Morningstar Fund Spy

What to Make of Target-Date Funds' Allocation Tweaks

Be prepared for potential performance gyrations and continued changes.

By Greg Carlson | 03-27-08

Target-date funds are designed to be very long-term holdings. They're constructed as one-stop-shopping options that offer broad exposure to stocks and bonds, and they grow more conservative over time as they near their target date (which is meant to roughly coincide with an investor's retirement date) and after they surpass it.

However, investors should be aware that, since launching the funds, some fund shops have tweaked their target-date funds' asset allocations, and the way in which those allocations change over time. (The latter is often referred to as a glide path and can be found in a target-date fund's prospectus.) That might be surprising, given the funds' long-term goals and the fact that so many target-date funds are still relatively new--more than 60% of the funds in Morningstar's three target-date categories (target-date 2000-2014, target-date 2015-2029 and target-date 2030+) have been in operation for less than three years, and more than 85% don't have five-year track records. Moreover, it's worth noting that some of the allocation changes we've seen could cause those funds to get whipsawed over the short term. In other words, some moves have boosted exposure to asset classes that have enjoyed strong recent performance, or reduced funds' stakes to securities that have been hit hard.

Alliance Tones It Down

AllianceBernstein's target-date funds came to market in late 2005, 2.5 years into a strong rally by riskier fare such as debt-heavy firms and lower-quality bonds, with one of the more aggressive glide paths around. The AllianceBernstein Retirement Strategy Funds initially put 10% in real estate investment trusts, no matter what the age range. It also kept more than a fourth of the funds' assets in international stocks until age 40 and did not introduce bonds to the portfolios until age 45, and even then it was mostly high-yield bonds. It backed up its equity-heavy allocations with a lot of research, including a 60-page white paper that maintained that getting too conservative too early was riskier than holding generous stock helpings before and after retirement, because it increased the odds that investors would run out of money--or not be able to maintain desired spending levels--in their golden years.

It's not wise to judge the efficacy of target-date funds by a couple of years of performance. What counts in the end is if they help you meet your goals. Yet when AllianceBernstein's offerings hit the market it seemed as though they'd be more prone to big short-term ups and downs than other target-date funds. So far, that has been the case. When REITs and international stocks were rocking in 2006, all of the AllianceBernstein Target Retirement funds finished the year in the top quartile of their respective categories. In the last year or so, though, as REITs and global equity markets in general have sold off, most of the funds have fallen to the bottom quartile of their categories.

Recently, however, AllianceBernstein added a 5% intermediate-bond allocation (primarily investment-grade debt) to its Retirement Strategy funds designed for investors 40 years old or younger (the seven funds dated from 2025 through 2055). The firm also dramatically cut the global REIT helpings of the same Retirement Strategies funds because the firm said REITs have some bond-like characteristics. Instead of keeping 10% in REITs, for example the AllianceBernstein Retirement Strategy 2050 (LTQAX) and 2055 (LTWAX) funds now have about 5% there.

The changes came at an interesting time, as REITs were falling after a years-long rally, as investment-grade bonds were enjoying decent results and sporting historically low yields, and as the funds themselves approached their three-year anniversaries, a milestone to which many advisors and investors pay a lot of attention. The firm, however, called the changes minor and said it made them to comply with Department of Labor requirements for retirement plan default options, which became effective at the end of 2007. In other words, it had to make the allocation adjustments to be considered a viable default option for 401(k) plans, a huge market. So, the changes to the funds could be driven more by business concerns than a change in investment thinking. AllianceBernstein's target-date funds have attracted a modest amount of assets (less than $1.5 billion between them) thus far, and access to the 401(k) market could lead to dramatically larger inflows. And from a performance standpoint, while the funds' poor one-year showings shouldn't make much of a difference given their long-term time horizons, they do have a big impact on their' performance rankings as they near the three-year mark--a milestone that many advisors and investors look at closely. (Conversely, we believe that target-date funds' performance over such a short time period isn't meaningful when assessing their merits.)

The timing of the funds' reduced REIT weighting is less than ideal, given the recent carnage in that industry. Also, investment-grade bonds have performed strongly over the past year and now sport historically low yields, making them less attractive. Regardless of the reasons behind the changes, they should take some of the edge off of these funds, which could make them easier for more squeamish investors to own.

Vanguard Gets Bolder

Vanguard's initial attempt at target-date funds was at the opposite end of the spectrum. Vanguard Target Retirement funds, rolled out in 2003, had less in equities overall than many of their peers and nothing in emerging-market stocks. Vanguard took a more conservative tack because of research that showed investors fear the agony of defeat more than they yearn for the thrill of victory. A less aggressive allocation would be smoother and easier to own. Consequently, in subsequent years the funds often didn't keep pace with rival target-date funds as stocks rallied. (In 2005 each of the Target Retirement funds in existence at that time lagged most of their respective peers.)

The firm did a do-over in 2006, though. It rolled out five additional funds, meaningfully increased the stock helpings of all of the existing funds and added Vanguard Emerging Markets Index (VEIEX) to the mix.

We think Vanguard's tweaks also came on the heels of a bout of underperformance and included adding asset classes, such as emerging markets, that had enjoyed strong runs. There were fundamental reasons for the changes, though. The firm recognized that investors are living longer and are thus at a greater risk of running out of money in their golden years. We were critical of the first iteration of Vanguard's Target Retirement funds and applauded the changes. But the timing of the firm's changes is noteworthy, and investors should be aware that the funds could be prone to more short-term performance swings in the future than they were in their original form.

Fidelity Opts For More Equities in Retirement

In 2006, Fidelity altered the asset-allocation plans for its target-date funds--some of which have been around since 1996. Previously, the funds had merged into Fidelity Freedom Income--which keeps its equity stake at a static 20%--within five to 10 years after hitting their target dates. However, the firm decided that retirees needed to hold a larger weighting in equities further into retirement, because people are living longer and thus run a greater risk of running out of money. So the firm postponed these mergers by roughly 10 years; each fund is now absorbed by Freedom Income 10 to 15 years after its target date. This move, like Vanguard's, came well into a healthy rally by stocks. Again, however, we don't think market events drove this decision. Like Vanguard, the firm came to believe that investors need to own significant stakes in stocks well into retirement.

We think there are two takeaways for investors here. First, the target-date fund industry is still relatively new, and research into optimal asset allocations is ongoing. Thus, we wouldn't be surprised to see further changes made to target-date funds' asset allocations and glide paths, particularly over the near term. Second, it bears repeating that these changes could weigh on performance over the near term, if the fortunes of the asset classes in question reverse.