

## WEEKLY MARKET MONITOR DECEMBER 10, 2007

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### WHAT'S UP WITH LIFECYCLE FUNDS?

TIAA-CREF introduced its lifecycle funds in 2004 and they are increasingly popular with individuals, colleges, and universities as the default option in pension plans. In the past couple of years, the overall lifecycle market has taken off; assets in these funds now total well over \$150 billion in assets and lifecycle sales account for about 7% of all mutual fund sales (up from about a half a percent in 2000), suggesting that there is room for this segment to grow. Unsurprisingly, a wide range of investment managers and consultants have scrambled to introduce their own lifecycle funds and there seems to be a race among them to differentiate their products in this important area.

- What are some of the key developments in the lifecycle world?
- How do some of the new designs stack up?
- As the lifecycle market continues to develop, what can we expect to see?

Lifecycle funds are also known as *target date maturity funds* since they are fund-of-funds whose asset mix changes over time to achieve a certain asset allocation on a targeted date intended to correspond roughly to the time an investor retires.



The purpose is to cut through the clutter of dozens of fund and allocation choices that can stymie individual investors who aren't interested in closely monitoring their retirement portfolios. By aligning an investor's changing human capital resources (or individual liabilities) with a fund that provides asset allocation, rebalancing, and reallocation, a lifecycle fund offers what to many people is an attractive, simple, one-stop, choose-and-forget, long-term savings option that embodies sophisticated professional thinking at both the asset allocation and fund management levels.

A retirement saver who chooses TIAA-CREF's version of lifecycle funds would normally make contributions to the fund targeted to their 65th birthday, say the Institutional Class Mutual Funds – Lifecycle 2040 fund (other funds are targeted to 2020, 2025, 2030, etc.). This fund starts with an allocation of 90% to actively managed equity mutual funds and 10% to actively managed fixed income mutual funds. After holding a steady allocation for a few years, it is designed with a *glidepath* that gradually reallocates toward fixed income funds. At the *target maturity* date in 2040, the fund will hold 50% of its assets in equity funds and 50% in fixed-income funds. Other TIAA-CREF lifecycle funds have similar glidepaths.

Most lifecycle industry offerings use this basic approach, with variations in terms of the overall allocation between equity and fixed-income and in terms of the number and type of specific funds that form the lifecycle lineup. For example, TIAA-CREF's lifecycle funds have among the highest percent allocations to equities for two reasons. One is that, early in a retirement saver's career, equity market volatility affects only a small proportion of the total assets he or she will ultimately have at retirement. So a downturn in the market will have much less effect on the eventual nest egg than a similar downturn nearer retirement. A second reason is that, at age 65, average life expectancy is well over two decades, so that a reasonable allocation to equities as well as inflation-linked bonds can help to combat long-term inflation.

More recently, fund firms and consultants have begun to differentiate lifecycle products by providing more customization. The idea is that one fund may not fit all investors. One new approach is to offer each investor

multiple funds with identical target dates but different levels of expected risk. Risk-tolerant investors can pick a lifecycle fund that changes over time, but that offers a higher risk level and higher expected return at each point. Risk-averse investors can choose a fund with a lower level of expected volatility and lower expected return.

Another new approach is a target maturity fund, which, 15 or so years before retirement, splits into different branches or options depending on the investor's current financial condition. Investors who feel that they are comfortably on track for retirement can continue on the original glidepath. Investors who feel that their nest egg is too small can shift to a fund with a higher risk/return expectation. And investors who are well ahead of their savings plan can shift to a fund that dials back the risk in order to protect their accumulations.

In both of these cases the idea is to enable the investor to choose from among multiple lifecycle funds. The difference is that in the first case the choice is immediate and in the second case the choice comes later on. Either of these approaches may sound attractive, since they offer more choice, which is one of the first principles of the 401(k) defined contribution approach to pensions. And what could be bad about more choice?

The problem is that one of the main reasons to offer lifecycle funds is the goal of putting sophisticated allocation and rebalancing advice in a product that is simple to use and understand. A lifecycle fund doesn't reduce choice. At TIAA-CREF it is designed for use in a retirement plan that contains a full range of individual asset allocation and fund selection options. So an investor who does not choose the lifecycle option can construct a customized individual asset allocation, rebalancing, and reallocation plan, either on his or her own, or with the help of independent third-party advice.

In addition, a lifecycle fund allows investors to change their minds. If at any point, the investor wishes to reallocate out of one lifecycle fund into another that is less risky or more risky, it is easy to do so. Or, if the investor wishes to modify their portfolio by combining a core lifecycle fund with other investments, they can do that, too.

And for some investors a lifecycle fund may not be the best choice. A fully individualized and customized investment plan may be appropriate for investors with special needs. Investors can make that assessment themselves in conjunction with counseling with a TIAA-CREF Wealth Management Advisor or an Individual Consultant.

In conclusion, new forms of lifecycle funds with a variety of risk levels, branches, and other features run the risk of needlessly boosting the complexity that already faces the individual investor without necessarily providing significant

new options that aren't available today. A more fruitful area of innovation could be addition of new asset classes that provide significant diversification to the current lineup of equity and fixed-income funds that are offered in most lifecycle funds. Current research into the potential inclusion of direct real estate, natural resources, private equity, and other alternatives into lifecycle funds suggests that these sorts of innovations could possibly produce return and risk benefits for participants while still keeping the basic, simple lifecycle structure that is easy to explain and use.

**You should consider the investment objectives, risks, charges and expenses carefully before investing. Please call 877-518-9161, or go to [www.tiaa-cref.org](http://www.tiaa-cref.org) for a current prospectus that contains this and other information. Please read the prospectus carefully before investing.**

In addition to asset allocation risk, the Lifecycle Funds are subject to the risks associated with the types of securities held by each of their underlying funds. For equity securities, these risks may include market risk, company risk, foreign investment risk, growth investment risk, value investing risk, style risk, and small-cap/mid-cap risk. For fixed-income securities, these risks may include interest rate risk, income volatility risk, credit risk, call risk, prepayment and extension risk, and special risks for inflation-indexed bonds.

The TIAA-CREF Institutional Mutual Funds – Lifecycle 2040 fund's overall risk level should gradually decline as the target allocation shifts more toward fixed income with the approach of the year 2040. For a more complete discussion of these and other risks, please see the prospectus.

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