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Simplify with Target-Date Funds

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When your employer asks you to pick the investments in your retirement account, you may feel you're in for a tough decision — almost as if you had to choose only one kind of ice cream for the rest of your life. The usual reaction to the ice cream question is to respond with your favorite flavor. But like the clever kid who chooses Neapolitan — chocolate, vanilla, and strawberry in a single carton — you can choose a fund that's the Neapolitan of the investment world, allowing you many flavors of funds within a single package.

Target-date funds — also known as *life-cycle funds, target retirement funds, target maturity funds,* and *age-based funds* — are mutual funds whose assets change based on your age. Because a target-date fund invests in other mutual funds, it's known as a *fund of funds.* These funds are a big hit with defined contribution retirement plans like 401(k)s. Employers and employees both love their simplicity, ease of use, and built-in variety.

One-Stop Shopping for a Diversified Retirement Portfolio

Target-date funds typically invest in a mix of other mutual funds to create an asset allocation consistent with the length of time an investor has until retirement, as designated by the date in the fund's name, such as XYZ Target 2030 Fund.

These funds are generally offered by large mutual fund families who manage the underlying funds, including Vanguard, Fidelity, and T. Rowe Price. Managers automatically rebalance the mix of funds over time so the asset allocation continues to reflect your proximity to retirement. The mix of funds within the target-date fund is more aggressive for younger investors and becomes more conservative for older investors.

WARNING!

Don't confuse a life-cycle fund with a *lifestyle fund,* also known as a *target-risk fund* or *risk-based fund.* These funds are also typically fund of funds, but they offer a static asset allocation. Although automatic rebalancing does occur, the asset mix doesn't change as you get closer to retirement. Target-risk funds usually come in three varieties: aggressive, moderate, and conservative. They're intended to correspond with an individual's risk tolerance.

The Upside of Target-Date Funds

Target-date funds can be beneficial in uncertain times, even if you're an experienced investor and even if you don't intend to use them as your core retirement savings. For instance, with small accounts, the automatic rebalancing feature may help save on the trading fees you'd pay on individual funds if you were to rebalance them yourself. These fees can be a significant drag on performance in accounts with small balances. Also, because most mutual funds require minimum initial investments, target-date funds give you the benefits of diversification in accounts not large enough to fund the investment minimums of multiple individual mutual funds.

TOUGH TIMES

Target-date funds can be an important investment tool in uncertain economic times because they keep you focused on saving rather than worrying about investment choices. They allocate and maintain your investment with your retirement date in mind. The ability to maintain an appropriate asset allocation and avoid emotional reactions to market conditions and uncertainty may be the single most important thing that you can do for your investment portfolio over the long haul.

Great Isn't Necessarily Perfect: The Downside of Target-Date Funds

Like any investment, target-date funds have tradeoffs and issues relating to personal situations and preferences. Here are some to be aware of:

- Target-date funds aren't personalized. The asset allocations are designed to be generally appropriate for people of a certain age or distance from retirement. That allocation may not be consistent with your own risk tolerance or financial situation. If you expect to retire in 2032, should you select the target 2030 fund or the target 2035 fund? Most target-date funds target age 65 for your retirement, but what if you plan to work longer than that? What if, due to other sources of retirement income, you don't intend to start accessing the money in your 401(k) for many years beyond your retirement date?
- Funds with the same target dates offered by different companies often have different initial allocations, may change allocations over time differently, and may have different allocations after they reach their target at retirement.

- Target-date funds can be difficult to integrate with other parts of your investment portfolio.

  Target-date funds are already diversified. Investors are often tempted to add other investments to their account because they know that diversification is important and having just one mutual fund feels wrong. Don't give in to the lure. Doing so can undermine your asset allocation and defeat the purpose you have for using a target-date fund.
- The underlying funds may not include exposure to as much of an asset class or as many asset classes as you may like.

However, for ease of use and the potential to get it mostly right, target-date funds can be a fantastic option.

Evaluate Your Options

A target-date fund may be a one-stop-shop, but it's not a one-time decision. Here are some ideas to keep in mind when evaluating which fund is right for you:

- Consider whether the internal asset allocation and progression is consistent with your needs, and compare allocations among various fund managers.
- Consider the fees. Target-date fund fees are based on the fees of their underlying assets, and though not typical, some managers may charge an additional management fee on top of those.
- Consider the track record and performance of the underlying funds. Some target-date funds are based on a mix of index funds, and others rely on actively managed mutual funds. Which type of funds suits you best?

No matter which fund you choose, monitor the fund's asset allocation and compare it to your own evolving preferences over time. And as with any investment, you should continue to monitor the fees and performance of the underlying funds at least annually to make sure that everything is on track.