

## **Lifestyle Funds for Retirement: The Answer or The Question**

By Mary Ann Golin, CFP®, CRPC

As mutual fund menus and the technology needed to track them have grown, mutual fund companies have in the last 4 to 5 years, started to offer fund portfolios that are, in a sense, "one-stop-shopping". These arrangements were originally designed for defined contribution retirement plans; mostly 401k plans which are still the largest holders of lifestyle funds. Hewitt Associates reported that 55% of plan sponsors offered lifestyle funds in 2003.

The average 401k participant looks at the funds available, selects the ones they will use, decides what percent of their contribution will go to each fund, and proceeds to ignore their retirement plan statements for the next 20 years. If that person changes jobs, they are advised to roll over their plan to an IRA and not much more happens as far as investment review is concerned. As the interactive technology capability in retirement plans has grown, it has become easier for participants to change their investment choices. Unfortunately, most people are not students of the markets and even when market trends change, there is typically little movement of funds within accounts.

The purpose of lifestyle funds is to establish a way for account owners to achieve better than market performance with the least effort. This is accomplished by selling a portion of one fund and buying into another based on achieving some goal or target in the fund or in one's life.

Target-risk funds have really been around a long time. They were originally known as balanced funds. In a lifestyle portfolio of funds, the process is a bit more sophisticated but it is very similar to the old balanced funds. Target-risk lifestyle funds often fall into the usual conservative, moderate and aggressive risk categories. Lori Lucas, director of participant behavior research at Hewitt Associates has noted that when investors do not know which fund they prefer, they tend to pick the fund of least extremes. This is probably the reason most people select the moderate risk lifestyle fund. It will often be made up of 60% stock funds and 40% bond funds. Depending on the frequency of adjustment, a typical account will be brought back to 60% stock funds and 40% bond funds on a regular schedule. A good example would work as follows: Mr. Jones chooses the moderate lifestyle portfolio which uses 60% stock funds and 40% bond funds. If the stock market goes up, Mr. Jones' stock funds will probably go up too. At the end of 6 months, which is when his portfolio adjusts, he may find that his stock funds now represent 70% of his account value while his bond funds are 30% of his account value. An old investment adage is to "buy low and sell high". Mr. Jones lifestyle fund will do just that. It will automatically sell off some of his stock portfolios and buy some of his bond portfolios until he is back to the 60-40 mix of stock funds and bond funds. The lessons learned during the late 90's stock market run prove that this is a sensible way for an unsophisticated investor to avoid concentration in one market sector.

The second, and more recent type of lifestyle fund is the target-date fund. This arrangement changes the asset mix for Mr. Jones based on his age. Financial Planners advise that as you reach retirement, your investment mix should become more conservative. Thus in the early years, more portfolio risk is possible but as retirement gets close, a more conservative portfolio is appropriate. In Mr. Jones case, his lifestyle fund portfolio will become more conservative as he matures. Thus, the lifestyle portfolio might have 80% stock funds and 20% bond funds when he is in his twenties. When he turns 30, his lifestyle portfolio might switch to 70% stock funds and 30% bond funds. During each decade, the portfolio could regularly adjust to maintain a more and more conservative profile.

Studies by Hewitt Associates show that the youngest participants hold the highest percentage of lifestyle funds, probably because they have the least experience in investing. The longer tenured and more mature participants have much lower amounts in lifestyle funds. They have other funds offered over the years and often have significant amounts of company stock that has grown in value. Some experts think that if a person is going to own lifestyle funds, it should be the only position in a retirement account; to own other positions is considered to be counterproductive. Due to the recent development of these funds and the already existing assets in many older workers' retirement accounts, it is difficult to assess, long term, whether the ownership of lifestyle fund portfolios along with other types of assets dilutes or enhances performance. Time will provide the answer.

There are many advantages to both types of lifestyle funds. Perhaps the most important advantage is that lifestyle funds take the emotion out of buying and selling decisions. In other words, it prevents holding winners until they become losers. Another advantage, especially with target-date funds, is that they reduce risk exposure as the target date nears. Ned Notzon, chairman of T. Rowe Price's retirement funds committee thinks most people reduce their stock fund ownership too much as retirement nears. A target-date fund will typically keep money in stock even beyond retirement to keep some inflation hedge in place.

There are disadvantages as well. Often lifestyle funds come from one fund family. Unfortunately, when a particular fund family's bond fund performance is less than the best, there is no alternative but to use it. Many experts argue that the sector diversification advantage outweighs that of a poorly performing fund. Another disadvantage is that performance extremes, low and high, are mitigated; so much so that returns don't have much sizzle. Since most people don't want their retirement assets to sizzle but prefer a safer more moderate return, this issue is usually not a problem. Another disadvantage is that some companies add a management or expense fee due to the extra oversight which they claim is necessary. There are some fund families such as Vanguard which do not charge extra for this service.

Plan fiduciaries need to provide sufficient opportunities and a forum for participants to review their options and make choices. Educating employees early and often is the key to making certain lifestyle fund portfolios are used appropriately and effectively. Ultimately, it is up to the investor. Volatility that is tolerable for one person would create insomnia for another. Lifestyle funds are the answer; only if the question is, "Do you want your retirement investments managed automatically?"

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