Business

Results aren't stellar, but lifecycle funds are easy

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Ease, not results, is big draw of lifecycle funds

By: MICHAEL J. FRANCIS - 401(k) ADVISER

In theory, empowering American workers by giving them control over their retirement investments seems like a great idea.

In practice, however, the concept has its drawbacks.

It's no wonder the 401(k) industry came up with the concept of "lifecycle funds" more than 15 years ago. Lifecycle funds make it easy for individuals to achieve professional diversification, offering ready-mixed portfolios to 401(k) investors who don't have the time, interest or ability to diversify their own retirement savings.

Over the years, lifecycle funds have gained in popularity and account for more than 20% of the assets in some 401(k) plans.

But are lifecycle funds truly the answer for those who lack investment experience? The short answer is, not always. The longer answer is that investors should take a closer look at the different types of lifecycle funds, their performance and expenses.

Risk vs. reward

You'll typically find "risk tolerance" lifecycle funds in groups of three to five, with each fund in the group geared toward a different level of potential risk/reward. You choose a fund based on a "score" determined by your age, retirement goals and willingness to take risks.

The major drawback of risk tolerance lifecycle funds is the rather cumbersome questionnaire process used to determine the score, which needs to be updated every five years or so to make sure the fund you selected continues to be the best fit.

Other lifecycle funds are created with a particular retirement year in mind. These funds rebalance their holdings automatically, becoming more conservative as their target dates approach.

The concept is simple - pick the fund with the target date in its title closest to when you hope to retire. These funds are wonderful for their simplicity. There are no questionnaires, subjective concepts like risk tolerance, and no need to keep revaluating as you get closer to retirement.

Such funds do not, however, take into consideration the emotional aspects of investing and can expose younger investors to more risk than they might prefer.

Middle-of-the-road performance

Lifecycle funds are not known for their stellar performance. That's because they are so widely diversified - typically made up of shares of numerous single-style mutual funds. The quality of the underlying funds also affects the performance of lifecycle funds.

Such broad diversification leads to performance that is often middle of the road.

Quite often, lifecycle funds are restricted to investing in the funds offered by the sponsoring fund company, which can undermine returns, since no single fund family is a top performer in all asset categories. If the sponsoring fund company is a great stock-picking organization, for example, but not so great with bonds, the portion of that lifecycle fund invested in bonds could underperform and thus lower the fund's overall return.

While professional diversification has its advantages, it can be expensive.

First of all, with a lifecycle fund that invests in other funds, you have to pay the management expense of each underlying fund.

Second, many lifecycle funds carry an additional management expense, charged by the sponsoring organization, for deciding how to invest among the underlying funds.

All together, some lifecycle funds carry an expense ratio well above the average balanced fund expense ratio of 1.30%, according to Morningstar. With a little research, however, you can find a number of lifecycle funds, designed with the cost-conscious in mind, that have total expense ratios below 1.00%.

Lifecycle funds were created for a very good reason - to help 401(k) investors who do not have the time, interest or ability to make good investment decisions. Short of hiring an investment professional on their own, many people need help properly diversifying so they can make the most out of their retirement savings. Lifecycle funds, when properly utilized, offer a reasonable compromise between a thoughtfully designed portfolio and throwing a dart.

It is very difficult to quantify the performance advantage of custom-building your own portfolio of funds, but experience tells me it can be significant. Of course that takes time, interest, and experience, which for many 401(k) investors can be in short supply. In that case, a lifecycle fund might be best for your bottom line.

Michael J. Francis, CIMA, JD is president and senior investment consultant of Francis Investment Counsel LLC, a registered investment adviser based in Hartland, WI. Mike Francis can be reached at michael.francis@francisinvco.com.