TIAA-CREF asset management®

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PEDALING INTO LIFECYCLE FUNDS

For over 40 years, TIAA-CREF promulgated its belief that participants could improve their chances of meeting their retirement income goals by dividing their contributions between TIAA Traditional and CREF Stock.[1] The investment philosophy behind that asset allocation advice hasn't changed, but TIAA-CREF has, by offering its participants a much wider range of long-term investment options. Among those are the TIAA-CREF Lifecycle Funds, which were opened in late 2004 and are being updated this year.

In this Market Monitor, we focus on:

- The rationale for investing in a lifecycle fund
- How the basic lifecycle approach exemplifies TIAA-CREF's investment philosophy
- What's on the horizon for lifecycle funds

Basically, a lifecycle fund is a simpler name for a target maturity balanced fund, which in turn is a fund of funds whose weights change over time and are rebalanced professionally. A lifecycle fund is geared to the participant's age and is designed to start out with a higher allocation to relatively risky assets and then reallocate gradually toward relatively lower risk assets over the participant's working life. Since their introduction in the mid-1990s, over 10 fund families now offer these funds with a total but rapidly growing market of over $100 billion.

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[1] The CREF Stock Account is a variable annuity investment option. These contracts are designed for retirement or other long-term goals, and offer a variety of income options, including lifetime income. Payments from the variable annuity accounts [and mutual funds] are not guaranteed and will rise and fall based on investment performance. Mutual funds do not offer the range of income options available through annuities.

The rationale for investing in a lifecycle fund rests on six basic principles, all of which are fundamental to the TIAA-CREF investment philosophy. The first is diversification. A well-designed lifecycle fund enables the individual to diversify his or her savings among asset classes, investment styles, and sizes in an effort to obtain an improved mix of return and risk compared to any one asset class.

A second principle is rebalancing and reallocation. Lifecycle funds are professionally reallocated over time and rebalanced regularly. Theoretically, an investor could maximize his or her returns by allocating all savings to a relatively high risk asset class, such as small-cap stocks. For example, a 60-year old investor with a portfolio allocated 100% to small-cap stocks is very exposed to market movements in this asset class and yet is only a few years from the normal retirement age of 65. If, for example, small-cap stocks were to experience a dramatic loss of 30%, this investor would have only a few years to recover from this loss with the likely result that his or her accumulation available to fund retirement would be much smaller than planned. Hence, his or her income—and living standards—during retirement would also be lower than planned. Another investor with a portfolio that reduced exposure to relatively higher risk assets and increased exposure to relatively lower risk assets would be much less exposed to a dramatic market downtown. This investor would have a higher probability of achieving his or her planned accumulation and, hence, also achieving his or her planned retirement income and retirement standard of living. This is the logic motivating the portfolio construction of a lifecycle fund.

A third principle relates to discipline. Lifecycle funds are regularly rebalanced back to the current target allocation and thus provide a more predictable risk-return exposure. This emphasizes predictability and transparency in that lifecycle funds offer a better chance of continuing to meet the individual investor's objectives as compared to a portfolio that is allowed to drift with market movements.

Fourth, the simplicity of lifecycle funds allows them to be used as a default option or a "set-and-forget" investment approach. Once the individual decides to invest he or she isn't required to reexamine the portfolio as often because the allocations and rebalancing are automatic. At the extreme, federal law now allows a pension sponsor to designate lifecycle funds as a safe harbor that is superior to previous default options that focus on low expected return money market or stable value funds.

A fifth principle is transparency. Well designed lifecycle funds use underlying funds that are transparent in the sense that they offer pure exposure to intended asset classes—what you see is what you get. That way, an investor's portfolio is fully invested according to the investment objective and doesn't have gaps or hidden unintended exposures.

The sixth principle is cost. Fund expenses are one element of investing that is easily visible and controllable by the investor. The lower the cost, the easier it is for the fund manager to provide good long-term returns. Since lifecycle funds are a basic building block of long-term investing they should be a leader in low costs.

All of these principles are basic to TIAA-CREF's investment philosophy, which rests on the benefits of diversification, rebalancing, investment transparency, discipline, simplicity and low cost. That's why we continue to look for ways to improve these basic building blocks of long-term retirement investing. For example, using Monte Carlo simulations and other approaches, TIAA-CREF recently evaluated the effect of different asset mixes, such as the split between equities and fixed income, the addition of high-yield bonds, the use of other asset classes such as real estate and TIAA Traditional, and options for a lifecycle retirement income fund.

Expect to see continuing research and development of the lifecycle funds over time in response to advances in the academic literature and to our own research efforts. In the interim, well-designed lifecycle funds should really be considered as a critical option for long-term savers with other things to think about.

In addition to asset allocation risk, the TIAA-CREF Lifecycle Funds are subject to the risks associated with the types of securities held by each of its underlying funds. For a more complete discussion of these and other risks, please consult the prospectus.

SOURCE: TIAA-CREF ASSET MANAGEMENT

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