



Some Conservative Allocation Funds Fail Safety Test

Ignites Article published on October 21, 2008

By [Kevin Burke](#)

Some conservative allocation funds have suffered eye-popping losses this year, suggesting that their portfolios are not as conservative as investors thought. Plus, the category itself is rather loosely defined, giving rise to wide-ranging allocations and varying risk levels that may confuse shareholders when choosing funds that dispense income.

The goal with many of these funds is to provide steady income and modest capital appreciation along with some downside protection in market swoons. However, nearly 20 mutual funds that fall into the conservative allocation category are down more than 25% year-to-date and the one-year period ending Oct. 16, according to **Morningstar**.

This has left some analysts scratching their heads. "Purportedly conservative strategies have been exposed," says Greg Carlson, an analyst at Morningstar. "Some of these funds are not going to provide downside protection in down markets."

Some financial advisors are also puzzled by the steep losses. "I can live with a conservative allocation fund being down 15% to 20% in this market, but 30%? It just doesn't add up," says one financial advisor at an **Ameriprise** branch in the Northeast who put some of his clients in the [Franklin Income Fund](#). He says this type of volatility would be expected in a technology fund.

Franklin Income, the largest fund in the category by a wide margin, has lost 35% over the last one-year period and 33% year-to-date. The \$46 billion fund has seen its stellar long-term track record get stained, presumably due to its exposure to high-yield bonds and financial stocks.

Specifically, meaningful positions in preferred shares of troubled financial services companies **AIG, Lehman Brothers, Fannie Mae, Freddie Mac, Citigroup** and **Bank of America** were in the portfolio as of its second-quarter holdings update. It also held common shares of **Washington Mutual, Merrill Lynch, Wells Fargo** and **JPMorgan Chase**. On top of that, a 15% stake in the utilities sector has hurt the fund this year.

ING Index Plus LargeCap Eq IV A	IVPAX	-36.8	-38.9	-11.1	-6.1
ING Index Plus LargeCap Equity II A	PIIAX	-36.5	-38.5	-11.4	-6.7
ING Index Plus LargeCap Equity III A	IIIAX	-35.4	-37.6	-12.2	-7.1
Utopia Core Conservative	UTCCX	-33.4	-34.2		
Franklin Income A	FKINX	-32.9	-34.6	-5.1	0.6
ING Index Plus LargeCap Equity VI A	VIPAX	-32.2	-33.3	-9.1	-4.9
ING Franklin Income I	IIFIX	-30.8	-33.4		
ING Index Plus LargeCap Equity V A	VVPAX	-30.4	-31.6	-8.2	-4.3
Evergreen Diversified Income Builder A	EKSAX	-29.9	-30.4	-8.6	-3.3
IMS Strategic Income	IMSIX	-29.9	-33.5	-5.7	-2.0
SEI Asset Alloc Divr Moderate Grth D	SMGDX	-29.8	-31.6	-6.0	-1.0
ING Index Plus LargeCap Equity VII A	INIAX	-28.6	-29.5	-7.5	-3.9
Columbia Thermostat Z	COTZX	-28.4	-28.6	-3.6	0.6
Fallen Angels Income	FAINX	-26.7	-33.2		
Utopia Yield Income	UTYIX	-26.7	-26.8		
JHancock2 Absolute Return Portfolio A	JHAEX	-26.5	-27.5		
Brandes Inst Enhanced Income I	BEIIX	-25.9			
Teberg	TEBRX	-25.7	-28.0	-4.1	-1.0
Oppenheimer Port Series Conserv Inv A	OACIX	-25.5	-26.4	-4.5	

By definition, funds in the conservative allocation category are more conservative and tend to have 50% to 80% of their portfolios in fixed income, with equity positions ranging from 20% to 50%, according to Morningstar. Any remaining portion is typically held in cash.

Lumping a bunch of funds together into the conservative allocation category because they use a mix of stocks and bonds does not give fund shareholders the whole picture and could lead them to make poor decisions with or without advice from their broker. Morningstar and Lipper classifications obfuscate the funds' investment strategies by assigning such a loose-fitting label, fund experts say.

"It's a very broad bucket," says Lisa Cohen, president of consulting firm **Momentum Partners**. "You can have very different strategies and still qualify for that broad label. This

could potentially be a truth-in-labeling issue.”

This makes it crucial for firms to be specific about their investment discipline. “Given the very generalized descriptions, fund companies need to explain what they mean by conservative,” says Jeff Tjornehoj, senior analyst at **Lipper**. “It’s not just the allocation. The key is what kind of bonds are in the portfolio.”

Another obstacle investors face is the adverse effect competition has on fund classifications. For example, a portfolio manager may be tempted to be less conservative with his asset allocation in an effort to boost performance relative to his peers. “No matter where we draw the line for fixed-income exposure, fund managers are typically pushing the envelope on the equity side,” Tjornehoj says.

Franklin is quick to point out its long-term track record — Franklin Income dates back to 1948 — and strong performance over the last five- and 10-year periods, but also explains why the fund may be experiencing a short-term slide.

“The fund's portfolio includes a substantial portion of higher-yielding, lower-rated securities,” says Stacey Johnston, a Franklin spokeswoman. “Because the fund's Morningstar peer group is more conservative, the category average will perform better in periods when bonds — particularly investment-grade debt and Treasuries — outperform equities and high yield, but over the long-term, Franklin Income Fund's diversified and flexible asset allocation has generated stronger returns than its peer group.”

Still, this may not explain the losses seen in a number of its peers. [Oppenheimer Portfolio Series: Conservative Investor](#), a fund of funds, is down 26% year-to-date and for the one-year period ending Oct. 16, despite a 66% fixed-income exposure across four of its bond funds. [Evergreen Diversified Income Builder](#) is down 30% for the year.

[Columbia Thermostat Z](#), a fund of funds containing a number of Columbia mutual funds, is down 29% over the last year and 28% year-to-date. Its recent downfall has been an overweighting in equities and a significant allocation to high-yield bonds. Despite its conservative billing, 70% of the fund's assets were held in proprietary Columbia equity funds, according to its portfolio holdings update in a May N-Q filing with the SEC.

“These funds may have gone after what they thought were juicy yields in preferred shares of financial stocks,” says Craig Callahan, president of investment manager **Icon Advisers**. He points out that financials are one of the few sectors that pay dividends, and equity income funds especially would be heavy in those preferred shares.

Beyond simply bad bets, Momentum's Cohen sees deficient risk management as part of the reason some of the funds in this category have failed to live up to expectations. In that, they're not alone, she says.