

## Target-Date Retirement Funds Use Junk Bonds for Yield (Update1)

By Margaret Collins and Jeff Plungis

Dec. 16 (Bloomberg) -- **John Hancock's Lifecycle 2010** mutual fund is marketed as an investment that "becomes more conservative" for people approaching retirement age. Thirty-five percent of the fund's debt holdings in September were **junk** bonds, according to Morningstar Inc.

Six of the nine largest U.S. target-date fund providers by assets have high-yield corporate bonds in their 2010 portfolios, according to Morningstar. The Hancock fund's **holdings** include bonds that financed construction of a New Mexico casino hotel, Inn of the Mountain Gods, that were in default as of Dec. 15. The U.S. default rate on high-risk, high-yield bonds was 11.28 percent in November, according to Standard & Poor's.

Target-date funds may present greater risks than consumers have been aware of, said **Laura Pavlenko Lutton**, editorial director in Morningstar's mutual-fund research group. The funds grew into a **\$311 billion** business by 2008, a year after the U.S. Department of Labor said employers may use them as an automatic enrollment investment option for 401(k) retirement plans.

"Participants accept that someone has gone through these things and they're reasonable," said **Tim Wood**, a Portland, Oregon-based retirement plan fiduciary who designs plans for employers with as many as 8,000 employees. "People are uninformed of the massive amount of risk they're undertaking."

'Tremendous Value'

Target-date funds, also known as lifecycle funds, move money from riskier investments such as stocks to more conservative alternatives like bonds as an investor approaches retirement. Last year, 7.3 million Americans held target-date funds, according to the Employee Benefit Research Institute's database of 24 million 401(k) participants.

A single bond in default is "not going to make or break the fund" because it's a very small portion of the thousands of bonds in the fund, said Bob Boyda, senior vice president in the investment management services division of John Hancock. "Even if a bond is in default it may have tremendous value."

Junk or high-yield, high-risk bonds are those rated below investment grade or BBB- by Standard & Poor's and Fitch Ratings and Baa3 by Moody's Investors Service.

Other 2010 retirement funds with bonds rated below investment grade include: **Principal Funds' LifeTime 2010 Fund**, at 21 percent of its total debt holdings; the **Fidelity Freedom 2010 Fund**, 17.1 percent; **T Rowe Price's Retirement 2010 Fund**, 13.1 percent; American Funds' **American 2010 Target Date Retirement Fund**, 11.4 percent and **TIAA-CREF's Lifecycle 2010 Fund**, 6.6 percent, as of the latest portfolio disclosure according to Morningstar, a Chicago-based investment-research firm.

The overall bond holdings in the funds range from 34 percent in **T. Rowe Price Group Inc.'s** fund to 45 percent in TIAA-CREF's fund, according to Morningstar.

Risk Concerns

Risk is only one of the concerns that someone who's about to retire needs to consider, said **Jonathan**

**Shelon**, manager of Fidelity Investments' **Freedom Funds**. There's inflation and the need to generate enough income to last for 20 years to 30 years, he said.

High-yield bonds help T. Rowe Price's 2010 fund earn income for a retiree up to age 95, said **Ned Notzon**, chairman of the Baltimore-based company's asset allocation committee. Principal Financial Group, based in Des Moines, Iowa, and New York-based TIAA-CREF said their allocation in high-yield bonds also offers diversification, according to spokeswomen for the companies. **American Funds** declined to comment, said spokeswoman Maura Griffin.

Three of the nine largest target-date fund companies don't have any junk bonds in their 2010 or 2015 target-date funds: **Vanguard Group Inc.**, **Wells Fargo & Co.** and **ING Groep NV**. Their overall bond holdings range from 35 percent in ING's fund to 65 percent in Wells Fargo's fund.

#### Muddy Waters

"We use our bond portfolio to mitigate potential equity risk. High-yield could start to muddy those waters," said **James Lauder**, chief executive officer of Global Index Advisors Inc. and co-portfolio manager of **Wells Fargo's** target-date series. **Vanguard Group's** avoidance of high-yield bonds is "very conscious," said **John Ameriks**, head of the company's investment counseling and research group. Junk bonds wouldn't add "significant diversification," and would raise expenses, he said.

The Senate Special Committee on Aging held hearings earlier this year after lifecycle funds lost as much as 41 percent in 2008, according to Morningstar, while the Standard & Poor's 500 Index dropped 38 percent.

#### 'Excessive Risk'

"I am extremely disturbed by the amount of junk bonds found in many 2010 target-date funds," said Senator **Herb Kohl**, a Wisconsin Democrat and committee chairman. "Stronger regulation is needed to ensure that participants on the brink of retirement are not exposed to such excessive risk."

Lack of disclosure on investments in target-date funds is one of the biggest problems with employers using them as an automatic option, said Richard Michaud, president of **New Frontier Advisors**, a Boston-based investment advisory firm.

"A default fund is by definition something you should be able to invest in without much thought," Michaud said. "Many of these funds have a wide variety of risk."

One of the reasons high-yield bonds are riskier than government or other corporate bonds is because they're less liquid and may be more difficult for fund managers to sell in weak markets, said **Paul Tramontano**, co-chief executive officer of **Constellation Wealth Advisors**, an independent advisory firm based in New York with about \$4 billion in assets.

#### Better Returns

"High-yield is an asset class that you don't want to have to sell at the least opportune time," said Tramontano of high-yield bonds.

High-yield bonds, including reinvested interest, have returned 54.8 percent this year as of Dec. 14, the most ever, according to Merrill Lynch & Co.'s U.S. High Yield Master II index.

Fund managers may be using high-yield bonds to gain better returns due to their performance this year, said Wood, the pension consultant. They also generate more fees because the funds typically have a higher expense ratio, he said.

The mere presence of junk bonds in a fund isn't necessarily a problem, said **Mercer Bullard**, founder of Fund Democracy, a consumer group that advocates on behalf of mutual-fund investors. The problem is with the **Department of Labor**, which hasn't issued investment guidelines for automatic 401(k) plans, since by definition they're for consumers who aren't savvy investors, he said.

#### Detective Work

"The onus is on the investor to go and find out what's in the funds before investing," Bullard said.

The Labor Department said it doesn't dictate specific investment allocations, Assistant Labor Secretary Phyllis Borzi said in an e-mail.

Discovering what's inside a target-date portfolio takes detective work, said Morningstar's Lutton. An investor receiving a semi-annual report for **Fidelity's Freedom 2010** Fund, for example, would need to read through to page 20 to find the allocation in its high-yield fixed-income funds. The report doesn't break down the percentages of bonds rated below investment grade. Investors may access that data by looking up the **fund's report** by Morningstar and clicking on the "Portfolio" tab.

Fidelity's **Freedom 2010** fund held 25 underlying funds, according to Bloomberg data.

"The fact that these investments are so complex and the disclosure is not so robust makes it challenging for the individual to know what's in there," Lutton said.

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