“Income” Funds with High Price Tags

By Editor Test *Wed, Oct 26, 2011*

Unless I’ve missed something, the three Putnam Retirement Income Lifestyle Funds, as “income funds,” seem long on promises and short on delivery—particularly in light of the costs.

This week, Putnam Investments introduced three Retirement Income Lifestyle Funds (numbered 1, 2, and 3) which it will market to advisors as potential “core holdings” for decumulation portfolios. The funds are intended for use as part of systematic withdrawal plans in retirement.

The Boston-based fund company, led by CEO Robert Reynolds and other former Fidelity executives, simultaneously announced an online calculator that shows clients how much monthly income they might expect from the funds, how long the income stream might last and how much money might be left over for heirs.

A conversation with Jeffrey Carney, Putnam’s Global Marketing and Products chief, showed that these funds-of-funds are, well, just fancy balanced funds. They don’t provide guaranteed income, either for life or for any specific period. They’re not managed payout funds. They aren’t intended for use as providers of “floor” income in retirement. Advisors who are looking for protection against longevity risk won’t find it here—although the funds do contain portions of Putnam’s family of Absolute Return funds, which use volatility hedges.

What’s new?

So what *is* new or different here? A marketing insight. According to Carney, the amount of money in final-stage target date funds (“Maturity” funds) is going to balloon over the next 20 years, from about $50 billion to $780 billion.

After owners of those funds roll them into IRAs, they and their advisors are likely to seek more flexible long-term alternatives, Putnam believes. It expects its three Retirement Income funds to appeal to those investors. Their rich compensation (4% for the A share and a 5% CDSC for the B share) should appeal to certain advisors.

Only one of these three funds is truly new. Retirement Income Lifestyle Fund 1 is simply a relabeled version of Putnam’s existing capstone target date fund, the former Retirement Ready Maturity Fund. The Retirement Income Lifestyle Fund 3 is the new name of what had been the Putnam Income Strategies Fund. Only the moderate fund, Retirement Income Lifestyle Fund 2, might be considered freshly minted.

Each fund has a bond allocation of up 60%. According to the Putnam website, Lifestyle Funds 1 and 2 currently have equity allocations of about 13%. Lifestyle 3 has an equity allocation of about 19%. But the equity allocations can vary over time, to as high as 50% for the relatively aggressive Lifestyle Fund 3, according to the discretion of the fund managers.

All three Lifestyle Funds are “funds of funds,” to the extent that they contain either the Putnam Conservative Asset Allocation Fund or varying amounts of Putnam’s 100, 300, 500 and 700 Absolute Return Funds. These funds aim to beat the rate of inflation over three years by 1%, 3%, 5% or 7%, respectively, using volatility hedges as stabilizers.

Ask Mr. Wizard

So how does income enter the picture? That’s where Putnam’s online Retirement Income Analysis Tool comes in. This wizard helps prospective owners of the Retirement Income Lifestyle Funds anticipate how much income they might draw down from the funds each month through a systematic withdrawal plan. It also shows how clients long that income might last and how confident they can be in the wizard’s forecast.

To its merit, the wizard involved only a few steps and required no homework. On the initial page, it directed me to enter my “current assets.” I typed in $200,000. (There are separate windows for “taxable,” “tax-deferred” and “tax-free” savings. Only the total amount seemed to affect the calculation, however).

On the second page, the wizard provided two sliders, one for choosing age at retirement (50 to 85) and one for choosing a desired “confidence in meeting income goals” (50% to 99%). I set the first slider at age 65 and the second at 90%. The screen also required me to choose me a male or female mortality table.

The wizard instantly showed me that I could spend about $1,200 a month (7% of my savings) each year. The results for all three Lifestyle funds were virtually identical, oddly enough. If I experienced median results, the tool implied, I’d die in 18 years with about $35,000 left over (give or take about $40,000).

By clicking on a tab, I was able to reveal a third page. A new slider allowed me to set my desired payout rate and showed me how long my money was likely to last. I chose a spending rate of 5% per year, or $833 a month, and the wizard told me that my money would last for 24 years, with a 90% chance of success. If I spent only 4% a year—the textbook sustainable retirement payout percentage—my money was likely to last until I reached age 97.

That was an interesting exercise—the type of financial exercise every pre-retiree should get more of—but what did it have to do with these new Putnam funds? I suspected that any number of broadly diversified balanced funds or funds-of-funds could have produced similar results.

These funds, by the way, aren’t cheap, which implies a drag on returns and therefore on the income they produce. Aside from the load (mentioned earlier), Lifestyle Fund 1 costs 103 basis points a year, Lifestyle Fund 2 costs 163 basis points, and the Lifestyle Fund 3 costs 185 basis points, according to Carney. (According to the product fact sheet, investors would pay only 99, 103, and 113 basis points for these funds, respectively, on top of any distribution fees, because of a Putnam management decision to cap the fees, at least temporarily.)

A retiree who invests $100,000 in these funds and averages a 5% return would end up paying about $24,000 in fees over 10 years, according to the prospectus. Incidentally, the best performer of these three funds has gained an average of less than 1.5% a year (net of fees) since 2006.

Unless I've missed something, the Putnam Retirement Income Lifestyle Funds, as "income funds," seem long on promises and short on proven delivery—particularly in light of costs that, judging by the prospectus, can be significant.