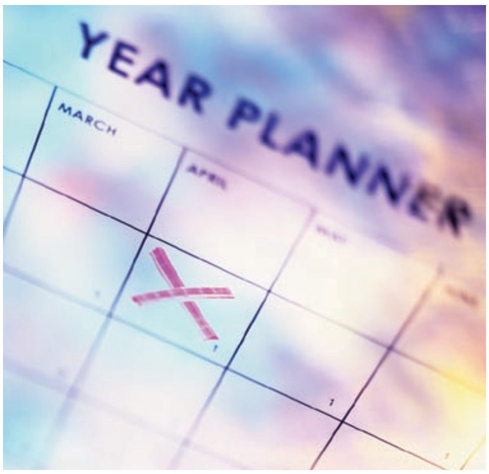
PORTFOLIO



Target Funds: To or Through?

Should your clients stay in a target-date fund beyond the target date?

By Craig L. Israelsen

How do you decide when it's the right time to say goodbye to a client's target-date funds — when they reach the specified year or all the way through the retirement years?

The issue is at the heart of the "to versus through" debate. Some target-date funds have an asset allocation model, or glidepath, that is dynamic until it reaches the target date (the year 2020, for example). At that point, the glidepath becomes static at its most conservative allocation. This is a "to" fund, meaning it glides dynamically over time until it reaches the stated target date and then becomes a fixed allocation fund.

But other target-date funds have a glidepath that's dynamic before and after the specified year. That means the fund's asset allocation changes even years after the target date has been reached. These funds are "through" funds, meaning their asset allocation model extends through the target date.

The job of a target-date fund during the pre-target years is to grow an investor's contributions prudently. Within five years of the target date, growth is still the objective, but in a risk-controlled manner.

Once a target date is reached, a fund's job becomes much more difficult because most investors are no longer depositing money in the fund — they are withdrawing it systematically. This is a consequential change in the demands placed on the asset allocation model and on the fund's managers.

Advancing the argument, should your clients make their retirement ride in a through target-date fund? Or are other types of funds better suited as distribution vehicles?

Let's explore how well the Fidelity Freedom 2000 fund performed as a retirement fund after reaching its target date. Fidelity Freedom 2000 is a through fund, and the only 2000 target-date fund that also has a performance history extending back to 2000. For comparative purposes, let's include the three largest conservative allocation funds: Franklin Income, Vanguard Wellesley Income and Permanent Portfolio. These four funds were tested in distribution mode for the 11-year period of January 2000 to December 2010.

Assume a starting balance of $250,000 for each fund on Jan. 1, 2000. Withdrawals were made at the end of the first year. The first withdrawal was 5% of the starting balance, or $12,500. The annual inflation rate for withdrawals was set at 3%. Thus, the second annual withdrawals were $12,875 from each of the four funds.

RELAY RACE

As the "Torture Test" chart on page 122 shows, the performance of Fidelity Freedom 2000 as a distribution vehicle during the post-target years paled in comparison to the three conservative allocation funds. Fidelity Freedom 2000 took a beating over 11 years in three categories: ending account balance, internal rate of return and

TORTURE TEST

The performance of Fidelity Freedom 2000 as a distribution vehicle during its post-target years paled in comparison with three conservative allocation funds.

2000–2010

Mutual Fund	Balance on Dec. 31, 2010	Internal rate of return over 11-year period	Largest annual loss over 11-year period
Fidelity Freedom 2000	$171,392	2.76%	–21.6%
Franklin Income	$369,120	8.13%	–34.4%
Vanguard Wellesley Income	$322,770	7.12%	–14.7%
Permanent Portfolio	$479,344	10.2%	–12.2%

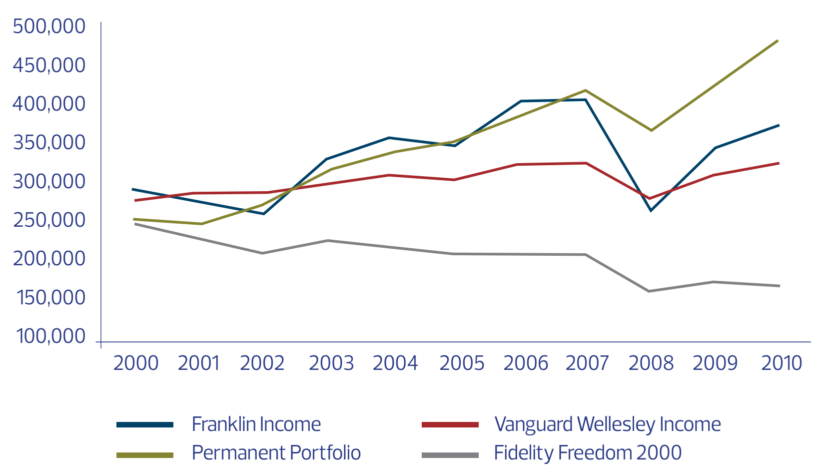
Note: Assumes portfolio with a starting balance on Jan. 1, 2000, of $250,000, 5% initial withdrawal rate and 3% annual inflation increase in withdrawals.

Source: Data from Morningstar, calculations by author

PATHS OF FORTUNE

Fidelity Freedom 2000 was the only fund to fall below its starting balance of $250,000 after 11 years of withdrawals.

End-of-Year Account Balances, 2000 to 2010



Note: Assumes portfolio with a starting balance on Jan. 1, 2000, of $250,000, 5% initial withdrawal rate and 3% annual inflation increase in withdrawals.

Source: Data from Morningstar, calculations by author

worst-case annual drawdown.

After 11 end-of-year withdrawals, the ending account balance for Fidelity Freedom 2000 fell below the starting balance of $250,000, the only fund to do so. (See "Paths of Fortune" chart, above.) Franklin Income and Vanguard Wellesley Income had ending account balances about twice the size of Fidelity Freedom 2000, and the Permanent Portfolio fund was nearly three times larger.

As the performance winner, Permanent Portfolio posted an internal rate of return of 10.2%, followed by Franklin Income at 8.1% and Vanguard Wellesley Income at 7.1%. Fidelity Freedom 2000's rate was just 2.8%.

The one bright spot for Fidelity Freedom 2000 was its smaller, worst-case annual drawdown, compared with Franklin Income. This is hardly consoling, however, because Franklin Income fell from grace in 2008 with a loss of 30.5%. Combined with the annual withdrawal that year, it led to a total account loss of 34.4%.

Much like a relay race, investors would have been better off liquidating their assets in Fidelity Freedom 2000 once the specified year was reached and choosing one of the three conservative allocation funds. In essence, target-date funds with a through glidepath are attempting to run a relay race with just one runner. With all the specialization and segmentation in the mutual fund marketplace over the past two decades, it's overly optimistic to assume a single target-date fund can be the sole investment solution for an investor over his or her entire lifetime.

DEFAULT CHOICE

Despite the drawbacks later in life, target-date funds can be useful default choices for savers younger than 60. Workers in their thirties should not be investing their 401(k) contributions into money market mutual funds or stable value funds. Those conservative investment products are more appropriate for older investors who need to focus on capital preservation. Young investors should have investment portfolios largely comprised of assets with higher return potential, such as equities and diversifiers (real estate, commodities, international bonds, etc.) when the target date is 30 years away.

However, as investors approach retirement age, the potential variability in their financial situations warrants more personalized asset allocation decisions. For example, take two different 60-year-olds. The first has amassed $2.5 million in her retirement account, has no debt, has qualified for a pension and wants to preserve a fairly large sum for heirs. The second has a retirement account balance of $300,000, has significant debt, no pension and no plans to bequeath any money to heirs.

The only factor these two people have in common is their age. Yet if you were designing a retirement distribution portfolio for each of these two, the asset allocation would not be identical.

Unfortunately, target-date funds don't take any of these life variables into account. The XYZ 2020 Fund or QRS 2000 Fund have a set asset allocation model regardless of whether you're the first investor in this example or the second.

PORTFOLIO CHECKUP

Advisors should meet with clients approaching retirement and review their portfolios, which may guide decisions about whether to stay in target-date funds in the years to come. Staying put in a fund as its asset allocation continues to glide through the target date is clearly the path of least resistance. But it's quite possible the fund has run its course after arriving at the specified year. If the fund's asset allocation model no longer matches a client's specific needs during retirement, advisors should find a fund — or build a portfolio of funds — that does. **FP**

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