Fidelity INVESTMENTS

Viewpoint

INVESTMENT CONCEPTS WHITE PAPER

THE CASE FOR AGE-BASED LIFECYCLE INVESTING

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INVESTORS AND THE PERFORMANCE GAP

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EXECUTIVE SUMMARY

In the past generation, the United States has become a nation of investors. For the first time in our history, a majority of people hold securities, whether through mutual funds, Individual Retirement Accounts (IRAs), workplace savings plans like 401(k)s, or directly through brokerage accounts. Clearly, Americans understand that investing in the securities markets can help put them on the path to their financial goals. But there is also evidence that suggests greater efforts need to be placed on educating Americans about how to invest.

For example, industry studies reveal that many investors continue to try to “time the market” in an effort to maximize investment returns. Instead, what investors end up doing is chasing hot performance when markets are up and retreating on market downturns — in essence, buying high and selling low, almost systematically.

As a result, too many investors earn returns that are below what market benchmarks suggest they should be earning. Not surprisingly, many Americans have become disillusioned with the whole investment process.

This paper discusses an investment strategy, known as *age-based lifecycle investing*, that Fidelity believes can help investors get back on track with their portfolios. The basic premise of lifecycle investing is straightforward: based on decades of past performance of equity, bond, and cash investments, it is possible to statistically design a proper mix of these asset classes for any goal and for any point on the lifecycle.

Of course, there can never be any guarantee of investment success. But Fidelity believes that by adopting lifecycle investment strategies, more investors can avoid making anxiety-driven decisions, seek to improve their chances of reaching their objectives, and better manage the emotions caused by market volatility.

In this paper, we discuss the theory behind lifecycle investing, look at some of the historical data that reinforce the theory, and discuss some of the issues that will need to be addressed in order to foster greater awareness and usage of lifecycle investing among individuals in all walks of life.

Part I

VOLATILITY, ANXIETY, AND THE SEARCH FOR INVESTMENT STRATEGIES

From the cresting of the stock market bubble through three consecutive years of declining stock prices, on to the major equity market rebound of 2003, American investors have just lived through a period of increased volatility in the financial markets.

Specifically, the S&P 500® Index moved up or down by 2% in a single trading day just nine days a year on average during the 1990s. However, from 1999 to 2003, the number of 2% daily swings for the S&P more than tripled — to an average of 31 days a year. Other equity indices, including the Dow Jones Industrial Average and the NASDAQ Composite, have shown similar increases.

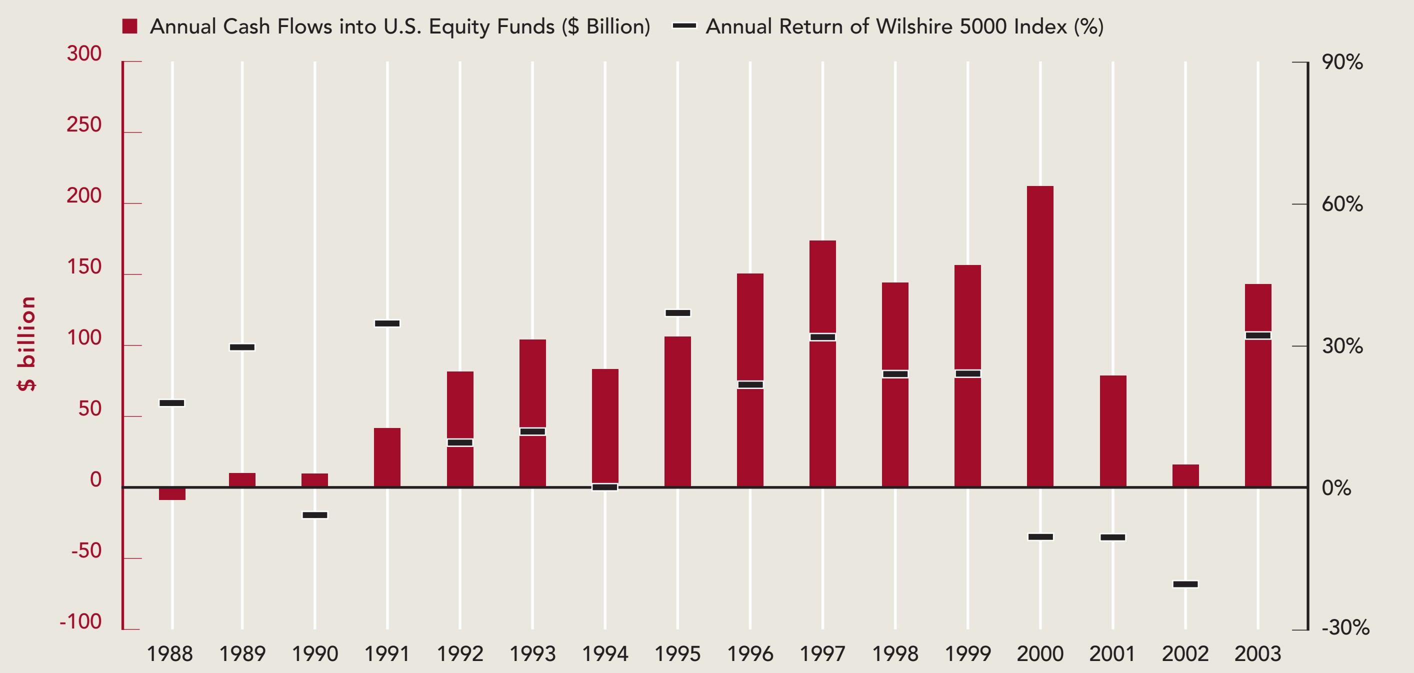
Another characteristic of the 1999–2003 period was unpredictable year-to-year reversals of the "winners and losers" among such investment sub-classes as international stocks, high-yield bonds, or value and growth stocks.

Navigating through such large and frequent shifts in the performance of markets and asset classes is challenging even for professional investors, still more so for new investors. The understandable anxiety caused by rapid market movements has been exacerbated by the threat of terrorism, by wars in Afghanistan and Iraq, and by the post-Enron wave of corporate scandals. And it comes at a time when American investors are assuming an ever-greater share of responsibility for making their own investment choices — particularly for retirement savings.

Amid the increased volatility and uncertainty, many investors have made classic investment mistakes: chasing hot stocks or mutual funds, for example, just as they crested, or even shifting whole portfolios to all-stock, all-bond, or all-cash positions in reaction to recent market moves. Such "unidimensional" decisions often lead investors to concentrate too much — and too late — in areas where most of the likely gains have already been realized, or to bail out of areas of the securities markets that have been hard hit but are due to rebound.

Drawing on knowledge accumulated over generations of investing, the lifecycle concept seeks to identify how investors' portfolios should evolve over time, starting from the time they make their first investment toward a goal.

Exhibit 1 Equity Fund Cash Flows vs. Equity Market Performance



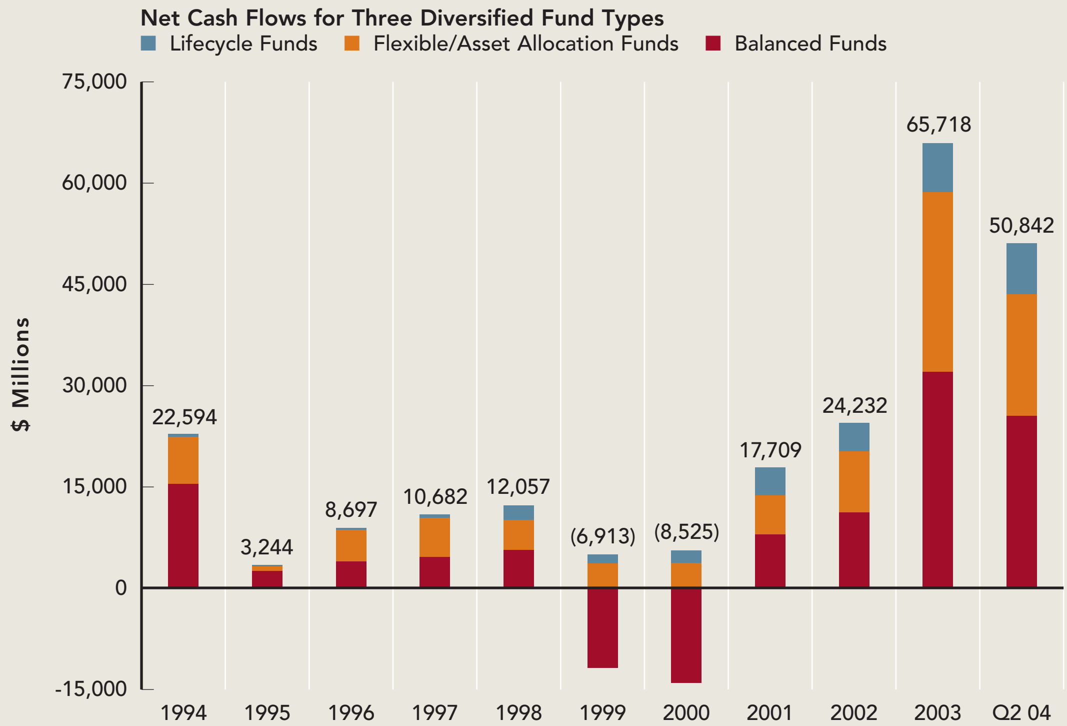
Source: Strategic Insight and Wilshire Associates. Annual fund flows are for U.S. domestic equity funds. You cannot invest directly in an index. Past performance cannot guarantee future results. Please refer to the Important Legal Information page for index information.

THE HIGH COST OF CHASING HIGH PERFORMANCE

The tendency of investors to react to recent market moves has harmed their possible returns more often than not. **Exhibit 1** (above) shows that many investors, made wary by the 1987 market crash, shunned equity funds in the late 1980s and early 1990s. In doing so, they missed out on some very impressive return years, notably 1989 and 1991. Then, a few years later, five consecutive years of returns over 20% (1995 through 1999) helped create a false sense of security about equities, which caused investors to pile into equity funds just as the market was peaking in early 2000. Investors again reversed course in 2001 and 2002 when the severity of the bear market became clear.

Now, some investors may feel that they do better by moving in and out of stocks. However, the benefits of this method of investing are difficult to sustain over the long term. For instance, in 2001 and 2002, investors who moved out of stock investments would have earned better returns, since cash investments significantly outperformed stock investments in these two years. But investors who avoided the stock market during this time period ran the risk of being left behind when stocks rallied (as they did in 2003). The bottom line is that there is no crystal ball to tell you when to jump back into stocks as they approach a bottom — or when to stop pouring money in as they approach a top. And to be successful at market timing, an investor needs to be correct not only about one, but about both.

Exhibit 2 Investors Diversify in Response to Market Volatility



Source: Financial Research Corporation.

Yet there is also evidence indicating that a growing number of individual investors, financial advisors, and sponsors of defined contribution retirement savings plans are seeking ways to steer clear of such traps. As we see in **Exhibit 2** (above), in 2003 more than $65 billion in net cash flowed into asset allocation funds, balanced funds, and lifecycle funds — three types of diversified funds that are designed to help investors deal with market volatility. This influx represented a more than twofold increase over 2002, and a dramatic reversal compared with the outflows these funds experienced when speculative fever gripped investors during the height of the 1990s bull market. And in 2004 the popularity of these funds has grown even further, as they have seen inflows of over $50 billion through the end of June.

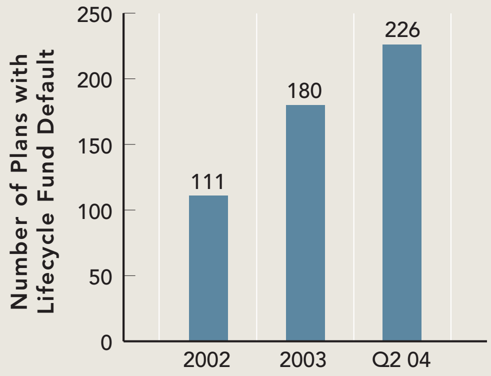
While this trend is encouraging, it is not yet clear whether it reflects a growing awareness on the part of investors about the advantages of taking a diversified long-term approach to investing or simply is another manifestation of cyclical "performance shopping" that will reverse once more-aggressive investments deliver a few good years of returns.

Clearer evidence for a secular change can be found among institutional investors. An increasing number of retirement savings plan sponsors are offering lifecycle funds — not only as options, but as the "default" choice in defined contribution plans for their employees (**Exhibit 3**, right). Given that data from Fidelity Institutional Retirement & Services Company (FIRSCo) indicate that nearly

90% of 401(k) participants don't rebalance their portfolios every year, the potential for lifecycle funds to help keep participants' investments from getting off track is significant.

What's behind this movement by retail investors, retirement plans, and consultants to embrace lifecycle funds? To answer that, it's first necessary to understand what lifecycle investing is and why it can be more effective than other approaches at helping investors select appropriate investment strategies.

Exhibit 3
More Fidelity 401(k) Plans Are Using Lifecycle Funds as the Default Option



Source: Fidelity Institutional Retirement & Services Company.

Part 2

THE LIFECYCLE INVESTING CONCEPT

At its core, lifecycle investing is little more than applied arithmetic that draws on knowledge gained by generations of investors. Its aim is to avoid the twin risks of excessive caution early in life and excessive risk-taking as the investor approaches his or her financial goals.

The premise is that by taking certain "knowns" — such as an investor's time horizon and the historical performance of various asset classes — it's possible to structure an investment portfolio that, based on past performance, may have a better chance of reaching a specific financial goal. Naturally, past performance does not guarantee future results. But lifecycle investment theory suggests that you can, indeed, potentially increase your chances of success (in terms of historical likelihoods) through wise initial allocation of your assets — then by following up with periodic rebalancing of those assets as you move closer to your financial goal.

The basics of lifecycle investing can be summed up in three simple principles, each of which we'll discuss in greater detail:

- Know what level of risk is prudent for you, based on your current age or investment time horizon — what Burton Malkiel, author of *A Random Walk Down Wall Street*, has called "lifecycle risk capacity"
- Set an initial target asset allocation, based on this risk profile
- Have a systematic plan for adjusting the asset allocation — incrementally rolling out of equities and into fixed income investments — as you move closer to your goals

KNOWING YOUR RISK CAPACITY

An old axiom is that emotions — such as greed and fear — drive investor behavior as much as market fundamentals. Today's 24/7 financial news coverage, with its focus on every market ripple and investing fad, only amplifies the emotional aspects of investing, encouraging investors to make short-sighted decisions about investments intended for long-term goals.

By focusing on an investor's age and time horizon rather than the subjective concept of risk tolerance, lifecycle investing is able to offer a more objective way to determine how much risk is acceptable.

One way to arrive at a clearer perspective — and to avoid irrational miscues — is for investors to gain an awareness of their own age-appropriate "lifecycle risk capacity." This measurement of risk takes into consideration a person's age and the length of time they have ahead of them to invest for a specific goal. Taking into account the way that various asset classes have performed historically, it also weighs the likelihood that the portfolio they are creating to reach that target can get back on track should markets experience a short-term dip.

Lifecycle risk capacity is a more objective way of calculating age-appropriate levels of risk than the traditional concept of "risk tolerance," which is inherently subjective and emotional, and only considers how much volatility a given individual feels he or she can accept while investing for a long-term goal.

In contrast, lifecycle risk capacity looks at what opportunities an investor cannot afford to miss and what risks he or she should not run. Far too many investors create poorly structured strategies simply because they are more cautious or more confident than their lifecycle circumstances warrant. The consequences can literally mean the difference between achieving lifetime financial goals or failing to achieve them.

Consider, for instance, a young risk-averse 401(k) investor who, although 40 years away from retiring, avoids equities in favor of stable-value investments. Objectively speaking, this investor is taking a huge "risk" in terms of the missed opportunity to pursue the superior returns that stocks historically have produced over long time frames.

Similarly, consider an older investor who is a few years from retirement and, having a high subjective risk tolerance, holds most of his nest egg in stocks. This investor is running a high objective risk that he may be struck by one of the severe downturns the stock market has historically experienced.

This is not to say that personal risk tolerance should be dismissed altogether. Low-risk, low-return assets can be a rational choice for a young investor who simply cannot handle the emotional stress of market swings. But this investor should make this choice in the full knowledge that he may well have to do a great deal more saving to reach his retirement goal.

Conversely, the aggressive all-stock investor who is close to retirement might be able to survive a 39% stock market downturn (such as the one actually posted by the S&P 500® for the 12-month period ending 9/30/74) without much change in lifestyle if it meant going from, for instance, $10 million to $6.1 million. But a similar fall from $1 million to $610,000 could be far more wrenching, and might require some major retirement belt-tightening.

Exhibit 4 (right) illustrates how much easier it could be for a young investor to recover from a major stock market loss than for an older investor.

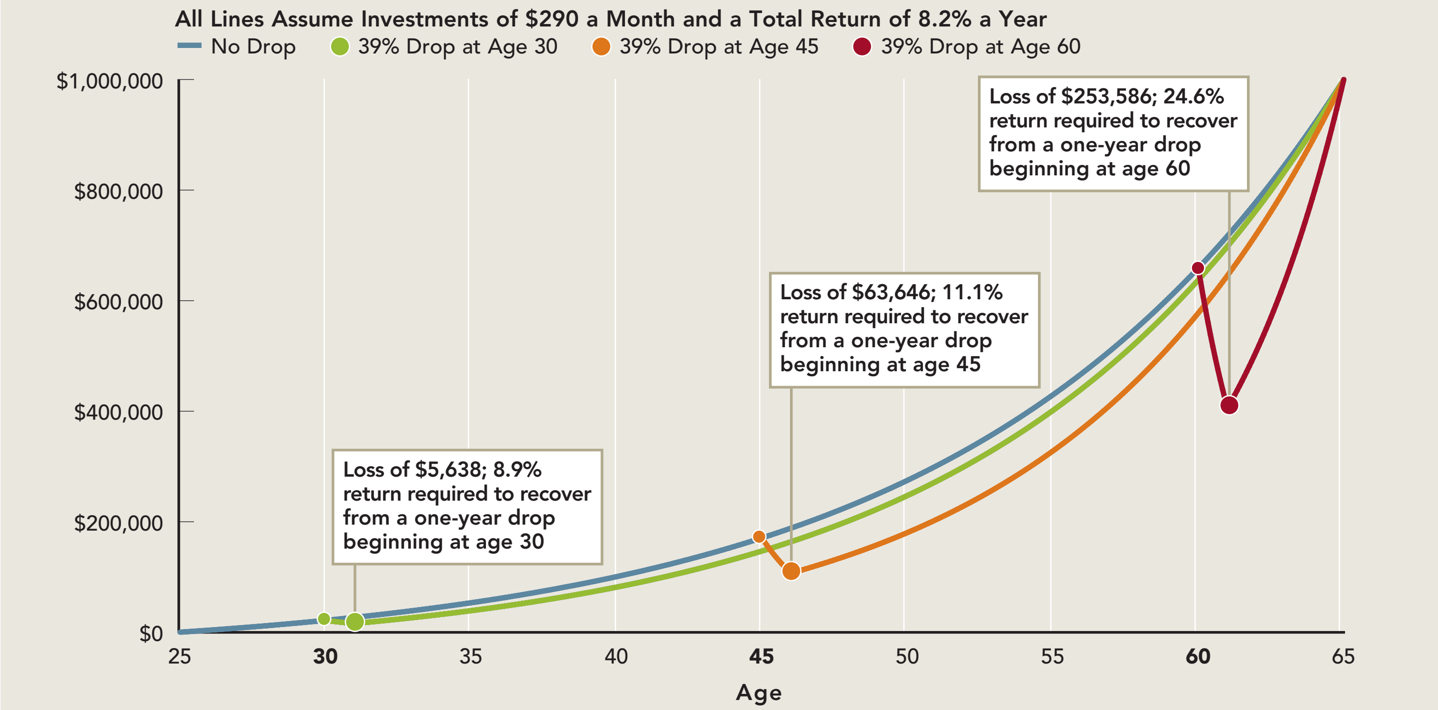
The smooth top line shows the cumulative value of a hypothetical investment in which $290 is invested every month for 40 years at an 8.2% return — from the first contribution to a $1 million total. The other three lines all start off with the same assumptions, but factor in a 39% decline at some point during the time frame.

Let's assume that the investors represented by these three lines each determine that, since $1 million is what they'll need for their goal, they'll have to try to get back on track. As we can see, the 30-year-old investor would need to increase his or her returns just 0.7% per year to get back on track. The 45-year-old, however, would need to increase returns by nearly 3%, while the 60-year-old would face the enormous challenge of somehow tripling returns — from 8.2% to 24.6% a year for five years — in order to recoup a 39% loss that hit so close to the target retirement date.

The financial impact to the 60-year-old investor is also dramatically more severe than for the 30-year-old. Although each investor experiences a one-year drop of 39%, it only amounts to $5,638 for the younger investor, whereas for the older investor it's $253,586.

It's easier for the younger investor to get back on track either by taking on slightly more risk or by contributing slightly more to his or her retirement account (or a mix of both). For the older investor, it's more difficult. It's highly unlikely this investor will be able to find the

Exhibit 4 The Likelihood of Recovering from a Severe Market Correction Diminishes with Age



Source: Fidelity Investments. The hypothetical illustration assumes that investments are made in an untaxed account. The hypothetical average annual total return of 8.2% used in the exhibit is the steady rate of return required to accumulate $1,000,000 by age 65, if monthly investments of $290 are made beginning at age 25. The hypothetical 39% loss used at ages 25, 45, and 60 is the same loss experienced by the S&P 500® Index for the 12-month period ended 9/30/74. Making regular investments does not ensure a profit or guarantee against loss in declining markets. Please see Important Legal Information page for index information.

nearly 25% a year return that would be necessary to make up for the drop in account value (to say nothing of the level of risk such an investment would entail). The prospect of making up the bulk of the $253,586 drop in five years through additional contributions is equally doubtful. The most likely outcome is that this pre-retiree will either have to re-adjust his or her retirement lifestyle or postpone retirement until the nest egg can be replenished.

SETTING THE RIGHT TARGET ASSET MIX

Knowing whether an investor is likely to have enough time to bounce back from a major market dip is only part of the lifecycle investing equation. The second part is structuring the right mix of investments that gives the optimal balance between risk and potential return.

Indeed, the classic study on asset allocation, conducted by Brinson, Hood, and Beebower, found that basic asset allocation accounts for over 90% of the variance in returns, confirming its status as the leading factor in investment performance. Institutional investors apply this knowledge in the way they manage money for pension plans. And getting the strategic asset allocation part of the equation correct is as critical for an individual as it is for a professional. The first step in doing so is to understand how the major asset classes have performed historically and how to blend these asset classes for investors at any given point on the lifecycle.

The Building Blocks: Stocks, Bonds, and Cash For years, investors have been told that stocks have outperformed bonds and short cash investments, such as CDs and Treasury bills, over the long term, but are riskier and more volatile over the short term. But exactly how does this actually play out in terms of historical performance?

Exhibit 5 (below) shows the range of historical investment returns for stocks, bonds, and cash investments for every 1-, 5-, 10-, and 20-year time period from 1926 through 2003. It reinforces that U.S. equities can have a wide range in returns in

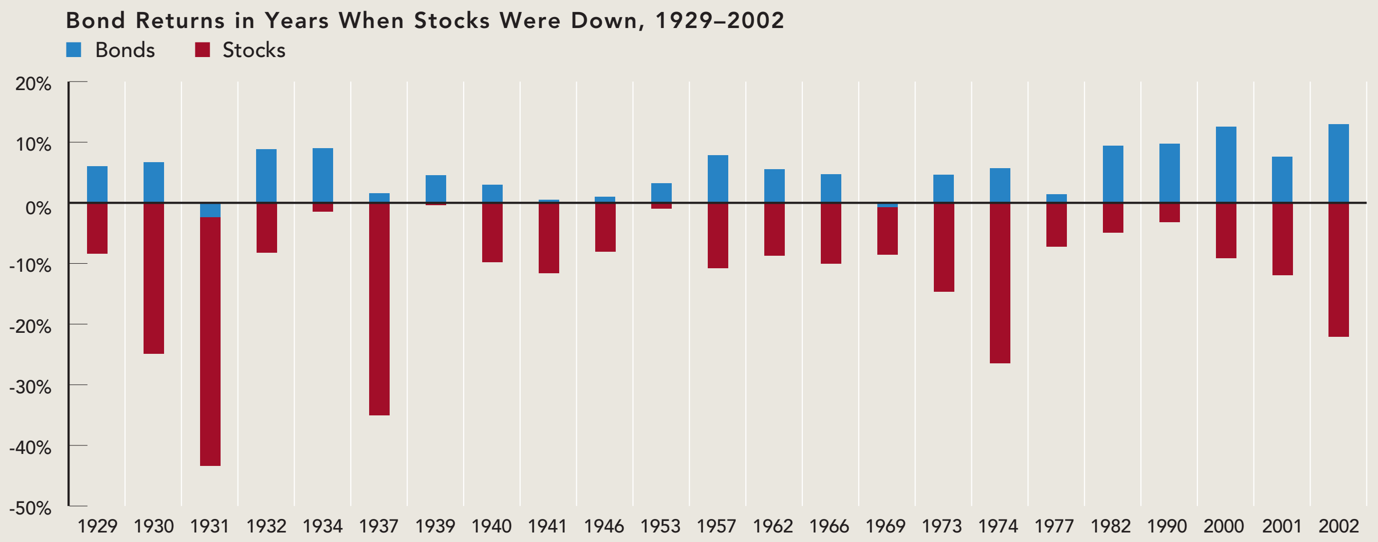
Exhibit 5 Variability in Asset Class Performance Narrows Dramatically over Time

Rolling Period Annualized Returns (%) for U.S. Asset Classes, 1926–2003

	1 Year			5 Year			10 Year			20 Year		
	Stocks	Bonds	T Bills	Stocks	Bonds	T Bills	Stocks	Bonds	T Bills	Stocks	Bonds	T Bills
	June 1933	Sept. 1982	Nov. 1981	May 1937	Aug. 1986	Oct. 1984	May 1959	Sept. 1991	Oct. 1987	March 2000	Sept. 2001	June 1992
BEST	162.89	32.70	15.20	36.12	19.46	11.13	21.43	13.73	9.20	18.25	10.50	7.73
AVERAGE	12.70	5.55	3.80	10.75	5.43	3.84	11.22	5.40	3.88	11.41	5.28	4.04
WORST	-67.56	-5.56	-0.04	-17.36	0.66	0.06	-4.95	1.17	0.14	1.89	1.58	0.42
	June 1932	Oct. 1994	Oct. 1939	Aug. 1934	May 1953	Sept. 1942	Aug. 1939	May 1953	Sept. 1942	Aug. 1949	Dec. 1959	Jan. 1951

Source: Ibbotson Associates. Stocks, bonds, and cash investments are represented by the returns of the S&P 500,® U.S. Intermediate Government Bonds, and U.S. 30-day Treasury Bills (T Bills). The rolling 1-, 5-, 10-, and 20-year returns are annualized as of every month-end from December 1926 through December 2003. The number of rolling 1-, 5-, 10-, and 20-year performance periods evaluated were 925, 877, 817, and 697, respectively. Generally, stocks are more volatile than bonds or T Bills. Bonds are less volatile than stocks but offer lower potential long-term returns. T Bills maintain a stable value if held to maturity but their returns are generally only slightly greater than inflation. Past performance does not guarantee future results. Please see Important Legal Information page for index information. You cannot invest directly in an index.

Exhibit 6 When Equities Decline, the Diversification Benefits of Bonds Become More Noticeable



Source: Ibbotson Associates, 1926–2003. Stocks represented by S&P 500® and bonds represented by Ibbotson Intermediate Government Bonds. Although bonds generally are less volatile than stocks, they carry other risks, such as interest rate risk (when interest rates rise, bond prices generally fall), default risk (the risk that an issuer will be unable to make timely payments to bondholders), and inflation risk (the risk that returns may not keep pace with inflation). Past performance does not guarantee future results. Please see Important Legal Information page for additional index information.

any given year. For the 12-month periods that were measured, equity returns ranged from a high of 162.89% to a loss of -67.56%. Less volatile than stocks, bonds had a dispersion in returns that ranged from a 12-month best of 32.70% to -5.56%. While cash investments never did worse than -0.04%, they never did better than 15.20%, and this high was during a period of double-digit inflation, meaning that real gains were significantly lower.

But looking at the longer-term results, we can see that time dampened the effects of short-term swings in returns for these asset classes, most notably with stocks. In fact, between 1926 and 2003, where there were 697 rolling 20-year periods (measuring through the end of each month), there was not a single one of these periods in which stocks produced a negative return. The return ranges for bonds also became much tighter over time — always showing a positive total return for every five-year time period we measured — while those for cash became tighter still. Although neither asset allocation nor diversification can ensure a profit or guarantee against loss in declining markets, these ranges nonetheless suggest why fixed income securities can, if used properly, add ballast to a stock-heavy portfolio.

The diversification benefits of fixed income securities are particularly noticeable in years when stock prices have fallen. **Exhibit 6** (above) shows that while there were 23 years between 1926 and 2003 when stocks declined, bonds were up during all but two of those 23 years. The average loss in stocks for those years was -12.60% while the average gain for bonds was 5.36%.

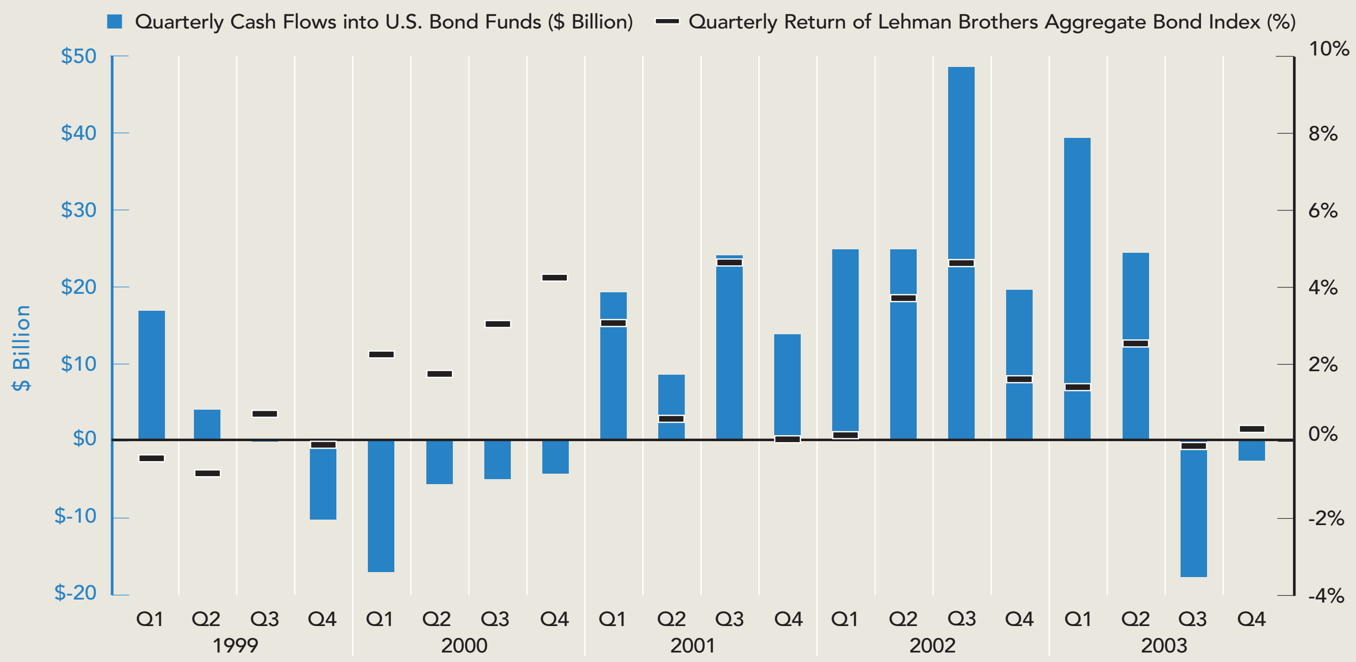
Knowing that the major asset classes (stocks, bonds, and cash) don't generally move in lockstep but instead display "non-correlated," or offsetting, tendencies, can help investors understand why diversifying across these classes can help smooth out the roller-coaster ride of investing for long-term goals. Unfortunately, investors too often ignore the benefits of continuously maintaining cross-class diversification — but shift instead to chase "hot" investments.

This is clear, for example, from **Exhibit 7** (below), which looks at quarterly cash flows into and out of U.S. bond funds between 1999 and 2003, along with the total returns for the Lehman Brothers Aggregate Bond Index.

After being overlooked in favor of equity funds in 1999 and 2000, bond funds began seeing positive net sales in Q1 2001, long after the stock market had begun its three-year correction. In fact, bond fund sales actually peaked in late 2002 and early 2003, right before stocks began a powerful comeback. Investors reversed course again in Q3 2003, shifting from bond funds to equity funds, *after* the stock market posted one of its best quarters ever.

This is not to fault investors for seeking the relative stability of bonds amidst the second-worst stock market correction on record. Many professional investors did the same thing. But by piling out of stocks and into bonds, then back into stocks — each time a step behind the markets' moves — many investors were careening from guardrail to guardrail chasing after recent winners. A far better strategy, for most investors, would have been to establish up front a mix of stock and bond funds that would provide a reasonable, if less "exciting,"

Exhibit 7 Quarterly Flows and Returns for Bond Funds, 1999–2003



Source: Strategic Insight. You cannot invest directly in an index. Past performance cannot guarantee future results. Please refer to the Important Legal Information page for index information.

Exhibit 8 Mixing Asset Classes Can Help Investors Moderate Risk

Performance of a Range of Fixed Allocations, 1954–2003

	100% Stocks	85% Stocks, 15% Bonds	70% Stocks, 25% Bonds, 5% Cash	60% Stocks, 35% Bonds, 5% Cash	50% Stocks, 40% Bonds, 10% Cash	20% Stocks, 40% Bonds, 40% Cash
Average Annual Total Return	11.7%	11.1%	10.3%	9.9%	9.3%	7.3%
Number of Down Years	12	12	12	11	10	2
Average Loss — Down Years	-11.5%	-8.8%	-6.2%	-5.1%	-3.9%	-0.3%
Worst One-Year Loss	-26.5%	-22.0%	-17.3%	-14.2%	-10.9%	-1.1%

Source: Fidelity Investments and Ibbotson Associates. The S&P 500,® U.S. Intermediate Government Bonds, and U.S. 30-day Treasury Bills were used to calculate the hypothetical portfolio performance figures used in this exhibit. Data is based on calendar year-end annual total returns from December 1954 to December 2003. An investor cannot invest directly in any of these indices. Past performance does not guarantee future results. Please see Important Legal Information page for index information.

combination of upside potential and downside protection. They then could have made small adjustments along the way, rolling down from equities to more conservative fixed income investments as they moved toward their goals.

Lifecycle investing reinforces this principle by encouraging investors to build a portfolio that combines the best elements of stock and fixed income investments. It applies in practice what professional investors know as Modern Portfolio Theory — the notion, pioneered in 1952 by Harry Markowitz (who later received the Nobel Prize), that there is a specific mix of assets whose inherent risks and returns should be most likely to deliver the best results over a given time frame for the amount of risk taken. Markowitz coined the term "efficient frontier" to describe these optimal asset mixes.

Although Markowitz was the first to state this concept in a rigorous, mathematical way, his ideas confirmed what generations of experience had already taught wealth managers: that asset allocation is to investing as location is to real estate. The successful long-term investor needs to diversify, both across and within the major asset classes.

Comparing the performance of diversified portfolios shows the central role that strategic asset allocation plays in returns. From 1954 to 2003, as we see in **Exhibit 8** (above), an all-stock portfolio produced an average annual return of 11.7%. But returns for 12 of the 50 years were negative, with a painful worst-year loss of -26.5%.

A portfolio of 70% stocks, 25% bonds, and 5% cash — diversified but oriented toward growth — produced a still-impressive 10.3%. It, too, registered losses in 12 years, with a -17.3% at its worst. By contrast, the most conservative portfolio, which was 20% equities, 40% bonds, and 40% cash investments, returned a respectable 7.3% over these years, but fell in just two years over a half-century, with a worst one-year drop of just -1.1%.

ADJUSTING THE TARGET MIX

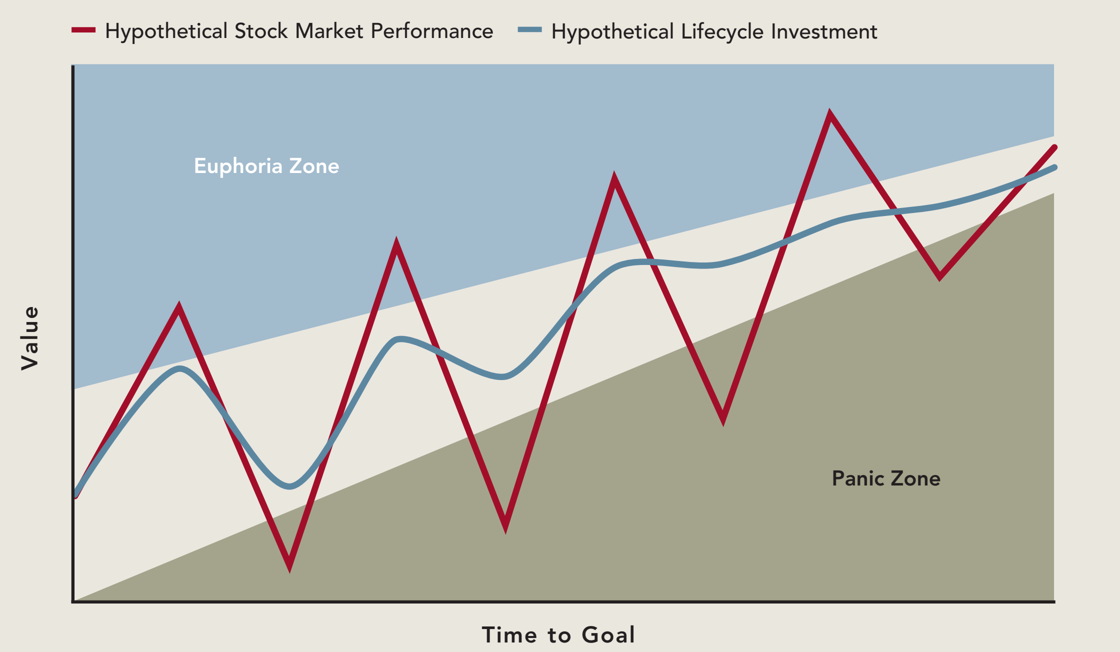
The efficient frontier provides a good starting point for building an investment portfolio: balancing the tradeoff between the risks and potential returns of various asset classes. But it remains a two-dimensional look at portfolio construction. Integrating an investor's time horizon gives a richer, three-dimensional sense — a feeling for whether the risk an investor is assuming is appropriate for his or her stage of the lifecycle.

Incorporating a commitment to monitor and regularly rebalance a portfolio takes the strategy up one more notch, from static to dynamic lifecycle investing. This is where the strongest link can be forged between portfolio theory and real-life investing — because investing for the future is a dynamic process, one that changes as a person's time horizon and goals change.

Lifecycle investing aims to maximize the likelihood of an investor's portfolio reaching its target with a minimum of volatility along the way. In effect, it aims to take investors — and their portfolios — along a path to a goal that stays within what we might call an investment "comfort zone."

Exhibit 9 (below) is a hypothetical illustration of this concept. It suggests how stock market movements can cause investors to become overly optimistic or pessimistic about future prospects, which can lead to making investment mistakes.

Exhibit 9 An Investor's "Comfort Zone" Narrows over Time



This exhibit is illustrative in nature and does not represent the historical returns of any particular index or investment.

In this exhibit, the narrowing central band represents an investor's subjective "comfort zone" — the amount of portfolio volatility that he or she can handle without too much anxiety — and how this zone narrows the closer they come to needing to draw on their money. The angular red line resembles the ups and downs the stock market can take over the course of time, while the blue line represents the less volatile approach to accumulating wealth through a lifecycle investment strategy.

In the first years of investing, when a lifecycle portfolio focuses on maximizing growth, the lifecycle investment line shows nearly as much volatility as the market. Over time, the lifecycle investment line becomes less and less volatile, as the allocation to equities decreases and the allocation to fixed income investments increases. Although this may be a less exciting path to travel, it can keep investors from experiencing the euphoria that leads to speculation at market peaks or the panic that leads to sell-offs when the market is in the throes of a correction.

FROM PLAN TO ACTION: HOW CAN INVESTORS FOLLOW THROUGH?

Given the volatility that investors have experienced over the last few years, the benefits of lifecycle investing may well have more appeal today than they did during either the euphoria of the late 1990s or the anxiety of the early 2000s. But assuming an investor is finally ready to give up the chase for hot performance and do some serious long-range planning that draws upon the lifecycle concept, what options do they have?

As we have noted earlier, the basic idea of lifecycle investing isn't complicated, and for investors who have the time and inclination, the tools to apply lifecycle principles to their own portfolios certainly exist.

But since the essence of lifecycle investing lies in the regular monitoring and adjusting of the portfolio over many years, the most realistic approach for many investors may be to rely on professional assistance of some kind. This can allow the investor to follow a chosen lifecycle plan whether he or she is personally able to manage it or not.

Many financial advisors use the principles of lifecycle investing in managing money for their clients. There is also a growing number of lifecycle funds that offer age-based investment pools, making it easy for investors to take advantage of the principles of age-based lifecycle investing. Many of these are designed to invest for retirement, while others are geared to helping parents save for their children's college educations.

Conclusion

THE CASE FOR LIFECYCLE INVESTING

Willingly or not, Americans from all walks of life find that they are being required to take more responsibility for making critical investment decisions about their own financial goals. Americans have responded to this challenge admirably, but still could benefit from more help from the financial services industry if they hope to achieve the desired results from investing in the securities markets.

As evidenced by erratic, market-reactive mutual fund cash flows, it seems clear that many investors continue to make emotional, undisciplined decisions about their investments as they strive to achieve important financial goals. Fidelity believes that age-based lifecycle investing can help address this problem and put more people in a position to succeed.

Because it involves investing for wealth accumulation at first, then gradually shifting over to strategies for protecting wealth, lifecycle investing is arguably the optimal strategy for building retirement and college savings. And, while lifecycle investing is a major commitment to managing your assets in a disciplined fashion, it need not be a burdensome one. Different approaches investors can take include relying on the help of a financial advisor or investing in a lifecycle mutual fund.

Similarly, it is important to understand that lifecycle investing can only really do the job for investors if it is used as the core strategy for most of the assets being earmarked for a given goal. Allocating a small portion of assets to a lifecycle investment program will neither provide the diversification nor the age-appropriate risk exposure that is so critical to this way of investing.

One point that investors should have no difficulty appreciating is that when you do use a lifecycle approach as a core investment strategy, it can open up an opportunity to invest some portion of the remaining assets more aggressively in an effort to seek incremental performance. With the bulk of your retirement assets committed to a prudent, age-appropriate management program, the risk to your portfolio is greatly diminished if these more aggressive investment opportunities do not perform as expected.

There are some hurdles to winning broader acceptance for lifecycle investing. It is only human nature to want to “do something” in response to market actions — to want to “get in on the action” when markets are hot and “get off the roller coaster” when markets are down or highly volatile. Education can help investors understand the fact that, even though it may not feel like it at times, with lifecycle investing they have done something strategic and proactive to deal with market volatility and, more importantly, put themselves in a potentially better position to achieve long-term financial goals.

By choosing a lifecycle mutual fund as a primary retirement investment, individuals can have more time for other pursuits — and the potential to enjoy them more fully.

Ironically, one of the principles of sound investing that Americans have taken to heart may also pose a hurdle to lifecycle funds: the notion that one should never "put all their eggs in one basket." Again, with additional education, investors should be able to understand that this clearly doesn't apply to a lifecycle fund that may include dozens of underlying mutual funds holding hundreds or even thousands of individual securities.

One appealing aspect of a lifecycle fund is that it can free up time and attention for other things — whether they are other financial matters (such as estate planning or business interests) or family and leisure time. For these investors particularly, lifecycle investing can deliver both a sense of security and the freedom to aspire.

From the evidence presented in this paper, Fidelity believes it is clear that future educational efforts by the financial services industry and the media should focus less on the hype and more on the "how-to's" of investing. This means educating more investors about how to build portfolios that are appropriate for where they currently are in their lives and setting more realistic expectations about investment returns. It also means helping investors shift their focus away from product-centered "performance chasing" and toward portfolio-centered strategic thinking. While absolute performance can be very helpful when comparing like types of mutual funds, the first question investors need to ask is "What type of fund do I need in my portfolio?" not "Who was last month's top performer?"

Ultimately, the goal should be to set more American families on the track of achieving important lifetime financial goals — such as affording comfortable retirements, college educations for children, and quality health care for family members throughout life — while giving them a greater sense of confidence to cope with the inevitable ups and downs that come with investing in the securities markets. We believe age-based lifecycle investing has the potential to play a significant role in meeting this challenge.

IMPORTANT LEGAL INFORMATION

Diversification does not ensure a profit or guarantee against a loss.

The Dow Jones Wilshire 5000 Total Market Index is an unmanaged market-weighted index that provides a broad measure of stock price trends in U.S. stocks. The index includes all stocks that trade on the New York Stock Exchange and American Stock Exchange as well as the most actively traded over-the-counter stocks.

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The NASDAQ Composite Index is an unmanaged market capitalization-weighted index that is designed to represent the performance of the National Market System, which includes over 5,000 stocks traded only over-the-counter and not on an exchange.

The Dow Jones Industrial Average is an unmanaged average of 30 actively traded stocks (primarily industrial) and assumes reinvestment of dividends. The Lehman Brothers Aggregate Bond Index is an unmanaged market value-weighted index of investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-back securities, with maturities of one year or more.

The MSCI EAFE Index is an unmanaged benchmark index comprised of 21 MSCI country indices representing the developed markets outside North American including Europe, Australasia, and the Far East.

The Lehman Brothers 3-Month Treasury Bill Index is an unmanaged index that represents the average of Treasury Bill rates for each of the prior three months, adjusted to a bond equivalent yield basis.

The Lehman Brothers Intermediate Government/Corporate Bond Index is an unmanaged market value-weighted performance benchmark for government and corporate fixed-rate debt issues with maturities between one and ten years.

The Merrill Lynch High Yield Master II Index is an unmanaged market value-weighted index of all domestic and yankee high-yield bonds, including deferred-interest bonds and payment-in-kind securities. Issues included in the index have maturities of one year or more and have a credit rating lower than BBB-/Baa3, but are not in default.

The Ibbotson U.S. 30 Day T-Bill data series is a total return series that is calculated using data from the *Wall Street Journal* from 1977 to present and the CRSP U.S. Government Bond File from 1926 to 1976.

The Ibbotson Intermediate Government data series is a total return series which is calculated using data from the *Wall Street Journal* from 1987 to present and from the CRSP Government Bond file from 1934–1986. From 1926–1933, data was obtained from Thomas S. Coleman, Lawrence Fisher and Roger G. Ibbotson's *Historical U.S. Treasury Yield Curves: 1926–1992* with 1994 update (Ibbotson Associates, Chicago, 1994).

All index returns include reinvestment of dividends and interest income. It is not possible to invest directly in any of the indices described above. Investors may be charged fees when investing in an actual portfolio of securities, which are not reflected in illustrations utilizing returns of market indices.

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