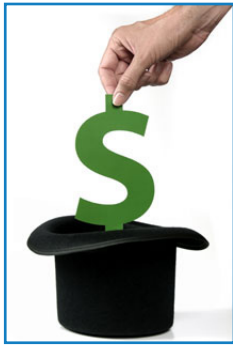


SECOND OPINION



Target Funds are Good Marketing but Lousy Personal Finance

Q: Can you talk about the pros and cons of creating your “Five-Fold” portfolio vs. investing in a targeted retirement mutual fund? Could you also touch on the practical aspects of trying to create and rebalance a Five-Fold portfolio with a variety of accounts at different investment companies. I’ve considered consolidating my 401(k) plans into existing IRAs at one firm, but I like the reduced fees, distribution flexibility and borrowing capability associated with 401(k) plans. — B.R., Texas

A: The Five-Fold portfolio is one of the Couch Potato Building Block portfolios. It is constructed with inexpensive index funds or ETFs and represents a moderate level of portfolio risk that remains constant.

The target retirement funds — now available from many mutual fund companies — are a great example of how marketing trumps actual thought in the financial services business. While their actual asset allocations differ, the common feature of these funds is that they suggest holding lots of equities when you are young and fewer when you are old. This is the conventional wisdom, but a growing body of research suggests it is wrong.

Equally important, the implicit assumption in creating a time-dated mutual fund is that the cookie-cutter approach will be appropriate for every person and household, regardless of the differences in their circumstances. In fact, there are gigantic differences between people during their careers and at retirement. The differences should be reflected in the allocation of financial assets.

We accumulate financial assets because we eventually have to replace our faded human capital — the skills, talent and energy we bring to the workplace as young workers. How our savings are invested needs to

reflect the security and prospects of our work and our age. You can’t do that with a cookie-cutter target fund.

Here are some examples:

- In your 20s you should be more conservative with your investments because your career is uncertain and you are faced with a major series of expensive projects: paying for education loans, getting married, buying a house, etc. So it’s better to take a bit less risk in your investments to support your mobility and career uncertainty.
- In your 30s and 40s you should be most aggressive with your investments because your employment is relatively secure, you’ve bought a house, and you may be able to take more risk. Even there, a tenured college professor can take more risk than a high-tech sales manager.
- In your 50s you need to dial back your risk because you are more vulnerable on several fronts. The 50s is a period of substantial life risk — health, marriage, employment and career.

- In your 60s the amount of risk you take will depend on what retirement resources you have and when you intend to use them. A worker who will have a pension, for instance, should be a more aggressive investor than a worker who has only a 401(k) plan. A worker who retires without paying off a home mortgage should be more cautious than one who has no mortgage. A lower-income worker with Social Security benefits, a pension and a mortgage-free home can be more aggressive than a high-income worker who will depend on investments for the bulk of her retirement income.

The cookie-cutter target funds don’t take any of this into consideration.

That’s why I favor the construction of portfolios that fit your particular circumstances and risk tolerance. You should also know that I didn’t pull these ideas out of thin air. They are based on following the best research available, including work by Nobel laureate Paul Samuelson. That research is now moving out of academia toward practice. The best recent example is a study funded by the Research Foundation of the CFA Institute. “Lifetime Financial Advice: Human Capital, Asset Allocation and Insurance” by

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Roger Ibbotson et al. shows why the cookie-cutter approach of the target retirement funds is sloppy personal finance. (The book is now available as a \$35 paperback through Amazon. It's not an easy read, but it should be required reading for financial planners.)

Trust me — it will be 10 years before the folks in mutual fund marketing hear about it.

If you keep your portfolio relatively simple — and you can do that with five asset classes — you will have no difficulty duplicating the same portfolio in several accounts.

(Questions about personal finance and investments may be sent by e-mail to scott@scottburns.com or by fax to 505-424-0938. Check the Web site: www.scottburns.com. Questions of general interest will be answered in future columns.)

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