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Lifecycle Mutual Funds

From Dustin Woodard,
Your Guide to Mutual Funds.
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Are lifecycle funds right for you?

Lifecycle funds were designed to make retirement investing easier. They succeed in doing so, but there are reasons why you might want to avoid them.

Lifecycle funds (also known as age-based funds or target-date funds) were first introduced in the 90s, but didn't become popular until recently. They are commonly found in 401(k) plans as they are geared towards those who are investing for retirement.

Lifecycle Funds Make Life Easier
It's no surprise that lifecycle funds came into existence. Investing properly for retirement can be a pain. Investors have to determine their asset allocation, rebalance, and adjust their asset allocation over time.

For example, Joe might decide that he wants 80% of his money in stock mutual funds and 20% in bond mutual funds. Then each year he rebalances his portfolio because the stocks may outperform the bonds one year, causing his allocation to be 82% stocks and 18% bonds or the opposite could happen in other years. Then, as he approaches retirement, he might reduce his stock holdings to 20% and increase his bond holdings to 80%. This is a simplified example as there is more to asset allocation then just choosing between stocks and bonds.

Many investors are attracted to lifecycle funds because they take care of all the asset allocation and rebalancing issues. There are hundreds of lifecycle funds to choose from - I've even created a list of 127 no-load lifecycle funds you might want to consider. There are basically two varities of lifecycle funds: target-date and target-risk.

Target-Date Lifecycle Funds
The first type ties the asset allocation formula to a specific retirement date. If you knew you were going to retire in 2030, you might choose one of the eleven 2030 funds on my list. These funds automatically adjust the asset allocation as you approach retirement. For example, the Fidelity Freedom 2030 fund features 80% stocks, 15% bonds, and 5% cash, while the Fidelity Freedom 2010 fund features around 50% stocks, 35% bonds, and 15% cash (as of Sept. 2005).

Target-Risk Lifecycle Funds
These funds are usualy split into three groups, based on risk: aggressive, moderate, and conservative. It is up to the investor to decide when they want to switch from one to the other, so for retirement, someone might start with the aggressive fund, then switch to moderate halfway towards retirement and then conservative when they are a few years from retirement. For example, the Russell Life Aggressive fund invests 74% in stocks, while the Russell Life Conservative fund only invests 19% in stocks (as of Sept. 2005). Funds that are based on risk levels have been around for a long time.

Lifecycle Funds Flaws
The one-size-fits-all approach to retirement investing comes with problems. If you have taken my risk tolerance or risk capacity quizzes and compared notes with your friends (even if they are your age), you will quickly see that investors have different portfolio needs. Even the fund companies don't agree on the proper allocation - just compare the allocation from one fund family's target-date fund to another's. Does it make sense for Bob, a single millionaire who likes to take risks, to have the same allocation as Sandy, a conservative librarian with three children just because they plan on retiring in the same year?

If you did deeper into the asset allocation of lifecycle funds, you might not like what you see. For example, I believe most of these funds don't invest enough in international funds (many invest 30% or less in international funds), don't put enough into value stocks, don't put enough in small companies and put too much money in cash. They tend to sell to the path of least resistance, which for many investors means mostly U.S. and mostly large growth stocks, even though most professionals who study the numbers would say that you are short-changing yourself.

Other flaws include: retirement year (the nearest fund to your retirement year might be over 5 years off), active investing (active investing isn't the flaw, but the lack of a choice is - many of the lifecycle funds tend to use active mutual funds

rather than index funds), and narrow fund selection (many lifecycle funds only invest in funds in the fund family, rather than the entire universe of over 10,000 mutual funds).

Summary
For those who **aren't willing** to spend the time making the appropriate adjustments to their portfolio over time, lifecycle funds might suit them well. For those who **are willing** spend more time to create an appropriate retirement portfolio for themselves, lifecycle funds should be avoided.

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