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A New Generation Of Life Cycle Funds

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Most financial planning experts agree that in order for people to maintain the same standard of living when they **retire**, their **retirement** income needs to be equal to at least 70 per cent of their pre-**retirement** earnings. Government **pension plans** will provide a modest base income to which additional savings must be added, mainly from employer **pension plans** and personal **retirement** savings. With the baby boomers **retiring** and the life expectancy of Canadians increasing, employer **pension plans** have become an essential component of the **benefits** offered to employees.

While people understand the importance of saving for **retirement**, the average person doesn't generally show a great deal of interest in the financial planning associated with this important task. Most people would rather go out with their friends on a Saturday night than sit at home doing something as dull and tedious as planning for their **retirement**. As a result, **group pension plan sponsors** need to appeal to their employees and promote the importance of saving for **retirement** so the plan members will be more inclined to join the **pension plan** and make regular contributions.

To simplify matters for **plan sponsors**, there are **investment** solutions designed specifically to make enrolling in a **group pension plan** as easy as possible, and to make the process of choosing **investments** fast, easy, and efficient.

Keep It Simple

The '90s were a decade of 'à la carte' solutions driven by the demand from plan sponsors to give members more investment choices to enable them to build their own investment portfolios. However, the volatility of the stock markets of the past few years has made investors realize that investing isn't as easy as they thought.

Since then, people have demonstrated a strong need for simplified investment solutions. Thus, in the past few years, we have witnessed a strong trend towards turnkey investment solutions such as asset allocation funds. These solutions have the advantage of offering a series of diversified investment portfolios, managed by investment specialists, that respect the profile of each investor.

A person's investor profile is associated with their risk tolerance level. This is measured by assessing various characteristics of the investor – their personal financial position, age, their investment horizon, their economic and financial knowledge, and their tolerance to risk. Generally, the tool used for this assessment is a questionnaire where the scoring system classifies the respondents into a particular investor profile category, depending on their score. These approaches should satisfy the needs of most plan members.

However, remember, most group pension plan members have little interest in financial planning. Canadian plan sponsors find getting their members to enrol in a plan to be a challenge and wrestle with the problem of too many plan members in a default option, which is only designed as a parking spot while they create an individual portfolio and not as the longterm solution to their retirement planning needs.

So even simpler, but effective, solutions are needed. Life Cycle Funds or Target-Date Funds, which have been available for a few years now in Canada, are a solution which is attracting more attention.

What Are Life Cycle Funds?

Group pension plan members who choose to use a Life Cycle Fund virtually put their portfolio on 'automatic pilot.' Life Cycle Funds are diversified portfolios allocated among fixed income and equity funds whose asset allocation, and risk level, is defined by the current age of the plan member and a target retirement year. Designed to make life easier for members, the main characteristic of these funds is that their asset allocation is adjusted automatically to maximize growth potential at the start of the investor's career and then gradually, over time, become more conservative thereby preserving their capital as the retirement date approaches. In other words, these funds use an old fundamental investment principle – diversification – and add a dynamic dimension – over time – so plan members can be sure that their investments are in line with their needs at all times.

Since their creation, Life Cycle Funds have gained in popularity thanks to their simplicity and flexibility. These funds offer a solution that is unique in both the peace of mind they offer investors and the focus they preserve.

Life Cycle Funds meet a growing need to invest appropriately for retirement. Investors who do not have access to such solutions must determine how to allocate their assets, rebalance their portfolio periodically, and make adjustments over time to ensure that their investments continue to meet their changing needs. Life Cycle Funds offer a turnkey solution that evolves over time.

The Perfect Solution?

Traditional Life Cycle Funds, which we've just described, are not the perfect solution, however. One asset allocation is not ideal for everyone who is 'X' years old and plans to retire in year 'Y.' For example, a 35-year-old who follows the stock market closely and who is a risk-taker will want a different asset allocation than someone who is the same age but more conservative, and who has significant family responsibilities, even if both of them plan to retire the same year and, therefore, have the same investment horizon. Traditional Life Cycle Funds only take into account the time remaining until retirement and completely ignore individual differences like financial knowledge, accumulated savings, and risk tolerance. They use the same format for anyone with the same investment horizon!

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For many years, financial experts have been telling investors how important it is to determine their investor profile and make their investment choices accordingly. However, this concept that is so vigorously promoted is ignored in traditional Life Cycle Funds, which only take into consideration the investment horizon. Why not integrate this key factor – the willingness to take risk – which is still, without a doubt, a fundamental investment principle?

This is what the new generation of Life Cycle Funds offers. Thus, in addition to looking at the investment horizon, this 'improved' generation of Life Cycle Funds also takes into account each investor's attitude toward risk. With this unique, avantgarde solution, each plan member can invest in a portfolio that will be automatically adjusted over time to preserve their capital as retirement approaches, while respecting their investor profile at all times. This new approach offers the best of both worlds, combining respect for the investor's risk tolerance with automatic adjustment of their asset allocation based on how much time is left before retirement.

These 'improved' Life Cycle Funds are also an especially attractive investment option to help plan sponsors achieve the sound governance standards for capital accumulation plans set out in the guidelines published by the Joint Forum of Financial Market Regulators. Under these guidelines, the choice of investment options available must take into account several factors, including the ability to review the options regularly, the diversity of the members' demographic profile, the diversification of the investment options available, and their level of risk.

The new generation of Life Cycle Funds is an investment alternative that takes into account each member's situation in terms of risk tolerance and investment horizon, that is adjusted automatically over time, making it easier for plan members to meet their responsibility to review their investment choices on a regular basis. This solution is even more attractive when you consider that plan members are not always diligent about their responsibility to get the information they need to make informed investment decisions, even though plan sponsors endeavour to make all the necessary tools and information available to them.

As well, these investment vehicles are excellent default options for plan members who have not provided any investment instructions. The plan member's contributions would then be invested in a Life Cycle Fund that corresponds to their investment horizon. Keep in mind that, under the guidelines, it is the plan sponsor's responsibility to establish default investment instructions.

How Are Life Cycle Funds Designed?

Life Cycle Funds differ from one provider to another in terms of how the assets are allocated among the various classes over time and in terms of the investment funds and managers that make up the portfolio. Nevertheless, there are certain basic principles that must be followed.

The most forward-thinking providers offer multiple-manager solutions. The selection and monitoring of these managers and their investment funds is a rigorous process using a series of qualitative and quantitative criteria such as:

- the investment firm reputation
- its expertise
- the stability and depth of the investment team
- a proven investment process
- consistent added value
- superior risk/return profile
- consistent style adherence

How well the managers and the investment funds selected complement one another is also a key factor to consider in designing the Life Cycle investment solution. It is essential to integrate the visions and investment strategies of several managers in order to maximize the diversification of the investment funds and, therefore, reduce their volatility. Regular audits must be carried out to ensure that the managers and funds initially selected are still a good complement to one another.

Certain plan sponsors will really appreciate a provider that offers them the option to build customized portfolios to meet the specific needs of their group. In these cases, the investment funds and managers and their allocation within each portfolio, along with the investor profiles and retirement dates, could then be determined according to the client's preferences.

A New Era?

We can expect the trend in investment options available under group pension plans to move toward replacing asset allocation funds with Life Cycle Funds, in particular the new generation of these funds. Some companies have already gone in this direction, and others are likely to do so before too long since these investment vehicles are the perfect way to meet the need for simplicity and peace of mind so highly sought after by today's investors. ■

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