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## The Sound Investor Series #10

### Life-Cycle Funds – The Pros and Cons

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Life-Cycle Funds are becoming a popular investment option in 401(k) plans and are one of the fastest growing types of mutual funds. In fact, many 401(k) plans have switched their default investment option from Money Market Funds to Life-Cycle Funds. In my opinion this is good in the short run, but in the longer-term, investors should take a more active role in their asset allocation decisions.

Today I want to give a quick overview of Life-Cycle Funds along with their pros and cons. To start we need to briefly review what Asset Allocation means.

Asset Allocation in the simplest case refers to how you split your long-term investments between stocks and bonds. For instance, you might split your money evenly; putting 50% in stocks and 50% in bonds. How you allocate your assets will be the most important determinant of your long term results.

So how should you determine your asset allocation. First, everyone agrees diversification is important so you should own both stocks and bonds. Second, it is widely accepted that stocks are riskier than bonds but also have higher potential returns. So, most professionals recommend younger investors hold a high percentage of their assets in stocks and slowly shift to bonds as they age. The logic being if something goes wrong, a younger person has more time to wait for the markets to right themselves before they need the money. (Please see The Sound Investor #3 for more detail.)

If you want to put your asset allocation decisions on auto-pilot, you can buy a Life-Cycle Fund. These are designed to be more heavily invested in stocks when you are young and shift toward bonds as you get older. It “knows” your age by which fund you buy. If you are 40 and planning on retiring at 70 in 2035, you would buy a “2035 Fund.”

For investors who do not care about personally managing their investments, I think this is a pretty good product. It is certainly much better than leaving your 401(k) in Money Market Funds.

But nothing is perfect and Life-Cycle Funds do have a few drawbacks. First, the fund’s managers making the asset allocation decisions assume this is your only investment. But asset allocation decisions need to be made when evaluating all your assets, not just one fund at a time. The result is that if you hold other investments, the fund’s decisions will

be thrown out of whack unless you rebalance your investments to match theirs. And if you are doing the asset allocation work to compensate for their changes, you probably don't need their help in the first place!

The second problem is the actual asset allocations of Life-Cycle Funds. The split between stocks and bonds varies all over the place and is generally too conservative. For investors planning on retiring this year, the Vanguard 2005 Fund has 33% of its assets in stocks; Fidelity 45% and T. Rowe Price 58%.

Which one has the right stock allocation is difficult to determine in advance, but I feel an investor's asset allocation should be more than a one-dimensional decision based on age. It also depends on your total assets, health and short-term financial considerations.

Third is the problem of fees. Most Life-Cycle Funds invest in other funds in the same fund family. Sometimes investors are hit with fees from both the Life-Cycle Fund and the underlying funds in which it invests, it is important to check. In any case, most Life-Cycle Funds have lower expenses than actively managed funds, but have substantially higher fees than Exchange-Traded Funds (ETFs) or index funds.

For investors with both taxable and tax-qualified accounts, the last major drawback of Life-Cycle Funds is that they hinder your ability to hold investments in the most tax-efficient account. Under current tax law, interest income in a taxable account is taxed when it is received. But if the investment is held in a tax-qualified account the interest is not taxed until it is withdrawn. Therefore, if everything else is equal, it is best to first fill your tax-qualified plans with the bonds you own and let your stock positions spill over into your taxable accounts if necessary.

The bottom line is that I expect these funds will have the positive effect of increasing investors' exposure to stocks when they are young. But at some point investors should move beyond these funds to manage their asset allocation in a more personalized manner.

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