

Ibbotson Target Maturity Report Q2 2009



Tom Idzorek

Chief Investment Officer
and Director of Research

Ibbotson Associates

Ahh – relief! The stock market rally that started in March continued throughout the second quarter ending the string of six consecutive quarters in which the average target maturity fund lost money. These six consecutive quarters have investors, the press, and the government rightfully questioning the efficiency and usage of target maturity funds. The ire over a year and half of negative returns culminated with a joint SEC and DOL hearing examining target maturity funds on June 18. Following our traditional report on the performance of target maturity funds, we present our view of the hearings.



Rod Bare

Director of Asset Allocation
Indexes

Morningstar, Inc.

Target Maturity Performance Summary

The average target maturity fund returned 15.5% during the second quarter, slightly below the S&P 500 Index, which gained 15.9%. The weighted-average return of the 13 indices that collectively form the Moderate Morningstar Lifetime Allocation Index family was 15.3%.¹ Despite the recent gains, on a year-over-year basis, the average target maturity fund lost 20.7%, while the S&P 500 Index and the Moderate Morningstar Lifetime Allocation Index family lost 26.2% and 19.1%, respectively.

Table 1: Target Maturity Performance Summary

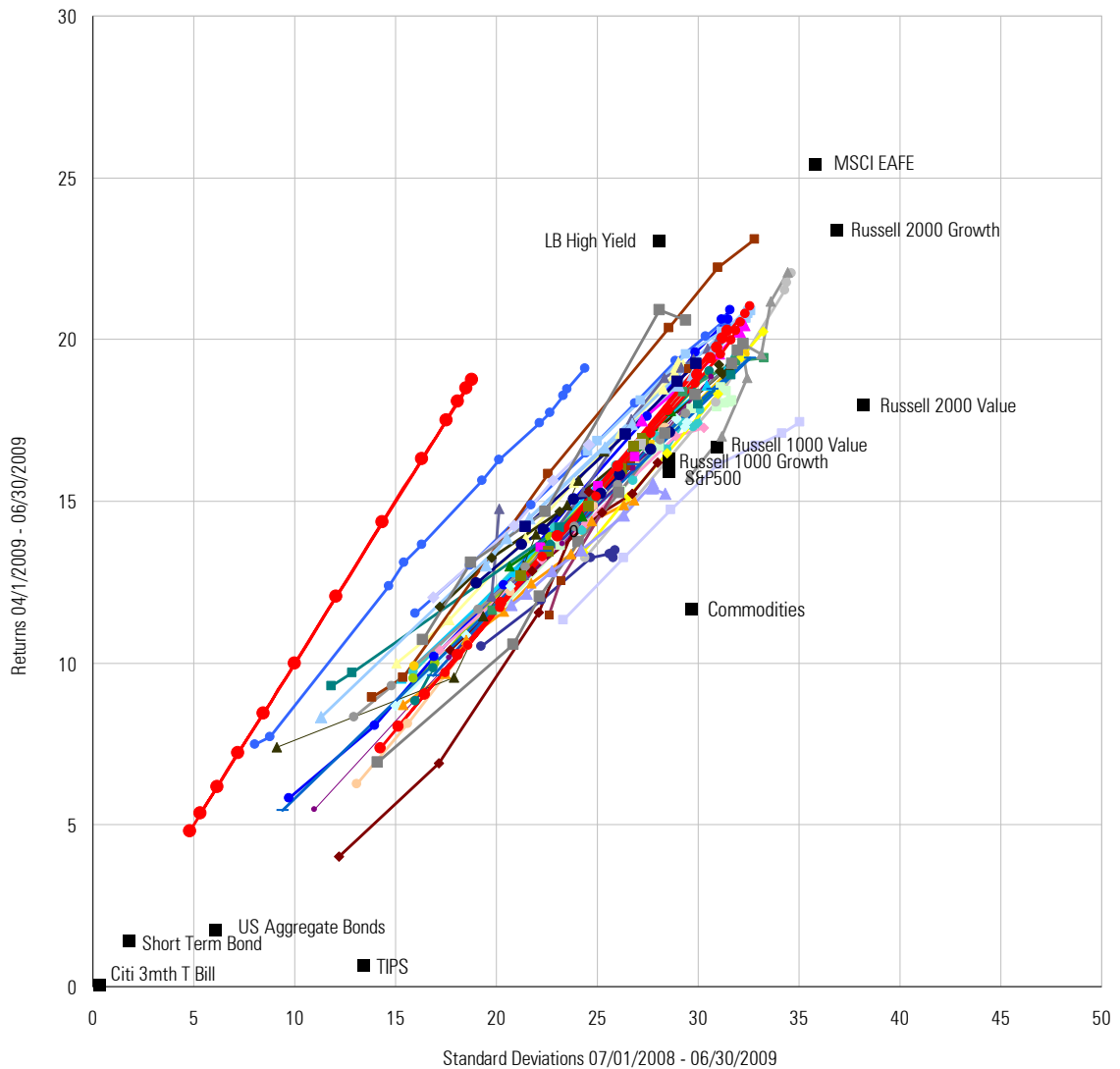
	Q2 Return	12 Month Return Ending June 30 2009
Average Target Maturity Fund	15.5%	-20.7%
Moderate Morningstar Lifetime Allocation Index	15.3%	-19.1%
S&P 500 Index	15.9%	-26.2%

¹ Ibbotson Associates creates the glide paths and asset allocations for the 39 indexes that form the Morningstar Lifetime Allocation Index family using our Lifetime Asset Allocation framework. The weighted average return presented here for the Moderate Morningstar Lifetime Allocation Index is based on the number of funds currently in each of the 13 respective date-based categories, 2055 to Income.

Fund Family Performance

The performance of target maturity fund families during the second quarter is summarized in Figure 1. We are now tracking 312 unique target maturity funds with at least a one-year track record representing 48 fund families. The lines in the graph connect funds from the same fund family. This efficient frontier-like risk and return graph enables one to see the distinct performance of different fund families. Plot points that are northwest (up and left representing high return and low risk) are better. In sharp contrast with the last two quarters in which only one fund eked out a positive return; this quarter all target maturity funds had a positive return. As we typically observe, the aggregate stock-bond split was the primary driver of *total* returns. Relative return differences among funds with similar aggregate stock-bond splits are caused by detailed asset allocation differences and manager specific performance. The three Morningstar Lifetime Allocation indexes are displayed in red with red circles.

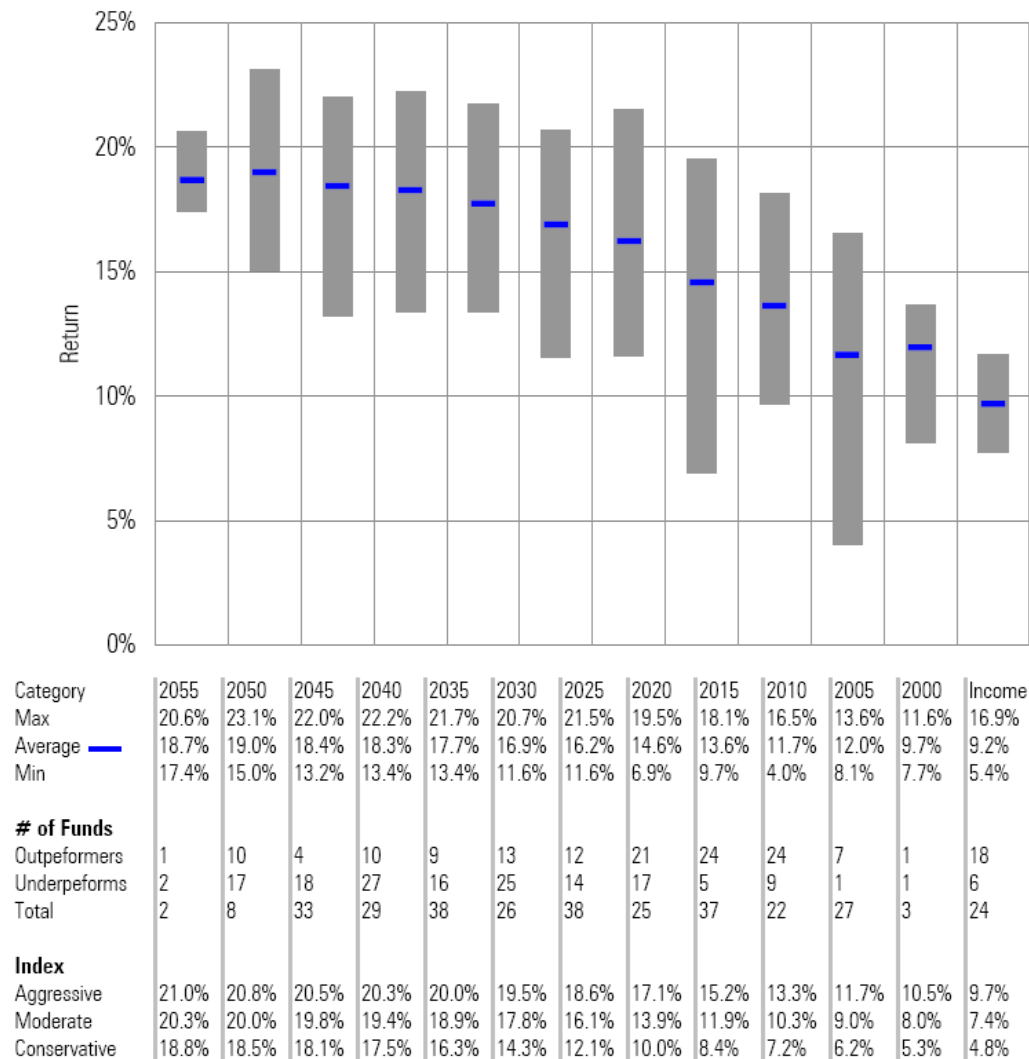
Figure 1: Target Maturity Fund Family Performance Q2 2009



Target Maturity Fund Performance

In Figure 2 the floating gray bars show the range of returns for the 13 target date-based categories. The blue lines near the middle of the bars identify the average fund performance for each category. As usual, there are meaningful differences between the best-performing funds (Max row) and the worst-performing funds (Min row) reflecting the substantial “intra-category” differences in equity exposure. In up markets in which aggregate equity exposure is the primary driver of performance, such as this quarter, the blue lines identifying the averages form a pattern that resembles a typical equity glide path. The table identifies the number of mutual funds in each peer group that outperformed or underperformed the peer group’s corresponding Moderate Morningstar Lifetime Allocation Index based on Ibbotson’s Lifetime Asset Allocation methodology. Relative to the Moderate Morningstar Lifetime Allocation Index family, 154 funds outperformed and 158 underperformed.

Figure 2: Target Maturity Fund Category Performance Q2 2009



Source: Ibbotson Associates and Morningstar

Asset Class Performance

Table 2 helps us attribute fund performance differences to various asset class exposures. The table contains quarterly performance for the most common asset class building blocks that make up target maturity funds.

Table 2: Asset Class Performance Q2 2009

Asset Class	Q2 2009 Return	12-Month Standard Deviation
US Large Growth	16.3%	28.5%
US Large Value	16.7%	30.9%
US Small Growth	23.4%	36.8%
US Small Value	18.0%	38.2%
Non-US Developed	25.9%	35.8%
Emerging Market Stocks	34.8%	47.4%
Real Estate	28.8%	61.2%
Commodities (Futures)	11.7%	29.6%
High Yield	23.1%	28.0%
US Aggregate Bonds	1.8%	6.1%
US Short-Term Bonds	1.4%	1.8%
TIPS	0.7%	13.4%
Cash	0.1%	0.3%

Source: Ibbotson Associates and Morningstar DirectSM

As some hedge fund managers call it, the “dash for trash” began on March 9 and continued throughout the second quarter. All of the asset classes had positive returns. Most of the fixed income asset classes were slightly positive; however, high yield bonds returned 23.1% besting many of the equity asset classes and helping the performance of target maturity funds that implement a portion of their fixed income asset allocation with high yield. The equity asset classes were all sharply positive. Emerging market stocks, non-U.S. developed stocks, and real estate were the standout performers helping funds with higher than average exposures to these asset classes. Within U.S. equities, small-cap stocks outperformed large-cap stocks.

Morningstar Lifetime Allocation Indexes

Table 3 presents the performance figures for the complete Morningstar Lifetime Asset Allocation Index family. The Morningstar Lifetime Allocation Index family is based on Ibbotson's Lifetime Asset Allocation methodology.

Table 3: Morningstar Lifetime Allocation Indexes

<i>(As of 6/30/2009; multiyear periods annualized)</i>	1 Mo	3 Mo	1 Yr	3 Yr	5 Yr
Income					
Conservative Income	(0.08)	4.80	(4.57)	3.88	4.60
Moderate Income	(0.10)	7.38	(8.63)	2.10	4.08
Aggressive Income	(0.12)	9.71	(12.45)	0.37	3.54
2000					
Conservative 2000	0.02	5.35	(4.77)	3.79	4.71
Moderate 2000	(0.03)	8.05	(9.06)	1.91	4.16
Aggressive 2000	(0.07)	10.54	(13.22)	0.03	3.57
2005					
Conservative 2005	0.11	6.18	(5.40)	3.51	4.75
Moderate 2005	0.04	9.02	(10.00)	1.50	4.17
Aggressive 2005	(0.03)	11.72	(14.61)	(0.59)	3.50
2010					
Conservative 2010	0.18	7.22	(6.41)	3.08	4.74
Moderate 2010	0.09	10.26	(11.46)	0.87	4.11
Aggressive 2010	(0.02)	13.27	(16.74)	(1.55)	3.30
2015					
Conservative 2015	0.23	8.44	(7.77)	2.51	4.72
Moderate 2015	0.10	11.86	(13.62)	(0.07)	3.96
Aggressive 2015	(0.04)	15.15	(19.60)	(2.87)	2.91
2020					
Conservative 2020	0.25	9.98	(9.75)	1.68	4.64
Moderate 2020	0.07	13.91	(16.70)	(1.46)	3.58
Aggressive 2020	(0.10)	17.08	(22.69)	(4.35)	2.37
2025					
Conservative 2025	0.22	12.05	(12.74)	0.39	4.35
Moderate 2025	(0.00)	16.08	(20.16)	(3.07)	3.01
Aggressive 2025	(0.16)	18.63	(25.17)	(5.55)	1.89
2030					
Conservative 2030	0.14	14.35	(16.31)	(1.22)	3.85
Moderate 2030	(0.08)	17.83	(23.01)	(4.43)	2.48
Aggressive 2030	(0.21)	19.54	(26.47)	(6.16)	1.66
2035					
Conservative 2035	0.05	16.30	(19.45)	(2.67)	3.30
Moderate 2035	(0.14)	18.90	(24.60)	(5.17)	2.20
Aggressive 2035	(0.22)	19.98	(26.82)	(6.27)	1.70
2040					
Conservative 2040	(0.01)	17.50	(21.25)	(3.49)	3.00
Moderate 2040	(0.16)	19.42	(25.12)	(5.37)	2.21
Aggressive 2040	(0.23)	20.27	(26.86)	(6.23)	1.83
2045					
Conservative 2045	(0.03)	18.10	(21.96)	(3.77)	2.97
Moderate 2045	(0.17)	19.75	(25.27)	(5.37)	2.31
Aggressive 2045	(0.23)	20.53	(26.85)	(6.15)	1.98
2050					
Conservative 2050	(0.04)	18.50	(22.25)	(3.84)	3.03
Moderate 2050	(0.17)	20.04	(25.31)	(5.32)	2.44
Aggressive 2050	(0.23)	20.78	(26.83)	(6.06)	2.13
2055					
Conservative 2055	(0.05)	18.76	(22.30)	(3.82)	3.08
Moderate 2055	(0.18)	20.28	(25.29)	(5.25)	2.51
Aggressive 2055	(0.24)	21.04	(26.81)	(6.00)	2.21

Fund Flows

Starting with this report, we are reporting target maturity fund flow data from Morningstar's Fund Flow database, which is available via Morningstar Direct^{SM2}, our global institutional research platform. For all of the Morningstar Categories, the database tracks all individual fund flows, and hence, the aggregate fund flows for any of the Morningstar Categories. In this section, our focus is on Morningstar's 10 target maturity categories.

Flows into target maturity funds continued unabated despite poor 2008 performance and controversy around the appropriateness of their investment policies for their intended purposes. Target Maturity flows amounted to over 6% of beginning AUM for the quarter, versus 2.3% for all other open-end funds despite very strong inflows into non-Target Maturity funds year-to-date. The comparison is even starker looking back to the bleak Q4 of 2008. Target Maturity funds managed to pull in estimated net flows of \$5 billion while the rest of the industry endured \$181 billion in outflows.

In summary, the Target Maturity funds are not only surviving, they are thriving.

Table 4: Target Maturity Fund Flows Q2 2009

Target Date	Asset Under Management (Mil\$)		Estimated Net Flow Q2	Average Quarterly Flow (past four qtrs.)	Q2 Flow as a % of beginning AUM
	End Q1	End Q2			
Income	7,532	8,400	283	140	4%
2000-2010	24,261	27,398	243	(224)	1%
2011-2015	20,279	23,891	1,041	880	5%
2016-2020	33,242	40,068	1,698	1,327	5%
2021-2025	19,004	23,475	1,476	1,359	8%
2026-2030	23,375	29,167	1,655	1,555	7%
2031-2035	11,827	15,130	1,191	1,160	10%
2036-2040	13,646	17,539	1,348	1,266	10%
2041-2045	4,808	6,356	674	634	14%
2050+	2,545	3,496	475	434	19%
Totals	160,518	194,921	10,083	853	6%

Source: Morningstar DirectSM

² For more information on Morningstar DirectSM and the fund flow data, visit <http://corporate.morningstar.com/us/asp/subject.aspx?xmlfile=2955.xml>.

The Joint SEC DOL Hearing on Target Maturity Funds

On June 18, the Securities and Exchange Commission (SEC) and the Department of Labor held a joint hearing on target maturity (or date) funds. One of the authors of this report, Rod Bare, testified at the hearings. While it is difficult to predict what will come from the hearings, we think the most likely action is increased disclosure requirements regarding the risk(s) associated with the funds, the amount of current and future anticipated equity exposure of the funds, and if the glide path of the fund goes “to” retirement or “through” retirement. Here we recap the major themes of the hearings and present our opinions on the themes and points of contention that emerged.

While there were a wide variety of opinions, five themes emerged from the majority of the panelists:

1. Most panelists believe that target-maturity solutions are a great innovation for investors;
2. Most panelists are open to greater required disclosure;
3. Most panelists are against any sort of mandated “one-size-fits” all or “range” requirement for target-date fund glide paths;
4. Most panelists believe that target-date funds should not only contain equity at the point of retirement, but that glide paths should continue to evolve during retirement; and,
5. Most panelists agreed that the participant’s savings rate is the most important factor influencing a successful retirement.

In general, Ibbotson shares the majority opinion on these issues: Target-maturity solutions are extremely beneficial to the majority of plan participants; better disclosure is necessary; customization and choice are good and mandated asset allocations are bad; the glide path should continue to evolve after retirement to meet the changing needs of retirees; and a proper savings rate during accumulation is the most important determinant of future retirement success.

There was considerable consensus around these themes, but we think that it is important to address one of the dissenting opinions regarding whether or not glide paths should continue to evolve during retirement. One panelist asserted that the only acceptable goal of target-maturity solutions is to get the participant “to” the retirement date, and at that point the retirees’ equity should be invested entirely in fixed-income vehicles. We strongly disagree for three reasons. First, in the vast majority of potential future outcomes, such a strategy will significantly reduce the quality of an investor’s retirement. Next, a significant and growing number of participants remain in their 401(k) plan after retirement, and a large percentage of participants tend to “do nothing;” thus, the strategy should continue to evolve throughout retirement to help those that remain in the funds. We should note that it is often beneficial to remain in a 401(k) plan after retirement, given that retail rollover accounts often come with higher fees. Finally, investing entirely in fixed income at retirement suggests that all investors are identical. The economic situations and risk preferences of investors vary significantly.

Whether target-date funds should be managed “to” retirement or “through” retirement was mentioned by a large number of panelists. Most of the panelists that touched on this subject expressed the opinion that target-date funds should be managed “through” retirement. Some panelists referred to funds that evolve through retirement as “lifecycle” or “lifetime” funds. Two panelists called for naming conventions that distinguish between funds that are managed “to” retirement and those that are managed “through” retirement. Ibbotson has always felt that the use of a target retirement date in fund names is less than ideal, and Ibbotson advocates the use of birth date as a superior convention. Additionally, we prefer to use the word “lifetime” in the naming of our solutions to emphasize that our solutions continue to glide throughout an investor’s lifetime.

Several secondary themes and points of contention were also apparent from the panelists' testimony. A number of panelists expressed the position that retirement plans' widespread use of proprietary target-date funds, in which all of the underlying managers are from the same fund manufacturer, represents a step backward. Numerous 401(k) plan sponsors and consultants advocate the advantage of open-architecture plan lineups and investment solutions. Panelists identified potential problems with self-dealing and conflicts of interest for off-the-shelf funds that design a glide path and then implement the glide path with proprietary managers. The primary fear is that the glide paths from these conflicted providers may have larger-than-warranted allocations to asset classes associated with higher fees, such as equity asset classes or various alternatives. Secondary concerns include channeling the funds to underperforming internal managers and the seeding of new startup managers. Panelists from asset management firms dismissed these potential conflicts of interest, but we think the potential conflicts are clear.

Building on the idea of best practices, several panelists applauded the movement of large 401(k) plans to custom target-maturity solutions. Clearly, Ibbotson believes that the movement of large plan sponsors to a custom target-maturity glide path that is developed by an independent third party asset allocation expert and then implemented with the plan sponsor's best-in-class institutionally priced investment options is beneficial to plan participants.

Several panelists discussed the innovative work that is being done to combine target-maturity solutions with insurance guarantees, and the hurdles (single-carrier risk, portability, and cost) such products face. Ibbotson believes that insurance products can play an important role in reducing the longevity risk faced by retirees, and we hope that regulators will encourage such innovations.

A couple of panelists stated their belief that "managed accounts" are a superior alternative to target-maturity solutions. Ibbotson offers both managed accounts and target-maturity solutions, and we believe that managed accounts are superior, especially when participants provide us with enough information on their unique financial circumstances. Target-maturity solutions are an excellent alternative to managed accounts. We believe that target-maturity solutions and a managed accounts program can be complementary—younger participants could start in a target-maturity solution and then transfer into managed accounts as their financial situation becomes more complicated, for example.

Interesting survey-based data highlighted that many investors do not understand the risks associated with target-date funds, with some investors thinking that traditional target-date funds offer some form of guarantee or minimum. Ibbotson thinks that it is incorrect to attribute this type of confusion directly to target-date funds; rather, this type of investor confusion speaks to the overall lack of understanding of retirement plans and investment products. Not many investors know, for example, the difference between defined contribution (DC) plans and defined benefit (DB) plans, and which kind of plan provides a guaranteed income.

Finally, and not surprisingly, there was no agreement regarding the best glide path or how to develop it.

Why Target Maturity Solutions Make Sense

Target maturity funds remove investors from the burden of constructing a portfolio of individual mutual funds. We believe target maturity funds absolutely make sense and the reasons are grounded in modern portfolio theory and what we like to call lifecycle finance. By no means are we saying that target maturity funds are perfect solutions.

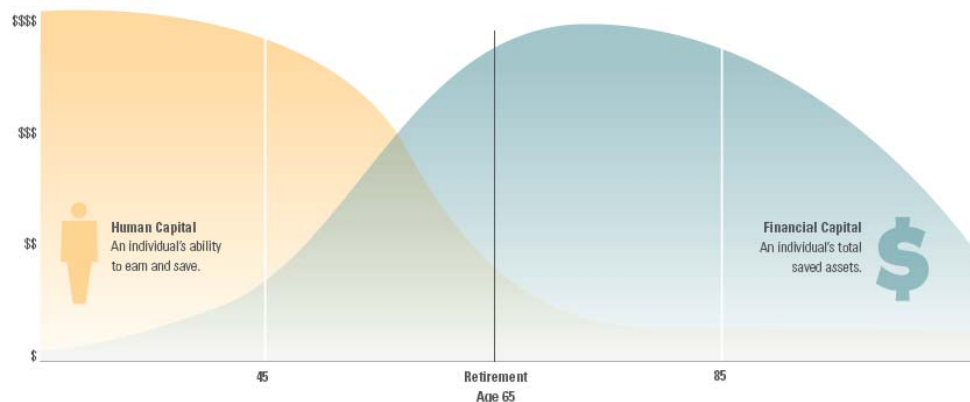
A central tenant of modern portfolio theory – mostly the work of Nobel Prize winners Harry Markowitz and William Sharpe – is the idea that there is a single, global all-inclusive basket containing all tradable and non-tradable goods held at their respective market values that has the best possible risk and return characteristics of any portfolio. This is a profound idea. The key implication is that all investors should attempt to emulate the weighting scheme of this all-inclusive market basket with their own portfolios. More precisely, investors should organize a portion of their total economic worth to emulate the market portfolio and then either borrow or lend money to create a complete mix that meets their particular risk appetite.

It's important to elaborate on two related items that deserve further explanation – non-tradable goods and total economic worth. The most significant non-tradable good in the all-inclusive market portfolio is the aggregate human capital of the world—individuals' potential to earn and save. Academics typically estimate that human capital represents 60% to 80% of the market portfolio. Another way of thinking about the tradable and non-tradable components of the market portfolio is as financial capital and human capital. Like the market portfolio, the total economic worth of any investor is made up of the same two components—financial capital and human capital.

Researchers almost uniformly agree that the investment-like characteristics of a typical person's human capital is more bond-like than stock-like. Ibbotson believes that the typical investor's human capital is like a junk bond – during good times the cash flows from human capital are steady (bond-like) and during bad times the cash flows are volatile (stock-like).

Figure 4 displays how the two key components of total economic worth evolve for a typical investor on a relative basis. Intuitively, young investors have substantial human capital and very little financial capital. As investors age, they typically save or convert some of their human capital into financial capital. Notice that human capital does not go to zero at the assumed retirement age of 65 because individuals can always return to work (a real option), and they have accrued deferred labor income in the form of Social Security and, for some, a defined benefit pension.

Figure 4 – Lifecycle of Total Economic Worth



As the ratio of human capital to financial capital changes over the investor's lifetime, their investments must also change to keep their total economic worth in line with the hypothetical optimal market portfolio. That is why target date funds make sense. For example, given that human capital is more bond-like than stock-like, and young investors have a great deal of human capital, their total economic worth does not look like the market portfolio of modern portfolio theory. Young investors have an over weight in bonds. To bring their economic worth closer to the optimal balance implied by the market portfolio, young investors need to invest practically all of their financial wealth in stocks. Over time, as investors convert human capital into financial capital and financial wealth constitutes a larger proportion of their total economic worth, they can slowly reduce the amount that is invested in stocks. Whether the fund manufacturers intended it or not, all of the target maturity fund glide paths that we are tracking have glide paths that are consistent with this modern portfolio theory-based framework. So yes, target maturity funds and the shape of their respective glide paths make sense!

About Ibbotson

Ibbotson Associates is a leading independent provider of asset allocation, manager selection, and portfolio construction services. The company leverages its innovative academic research to create customized investment advisory solutions that help investors meet their goals.

For more information, contact:

Ibbotson Associates
22 West Washington Street
Chicago, Illinois 60602
312 696-6700
312 696-6701 fax
ibbotson.com

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Appendix: Index Definition

Morningstar Lifetime Allocation Indexes are a family of multi-asset class target maturity indexes available in three risk tracks: Aggressive, Moderate, and Conservative. Each risk track consists of 13 indexes ranging from a 2055 index to an income index. The glide paths and strategic asset allocations of the indexes is based on Ibbotson's Lifetime Asset Allocation methodology. Security selection for each sub asset class in the index family is provided by a matching Morningstar market index.

Standard & Poor's 500 Index: Market-capitalization-weighted index of 500 widely held stocks. Member companies are chosen based on market size, liquidity, and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies.