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Get A Clue About Target Funds

Pack your investment toolbox with a good navigation plan

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BY KARIN PRICE MUELLER

Star-Ledger Staff

Adviser and academic studies agree that the key to reaching your investment goals is asset allocation -- the percentage of stocks, bonds and cash in your portfolio -- and not the specific investments you choose.

Since the start of the stock market's decline, many financial pros have been recommending so-called target date funds. Also called target allocation funds, age-based or life-cycle funds, these investments take the guesswork out of investing by automatically shifting assets from heavier stock exposure to more safe investments as it moves closer to the maturity date.

Target allocation funds are not the be-all-end-all, but in the absence of proper investment counsel and/or knowledge, target allocation funds can be a savior for investors as the fund strives to provide proper investment allocation in line with an investor's time horizon and tolerance for risk," says Michael Pirrello, a certified financial planner with Mill Ridge Wealth Management in Chester.

These may be handy investment tools for those who have a target year for the start of college or retirement, but they're not for everyone, and they're not without pitfalls. Here's what you need to know before investing:

THE EXPERTS

Margaret O'Meara, certified financial planner, O'Meara Financial Group, Red Bank Michael Palazzolo, certified financial planner and certified public accountant, Access Wealth Planning, Princeton and Roseland

Michael Pirrello, certified financial planner, Mill Ridge Wealth Management, Chester

Greg Plechner, principal, Modera Wealth Management, Old Tappan

HOW THEY WORK

The concept is simple: choose a target date, such as when you want to retire or when your child will start college, and the fund will automatically adjust its allocation accordingly. To reach the target allocation, some funds actually take the fund-of-funds approach: investing in other mutual funds within a fund family. Others purchase individual securities like traditional other mutual fund.

Say you want to retire in about 20 years. You might choose a target fund with the year 2030 in its name.

"As you approach your retirement date, the fund rebalances and is invested more conservatively, so that your nest egg will be intact that you won't be taking as many risks with your money as you get closer to retirement," O'Meara says. "With these funds an investor can set it and forget it."

The funds in theory mirror the kind of asset allocation strategy you should use for your portfolio, simply getting more conservative as you near the date you'll need the money.

They're also attractive to people who take a hands-off approach to investing.

"These may be right for an investor that never reviews nor modifies their portfolio holdings," Plechner says.

HANDS-OFF ? NOT WISE

The concept of target funds a simple, maintenance-free way to invest sounds simple enough. But no investment can be purchased and then left completely on auto-pilot.

"Investors still need to take time to evaluate the target date funds they are investing in," Palazzolo says.

Palazzolo says the allocation among domestic equities, international equities, bonds and cash investments can vary significantly, even for funds with the same target date in the title. The bond side can also be quite different from fund to fund: U.S. Treasuries, federal agency, investment grade corporate and high yield bonds.

The range of results last year among target date funds with the same target date was quite dramatic.

Pirrello offers this example: In 2008, the S&P 500 index fell 38 percent. Some target funds -- even those with target dates that were awfully close, meaning they should be on the conservative side -- fared worse. Take the Oppenheimer 2010 target allocation fund (OTTAX), which lost 41.32 percent.

"That's right, a fund that was designed for investors that planned to retire within two years, in 2010, was actually down over 41 percent," Pirrello says. "So much for preserving a career's worth of savings."

He says the poor performance highlights the issues with target allocation funds -- not all funds are created equal. With a target allocation fund, each mutual fund company has the ability to determine their own asset allocation, meaning that there are no standard asset allocation mixes to govern the given target class of funds.

Pirrello says in the fourth quarter of 2008, the Oppenheimer 2010 fund was invested approximately 36 percent in bonds and almost 64 percent in stocks. By contrast, the 2010 fund from DWS (KRFAX) was invested almost 87 percent in bonds and only 13 percent in stocks. While the Oppenheimer fund lost more than 41 percent, the DWS fund lost only 3.61 percent.

CHOOSING A FUND

If you've determined a target date for college or retirement, your work has only begun. The investment objectives and costs of funds may be very different, no matter what target year the fund carries.

"Although target date funds can make investing for retirement or college simpler, they do not absolve investors from checking under the hood and taking a look at the makeup of the fund," Palazzolo says.

He says investors should read the fund's prospectus to see how the fund is allocated and how the fund changes those allocations over time.

Performance is your next stop. Check Morningstar.com for listings of the best performing funds in a particular class/target year. In general, the best funds are those that have proven track records of at least three years from mutual fund companies that have experience with these types of funds, O'Meara says.

Next, take a close look at fees.

According to Morningstar, the average expense ratio of target funds is 1.11 percent somewhere between the average expense ratio of a bond fund and a stock fund.

O'Meara says investors should find out the average expense ratio of the underlying funds and make sure that the company is not charging an additional fee for managing the allocation. There are some target funds with expenses as low as .2 percent.

Plechner argues there's no reason for target funds to have higher expenses.

"These funds should be less expensive since a portion of the portfolio is invested in lower cost bonds and cash," Plechner says. "A one percent maximum fee is a good starting point in selecting a fund family's target date fund."

WHO ARE THEY WRONG FOR?

Each person has different risk tolerances and cash flow objectives in planning for retirement, O'Meara says. She says if you are behind on saving, a target fund might not provide the long-term returns you need. If you're planning to retire at a young age, target funds may not do the job. Plechner says instead, you should focus on time horizon. For example, if you're a police officer retiring after 20 years of service and you started right after college, you may only be age 41. "A 41-year-old should be not be 100 percent in bonds and cash since their life expectancy is easily another 40 years," Plechner says. If you may need retirement funds before your actual retirement date, such as to start a business or buy a house, a more conservative investment option may be more appropriate, O'Meara says. If you want to exercise control over your investments, these funds might not be right for you.

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