



Assessing the Damage of January, 2008 on Global Stocks and Target Date Lifecycle Funds

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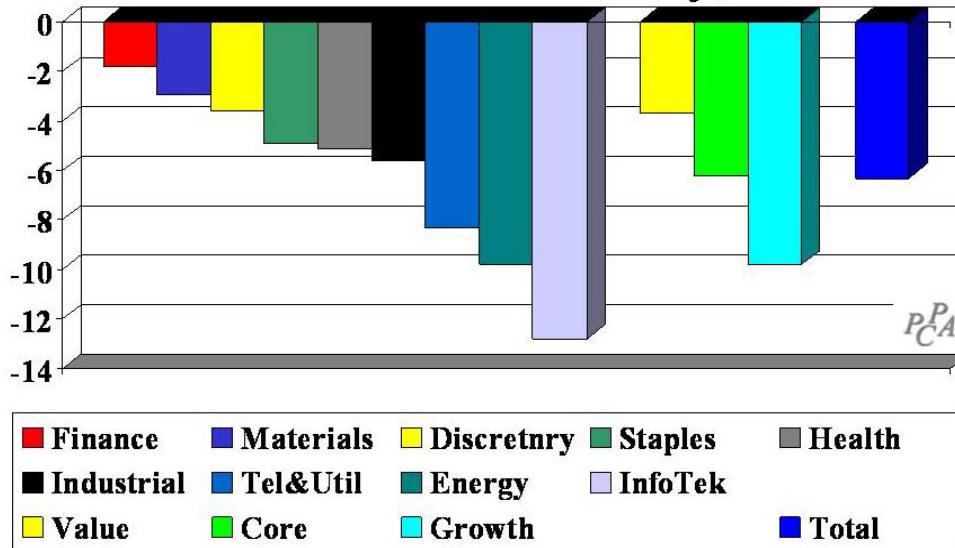
Global stock markets were hammered in January, with US stocks losing 6% and foreign companies faring even worse, losing 10%. This follows a 2-month November-December, 2007 US loss of 5%, so the US market is down 11% for the 3 months ending January 31, 2008. It's been miserable and worrisome. The following commentary assesses the January damage. We first examine domestic style and sector returns, and then move outside the US for more bad news.

As investors react to the current dilemma, many will be looking to their target date lifecycle funds, which are becoming the mainstay of defined contribution retirement plans, as well as college savings plans. We report on how these funds fared in January. Also, we have conducted detailed analyses of target fund performance over the past 3 years, which is pretty much the entire history of this blossoming industry. You'll be surprised to learn what is working and what is not, at least so far.

Global Stock Market Losses: Reversals of Fortune

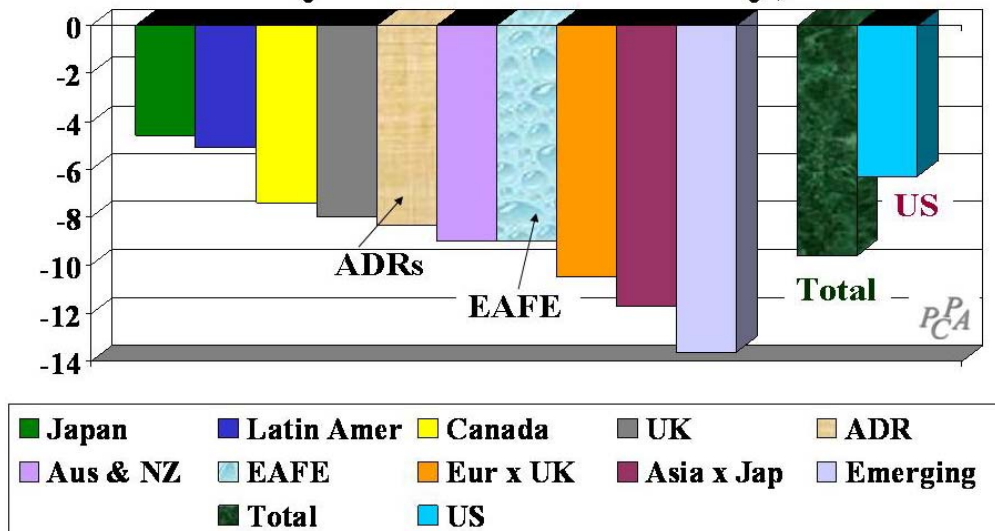
Since much of the blame for the current market decline has been placed on the credit crisis, wouldn't you think that the Finance sector would have been hit hard in January? Not so. Finance was the best performing US sector on a relative basis, losing "only" 2%. Further contorting expectations, those sectors that had been doing well, namely Energy and Information Technology, were the hardest hit, losing 10% and 13% respectively. And to round out this regression toward the mean, value outperformed growth, whereas growth outperformed value in 2007. As investors sold off their winners there was no place to hide in January. Every sector and every style lost value. We use Surz Styles throughout this commentary, as described at [Surz Styles](#).

U.S. Losses for January, 2008



Turning our attention beyond the US, foreign markets lost 10% in January, and also evidenced the mass selling of winners. As the next exhibit shows, Japan, which had been the worst performing country, performed best, losing “only” 4.5%, while the best performing region of this century, Emerging Markets, lost the most, declining 14%. Foreign markets had been persistently outperforming the US for the past 8 years, so January represents a reversal of this long trend.

Country Losses for January, 2008

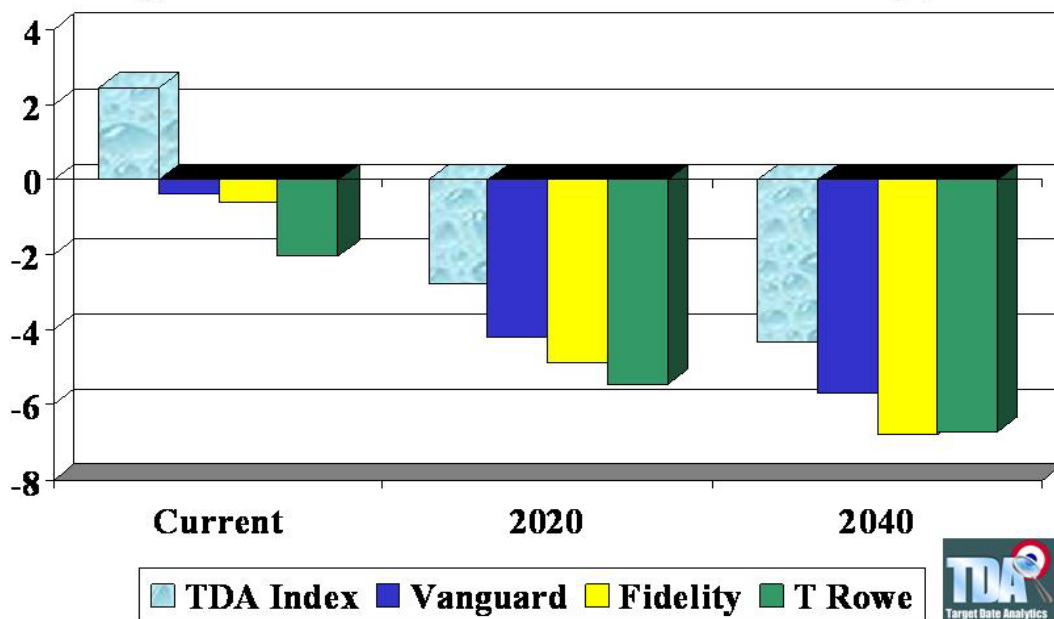


Target Date Lifecycle Funds

I founded a new company last year to provide advice and guidance on target date lifecycle funds, which are becoming the mainstay of defined contribution retirement plans. Target Date Analytics (TDA) provides educational papers, benchmarks, and analyses of target date mutual fund performance, all for free, at least for now -- **our gifts to you. Please visit us at www.TDBench.com.**

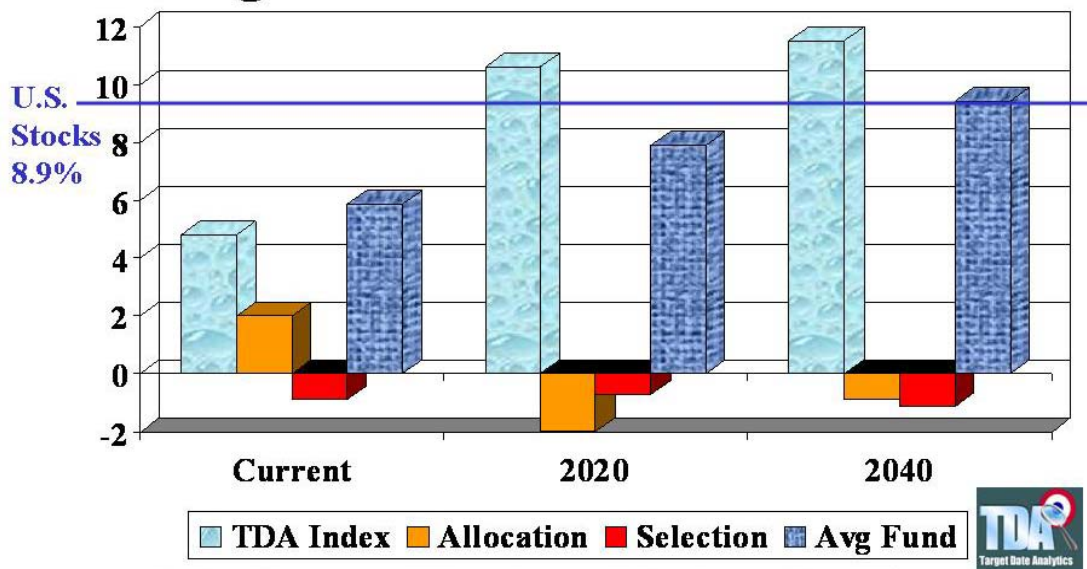
With stocks down more than 6%, and T-Bills earning a meager .3%, it was hard to get out of the way in January. As you can see in the following exhibit, even the “current” funds, which are those whose target dates have passed, lost value in the month, although our benchmark earned a positive return. The exhibit shows the performance of the 3 largest target date families – Vanguard, Fidelity, and T. Rowe Price. These 3 providers currently dominate the target date fund industry. The glide paths of most target funds start out fairly aggressive, with higher equity exposures, and then become more defensive as the target date nears, so we expect current funds to protect in this environment, but the January results are disappointing, primarily because these funds have substantial equity exposure. By contrast, our Target Date Analytics (TDA) Defensive Pure Index Series, which is our signature benchmark, is all cash and TIPs at the target date, so as you can see it came through January just fine. Extending the horizon for longer-dated funds shows that losses grew with longer dates because these funds have greater equity exposures.

Target Date Returns for January, 2008



But one month is an awfully short time to make judgments about fund performance. TDA is proud to announce that we have completed attribution analyses of all target date mutual funds with 3 years of history or more, which is pretty much the complete history of this industry. A quick overview of our findings is presented in the next exhibit.

Target Date Attribution for 2005-2007



$$\text{Index Return} + \text{Allocation} + \text{Selection} = \text{Fund Return}$$

The “TDA Index” in the exhibit is our signature Pure Target Defensive Series. We calculate the “Selection” effect by using each mutual fund’s actual average allocation to 5 asset classes during the 3 years and applying these to passive index returns. The difference between the fund’s actual performance and this passive return is the Selection effect. The 5 asset classes are U.S. Stocks, Foreign Stocks, Bonds, Cash, and Other. Then we measure an “Allocation effect” as the difference between the return on this passive implementation of the fund’s actual allocation and our benchmark’s return, since our benchmark is almost entirely passively managed. This Allocation effect is driven primarily by differences between the mutual fund’s glide path and the glide path of the TDA Index.

Most near-dated target funds outperformed our Defensive Pure Target Index benchmark over the past 3 years because of their higher equity exposure, which generates a good Allocation score. Equities performed better than cash and bonds in the past 3 years, and our Defensive Index is entirely cash and bonds at target date.



By contrast most longer-dated mutual funds have negative Allocation scores because they are less diversified, and occasionally less aggressive, than the Defensive index.

Selection scores for the past 3 years are generally negative across all target dates, indicating that passive implementation of the actual asset mix would have served investors better.

In summary, our Defensive Pure Target Series tends to have similar equity allocations to most target date funds in early years, when the horizon to target date is long, and less equity in later years, as the target date nears. However, our index's equity allocations at all times are substantially more diversified than most target date mutual funds. Consequently, in a rising equity market, the index is easy to beat for current and near-dated funds, and hard to beat for distant dates. Of course, this tendency will reverse in a weak or falling equity market. (For example, there were a total of 50 Current and 2010 Target funds with one-year performance as of 12/31/2007---49 of them underperformed the Defensive Pure Target Index by over 330 bps on average). In other words, mutual funds tend to use different glide paths than our Defensive Pure Target Series. Please see the TDA Website for the rationale underlying our benchmark glide path. It's based on solid logic including Probability of Loss Theory and Liability-Driven Investing (LDI). We expect our long-dated indexes to be difficult to beat in most market environments, setting the standard for the future.

On the security selection front we find persistently negative scores, indicating value subtracted by active management across the board. This persistence is even more pronounced than the tendency for active single asset class managers to underperform their benchmarks. The promise of enhanced performance through active management is not being delivered by most target date funds.

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