When You're Serious…

by Bradley R. Newman, CFP®

Target-dated funds sometimes miss the mark

As investors have grown weary and whipsawed by the continued volatility in the global economy and the financial markets, many have become attracted to the idea of utilizing "target-dated" funds as a means of getting portfolio management based on the broad parameters of their situation.

The concept of the target-dated fund is that you pick a fund based on your anticipated retirement date — i.e., 2015, 2025, 2035 — and the mutual fund managers will invest your money appropriately based on that retirement date. The fund managers are supposed to adjust your investment mix as you get closer to retirement and protect you from downturns in the investment markets.

Unfortunately, many investors are getting neither appropriate investment portfolios nor the ongoing management they have expected.

Little consistency

You may think that it would be reasonable to assume that mutual fund mangers from different companies would recommend similar levels of stock/bond exposure for someone planning to retire in the year 2015; however, the differences across target-dated funds with this mandate is shocking. Of the 169 target-dated funds reviewed by Morningstar with a 2015 target, the level of stock market exposure ranges from a low of 8.6 percent to a high of 61.2 percent, a differential of 52.6 percentage points.

The point is not to debate what the appropriate level of stock exposure should be for someone set to retire three years from now, because each person's situation and circumstances will impact that answer. The point is that there is little consistency found among mutual fund managers charged with a specific goal, and it is likely that few of the people who own these funds know how much stock exposure they have.

Is this management?

Let's look beneath the covers and try to determine what type of investment management, if any, these types of funds are providing. While many investors seem disappointed in the lackluster performance of the U.S. stock market in 2011, domestic markets fared significantly better than our foreign counterparts: the MSCI-EAFE (one of the broadest and most recognized foreign indexes) was down 12.1 percent in 2011.

The poor performance of the foreign markets should not be a surprise to anyone who has read a newspaper or seen the news last year, let alone a highly paid mutual fund manager. Despite the fact that avoiding dedicated foreign exposure last year should not have been seen as a nuanced investment decision, the level of dedicated foreign exposure in the same 169 target-dated funds ranged from 3.5 percent to 30.9 percent. To put that in perspective, the losses from the dedicated foreign portion of a $500,000 portfolio ranged from roughly $215 to $18,725, depending on which fund family you selected.

That's quite a difference

The discrepancies in the level of stock market exposure and the wide variations across the management of the portfolios are just two examples of inconsistencies and issues within the world of target-dated mutual funds.

The variation across fees, levels of volatility, investment styles and sector exposures would make your head spin.

The bottom line is that, even with the simple mandate of creating an investment portfolio for someone who is planning to retire in 2015, the inconsistency among the investment returns is staggering: Last year, the best performing fund that the 2015 category produced was a gain of 5.5 percent, while the worst performing fund created a loss of 5.6 percent. On that same portfolio of $500,000, the cost of making a wrong decision, within what should be a tightly clustered group of funds, could have produced a net gain or loss differential of more than 11 percent, or $55,500.

Do your homework

You might share the investor fatigue that has led many others to utilize the target-dated funds in order to get what they assume is an appropriate investment mix with ongoing management, but don't rely solely on the name or claim of the fund. Do your homework to asses whether that fund is appropriate for your situation and continue to monitor the fund going forward to determine if it continues to meet your needs.

If you don't feel comfortable making that assessment on your own, hire an independent expert to assist you. Consider utilizing a fee-only firm to avoid any potential conflicts of interest. Yes, you will have to pay for the advice, but it likely won't cost you $55,500.

Bradley R. Newman, CFP® is with Roof Advisory Group Inc., an independent investment management and financial advisory firm based in Harrisburg. The firm is a fee-only registered investment adviser that provides portfolio management and financial planning services for individual and institutional clientele. The firm's email address is invest@roofadvisory.com