How Will Advisors Screen Target-Date Funds?

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The seemingly endless proliferation of target-maturity funds has created a challenge for financial advisors and no-load investors: how to compare one target-date fund to another. These set-it-and-forget-it retirement vehicles, while alluring, come in a dizzying array of shapes and sizes even when pegged to the same retirement date.

Now, in an effort to alleviate some of the confusion surrounding these fledgling funds, **Lipper** is advocating ranking target-date funds based on past performance. Andrew Clark, head of research at Lipper, argues that the best way to navigate the nebulous sea of target-date offerings is to weed out those without a proven track record.

In a report entitled "Ranking Target-Date Funds Using Past Performance," published Tuesday, he says that by ranking all similarly dated funds based on their three-year track records, advisors and investors will have a smaller menu of funds from which to choose at their fingertips.

While he acknowledges that it is not a panacea, he says it is "a good way to winnow the large group of possible target-date funds to be a more manageable handful."

The ranking methodology in the report pits the performance of all 2030 funds against one another on a quarter-by-quarter basis for 12 consecutive quarters ended September 2007.

By doing so, a clearly dominant set of outperforming funds will emerge, Clark says. **T. Rowe Price**, **Fidelity Investments** and **Principal Financial Group** were the top performers, according to the report.

"The dominant set is where we think individual investors and advisors should start their search for a target-date fund," Clark says. "They tend to consistently beat their peers."

The battle for assets in lifecycle funds is fierce, so understanding how advisors assess these funds will be crucial. Indeed, lifecycle funds, which include target-date and target-risk funds, have enjoyed robust growth in the last three years, according to **Financial Research Corp**. Net flows in target-date funds stood at $41.1 billion in 2007 as of Oct. 30, FRC says.

That compares to $34.4 billion in all of 2006 and $22.4 billion in 2005. Overall, assets of lifecycle funds — 43% of which are of the target-date variety — stand at $391.4 billion. Assets are expected to balloon to $567.5 billion by the year 2011, FRC says.

But not everyone is sold on the idea of comparing funds based on performance. In fact, the ability to make a fair comparison across target-date funds has yet to materialize because of the multitude of variables that exist across the industry.

True comparison shopping cannot exist unless there is a set of fixed criteria. But that type of uniformity can handcuff a manager's ability to produce outsize returns.

"Standardization is what is needed in order to make sure we capture apples-to-apples performance," says Lynette DeWitt, associate director of retail investment markets at FRC. "But if you do that, you pigeonhole the investment manager into a strategy that limits the fund's value. The value of the whole sphere of target-date strategies is in their uniqueness, not in their sameness."

Choosing a target-date fund is far more complex for advisors than buying a single mutual fund because they contain anywhere from five to 20 underlying funds. And the asset allocation schemes these funds employ vary widely, which makes it difficult to evaluate performance. Different asset allocation schemes or so-called "glide paths" also mean different expense levels, making it difficult to assess across the target-date fund universe as well.

For now, past performance will, by default, remain a key metric in the screening process as most financial advisors are accustomed to picking funds in that fashion.

Jerome Clark, portfolio manager for the T. Rowe Price Retirement Funds, attributes his firm's success to its

aggressive equity allocation, which has been higher than its peers' since it launched the target-date lineup. Its tactical allocation, or "asset allocation overlay," has been another catalyst, which allows him to adjust the glide path 5% in either direction, he says.

"It's not a black box for us," Clark says. Ultimately, active management — and being good at it — is what will separate T. Rowe from the pack. "The consistency of performance, particularly in an all-in product, is paramount," he says.

Yet, by screening only by three-year track records, advisors would effectively be cutting out all the new entrants to the business, such as **American Funds**, which happens to be among the top five asset gatherers in that market.

AllianceBernstein and **Vanguard** also don't have a three-year track record, but rely on back-tested models that show better performance over the time horizon pegged to the fund. In their case, the probable set of returns would be based on the asset allocation scheme.

Unlike T. Rowe, these shops adhere strictly to the glide path, which they would argue makes their returns more predictable. These target-date funds also have a passive bent, fewer funds and lower expenses.

One could argue that the whole point of target-date funds is to move away from the present- and past-performance mentality, and rely on estimated future performance — not an easy task.

"This is much more complicated to estimate, because then you have to consider the fund's roll-down strategy, asset allocation and rebalancing processes, and the varying theories of the investment managers in regard to managing the fund," says FRC's DeWitt.

Beyond performance, advisors and investors can whittle down the universe of funds even further according to individual preferences, including expenses, active vs. passive management, equity exposure, proprietary funds vs. best-of-breed options, large-cap vs. small-cap, value vs. growth or alternatives vs. more conservative offerings. "It's going to come down to personal choices," Clark says.

Performance is still the name of the game in portfolio management, as any fund professional worth his salt will argue, but target-date funds are somewhat of a different animal, which makes past performance far less relevant.

"It's a good starting point, assuming the funds are actively managed," says Lisa Cohen, president of sales consulting firm Momentum Partners. "If the funds are index-oriented, past performance is irrelevant."

So far, DC plan sponsor due diligence teams have been comparing a target-date fund's returns to those of a passive benchmark. Analysts say this is a shortsighted approach because it doesn't account for the manager's asset mix decisions, which tend to dictate returns.

"While performance has been a generally accepted measurement for fund selection, it should not be heavily relied on for target-date funds," says FRC's DeWitt. "It is comparing apples to oranges, even for funds with the same retirement dates."

To illustrate that point, FRC found a 20% variance in domestic equity allocations, a 6% variance for international equity allocations and 12% for bonds when reviewing only six target-date funds.

Dressed to the Nine

The top nine 2030 target-date funds with a three-year track record

Fund Name	Ticker	Three-Year Annualized Return
T. Rowe Price Retirement 2030	TRRCX	15.19%
Fidelity Freedom 2030	FFFEX	14.30
Principal Life 2030 Instl.	PMTIX	14.09
Fidelity Adv Freedom 2030 A	FAFEX	13.84
Barclays Global Investors Inv: L 2030 I	STLDX	12.71

State Farm LP 2030; LA	SAYAX	12.22
WellsFargo: Dow Jones 2030 A	STHRX	12.15
MassMutual Select:R 2030 A	MRYAX	11.55
American Independence Nest Egg Dow Jones 2030 Instl.	NETHX	10.34

Source: Lipper, a Reuters Company