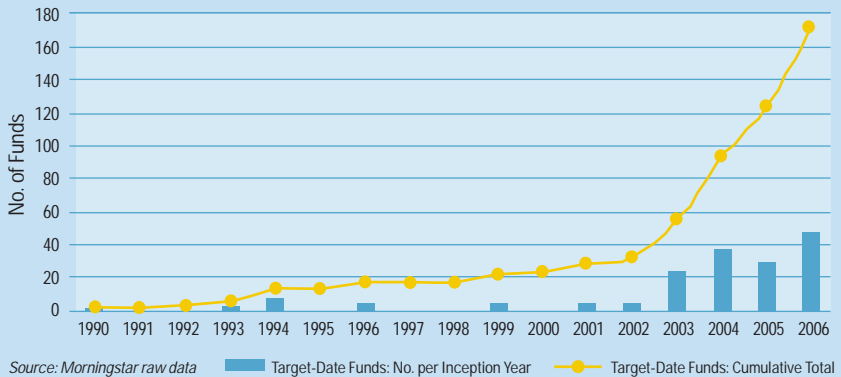
ASSESSING THE ALLOCATIONS

Let’s now focus our attention on the allocations to U.S. equities within the various target-date fund groups, ranging from 2005 to 2050. Also included is a comparison group of non-target-date funds. This comparison group consists of 72 funds which have the Dow Jones Moderate Portfolio as their best-fit index. (This is the most common best-fit index among target-date funds.)

As shown in “Cookie Cutter U.S. Equity Holdings” on page 110, regardless of the target date the specific suballocations to large caps, mid-caps and small caps is virtually identical. Interestingly, the allocations to large, mid-cap and small U.S. equities among all the target-date funds are essentially the same as the allocation among the 72 non-target-date

UP AND COMING

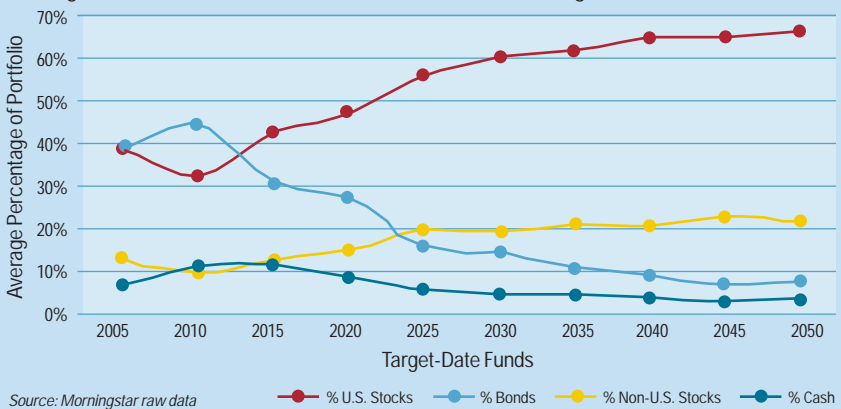
Number of distinct target-date funds as of year-end 2006, broken out by inception year.



Source: Morningstar raw data

ASSET ALLOCATION À LA CARTE

Average allocations to stocks, bonds and cash in different target-date funds.



Source: Morningstar raw data

FINDING A FOREIGN FOCUS

The best-performing funds of 2006 had a heavier weighting in international stocks.

Based on One-Year Performance in 2006	Avg. 2006 Return (%)	Average % of Portfolio in			
		Cash	U.S. Stocks	Non-U.S. Stocks	Bonds
Best Five 2020 Funds (1)	13.6	6.2	50.1	14.8	26.3
Worst Five 2020 Funds	9.4	15.5	39.7	7.8	36.8
Best Five 2030 Funds (2)	15.9	5.7	55.9	20.9	15.4
Worst Five 2030 Funds	10.9	4.9	62.1	13.6	18.5
Best Five 2040 Funds (3)	16.6	5.0	60.8	22.0	10.4
Worst Five 2040 Funds	12.5	2.9	73.9	15.2	7.7

(1) T. Rowe Price Retirement 2020, Principal Inv 2020, Schwab Target 2020, Barclays Global Inv LP 2020, State Farm LP 2020

(2) Alliance Bernstein 2030 Retirement Strategy, T. Rowe Price Retirement 2030, Russell Life Point 2030 Strategy, Principal Investors 2030, Barclays Global Inv LP 2030

(3) Alliance Bernstein 2040 Retirement Strategy, Barclays Global Inv LP 2040, Russell Life Point 2040 Strategy, T. Rowe Price Retirement 2040, Principal Inv 2040

Source: Morningstar raw data

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funds that closely resemble the Dow Jones Moderate Portfolio Index.

While the portion of the portfolio allocated to U.S. equities varies by target date, the allocations within the U.S. equity allocation vary very little. The portion of the U.S. equity allocation devoted to large-cap stocks (i.e., large-cap indexes) is essentially 75% no matter what the target date may be. The allocation to mid-caps is about 20%, while small caps have a 7% to 8% allocation within the overall U.S. equity holdings.

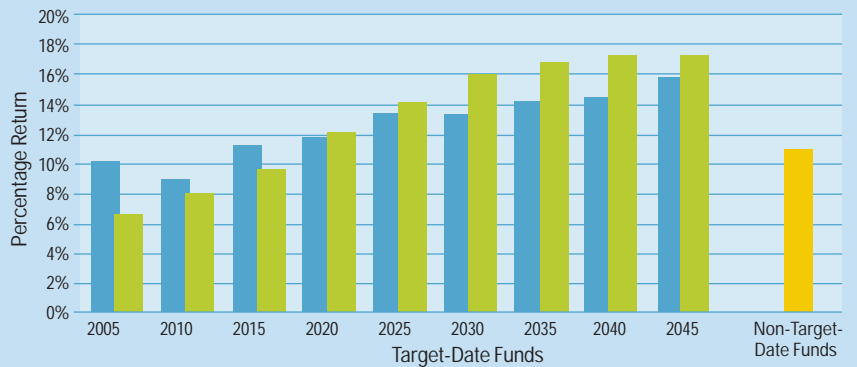
Dig a little deeper and we see that the suballocations within each capitalization also follow a one-size-fits-all model. As shown in “One Cap Fits All” on page 112, regardless of the target date, the 75% allocation to U.S. large-cap equity is equally divided among value, blend (or core) and growth. Among mid-caps, the 20% allocation is equally subdivided among value, core and growth, with each style representing about 6% to 7% of the U.S. equity portion in any target-date portfolio. Small-cap value, small blend and small-cap growth each represent about 2% to 3% of the U.S. equity portion of a target-date fund—regardless of the target date.

Understandably, compared with a 2010 fund, a 2045 target-date fund has a higher allocation to U.S. equity and therefore will have a proportionally higher exposure to small-cap U.S. equities. Nevertheless, regardless of target date, the only factor that increases the exposure to small- and mid-cap U.S. equities is the overall allocation to U.S. equities in general. Alas, the well-known small-cap premium disappears into the black hole of target-date-fund methodology.

PERFORMANCE ISSUES

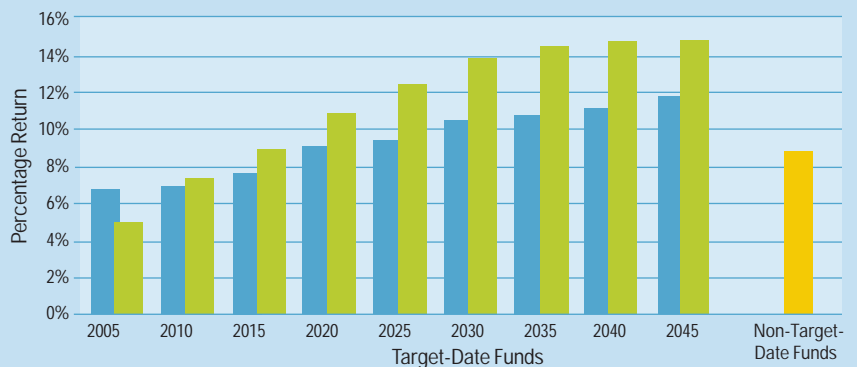
Only now have target-date funds been on the market long enough to get a sense of their performance over time. Thus far, the news is only so-so. Let's start with last year: As seen in “Perfor-

PERFORMANCE IN 2006



Source: Morningstar raw data

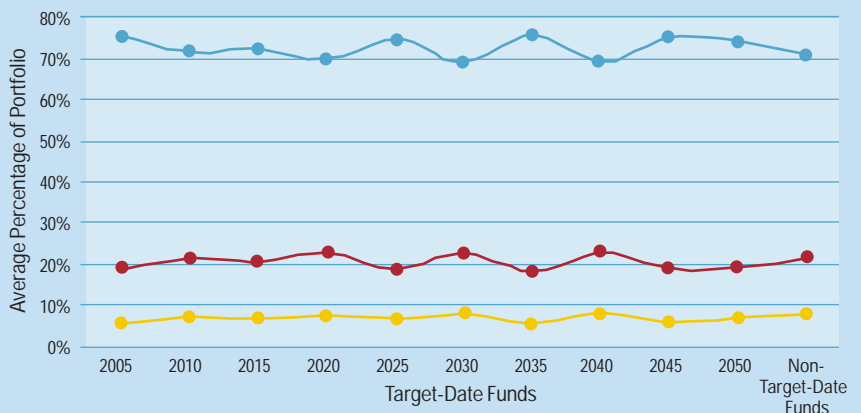
3-YR. PERFORMANCE RECORD (2004-06)



Source: Morningstar raw data

COOKIE-CUTTER U.S. EQUITY HOLDINGS

Distribution of the U.S. equity portion of different target-date portfolios.



Source: Morningstar raw data

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mance in 2006” on page 110, near-term (2005, 2010, 2015) target-date funds outperformed their respective Dow Jones Target-Date Indexes in 2006. But as the target date moves out to 2020 and beyond, target-date funds underperformed the DJ Target-Date Indexes. The performance of the comparison group of non-target-date funds is most similar to that of funds with target dates of 2015 and 2020.

The best-performing funds in 2006 had a heavier weighting in non-U.S. equities, as you can see in the table “Finding a Foreign Focus,” (page 108). The top five funds in the target-date cohorts of 2020, 2030 and 2040 are shown below the table. Fund families with a strong showing include T. Rowe Price, Alliance Bernstein, Russell, Principal and Barclays Global. This forces us to question whether, over the long term, enhanced exposure to foreign equities will become a standard feature among target-date funds.

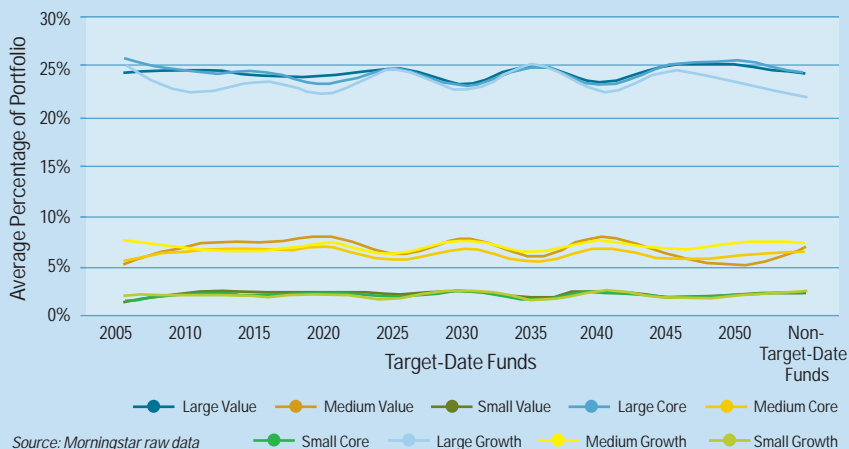
Looking longer term, the performance gap widens. As shown in “3-Yr. Performance Record (2004-06)” on page 110, over a three-year period the performance of the DJ Target-Date Indexes surpassed the average performance of the target-date funds. The only exception was target date 2005. Once again, the performance of the non-target-date comparison group was most like the performance of the 2015 and 2020 target-date funds.

QUALITY INGREDIENTS

In summary, it’s important to remember that in almost all cases, target-date funds comprise in-house funds. For instance, the T. Rowe Price Retirement 2030 Fund is made up of 12 T. Rowe Price funds (Growth Stock, Value, Equity Index 500, International Stock, etc.); Barclays Global target-date funds primarily consist of iShares exchange-traded funds; Russell target-date portfolios are built with Russell funds, and so on.

The asset allocation model and

ONE CAP FITS ALL



Source: Morningstar raw data

TARGETING THE TARGET-DATE FUNDS

Breakdown of target-date funds on the market as of year-end 2006.

Target Date of Fund (as stated in name of fund)	Total Assets (\$ Million) (includes all share classes)	Number of Distinct Target-Date Funds
2000	1,652	2
2005	2,455	6
2010	18,877	24
2011	77	1
2012	60	1
2013	43	1
2014	44	1
2015	12,128	19
2020	27,191	23
2025	11,079	16
2030	17,538	21
2035	6,650	16
2040	9,139	20
2045	2,038	12
2050	485	5
TOTAL	\$109,454	168

Source: Morningstar raw data

glide path of a target fund are important elements. The quality of the assets within a target fund may, however, be even more important. Fund families that have a strong lineup of stand-alone funds are the best places to start shopping for a target-date fund. Let’s face it, the best ingredients make the best cookies—not the shape of the cutter.



Craig L. Israelsen, PhD, teaches family finance at Brigham Young University. You can email him at craig_israelsen@byu.edu.

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