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Asset Allocation Funds: Lifestyle, Lifecycle, and Distribution

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Tailoring a fund to a goal, risk level, or time frame

Some mutual funds follow an asset allocation model of investing. Rather than concentrating on a single type of investment, such as stocks or bonds, they're designed to be a broad-based approach to diversifying investments across multiple asset classes. The proportion of each asset class in an asset allocation fund will depend on what need the fund is attempting to address. The idea is to automate an investor's asset allocation process by tailoring a fund to a time frame, life goal, or level of risk tolerance. Because asset allocation is such an important factor in an investor's overall return, the theory is that such funds can not only tailor an asset allocation to a goal, but help take emotion out of investment decisions.

Funds based on an asset allocation model take a step further the concept of a balanced fund, which invests in stocks and bond or other fixed-income investments. Though an asset allocation-based fund may have a so-called "neutral mix" of asset classes, it typically has the flexibility to adjust its allocation strategy, depending on market conditions. In fact, some, such as lifecycle funds, plan for specific adjustments to that mix over time.

How does a basic asset allocation fund work?

Different types of asset allocation funds work differently. With the most basic type of fund, the asset allocation is determined when the fund is launched, and fund assets are invested accordingly. For example, a hypothetical standard asset allocation fund might state in its prospectus that it intends to invest 50 percent of the fund's asset in stocks, which might be a mix of large- and small-cap stocks. Another 30 percent might be in a mix of investment-grade corporate bonds, high-yield bonds, and intermediate Treasury securities. The remaining 20 percent might be in money market securities. Another asset allocation fund might have 60-75 percent in a mix of large-cap, small-cap, and international stocks; 20-35 percent in long-term Treasury securities, and 5-10 percent in money market securities.

Once the appropriate percentage (or range of percentages) for each type of investment is determined, the manager will periodically rebalance the portfolio to maintain those targets over time, though they may deviate a bit in the short term. For example, if the stock portion has done well and now exceeds its targeted percentage of the portfolio, the manager might sell certain stocks, and buy more bonds to bring the fund back in line with its targets.

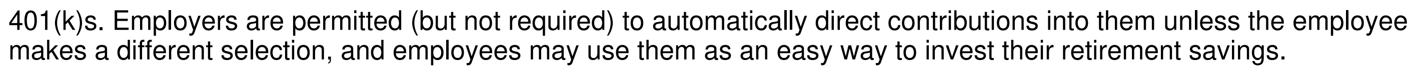
An asset allocation fund may also vary the percentages it chooses to allocate to each category, attempting to take advantage of temporary conditions in various markets, although it must still adhere to any restrictions outlined in the prospectus. For example, a manager who believes stocks are underpriced relative to their value might choose to invest a higher percentage than usual in stocks. If a correction or high levels of shareholder redemptions are anticipated, the manage might increase the portion of the portfolio devoted to cash alternatives.

Specific types of asset allocation funds may determine their asset allocation strategy based on a specific goal, investing style, time horizon, or payout strategy. Various types are discussed below. If a fund's objectives change --for example, if a fund shifts from focusing on growth to focusing on income--it should spell out how it makes those changes and how they will affect its investment strategy and potentially its results. Keep in mind that each asset allocation fund has its own approach, and there is no assurance that any fund will perform as expected. Be sure you understand an individual fund's approach.

Caution: *Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which are included in the prospectus available from the fund. Read it carefully before investing. Asset allocation is a method used to help manage investment risk; it does not guarantee a profit or protect against investment loss.*

Strengths of asset allocation funds

- Asset allocation funds offer a simple way to diversify across several asset classes by automatically determining how much of the portfolio should be invested in each one. A professional manager monitors the asset allocation and adjusts it as needed, which eliminates the need to rebalance that portfolio yourself.
- Depending on the type of fund, an asset allocation fund can be useful for targeting a particular time frame, investment goal, or risk tolerance.
- Asset allocation funds have become a popular default option in employer-sponsored retirement savings plans, such as



401(k)s. Employers are permitted (but not required) to automatically direct contributions into them unless the employee makes a different selection, and employees may use them as an easy way to invest their retirement savings.

Tradeoffs involved with asset allocation funds

- Asset allocation funds can be challenging to integrate with other portions of your portfolio to achieve a total asset allocation that addresses all of your financial needs and goals.
- An asset allocation fund may be a "fund of funds," achieving its asset allocation by investing multiple funds, each of which is devoted to a specific asset class. That can sometimes mean multiple layers of fund expenses.
- An asset allocation fund doesn't take into account your individual risk tolerance. For example, one investor who considers him/herself conservative may have a very different risk profile from another who may also consider him/herself conservative but who has greater (or fewer) assets outside the fund.
- An asset allocation fund may not include more than the three basic asset classes: stocks, bonds, and cash. If it does not, that would eliminate any potential benefits from additional diversification into other non-correlated asset classes, such as alternative investments.

Lifestyle funds: targeting your risk tolerance

So-called lifestyle or target-risk funds establish their asset allocations based on various levels of risk tolerance. They typically are part of a series of funds that fall along a spectrum ranging from conservative (focused on stability and/or income) to aggressive (focused on growth/capital appreciation). The more focused on growth a lifestyle fund is, the more it will tend to have invested in stocks; a more conservative lifestyle fund will have a higher percentage of assets in bonds and/or money market securities. Periodic rebalancing keeps those percentages relatively stable over the life of the fund, although a manager may have some discretion in the short term.

Lifestyle funds were designed to allow investors to target and maintain a specific asset allocation without having to select multiple funds themselves or worry about rebalancing asset classes. A lifestyle fund may invest directly in individual securities or be structured as a so-called fund-of-funds; these include multiple mutual funds, each of which focuses on a specific asset class.

Lifecycle funds: targeting your time horizon

Lifecycle funds attempt to tailor each fund's asset allocation not only to your risk tolerance, but to how soon you expect to use that money. Unlike lifestyle funds, lifecycle funds tend to set and adjust a given asset allocation based on a given date in the future, shifting the mix of investments gradually over time to increase the focus on capital preservation as the target date approaches. The pattern over time for changing the mix of asset classes is known as a portfolio's glide path; it generally involves reducing the portion devoted to equities.

Like lifestyle funds, lifecycle funds tend to be available in series; each fund in the series targets a different time horizon. That's one reason why lifecycle funds are sometimes known as target date funds; the "target date" is the approximate date when an investor expects to begin withdrawing money from the fund. For example, someone investing for retirement in a fund with a target date of 2030 typically expects to retire in 2030 and begin tapping the fund for income. For example, a series of five lifecycle funds might target dates that are 10 years apart; the fund with the closest target date would typically be the most conservative.

Caution: *Not all lifecycle funds take the same approach. Some maintain a fixed asset allocation once they've reached their target date; others continue to get more conservative even after the target date has passed. They also may plan for different lifespans after retirement. Be sure to check a fund's prospectus before investing to know what approach it uses.*

Caution: *The target date is the approximate date upon which an investor plans to withdraw their money. For example, typically, target date funds are based on a date that corresponds to the date when an investor expects to retire or needs access to their funds. The mix of investments in the target date fund becomes more conservative as the date grows closer. For example: typically the funds are sold by date, such as a 2030 fund. The farther away the date is, the greater the risks the fund usually takes. As the target date approaches, the fund should change its balance of investments to emphasize conserving the value it has built up and to shift toward more conservative income-producing investments. The principal value is not guaranteed at any time, including at the target date. There is no guarantee that a target date fund will meet its stated objectives. It is important to note that no two target date funds with the same target date are alike. Typically they won't have the same asset allocation, investment holdings, turnover rate, or glide path. So it is important for an investor to look beyond the target date to determine if a particular target date fund is an appropriate investment.*

Strengths of lifecycle funds

- Lifecycle funds often are used to target a specific financial goal. For example, lifecycle funds are popular options for retirement planning, especially within employer-sponsored retirement plans such as 401(k)s, which are permitted to offer them as a default option for employees who do not choose an investment option for their money on their own.
- Lifecycle funds automate the process of monitoring your asset allocation for a particular financial goal or time frame. They can be less time consuming in terms of monitoring your investment for a specific goal.

Tradeoffs with lifecycle funds

- If you jump in and out of a lifecycle fund, you will be working against the fund's long-term strategy, which is based on the fund's target date. That defeats the very rationale for investing in a lifecycle fund.
- As with other asset allocation funds, it can be difficult to combine a lifecycle fund with the rest of your portfolio. How you invest other assets outside the fund will have a substantial impact on your overall asset allocation, which may be quite different from that of your lifecycle fund.
- It can be challenging to determine how best to benchmark the performance of a lifecycle fund. Asset allocations that evolve over time and differences among the various approaches taken to managing a lifecycle fund contribute to the difficulty of comparing fund performance. Some approaches that have been suggested include (1) comparing returns to a hypothetical mix of indexes representing the various asset classes in the fund, (2) comparing returns to some sort of absolute return measure, such as the rate of inflation plus a premium, and (3) comparing a fund to its peers with similar target dates.
- Transactions involved in periodic rebalancing and asset allocation adjustments may generate higher capital gains for taxable accounts.
- As with other mutual funds, the value of any principal invested in a lifecycle or target date fund is not guaranteed at any time, including the target date.

Distribution funds

A relatively new variation on the concept of asset allocation funds focuses not on accumulating assets but on how those assets are distributed to an individual investor over time. They allocate assets in order to provide an income stream from year to year--for example, to provide a basic level of retirement income. In fact, they are sometimes referred to collectively as managed payment, managed payout, or retirement income funds, even though investors have many other options for using them.

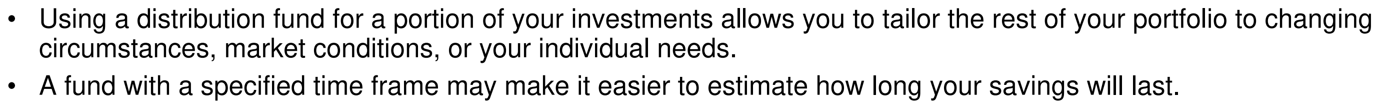
As with lifestyle or lifecycle funds, distribution funds also typically are available as part of a series. Each individual fund is designed to produce a specific percentage rate of return each year, or distribute income based on how long the portfolio is designed to last. Some distribution funds are designed for a specific time horizon, much like target-date or lifecycle funds; others have no expiration date.

Basically, these funds function much like a systematic withdrawal plan. They make periodic payments by setting aside a percentage of your assets each year and dividing that amount into equal payments scheduled at regular intervals (typically, monthly or quarterly). However, the methods used to generate returns and calculate payments vary widely. Some are managed so that all capital is exhausted by the end of a designated time period, generally getting more conservative as that end date gets closer. Others are designed to preserve capital and make payouts primarily from earnings; these typically have no time frame. In some cases, the amount of the payout is adjusted to keep pace with inflation. A distribution fund is generally structured as a fund of funds, although some also include other types of investments.

Such funds are designed to play a role in retirement income similar to that of annuity payments; however, there are some key differences between the two. Perhaps the most important is that these funds offer no guarantees of the payout levels they provide; annuities often do (subject to the claims-paying ability of the annuity's issuer). Also, a mutual fund is not an insurance contract, as an annuity is.

Strengths of distribution funds

- Distribution funds can simplify the process of receiving an ongoing income stream.
- Many investment products that provide a regular income stream may involve restrictions on use of your principal. Distribution funds permit you to withdraw money from your account at any time, giving you the flexibility to adjust your yearly income, if necessary.
- Distribution funds are designed to be a lower-cost alternative to an annuity as a source of ongoing income.



- Using a distribution fund for a portion of your investments allows you to tailor the rest of your portfolio to changing circumstances, market conditions, or your individual needs.
- A fund with a specified time frame may make it easier to estimate how long your savings will last.

Tradeoffs with distribution funds

- Although distribution funds strive to provide a steady income stream, there are no guarantees that those income levels will be met. Depending on how a fund is structured and managed, a steep or prolonged market decline could affect the amount of the scheduled payments.
- Distribution funds vary widely in how they are managed and how income is distributed. Be sure to obtain a fund's prospectus and read it so that you understand exactly how it functions.
- If you are willing and able to structure and manage a systematic withdrawal program on your own, you may be able to replicate many of the advantages of such a fund.
- If a fund's manager must sell securities from the portfolio in order to provide the desired income levels, that could generate capital gains for investors. If the fund is held in a taxable account, that might mean capital gains taxes on the distribution of any such gains.

To schedule an appointment with Faye Sykes, click [here](#) .

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