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Financials, mortgage bonds still abundant in target funds

Allocation exceeds 25% in some portfolios

By **Lisa Shidler**
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Despite the many miseries of financial services companies and the mortgage crisis, some of the most popular retirement account vehicles still are invested heavily in mortgage bonds and financial stocks.

In an informal poll of financial advisers, they were surprised to learn that according to an analysis by Chicago-based Morningstar Inc. of the 25 largest target date funds, some had between 20% and 30% of total assets invested in mortgage bonds and/or financial stocks.

The Principal LifeTime 2010 Fund, offered by The Principal Financial Group Inc. of Des Moines, Iowa, had 16% exposure to mortgage bonds and 14.7% to financial stocks. The Principal's 2020 fund had 11% exposure to mortgage bonds and 16% exposure to financial stocks.

The Target Retirement 2015 Fund, offered by The Vanguard Group Inc. of Malvern, Pa., had 14% in mortgage bonds and nearly 10% in financial stocks. The T. Rowe Price Retirement 2010 Fund, offered by Baltimore-based T. Rowe Price Group Inc., had 13% in mortgage bonds and 9.1% in financial stocks.

Target date funds were set up as easy solutions to help diversify participants' portfolios. However, advisers are worried that many participants in these funds might not want to be so heavily weighted in these two sectors.

Investors shouldn't have more than 5% invested in any one sector, said Rick Epple, a financial adviser with Epple Financial Advisors LLC in Wayzata, Minn., who manages $15 million in assets.

"The simple answer is, yes, it's too much exposure," he said. "That seems extremely high, and I'm sure investors don't realize what they have in their portfolio."

Some funds are less weighted in these sectors. Boston-based Fidelity Investments' 2020 Freedom Fund has 3.2% exposure to mortgage bonds and 10.3% exposure to financial stocks.

The mortgage category broken out by Morningstar includes mortgage bonds, collateralized mortgage obligations and adjustable-rate mortgages. The financial services category includes stocks of banks, financial companies, money management firms, and savings and loan institutions.

Even though bonds are considered safe in principle, some argue in the midst of the current mortgage crisis, mortgage bonds face uncertainty.

"Bonds aren't safe if the bonds default," according to Joseph Masterson, a senior vice president at Purchase, N.Y.-based Diversified Investment Advisors Inc., which has about $45 billion in assets under administration. "Think of the number of companies that were triple-rated that no longer exist."

Mr. Masterson also pointed out that some mortgage bonds are more risky than others. "I think it's important to understand the credit quality behind different securities," he said.

The problem with these funds is that the assets are passively managed and don't reflect changes in the market, said Kevin Mahn, chief investment officer at Hennion & Walsh Asset Management Inc. of Parsippany, N.J., which manages about $300 million.

"I was surprised [there was that much invested in] the mortgage bonds but not for financials. I think lots of firms have been buying financials," Mr. Mahn said. "Those exposures are relatively high."

UNDER CONTROL

Fund leaders say they have a well-thought-out strategy for their asset allocations and feel it's dangerous to make sudden changes based on market volatility. Staying the course in the long term is critical, they said.

Randy Welch, vice president and portfolio manager of Principal's target date funds, realizes they have more exposure to financial stocks and mortgage holdings than other target date funds, but maintains that the strategy is solid.

"We've not made any changes," he said. "That's a conscious decision to stay strategic and age the portfolio. We'd only make changes if the underlying funds aren't meeting the expectations."

Mr. Welch agrees bond funds have suffered recently. "Even though it's been a challenging year for the bond fund, we're quite comfortable," he said.

T. Rowe Price is overweighted on mortgage exposure, acknowledged Jerome Clark, portfolio manager of the firm's retirement department. However, it has weathered the subprime market well, he said.

Mr. Clark also agrees that the company's funds are overweighted in the financial sector. "What's driving our financial exposure is on the international side, more so than the domestic side," he said.

Vanguard's approach is to use the Total Bond Market Index Fund for its bond allocation, which determines the fund's holdings in mortgage bonds, said John Ameriks, a senior investment analyst with the firm. In many of Vanguard's target date funds, the company has 40% of its total bond holdings in mortgage bonds.

"If those bonds fall in price relative to the fixed-income price, they'll have a lower weighing; if they rise, they'll have a higher weighting," Mr. Ameriks said. "Those changes are based on individual decisions of millions of investors every day. It's not one person's judgment to decide what the weighting should be."

Meanwhile, Fidelity likes its strategy, said Jonathan Shelon, portfolio manager of the Freedom Funds, which have less exposure to financial stocks and mortgage bonds than some other target date funds.

"We've been very comfortable with our portfolios," he said. "We have enough financial exposure to maximize our benefits but we're not overly exposed."

It is important to stick with an investment philosophy, agrees Lynette DeWitt, a research director with Boston-based Financial Re-search Corp. "The reason to ensure diversification in a portfolio or fund is to allow it to weather market downturns in any particular segment," she wrote in an e-mail.

Still, advisers worry that investors don't have any idea how much exposure these funds have to mortgage bonds and financial stocks.

Some advisers don't even know the weightings in target date funds, said Doug Kinsey, an adviser with Artifex Financial Group LLC in Dayton, Ohio.

"I didn't realize they were that overweight in financials, and what about the average person who does not spend their days thinking about this?" he said. "That concerns me. That's why we've shied away from using them." Mr. Kinsey's firm manages $20 million in assets.

Having as much as 30% in mortgage bonds and financial stocks is not a good idea, according to Darin Pope, senior vice president and chief investment officer of United Atlantic Advisors LLC in Secaucus, N.J. He declined to disclose his firm's assets under management.

"Personally, I think it's too high," Mr. Pope said. "When the market weightings of one individual sector explode, we have to get concerned. We've seen that with financials."

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