Guide to Lifestyle/Lifecycle Funds for Asset Allocation

History and Rationale for Asset Allocation

It is well known that an investor's asset allocation strategy (how much they allocate to different asset classes) has a tremendous impact on performance, risk, and their final wealth outcome. The decision is so important, defined benefit plan trustees tend to make tremendous investments of time and expense to develop appropriate strategies to meet their plans' objectives.

Asset allocation is no less important for an individual investor in a defined contribution plan, like a typical §457 deferred compensation plan. However, most individual employees lack the specialized skills and time required to study the problem; they are also rarely willing to pay the fees required by expert planners. The result is that many fail to take full advantage of the opportunities presented by their retirement plan. Overwhelmed by the complexity of the decision, some choose not to participate at all; others limit the amount of money they are willing to contribute. Still others make arbitrary or ill-informed investment decisions, such as dividing their contributions equally among all plan investments (the famous "1/n strategy") or pouring all of their savings into the most recent hot performer.

The fallout is not just potentially lower retirement wealth; it is today's disappointed and frustrated employees. Productivity, recruiting, and retention can all suffer when people feel poorly served by their employer's retirement plan. Not surprisingly, plan sponsors have long sought products and services to help alleviate the problem, without creating nightmarish legal risk. The financial services industry has responded with a wide variety of potential solutions.

For this brochure, we'll use the term "asset allocation product" to describe any product or service designed to help plan participants allocate their balances among different asset classes or specific investment funds. The most common products today are lifestyle and lifecycle funds – self-contained investment funds that provide both asset management and asset allocation services that are easy for participants to select based on simple personal criteria. There are many alternatives to lifestyle and lifecycle funds; in fact, some plan sponsors will offer multiple solutions.

While asset allocation products differ greatly in design and implementation, they tend to target the same type of investor – one who is disengaged from the investment decision and wants to remain so, whether because they don't have the required skills and experience, or don't have the time and interest.

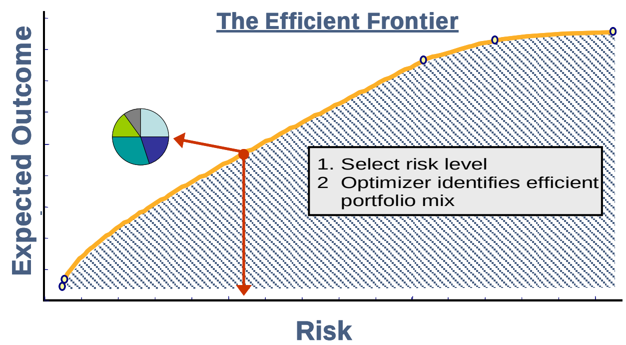
Lifestyle and Lifecycle Funds - Construction Methods

Asset Allocation Model

All asset allocation funds start with a computer model, called an "optimizer," which helps the investment manager determine an appropriate portfolio for a given level of risk tolerance. As input to this model, the investment manager must supply:

- A list of allowable asset classes
- A set of capital market assumptions
- A list of constraints

Capital market assumptions provide a forward-looking view for each asset class, establishing expectations of return, risk, and correlation. Developing capital market assumptions is a familiar exercise for people involved in running defined benefit plans. If your organization sponsors a pension plan, you might want to obtain its set of capital market assumptions. It makes a great baseline for evaluating the assumptions made by various asset allocation fund managers



Based on these assumptions, the optimizer tries every possible combination of asset classes and determines which portfolios have the highest expected return for a given level of risk. This set of portfolios is called the "efficient frontier" and is often displayed graphically. The optimizer's decisions are usually tempered by a set of real-world constraints, limiting the amount that can be allocated to certain asset classes; for example, real estate equity is usually limited to a small percentage of the portfolio due to liquidity limitations.

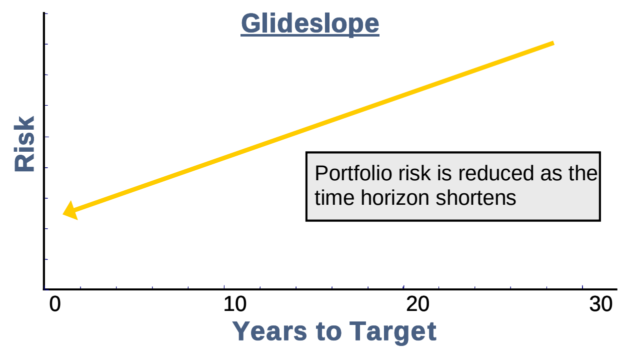
The optimizer produces an answer to a very simple question: "How should I invest my portfolio if I'm comfortable with a risk level of X?" Unfortunately, it does not answer the tougher question: "How much risk is appropriate for me?" Opinions and product designs vary sharply on this question.

Static Allocation versus a "Glideslope"

The simplest approach to asset allocation is to choose one portfolio, somewhere in the middle of the risk spectrum. The result is our old familiar friend, the balanced fund. Of course, the fundamental flaw with balanced funds is the notion that a particular risk level is right for everyone – a "one size fits all" approach. More modern products seek to place participants at a theoretically "correct" risk level appropriate for their circumstances.

Lifestyle funds (also called "risk-based" funds) are designed to offer each individual investor a simplified choice of preferred risk exposure. Typically 3-5 different funds are offered in a set, labeled progressively from "conservative" to "aggressive." The investor decides which label best describes his own risk tolerance; the asset manager makes the asset allocation decision based on the fund's labeling. Typically the investment manager does not change the risk exposure of a particular fund over time; in other words, the allocation is static.

An alternative approach is to assume that an investor's age should be the primary driver of risk appetite – that younger investors should take more risk, while older investors should take less risk. *Lifecycle* funds (also called "target-date" or "age-based" funds) are constructed using this notion. A set of funds is offered, and each fund has an associated "target date" (presumably the investor's expected retirement year). For simplicity, funds are usually offered in 10-year or 5-year increments. Funds with a long time horizon are initially invested in a risky allocation, and then over time the allocation is gradually tempered to a more conservative allocation. The gradual change in asset allocation over time is often referred to as the "glideslope"; the investment manager must decide how quickly a fund's allocation is tempered as the target date approaches (how "steep" the glideslope is), and how conservative the final position should be.



Lifecycle funds offer a compelling advantage for plan fiduciaries; they are the only products designed to allocate participant investments without the need for input from the participant (presuming you know their age). Of course, this assumes that the notion of age-based investing is fundamentally correct. Although many people believe strongly in age-based asset allocation, academic research findings vary on the issue, and it is a topic that fiduciaries should discuss thoroughly before choosing which allocation strategy to offer.

Common and Alternative Asset Classes

Most lifestyle and lifecycle funds allocate to U.S. and foreign stocks, U.S. fixed income, and cash equivalents. Often the U.S. stock market is sectioned based on market capitalization (large-cap vs. smallcap) and/or investment style (value vs. growth). Less often the foreign stock "slice" of the allocation pie is sectioned.

Increasingly investment managers are differentiating products by including emerging markets, real estate, high yield, and other asset classes in their modeling process. Allowing an optimizer to consider alternative asset classes often results in more efficient portfolios. However, fiduciaries should evaluate the investment manager's experience and capabilities in alternative asset classes, particularly for strategies that are naturally illiquid, rely on derivatives or leverage, or that are otherwise "exotic." While in theory a broad range of asset classes yields better results, it is not unusual for fiduciaries to conclude that they lack the time and resources necessary to learn about and monitor the risk of investing beyond the familiar, core asset classes.

Underlying investments

Once an asset allocation strategy is selected, the investment manager has countless options for implementation. The decisions a fund manager must make mirror those of a retirement plan sponsor – how many underlying funds are appropriate, who should manage them, and what level of fees are appropriate?

Active vs. passive

Asset allocation funds may be implemented using indexed strategies, actively managed strategies, or a combination of both. All of the usual pros and cons apply. Investors choose actively managed products in the hope that, through skillful management, the manager will deliver a return premium versus the benchmark index over the long term without increasing risk. Conversely, investors choose indexed products if they believe active managers are not likely to deliver a return premium large enough to cover their higher fees.

Fund-of-funds versus fund-of-managers

The most common implementation vehicle for lifecycle and lifestyle products is a pre-packaged mutual fund. Within that space, there are two common approaches. A “fund-of-funds” product is a mutual fund that invests exclusively in shares of other mutual funds. The fundamental idea is that the asset allocation manager can participate in large-scale, established portfolios that, if implemented well, deliver the lowest overall cost. Fiduciaries must evaluate whether or not economies of scale actually benefit the fund, keeping in mind that both the overarching asset allocation fund and the underlying funds bear fees. To figure out the all-in cost of investing in this structure, add up the fees of the underlying funds and add them to the expense ratio.

An alternative approach is for the asset allocation fund to own its own portfolio of securities (as opposed to other funds), and hire a series of sub-advisors to manage each “sleeve” of the portfolio. This allows the overall investment manager to seek talent from a much wider pool, including boutique investment management firms that do not run their own mutual funds. It also allows the manager to negotiate the subadvisor’s fees – a key advantage if the fund is well established with a large asset base. However, funds with a smaller asset base often find it difficult to execute a fund-of-managers approach economically, and suffer from higher fees.

Pre-packaged products versus customized products

Larger organizations may consider another alternative; developing a customized set of asset allocation funds where the plan fiduciaries, not the investment manager, decide who will manage the underlying funds. Usually the fiduciaries will use all, or a subset, of the investment funds or managers that are offered to participants on an individual basis. An overall investment manager is hired to manage the allocation and glideslope and reallocate fund assets as required.

Customized solutions are usually implemented using a collective employee benefits trust, separate account, or other institutional vehicle. The underlying investment funds may also be implemented with institutional accounts, mutual funds, or a mix on the two – whichever is most efficient. Typically the fiduciaries will select a trust company (either independent or a subsidiary of their overall service provider) to maintain the books and records of the fund and strike a daily “unit value” which is akin to the share price of a mutual fund.

The customized approach leverages the investment selection and monitoring process used by plan fiduciaries in a powerful way. The overall fiduciary burden of monitoring investment performance can be significantly lower with a custom fund since monitoring the underlying investment funds is a sunk cost. Operationally, customized funds are more complex; additional administrative vendors are typically required, and more resources are needed to develop and deploy educational and disclosure materials for the custom funds. Feasibility depends on scale; consequently, the customized approach is currently more popular for very large plans. However, as the approach becomes more popular and more vendors enter the field, one can expect customized funds to become much more common.

Implementation Issues for Lifestyle & Lifecycle Funds

Benchmark construction

There are two general methods for benchmarking the performance of any investment fund. The first method is to use an “index” representing the securities market(s) in which the fund can invest. Examples include the S&P 500 (largecap U.S. stocks), the Lehman Aggregate (investment-grade U.S. bonds), and the EAFE index (largecap foreign stocks). Alternatively, you can benchmark a fund against a set of other, similar investment funds called a "peer group" or "manager universe." Common suppliers of mutual fund peer groups include Morningstar and Lipper; other firms develop peer groups for institutional products such as separate accounts or collective trusts.

There is a long list of pros and cons to consider in deciding which approach to use. In fact, many plan fiduciaries use both methods, specifying a benchmark index and a peer group for each plan investment.

Asset allocation funds present a special challenge since they are composed of a mix of different asset classes. It is very tricky to develop a meaningful peer group for asset allocation funds since the underlying asset allocation strategies of any two funds can be very different; it is not very meaningful to compare the returns of two asset allocation funds unless they are designed for the same type of participant. While peer groups will likely improve over time, most fiduciaries prefer the benchmark index approach.

To construct a benchmark index for an asset allocation fund, first select a benchmark index for each underlying strategy. Then for each performance period (typically monthly), compute the weighted average performance based on the fund's neutral asset allocation. Finally, rebalance and link the returns to obtain benchmark returns for longer time periods.

Blended Benchmark - Single-Period Construction

Asset Class	Class Benchmark	1-Month Return	X	Portfolio Weight	=	Weighted Return
Largecap US Stocks	S&P 500	0.8421%		30%		0.2526%
Smallcap US Stocks	Russell 2000	0.9672%		15%		0.1451%
International Stocks	MSCI EAFE	1.3794%		20%		0.2759%
US Bonds	Lehman Aggregate	-0.0324%		30%		-0.0097%
Cash	SSB T-Bills	0.2658%		5%		0.0133%
		1-Month Benchmark Return:				**0.6772%**

Sound tricky? It's not as difficult as it sounds, but it does require special software. You may already have a performance measurement package on hand, such as MPI Stylus or Zephyr, or your colleagues who run your defined benefit plan may use one. In this case, simply specify the underlying benchmarks and weights, and the program spits out the blended benchmark returns. Alternatively, simply ask your investment manager or consultant to run the benchmark for you – they all have performance packages to do the calculations.

One final bit of added complexity – for lifecycle funds, the asset allocation for your benchmark needs to change over time as the fund advances along the glideslope. Again, the computer will handle the math, but you (or your manager or consultant) will need to make sure the correct glideslope is used.

Evaluating fees

As with any invesment fund, fees for asset allocation funds are very important -- but they should not exclusively drive the investment decision. Fiduciaries should seek good value -- if the lowest cost option is not selected, you should be able to articulate why the selected investment fund is worth the extra cost (e.g. higher expected returns, better quality strategy, more robust administrative and educational services).

Peer groups are typically used to provide a rough fee benchmark for a fund. For example, the fees for a largecap growth mutual fund can be compared to the average fee for all no-load largecap growth funds in Morningstar or Lipper universe. As a further refinement you can choose to include or exclude funds with 12b(1) fees, depending on whether or not your plan uses these fees to offset administrative costs. Using funds with below average fees compared to an appropiate peer group, while not a completely conclusive test, should give you some comfort that your plan investments are reasonably priced.

Asset allocation funds present a special challenge since, as discussed, it is more difficult to develop an appropriate peer group because asset allocation strategies vary so much. One possible solution is to simply use the asset allocation peer group median. While differences in asset allocation strategies will tend to have a huge impact on performance, the impact on fees is not as pronounced.

Plan fiduciaries that prefer a more accurate fee benchmark can construct a blended average fee benchmark using the same technique described for blended average performance benchmarks. First, find the median level of fees for each asset class, and then take the weighted average based on the fund's asset allocation strategy.

Some investment managers will claim that higher fees for asset allocation funds are justifiable since the manager is both investing the underlying assets and managing the overall asset allocation. While true, the amount of work required to manage a fund's allocation is usually quite small. If you construct a custom fee benchmark you might want to add a small premium for allocation services (e.g., 1 to 5 basis points).

Potential conflicts of interest

When using pre-packaged funds, the investment manager is in a position to select and allocate assets to underlying managers or funds. The most obvious potential conflict is selection or allocation policies that favor proprietary investments – underlying investments managed by the same firm, or a related firm, that manages the overall fund. Some asset allocation funds are completely proprietary; others offer a mix of in-house and outside investment capabilities.

There are three direct potential conflicts; first, there is the risk that the investment manager will select a proprietary product for an asset class where they have substandard capabilities. A second, more subtle risk is that the investment manager will alter their asset allocation model so that it applies more weight to asset classes where the manager has good proprietary capabilities. A third type of abusive practice, commonly called "incubation," occurs when the investment manager allocates assets to new, untested strategies in order to seed a fund with assets that it would otherwise not be able to attract in the open market due to lack of track record.

Conflicts can also arise with non-proprietary arrangements. For example, an investment manager might choose to use underlying managers that pay higher levels of "revenue sharing" payments, a common practice for products that use the fund-of-funds approach. The fund-of-managers approach has its problems as well since the manager may be tempted to allocate more to investment managers that have lower subadvisory fees.

Finally, fee differences exist among the major asset classes. In general, riskier and more exotic asset classes tend to command higher fees; the temptation here is to allocate less to cash and bonds, and more to riskier classes of stocks.

Fiduciaries should look carefully at potential conflicts of interest during routine due diligence by examining all candidate funds for evidence of misbehavior and obtaining a good understanding of the safeguards the management firm has in place to prevent potential future problems.

Pitfalls for participants

Possibly the most significant implementation risk is under-communication. Without a thorough explanation of what the product is trying to accomplish, participants may simply view the lifestyle or lifecycle fund as “just another fund” and allocate only a part of their account to it. As a result, the participant defeats the careful research that went into the product’s design and renders ineffective the asset allocation service they are in fact paying for! A carefully designed communication campaign should make the case for a complete, 100% allocation to the lifestyle or lifecycle fund of their choice.

Plan sponsors should also make clear to participants that all lifecycle and lifestyle funds bear investment risk – and that some funds, particularly long-dated lifecycle funds, can be very risky. Avoiding a discussion of investment risk sets up participants for shock and disappointment during the next market correction.

Default Investments

Many plan sponsors have implemented automatic enrollment, and many others are actively considering it. Automatic enrollment forces plan fiduciaries to select a default investment for participants; while opinions vary as to which type of default investment option is most prudent, lifecycle funds are certainly a popular choice.

Communicating risk is *especially* important when a lifecycle fund is used as the default investment for participants that are automatically enrolled into a plan. Since non-participants tend to be younger, almost all lifecycle funds will allocate them into a 100% equity position with significant exposure to smallcaps and foreign stocks. Such a participant may not even know what a “stock” is, and they may be very unhappy if short-term market conditions are unfavorable. A candid discussion of risk at the time of auto-enrollment, and at regular intervals until the participant takes charge of their own situation, can lessen the shock or market turbulence, and may keep participants from bailing out on the strategy (and possible, the plan itself) when the going gets tough.

Bundling Issues

For smaller plans, “bundled” service providers increasingly use lifestyle and lifecycle funds in order to generate enough proprietary assets under management to meet their profit targets. Bundling adds complexity to the investment selection process; often, a bundled service provider will only offer their proprietary asset allocation funds to smaller plans. When choice is offered, selecting a higher-quality non-proprietary set of funds can increase administrative costs for participants or the plan sponsor. It is tempting to cut corners and select the proprietary product set, even when it lacks a track record for evaluation.

Proprietary asset allocation funds in a bundled program present particularly difficult problems when underperformance develops. Fiduciaries may be placed in a situation where no viable alternative is available, and they are forced to choose between shutting down the investment or continuing to tolerate poor performance. Also, there is risk that only a subset of the funds will have poor performance. For example, what happens when your “2030” target date fund exhibits chronic underperformance but your "2020" fund performs well? Do you replace only the 2030 fund, keeping in mind that another fund could have a completely different glideslope and implementation strategy? Or do you replace the entire set, even though many participants are well served by their current choice?

These issues cannot be solved up front, – but they serve to remind plan sponsors of the need for ongoing due diligence. Also, while you cannot guarantee a successful outcome when choosing a bundled service provider, you can negotiate for flexibility in your service contract. You should look for a bundled provider that offers bench strength; specifically, access to alternative sets of asset allocation products that you can turn to in the future if necessary. To the extent a proprietary set of funds is required, you should also try to negotiate contractual performance standards that allow you to change the funds without penalty if underperformance develops.

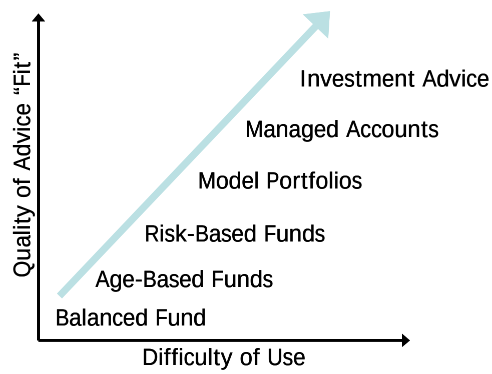
Alternative Solutions to Lifestyle/Lifecycle Funds

Lifecycle and lifestyle funds are not the only solutions to the asset allocation problem. Their primary selling point is "simplicity" since they represent a self-contained, one-stop solution for both the participant and the plan sponsor. The downside is that these funds are not very adaptable to a particular employee's personal situation. Many alternative solutions seek to offer a more customized experience for participants that are willing to invest a little more time.

Asset allocation models

The simplest alternative is the *asset allocation model* solution. The idea behind these products is to use recordkeeping technology instead of a self-contained mutual fund to deliver asset allocation recommendations.

Typically, a participant is asked to select a profile based on time horizon, risk tolerance, or a combination of both. Using the recordkeepers' technology, the product will then recommend a particular asset allocation and provide an easy path to implementation. Automatic rebalancing is usually coupled with the models.



One key distinction is that the participants are ultimately invested directly in the plan's investment options, not in an asset allocation fund with its own share price. There are several compelling advantages. If plan fiduciaries decide to change an investment fund due to performance, participants in the asset allocation service automatically benefit from the change. To the extent fiduciaries negotiate for high-quality, low-expense funds for the rest of the plan, participants using the models also benefit. Finally, the models are usually offered by the service provider at no additional cost as a loss leader for their other services.

To the extent these benefits are important to fiduciaries, only a fully customized lifestyle-lifecycle approach can compare. However, asset allocation models do not require significant scale for implementation efficiency so they are the preferred solution over customized funds for smaller plans.

Traditionally, the drawback to these products is that the "advice" is limited to the asset class level and is not sensitive to differences in individual funds in the plan. This limitation arises from

ERISA, which imposes fiduciary responsibility on any vendor that provides investment advice as defined under that law. Plan recordkeepers generally are not equipped to function as ERISA fiduciaries, so they must design their products to avoid triggering the status.

In theory, vendors could design more customized products for the public sector, where ERISA does not generally apply. To date, product development resources have tended to be focused on lifecycle funds instead. Over time, plan fiduciaries should stay abreast of developments with this technology – in the short term, existing products should be compared to asset allocation funds and the tradeoffs considered.

Investment advice

In stark contrast to allocation model products, *investment advisers* provide very specific advice that is customized to the plan's investment options and the participant's particular circumstances. These advisers accept fiduciary responsibility under ERISA or state law as applicable, and maintain policies to avoid conflicts of interest. Consequently, they tend to be independent of the recordkeeper and investment managers used for the plan.

Two fundamental approaches are common. One option is to offer a very personalized experience, usually delivered by a professional adviser face-to-face or through a call center. This approach allows the participant to ask questions and explore various options on a real-time basis. The alternative is to automate the advice process and deliver it through a website, intranet site, or a stripped-down call center. Some advisers offer various combinations of both techniques. Obviously the cost difference can be significant. The more standardized and consistent results delivered through an automated process are appealing to some fiduciaries (and not appealing to others, for the same reasons).

The most obvious downside to hiring an investment adviser is cost. Many cost models are available (per-head versus asset-based, on-demand or available to all participants, etc.) A second concern is that investment advisers require more information from the participant to craft a recommendation. While the results may be superior in quality, many participants are unwilling to share the information; many more cannot or will not take the time to go through the information gathering process.

Managed accounts

The term *managed accounts* applies to a fairly broad range of solutions. In this context we refer to discretionary investment advisory services – where an investment adviser not only forms an asset allocation for a participant, they execute the recommendations initially and on an ongoing basis. In other words, the investment manager "takes the steering wheel" from the participant rather than trying to tell them how to drive.

Managed accounts are usually offered with an asset-based wrap fee. As with nondiscretionary advisers, some more intensive interaction with the participant is usually required. Many nondiscretionary advisers will also offer a manager account solution; usually cost is the decision driver between the two solutions, both for the plan sponsor and participant.

Hybrid solutions

Some fiduciaries offer multiple asset allocation solutions. Sometimes the decision is driven by poor quality analysis, indecisiveness, or external requirements that multiple vendors be represented. The result is almost always bad for participants. Since the very people these products target have limited tolerance for complexity, posing a poorly organized suite of conflicting products is likely to scare them away from participation, or drive them back into an arbitrary and suboptimal investment decision.

However, a case can be made to offer a *very small* number of *clearly different* alternatives. The classic example is to offer lifecycle funds and independent investment advice, targeting two different prototype participants. The lifecycle funds would theoretically be most appealing to participants who will not invest any time or effort into the investment decision. Alternatively, participants that are willing to invest time and effort but want expert advice would be better served by a professional adviser, and they are more likely to have confidence in the results compared to a prepackaged lifecycle solution.

Hybrid solutions are inherently more complex for participants. Every additional alternative should be viewed with increasing skepticism; even if a product is internally sound, offering it to participants may decrease the overall quality of the investment lineup. Finally, communication to participants is especially critical. If multiple options are offered, your initial communication should explain the difference and, in clear and simple term, explain why an employee might prefer solution A over solution B.

Best Practices with Lifecycle and Lifestyle Funds

Asset allocation funds offer participants a simplified approach to investing their retirement assets. Unfortunately, products that simplify decisions for participants often make things more complicated for plan fiduciaries. Good planning and oversight can help you steer clear of potential pitfalls and deliver a top-quality product for your employees. In summary, here are a few tips:

- Do more research on your asset allocation funds than you do for your plan's other funds (since asset allocation funds are more complex)
- Understand your investment manager's approach to asset allocation
- Consider a custom-fund approach as opposed to pre-packaged mutual funds
- Evaluate fees carefully, particularly for fund-of-funds
- Develop a blended benchmark for each fund
- Identify, document, and manage conflicts of interest
- Communicate clearly to participants, especially about investment risk in longer-dated lifecycle funds
- Negotiate up-front with your service provider for access to non-proprietary funds, in case performance problems later emerge with their proprietary products
- Follow a selection/monitoring/replacement discipline just as you would for other Plan investments

Finally, keep in mind that investment companies are constantly innovating. Regular contact with your peers, vendors, and other experts through venues like NAGDCA will help keep your plan competitive.