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Target-Date Funds Are Cruise Control Of Investing

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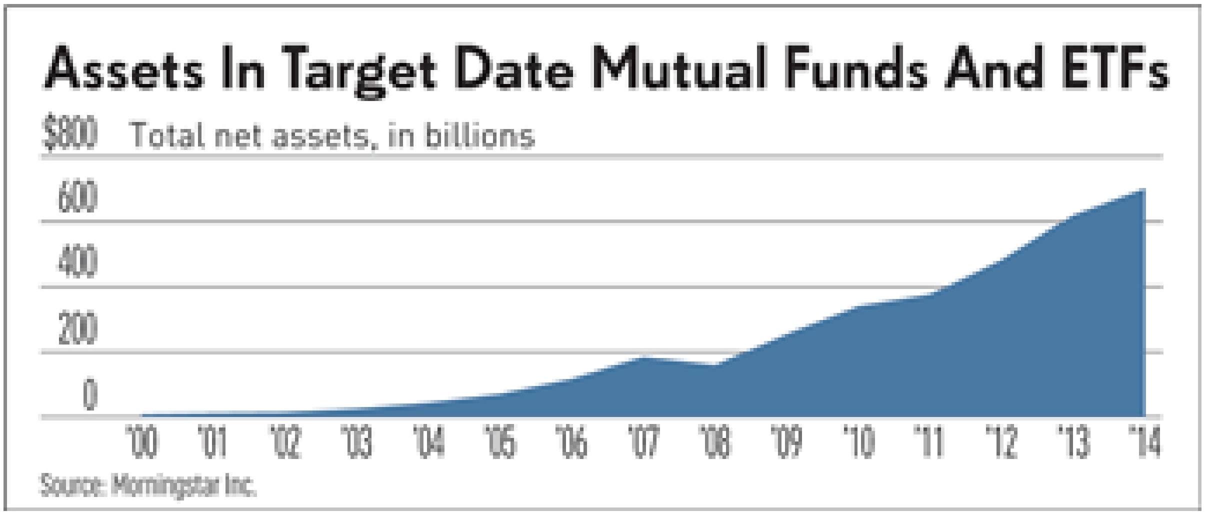

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Target-date, or life cycle, funds are the cruise control of investing. After you choose which fund to invest in, the fund does all the work for you. You don't have to think about it again until retirement.

Many target-date mutual funds are funds of funds. They hold a selection of equity funds, such as large-cap, small-cap and international funds, and a selection of fixed-income funds of multiple durations and yields.

The appeal of target-date funds is that they take care of all the asset allocation and rebalancing for you. It's a balancing act of managing market risk, inflation risk and longevity risk.

Typically, an investor picks a target date around the time he plans to retire. When the investor is young, the fund focuses on growth and mostly holds stock funds. But as the investor gets closer to retirement, the fund's asset allocation becomes more conservative and focuses on fixed income. The changing asset allocation is called the glide path.

Target-date funds hit the public consciousness after the Pension Protection Act of 2006. The legislation allowed 401(k) plan sponsors to make life cycle funds the default investments for participants who didn't choose their own funds. The logic was that since investors were now in charge of their own retirement funds, sitting in cash wasn't going to get them there.

"For the past nine years that we've been keeping track, there has been double-digit growth in assets, ever since Pension Protection came out," said Janet Yang, Morningstar's target-date fund analyst.

In 2006, of all the 401(k) plans, 57 offered target-date funds. In 2012 the number had jumped to 72, according to the Investment Company Institute.

In 2006, only 19% of 401(k) plan participants held target-date funds. Six years later it was 41%. Also, in 2006 target-date funds made up only 5% of 401(k) assets. By 2012 that had jumped to 15%.

By the end of Q2 2012, target-date mutual funds held $678 billion, said Sarah Holden, the ICI's senior director of retirement and investor research. The majority of those assets were held in retirement accounts. Defined contribution plans held 68% of the total, and individual retirement accounts 20%. The rest was in the personal accounts of investors looking for the glide path approach.

Vanguard, Fidelity and T. Rowe Price have the largest target-date funds.

Families of target-date funds can have different philosophies, which can lead to wide dispersions in the holdings, returns and fees for funds with the same target year. Recently, fees have become a big issue, and that has helped move plan sponsors toward index-based funds.

"Each client's needs are going to be different," said Don Wilson, chief investment officer at BrightWorth, an Atlanta asset manager. "Some target-date funds will be too risky, while others won't be risky enough."

Wilson said that if the investor picks his 65th birthday as the target date, he may have 20 years of retirement ahead of him. He may need to have more equities to help his account grow and outpace inflation. The target-date fund may not be taking this into account.

The only ETF provider with target-date portfolios now is Deutsche X-trackers.