S. HRG. 111–492

DEFAULT NATION: ARE 401(K) TARGET DATE FUNDS MISSING THE MARK?

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

WASHINGTON, DC

OCTOBER 28, 2009

Serial No. 111–14

Printed for the use of the Special Committee on Aging

Available via the World Wide Web: http://www.gpoaccess.gov/congress/index.html

U.S. GOVERNMENT PRINTING OFFICE

55–906 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
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DEFAULT NATION: ARE 401(K) TARGET DATE FUNDS MISSING THE MARK?

WEDNESDAY, OCTOBER 28, 2009

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The Committee met, pursuant to notice at 2:02 p.m., in room SD–562, Dirksen Senate Office Building, Hon. Herb Kohl (chairman of the committee) presiding.

Present: Senators Kohl, Bennet, Corker, and LeMieux.

OPENING STATEMENT OF SENATOR HERB KOHL, CHAIRMAN

The CHAIRMAN. Good afternoon and thank you all for being here.

Today we will be talking about the promise and the reality of target date funds, which are an increasingly popular choice for people saving for retirement. Target date funds were developed for the average American worker who understands the importance of saving but may not understand the complexity of investing. Target date funds, which automatically adjust their investment portfolios to become more conservative as the participant gets close to retirement, come with the promise from financial firms that investors can simply indicate when they would like to retire, and the firm will handle the rest.

Many Americans think target date funds sound like a great idea, and the U.S. Government agrees. In 2007, the Department of Labor qualified target date funds to be a default investment fund for millions of Americans who are automatically enrolled in 401(k) funds by their employer. As of March 2009, Fidelity reported that 96 percent of their plans with automatic enrollment used target date funds as their default option. Therefore, a conversation about target date funds is really a conversation about the future of America's retire security.

In February, our committee raised some concerns about the recent performance of target date funds. We found that the composition of these funds varied widely across the industry, and many contained an inappropriately high level of risk. Some workers in funds with a 2010 retirement date lost as much as 41 percent of their 401(k) savings in 2008.

We discovered that there is no standard for what financial firms label and advertise as target date funds and no regulation of their composition. In response to our request, the Securities and Exchange Commission and the Department of Labor held a joint hearing in June on target date funds, and I am hopeful that we will soon see greater oversight of this product that is on track to become the No. 1 savings vehicle in America.

The Aging Committee has also continued with our investigation of target date funds, and the more we learn, the more concerns we have. This afternoon we will discuss three key problems. First, there is a lack of transparency and consistency in the design of target date funds. Second, many funds charge excessive fees, eroding the value of a worker's assets over time. Third, fund managers have a conflict of interest in constructing target date funds and must resist the temptation to put their bottom line above the interests of the participants. Today the committee is releasing a report detailing each of these issues and their impact on retirement savings.

This afternoon's hearing is the third in a series we have held on strengthening the 401(k) system, which is steadily replacing defined contribution plans throughout our country. Previously we addressed the issue of hidden fees in 401(k) plans, which can have a big impact on retirement savings over several decades, and we have also examined the long-term effects of 401(k) loans and withdrawals on workers' retirement savings. We have introduced legislation with Senator Harkin to require the disclosure of 401(k) fees and will soon introduce a bill to implement GAO's recommendations to reduce the effects of loans and withdrawals. After all, in our efforts to encourage Americans to save for retirement, we must make sure that they are also able to save smartly.

I would like to turn right now to the ranking member on this committee, Senator Corker.

STATEMENT OF SENATOR BOB CORKER, RANKING MEMBER

Senator CORKER. Mr. Chairman, thank you. I apologize. I needed to introduce a panelist in another committee.

I want to welcome each of you as witnesses.

Mr. Chairman, thank you for calling this hearing. I think we obviously want to encourage Americans to save for the future. I think most of us are concerned about a calamity that is coming down the pike with people not saving as much as they should with retirement. At the same time, we want to make sure that people have the opportunity to invest in ways that are beneficial to them, and we do not want to discourage employers who are good actors, who are trying to encourage their employees to save, from doing so. So, Mr. Chairman, I thank you for, again, having this hearing.

I look forward to the panelists. Without further ado, I look forward to their testimony.

The CHAIRMAN. Thank you, Senator Corker.

Now we will be introducing our panel.

Our first witness on the panel will be Barbara Bovbjerg of the U.S. Government Accountability Office. Ms. Bovbjerg is the Director of the Education, Workforce and Income Security team where she oversees studies on aging and retirement income policy.

Next, we will be hearing from Andrew Donohue, the Director of the Division of Investment Management at the U.S. Securities and Exchange Commission. As Director, Mr. Donohue is responsible for developing regulatory policy and administering the Federal securities laws that apply to mutual funds and investment advisors.

Also joining us today is Phyllis Borzi, the Assistant Secretary of the Employee Benefits Security Administration at the Department of Labor where she oversees the administration, regulation, and enforcement of title I of ERISA.

Next, we will be hearing from John Rekenthaler of Morningstar, one of the leading providers of independent investment research. Mr. Rekenthaler is Vice President of Research and New Product Development.

The next witness will be Ralph Derbyshire, Senior Vice President and Deputy General Counsel for Fidelity Investments, the leading provider of target date funds.

Finally, we will be hearing from Michael Case Smith of Avatar Associates, an independent investment manager based in New York. Mr. Smith is Senior Vice President of Institutional Strategies and Portfolio Manager of Target date funds for Avatar.

Thank you all so much for being here. Ms. Bovbjerg, we will take your testimony.

STATEMENT OF BARBARA BOVBJERG, DIRECTOR, EDUCATION, WORKFORCE AND INCOME SECURITY, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Ms. BOVBJERG. Thank you, Mr. Chairman, Senator Corker.

I am pleased to be here today to set the stage for the discussion of default investments in 401(k) savings plans. Although in the past, 401(k)'s were supplemental to defined benefit pension plans, 401(k)'s are increasingly the primary source of workers' pension income today. As such, these accounts will need to be sufficient to support workers through decades of retirement.

My testimony today describes 401(k) saving and its challenges and measures that may improve such saving. My statement is based on reports we have issued over the last several years on 401(k)'s, many of them for this committee.

First, saving and its challenges. Only about half the workforce participates in a pension plan at all, and only about a third of workers save in defined contribution plans, of which 401(k)'s are the most common. Significantly, only about 8 percent of those in the lowest earnings quintile participate in one. The savings that result, of course, are insufficient.

According to the 2004 Survey of Consumer Finance, the median account balance for DC plans overall was about $23,000 for workers with a DC plan and not quite $28,000 for households. As you might expect, lower earners save much less. Their median account balance was $6,400. Workers nearing retirement age did better, but with median savings of about $40,000, and that is still not enough.

These figures suggest that relatively few save, and even those who do save, save too little to ensure a secure retirement. These findings were developed from data collected before the market meltdown, by the way, so account size has likely fallen even lower today.

Leakage from existing 401(k) savings partly explains the small account balances. Some 401(k) participants take actions that reduce savings they have already accumulated, such as borrowing from their account, taking hardship withdrawals, simply closing the account and taking the money when they change jobs. Although this so-called leakage affects a minority of 401(k) accounts, participants who take these actions can experience significant reductions of potential retirement income, both from the loss of compound interest, as well as from the financial penalties associated with the early withdrawals.

In a recent report to this committee, we called for measures to improve the information participants receive about the disadvantages of early withdrawals and for statutory changes in hardship withdrawal rules. Reducing leakage, which is in fact self-inflicted savings reduction, would certainly help maintain what little savings workers accumulate.

Fees can also reduce 401(k) savings, often without the account owner's knowledge. We have reported that 401(k) participants can be unaware that they pay any fees for their accounts, and even when they know fees are being charged, few participants know how much they are. Even small fees can add up over a working lifetime and reduce retirement savings in a significant way. Hidden service provider arrangements may also drive fees higher than they need to be and thus cause plan participants and fiduciaries to unknowingly pay more than they should.

We have called for improved disclosure of fees to help reduce excessive and unnecessary drains on 401(k) savings. I am pleased to note that Labor is taking regulatory actions and that, in fact, legislative remedies are also moving forward.

So let me turn now to some good news. As we reported to you last week, provisions to encourage automatic enrollment appear to be raising 401(k) participation, which means the prospects for improved saving are rising. Plans using auto enrollment have increased from 1 percent in 2004 to about 16 percent in 2009, with higher rates of adoption among larger plan sponsors. Indeed, Fidelity Investments estimates that almost half of all 401(k) participants are in auto enroll plans and that participation rates have risen accordingly. This is good news, indeed.

However, there are still some areas for concern. In our view, employers need to take action to increase saving, as well as participation, and this means higher default contribution rates and more adoption of automatic escalation.

We also note that the default investments are increasingly target date funds, a focus of today's hearing. Such funds can be advantageous to workers who do not want to rebalance their investments regularly, but the variation in these funds suggests that greater care should be given to their transparency and to their cost.

In conclusion, American workers are increasingly being asked to save for their own retirements and they are not saving enough. Government action to enhance participation holds promise, but measures to discourage leakage and the charging of hidden fees must also receive priority. Also, it would be shameful if the very act of encouraging participation through automatic mechanisms also placed workers funds in default investments that do not serve their needs. As workers are faced with increasing responsibility for their own retirements, more must be done by Government and employers to help them.

That concludes my statement.

[The prepared statement of Ms. Bovbjerg follows:]

United States Government Accountability Office

GAO

Testimony
Before the Special Committee on Aging, U.S. Senate

For Release on Delivery
Expected at 2:00 p.m. EDT
Wednesday, October 28, 2009

401(K) PLANS

Several Factors Can Diminish Retirement Savings, but Automatic Enrollment Shows Promise for Increasing Participation and Savings

Statement of Barbara D. Bovbjerg, Director
Education, Workforce, and Income Security

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Highlights

Highlights of GAO-10-153T, a testimony to the Special Committee on Aging, U.S. Senate

October 28, 2009

401(K) PLANS

Several Factors Can Diminish Retirement Savings, but Automatic Enrollment Shows Promise for Increasing Participation and Savings

Why GAO Did This Study

Over the past 25 years, the number of defined benefit (DB) plans has declined while the number of defined contribution (DC) plans has increased. Today, DC plans are the dominant type of employer-sponsored retirement plans, with more than 49 million U.S. workers participating in them. 401(k) plans currently cover over 85 percent of active DC plan participants and are the fastest growing type of employer-sponsored pension plan. Given these shifts in pension coverage, workers are increasingly relying on 401(k) plans for their pension income.

Recently, policy makers have focused attention on the ability of 401(k) plans to provide participants with adequate retirement income and the challenges that arise as 401(k) plans become the predominant retirement savings plan for employees. As a result, GAO was asked to report on (1) challenges to building and maintaining of savings in 401(k) plans, and (2) recent measures to improve 401(k) participation and savings levels.

What GAO Recommends

GAO is not making new recommendations as part of this testimony. In a recent report on leakage—actions that reduce savings prior to retirement—we called for measures to improve the information participants receive about the disadvantages of early withdrawals, and for a change in law to permit continued contributions immediately after hardship withdrawals.

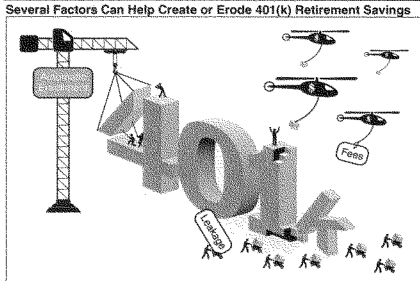
View GAO-10-153T or key components. For more information, contact Barbara D. Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

What GAO Found

There are challenges to building and saving through 401(k) plans. While low participation rates may be due, in part, to the fact that some workers participate in DB plans, there is also a large portion of workers who do not have access to an employer-sponsored retirement plan, as well as some who do not enroll in such a plan when an employer offers it. We found that for those who did participate, their overall balances were low, particularly for low-income and older workers who either did not have the means to save or have not had the opportunity to save in 401(k)s for much of their working lifetimes. There are also challenges workers face in maintaining savings in 401(k) plans. For example, 401(k) leakage—actions participants take that reduce the savings they have accumulated, such as borrowing from the account, taking hardship withdrawals, or cashing out the account when they change jobs—continues to affect retirement savings and increases the risk that 401(k) plans may yield insufficient retirement income for individual participants. Further, various fees, such as investment and other hidden fees, can erode retirement savings and individuals may not be aware of their impact.

Automatic enrollment of employees in 401(k) plans is one measure to increase participation rates and saving. Under automatic enrollment, which was encouraged by the Pension Protection Act of 2006 and recent regulatory changes, employers enroll workers into plans automatically unless they explicitly choose to opt out. Plan sponsors are increasingly adopting automatic enrollment policies, which can considerably increase participation rates, with some plans' rates reaching as high as 95 percent. Employers can also set default contribution rates and investment funds. Though target-date funds are a common type of default investment fund, there are concerns about their risks, particularly for participants nearing retirement.

Several Factors Can Help Create or Erode 401(k) Retirement Savings



Source: GAO analysis.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss participation and savings in 401(k) plans. While the percentage of U.S. workers participating in a pension plan has remained around 50 percent of the private-sector workforce, since the early 1980s pension coverage has seen a noticeable shift away from "traditional" defined benefit (DB) plans, in which workers typically accrue benefits based on years of service and earnings, toward defined contribution (DC) plans in which participants accumulate balances in personal accounts. Currently, there are more than 49 million U.S. workers participating in employer-sponsored DC plans. Further, 401(k) plans are the fastest growing type of employer-sponsored pension plan and currently cover over 85 percent of active DC plan participants. Given the decline of DB plans and the growth of 401(k) plans, many workers are increasingly relying on 401(k) plans for their pension income.

DC plans, including 401(k) plans, provide participants tax-deferred savings vehicles, portability, and the transparency of known account balances. However, they shift much of the responsibility of saving for retirement, and most of the risk, to employees. Under such plans, workers must contribute a portion of their pay and manage the investment of their plan assets throughout their lives. As 401(k) plans become an important source of workers' retirement income, policymakers are focusing on the adequacy of such plans for building and maintaining retirement savings. Overall issues, such as workers arriving at retirement with insufficient savings to support themselves, are a major concern, but other issues are beginning to require attention, such as participation levels in 401(k) plans and "leakage"—which occurs when participants tap into their savings before retirement. In addition, issues surrounding the fees charged to 401(k) plan participants continue to receive attention. Further, Congressional interest in automatic enrollment, including plan features associated with automatic enrollment, such as target-date funds (TDF), has called attention to options for expanding retirement plan coverage.[1]

My statement today is based on our body of work on 401(k) plans and retirement income security.[2] My remarks focus on (1) challenges to

[1]Throughout this testimony, we consider a worker to be covered by an employer-sponsored plan if the employer offers a retirement plan, the worker is eligible to participate under the plan's rules and the worker chooses to participate in it.

[2]For a list of the GAO reports and testimonies referenced in this testimony, see appendix I.

building and maintaining savings in 401(k) plans and (2) recent measures to improve participation and savings levels. We conducted our work in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In summary, there are various issues affecting workers' abilities to build and maintain savings in 401(k) plans. First, we found that participation in DC plans was low. While low participation rates may be due, in part, to the fact that many workers participate in DB plans, there are also some workers who do not have access to an employer-sponsored retirement plan or who do not take the actions required of them to enroll in such a plan. In addition, for those who do participate, savings levels are low. We found that low-income and older workers had particularly low savings balances, which is not surprising given the fact that older workers may not have had the opportunity to save in 401(k) plans for much of their working lifetimes and low-income workers may not have the means to save. However, the low savings levels become increasingly important as DC plans become an important source of retirement income. Second, leakage and fees can erode participants' retirement savings before retirement. Leakage can result in significant losses of potential income from the loss of compound interest as well as the financial penalties associated with early withdrawals. In addition, fees and conflicts of interest—such as undisclosed compensation arrangements between pension service providers—can also diminish retirement savings. Because the risk of investment is largely borne by the individual participant in a 401(k) plan, participants can be vulnerable to any decision, including those involving conflicts of interest, that could result in higher fees or other outcomes that can lower investment returns for participants. Recent changes in federal law, such as provisions explicitly permitting automatic enrollment in 401(k) plans (unless a worker opts out), show promise for increasing 401(k) participation and savings. However, there are concerns about some of the features associated with automatic enrollment, such as the common use of target-date funds as default investments.

Background

Both DB and DC plans operate in a voluntary system with tax incentives for employers to offer a plan and for employees to participate. In the past, DC plans, such as 401(k) plans, were supplemental to DB plans. However, over the past several decades, there has been a shift in pension plan coverage; the number of DC plans has increased while the number of DB plans has declined. Today, DC plans are the dominant type of private-sector employee pension. Compared to DB plans, DC plans offer workers more control over their retirement asset management and greater portability over their retirement savings, but also shift much of the responsibility and certain risks onto workers. Workers generally must elect to participate in a plan and accumulate savings in their individual accounts by making regular contributions over their careers. Participants typically choose how to invest plan assets from a range of options provided under their plan and accordingly face investment risk. There are several different categories of DC plans, but most are types of cash or deferred arrangements in which employees can direct pre-tax dollars, along with any employer contributions, into an account, with any asset growth tax-deferred until withdrawal.

One option available under some 401(k) plans is automatic enrollment, under which workers are enrolled in a 401(k) plan automatically, unless they explicitly choose to opt out. However, automatic enrollment has not been a traditional feature of 401(k) plans and, prior to 1998, plan sponsors feared that adopting automatic enrollment could lead to plan disqualification.[3] In 1998, the Internal Revenue Service (IRS) addressed this issue by stating that a plan sponsor could automatically enroll newly hired employees and, in 2000, clarified that automatic enrollment is permissible for current employees who have not enrolled.[4] Nonetheless, a number of considerations inhibited widespread adoption of automatic enrollment, including remaining concerns such as liability in the event that the employee's investments under the plan did not perform satisfactorily, and concerns about state laws that prohibit withholding employee pay without written employee consent. More recently, provisions of the Pension Protection Act of 2006 (PPA) and subsequent regulations further facilitated the adoption of automatic enrollment by providing incentives

[3]A plan must be considered "qualified" to obtain favorable tax treatment under federal law. One requirement for a qualified 401(k) plan is that participants must elect to have the employer provide an amount of salary to the employee in cash or to defer the amount of salary and deposit the amount in the employee's plan account.

[4]Rev. Rul. 98-30, 1998-1 C.B. 1273. The IRS held that employer contributions made to a plan on an employee's behalf, in lieu of cash payment, are considered elective contributions, so long as the employee has an opportunity to receive cash instead and has not affirmatively expressed a desire to do so. In a subsequent ruling, the IRS determined that contributions made on behalf of either a newly hired or current employee in lieu of cash compensation were valid elective contributions. Rev. Rul. 00-8, 2000-1 C.B. 617.

for doing so and by protecting plans from fiduciary and legal liability if certain conditions are met.[5] In September 2009, the Department of the Treasury announced IRS actions designed to further promote automatic enrollment and the use of automatic escalation policies.[6]

The Employee Retirement Income Security Act of 1974 (ERISA),[7] as amended, defines and sets certain standards for employee benefit plans, including 401(k) plans, sponsored by private-sector employers.[8] ERISA establishes the responsibilities of employee benefit plan decision makers and the requirements for disclosing information about plans.[9] ERISA requires that plan fiduciaries, which generally include the plan sponsor, carry out their responsibilities prudently and do so solely in the interest of the plan's participants and beneficiaries.[10] The Department of Labor's (Labor) Employee Benefits Security Administration (EBSA) is the primary agency responsible for enforcing Title I of ERISA and thereby protecting private-sector pension plan participants and beneficiaries from the misuse or theft of pension assets.[11] EBSA conducts civil and criminal investigations of plan fiduciaries and service providers to determine whether the provisions of ERISA or other relevant federal laws have been violated. In addition to Labor's oversight, the Securities and Exchange Commission (SEC) provides oversight for 401(k) investments. For example, the SEC, among other responsibilities, regulates registered securities including company stock and mutual funds under securities law.

[5]Pub. L. No. 109-280 § 902, 120 Stat. 780, 1033-39 (codified at 26 U.S.C. §§ 401(k)(13), 401(m)(12), 414(w) and 29 U.S.C. § 1144(e), and Automatic Contribution Arrangements, 74 Fed. Reg. 8,200 (Feb. 24, 2009).

[6]Rev. Rul.2009-30, 2009-39 I.R.B. 391 (demonstrating ways 401(k) plan sponsors can include automatic contribution increases in plans) and Notice 2009-65, 2009-39 I.R.B. 413 (providing sample automatic enrollment plan language 401(k) plan sponsors can adopt with automatic IRS approval).

[7]Pub. L. No. 930-406, 88 Stat. 829.

[8]26 U.S.C. § 401(k).

[9]29 U.S.C. § 1021.

[10]29 U.S.C. § 1104. For example, any person who makes investment decisions with respect to a qualified employee benefit plan's assets is a fiduciary. The duties the person performs for the plan rather than their title or office determines whether this person is a plan fiduciary. 29 U.S.C. § 1002(21)(A).

[11]EBSA shares responsibility for enforcing ERISA with the Internal Revenue Services and the Pension Benefit Guarantee Corporation.

Low Participation and Saving Rates Affect the Building of 401(k) Savings While Other Factors Affect Participants Ability to Maintain Retirement Savings

Challenges to Building and Maintaining 401(k) Savings

One issue of concern with DC plans is that participation and saving rates have been low. In 2007, we reported that the majority of U.S. workers, in all age groups, did not participate in DC plans with their current employers. In fact, only about half of all workers participate in any type of employer-sponsored retirement plan at any given time. According to data from the Current Population Survey, about 48 percent of the total U.S. workforce was not covered by an employer-sponsored plan in 2007.[12] About 40 percent worked for an employer that did not sponsor a plan, and about 8 percent did not participate in the plan that their employer sponsored. Certain segments of the working population have consistently had much lower rates of employment with employers sponsoring a plan, and lower participation rates than the working population overall, such as lower-income workers, younger workers, workers employed by smaller companies, and part-time workers who typically lack coverage compared to all full-time workers.

According to our analysis of the 2004 Survey of Consumer Finances, only 62 percent of workers were offered a retirement plan by their employer, and 84 percent of those offered a retirement plan participated. Participation rates were even lower for DC plan participants since only 36 percent of working individuals participated in a DC plan with their current employers at the time of our report. Although our analysis focused on DC

[12]The Current Population Survey is a monthly survey conducted by the U.S. Census Bureau among a nationally representative sample of approximately 100,000 households, primarily in order to estimate the rates of employment and unemployment. During March of each year, the survey includes supplemental questions about retirement plan participation and other financial matters.

plans as a group, 401(k) plans make up the vast majority of DC plans. At the household level, participation rates were also low; only 42 percent of households had at least one member actively participating in a DC plan. Further, only 8 percent of workers in the lowest income quartile participated in DC plans offered by their current employer. [13]

Participation rates are low partly because not all employers offer a retirement plan, and even when employers offer such plans, workers may not participate. Some small employers are hesitant to sponsor retirement plans because of concerns about cost. In addition, DC participation rates for the U.S. workforce may be low because some employers sponsor a DB plan rather than a DC plan. When companies do sponsor employer plans, some workers may not be eligible to participate in their employers' plan because they have not met the plan's minimum participation requirements. In addition, workers may choose not to enroll, or delay enrolling, in a retirement plan for a number of reasons. For example, they may think—in some cases, incorrectly—they are not eligible. They may also believe they cannot afford to contribute to the plan and, for low-income workers, it may be difficult for them to contribute. Also, some may be focused on more immediate savings objectives, such as saving for a house. Many non-participants may not have made a specific decision, but rather fail to participate because of a tendency to procrastinate and follow the path that does not require an active decision.

We also found that, for workers who participated in DC plans, plan savings were low. The median total DC account balance was $22,800 for individual workers with a current or former DC plan and $27,940 for households with a current or former DC plan. We reported that the account balances of lower-income and older workers were of particular concern. For example, workers in the lowest income quartile had a median total account balance of only $6,400. Older workers, particularly those who were less wealthy, also had limited retirement savings. For example, those aged 50 through 59 and at or below the median level of wealth had median total savings of only $13,800. The median total savings for all workers aged 50 through 59 was $43,200.

[13] See GAO, *Private Pensions: Low Defined Contribution Plan Savings May Pose Challenges to Retirement Security, Especially for Many Low-Income Workers*, GAO-08-8 (Washington, D.C.: Nov. 29, 2007).

We noted that the low level of retirement savings could be occurring for a couple of reasons. Workers who participated in a plan had modest overall balances in DC plans, suggesting a potentially small contribution toward retirement security for most plan participants and their households. For individuals nearing retirement age, total DC plan balances were also low, because DC plans were less common before the 1980s and older workers likely would not have had access to these plans their whole careers. Given trends in coverage since the 1980s, older workers close to retirement age were more likely than younger ones to have accrued retirement benefits in a DB plan. In addition, older workers who rely on DC plans for retirement income may also not have time to substantially increase their total savings without extending their working careers, perhaps for several years.[14] Further, the value of the income tax deferral on contributions is smaller for lower-income workers than for similarly situated higher-income workers, making participation less appealing for lower-income workers.

401(k) Leakage Erodes Retirement Savings Levels

In addition to somewhat small savings contributions, 401(k) participants can take actions, such as taking loans, withdrawals, or lump-sum cashouts,[15] that reduce the savings they have accumulated. This "leakage" continues to affect the retirement security of some participants. [16] While participants may find features that allow access to 401(k) savings prior to retirement desirable, leakage can result in significant losses of retirement savings from the loss of compound interest as well as the financial penalties associated with early withdrawals. Current law limits participant access to 401(k) savings in order to preserve the favorable tax treatment for retirement savings and ensure that the savings are, in fact, being used to provide retirement income.[17]

[14]See GAO-08-8.

[15]We use the term "cashout" to refer to a lump-sum distribution made to an employee at job separation.

[16]In this testimony, we use a standard definition of leakage—that is, participants tapping into their accrued retirement savings—typically through loans, withdrawals, and lump-sum cashouts—prior to retirement. We do not take into account other events that could adversely affect participant balances, such as participants not taking advantage of the full employer matching contribution or participants contributing less than the annual federal limit.

[17]26 U.S.C. § 401(k)(2)(b).

The incidence and amount of the principal forms of leakage from 401(k) plans have remained relatively steady through the end of 2008. For example, we found that approximately 15 percent of 401(k) participants between the ages of 15 and 60 initiated at least one form of leakage in 1998, 2003, and 2006, with loans being the most popular type of leakage in all 3 years. We also found that cashouts made when a worker changed jobs, at any age, resulted in the largest amounts of leakage and the greatest proportional loss in retirement savings.[18] Further, we reported that while most firms informed participants about the short-term costs of leakage, few informed them about the long-term costs.

As we reported in August of 2009, experts identified three legal requirements that had likely reduced the overall incidence and amounts of leakage, and another provision that may have exacerbated the long-term effects of leakage. Specifically, experts noted that the requirements imposing a 10 percent tax penalty on most withdrawals taken before age 59½, requiring participants to exhaust their plan's loan provisions before taking a hardship withdrawal and requiring plan sponsors to preserve the tax-deferred status of accounts with balances of more than $1,000 at job separation all helped reduce 401(k) leakage.[19] However, experts also noted that the requirement for a 6-month suspension of all contributions to an account following a hardship withdrawal exacerbated the effects of leakage.[20] Treasury officials told us that this provision is intended to serve as a test to ensure that the hardship is real and that the participants have no other assets available to address the hardship. However, a few outside experts believed that this provision deters hardship withdrawals and noted that it seems to contradict the goal of creating retirement income. One expert noted that the provision unnecessarily prevented participants who were able to continue making contributions from doing so. For example, an employed participant taking a withdrawal for a discrete, one-time purpose, such as paying for medical expenses, may otherwise be able to continue making contributions. In our August 2009 report, we recommended that Congress consider changing the requirement for the 6-month contribution suspension following a hardship withdrawal. We also

[18]See GAO, *401(k) Plans: Policy Changes Could Reduce the Long-term Effects of Leakage on Workers Retirement Savings*, GAO-09-715 (Washington, D.C.: Aug. 28, 2009).

[19]26 U.S.C. § 72(t), 26 C.F.R. § 1.401(k)-1(d)(3)(iv)(E)(1), and 26 U.S.C. § 401(a)(31).

[20]26 C.F.R. § 1.401(k)-1(d)(3)(iv)(E)(2).

called for measures to provide participants with more information on the disadvantages of hardship withdrawals.[21]

Fees and Conflicts of Interests Can also Hinder Participants' Ability to Maintain Retirement Savings

Although participants may choose to take money out of their 401(k) plans, fees and other factors outside of participants' control can also diminish their ability to build their retirement savings. Participants often pay fees, such as investment fees and record-keeping fees, and these fees may significantly reduce retirement savings, even with steady contributions and without leakage.[22] Investment fees, which are charged by companies managing mutual funds and other investment products for all services related to operating the fund, comprise the majority of fees in 401(k) plans and are typically borne by participants. Plan record-keeping fees generally account for the next largest portion of plan fees. These fees cover the cost of various administrative activities carried out to maintain participant accounts. Although plan sponsors often pay for record-keeping fees, participants bear them in a growing number of plans. We previously reported that participants can be unaware that they pay any fees at all for their 401(k) investments.[23] For example, investment and record-keeping fees are often charged indirectly by taking them out of investment returns prior to reporting those returns to participants. Consequently, more than 80 percent of 401(k) participants reported in a nationwide survey not knowing how much they pay in fees.[24]

The reduction to retirement savings resulting from fees is very sensitive to the size of the fees paid; even a seemingly small fee can have a large

[21]See GAO-09-715.

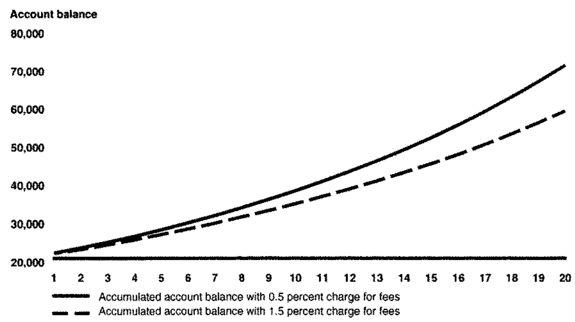
[22]Investment fees pay for: selecting a mutual fund's portfolio of securities and managing the fund; marketing the fund and compensating brokers who sell the fund; and providing other share-holder services such as distributing the fund prospectus. As participants accrue earnings on their investments, they also pay a number of fees, including expenses, commissions, or other charges associated with operating a 401(k) plan. Record-keeping fees cover a variety of activities such as enrolling plan participants, processing participant funds selections, preparing and mailing account statements, and other related administration activities. Unlike investment fees, plan record-keeping fees typically apply to the entire 401(k) plan rather than the individual investment options.

[23]See GAO, *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, GAO-07-21 (Washington, D.C.: Nov. 16, 2006).

[24]AARP Public Policy Institute, "Pension Participant Knowledge About Plan Fees," *Data Digest* (November 2004).

negative effect on savings in the long run. As shown in figure 1, an additional 1 percent annual charge for fees would significantly reduce an account balance at retirement.

Figure 1: Effect of 1-Percentage Point Higher Annual Fee on a $20,000 DC Plan Balance Invested over 20 Years



Source: GAO analysis.

Although all 401(k) plans are required to provide disclosures on plan operations, participant accounts, and the plan's financial status, they are often not required to disclose the fees borne by individual participants. These disclosures are provided in a piecemeal fashion and do not provide a simple way for participants to compare plan investment options and their fees. Some documents that contain fee information are provided to participants automatically, whereas others, such as prospectuses or fund profiles, may require that participants seek them out. According to industry professionals, participants may not know to seek such documents.[25]

Most industry professionals agree that information about investment fees—such as the expense ratio, a fund's operating fees as a percentage of its assets—is fundamental for plan participants to compare their options. Participants also need to be aware of other types of fees—such as record-

[25]See GAO-07-21.

keeping fees and redemption fees or surrender charges imposed for changing and selling investments—to gain a more complete understanding of all the fees that can affect their account balances. Whether participants receive only basic expense ratio information or more detailed information on various fees, presenting the information in a clear, easily comparable format can help participants understand the content of disclosures. In our previous reports, we recommended that Congress consider requiring plan sponsors to disclose fee information on 401(k) investment options to participants, such as the expense ratios, and Congress has introduced several bills to address fee disclosures.[26]

SEC identified certain undisclosed arrangements in the business practices of pension consultants that the agency referred to as conflicts of interest and released a report in May 2005 that raised questions about whether some pension consultants are fully disclosing potential conflicts of interest that may affect the objectivity of the advice.[27] The report highlighted concerns that compensation arrangements with brokers who sell mutual funds may provide incentives for pension consultants to recommend certain mutual funds to a 401(k) plan sponsor and create conflicts of interest that are not adequately disclosed to plan sponsors. Plan sponsors may not be aware of these arrangements and thus could select mutual funds recommended by the pension consultant over lower-cost alternatives. As a result, participants may have more limited investment options and may pay higher fees for these options than they otherwise would.

Conflicts of interest among plan sponsors and plan service providers can also affect participants' retirement savings. In our prior work on conflicts of interest in DB plans, we found a statistical association between inadequate disclosure of potential conflicts of interest and lower investment returns for ongoing plans, suggesting the possible adverse financial effect of such nondisclosure. Specifically, we detected lower annual rates of return for those ongoing plans associated with consultants that had failed to disclose significant conflicts of interest. These lower

[26]H.R. 1984, H.R. 2989, and S. 401, 111th Cong. (2009).

[27]Plan sponsors pay pension consultants to give them advice on matters such as selecting investment options for the plan and monitoring their performance and selecting other service providers, such as custodians, administrators, and broker-dealers. Office of Compliance Inspections and Examinations, *Staff Report Concerning Examinations of Select Pension Consultants* (U.S. Securities and Exchange Commission: May 16, 2005).

rates generally ranged from a statistically significant 1.2 to 1.3 percentage points over the 2000 to 2004 period.[28] Although this work was done for DB plans, some of the same conflicts apply to DC plans as well. Problems may occur when companies providing services to a plan also receive compensation from other service providers. Without disclosing these arrangements, service providers may be steering plan sponsors toward investment products or services that may not be in the best interest of participants.[29]

Conflicts of interest may be especially hidden when there is a business arrangement between one 401(k) plan service provider and a third-party provider for services that they do not disclose to the plan sponsor. The problem with these business arrangements is that the plan sponsor will not know who is receiving the compensation and whether or not the compensation fairly represents the value of the service being rendered. Without that information, plan sponsors may not be able to identify potential conflicts of interest and fulfill their fiduciary duty. If the plan sponsors do not know that a third party is receiving these fees, they cannot monitor them, evaluate the worthiness of the compensation in view of services rendered, and take action as needed. Because the risk of 401(k) investments is largely borne by the individual participant, such hidden conflicts can affect participants directly by lowering investment returns.

We previously recommended that Congress consider amending the law to explicitly require that 401(k) service providers disclose to plan sponsors the compensation that providers receive from other service providers. Although Congress has not changed the law, Labor has proposed regulations to expand fee and compensation disclosures to help address conflicts of interests.[30]

[28]See GAO, *Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, GAO-09-503T (Washington, D.C.: Mar. 24, 2009).

[29]In addition, plan sponsors, being unaware, are often unable to report information about these arrangements to Labor on Form 5500 Schedule C. See GAO-07-21.

[30]Labor published a notice of proposed rulemaking (NPRM) on July 23, 2008 (73 Fed. Reg. 43,014) but the regulation has not yet been finalized.

Automatic Enrollment, One Option for Increasing 401(k) Participation and Savings, Shows Promise

A recent change in law to facilitate automatic enrollment shows promise for increasing participation rates and savings. Under automatic enrollment, a worker is enrolled into the plan automatically, or by default, unless they explicitly choose to opt out. In addition, for participants who do not make their own choices, plan sponsors also establish default contribution rates—the portion of an employee's salary that will be deposited in the plan—and a default investment fund—the fund or other vehicle into which deferred savings will be invested. The Pension Protection Act of 2006 and recent regulatory changes have facilitated plan sponsors' adoption of automatic enrollment.[31] In fact, plan sponsors have increasingly been adopting automatic enrollment policies in recent years. According to Fidelity Investments, the number of plans with automatic enrollment has increased from 1 percent in December 2004 to about 16 percent in March 2009, with higher rates of adoption among larger plan sponsors. Fidelity Investments estimates that 47 percent of all 401(k) participants are in plans with automatic enrollment. Employers may also adopt an automatic escalation policy, another policy intended to increase retirement savings. Under automatic escalation, in the absence of an employee indicating otherwise, an employee's contribution rates would be automatically increased at periodic intervals, such as annually. For example, if the default contribution rate is 3 percent of pay, a plan sponsor may choose to increase an employee's rate of saving by 1 percent per year, up to some maximum, such as 6 percent.

One of our recent reports found that automatic enrollment policies can result in considerably increased participation rates for plans adopting them, with some plans' participation rates increasing to as high as 95 percent and that these high participation rates appeared to persist over time.[32] Moreover, automatic enrollment had a significant effect on subgroups of workers with relatively low participation rates, such as lower-income and younger workers. For example, according to a 2007 Fidelity Investments study, only 30 percent of workers aged 20 to 29 were participating in plans without automatic enrollment. In plans with automatic enrollment, the participation rate for workers in that age range

[31]Pub. L. No. 109-280 § 902, 120 Stat. 780, 1033-39 (codified at 26 U.S.C. §§ 401(k)(13), 401(m)(12), 414(w) and 29 U.S.C. § 1144(e), and Automatic Contribution Arrangements, 74 Fed. Reg. 8,200 (Feb. 24, 2009).

[32]See GAO, *Retirement Savings: Automatic Enrollment Shows Promise for Some Workers, but Proposals to Broaden Retirement Savings for Other Workers Could Face Challenges*, GAO-10-31 (Washington, D.C.: Oct. 23, 2009).

was 77 percent, a difference of 47 percentage points. Automatic enrollment, through its default contribution rates and default investment vehicles, offers an easy way to start saving because participants do not need to decide how much to contribute and how to invest these contributions unless they are interested in doing so. However, current evidence is mixed with regard to the extent to which plan sponsors with automatic enrollment have also adopted automatic escalation policies. In addition, many plan sponsors have adopted relatively low default contribution rates. While the adoption rate for automatic enrollment shows promise, a lag in adoption of automatic escalation policies, in combination with low default contribution rates, could result in low saving rates for participants who do not increase contribution rates over time.

Another recent GAO report offers additional evidence about the positive impact automatic enrollment could have on workers' savings levels at retirement. Specifically, we projected DC pension benefits for a stylized scenario where all employers that did not offer a pension plan were required to sponsor a DC plan with no employer contribution; that is, workers had universal access to a DC plan. When we coupled universal access with automatic enrollment, we found that approximately 91 percent of workers would have DC savings at retirement. Further, we found that about 84 percent of workers in the lowest income quartile would have accumulated DC savings.[33]

In our work on automatic enrollment, we found that plan sponsors have overwhelmingly adopted TDFs as the default investment. TDFs allocate their investments among various asset classes and shift that allocation from equity investments to fixed-income and money market investments as a "target" retirement date approaches; this shift in asset allocation is commonly referred to as the fund's "glide path."[34] Recent evidence suggests that participants who are automatically enrolled in plans with TDF defaults tend to have a high concentration of their savings in these funds. However, pension industry experts have raised questions about the risks of TDFs. For example, some TDFs designed for those expecting to

[33]See GAO, *Private Pensions: Alternative Approaches Could Address Retirement Risks Faced by Workers but Pose Trade-offs*, GAO-09-642 (Washington, D.C.: July 24, 2009).

[34]For example, a TDF could be designed for workers expecting to retire many years in the future and would typically have a much greater allocation to equities and a lesser allocation to fixed-income investments. As the workers near retirement age, the allocations would shift, resulting in a greater allocation to fixed-income investments.

retire in or around 2010 lost 25 percent or more in value following the 2008 stock market decline, leading some to question how plan sponsors evaluate, monitor, and use TDFs. GAO will be addressing a request from this committee to examine some of these concerns.

Concluding Observations

DC plans, particularly 401(k) plans, have clearly overtaken DB plans as the principal retirement plan for U.S. workers and are likely to become the sole retirement savings plan for most current and future workers. Yet, 401(k) plans face major challenges, not least of which is the fact that many employers do not offer employer-sponsored 401(k) plans or any other type of plan to their workers. This lack of coverage, coupled with the fact that participants in 401(k) plans sometimes spend their savings prior to retirement or have their retirement savings eroded by fees, make it evident that, without some changes, a large number of people will retire with little or no retirement savings.

Employers, workers, and the government all have to work together to ensure that 401(k) plans provide a meaningful contribution to retirement security. Employers have a role in first sponsoring 401(k) plans and then looking at ways to encourage participation, such as utilizing automatic enrollment and automatic escalation. Workers have a role to participate and save in 401(k) plans when they are given the opportunity to do so. In addition, both employers and workers have a role in preserving retirement savings. Government policy makers have an important role in setting the condition and the appropriate incentives that both encourage desired savings behavior but also protects participants. Recent government action that has helped enhance participation in 401(k) plans is a good first step. But action is still needed to improve disclosure on fees, especially those that are hidden, and measures need to be taken to discourage leakage. As this Committee and others move forward to address these issues, improvements may be made to 401(k) plans that can help assure that savings in such plans are an important part of individuals' secure retirement.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

Contacts and Staff Acknowledgments

For further questions about this statement, please contact Barbara D. Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov. Individuals making key contributions to this statement included Tamara Cross, David Lehrer, Joseph Applebaum, James Bennett, Jennifer Gregory, Angela Jacobs, Jessica Orr, and Craig Winslow.

Appendix I: Selected GAO Reports and Testimonies Related to 401(K) Plans

Retirement Savings: Automatic Enrollment Shows Promise for Some Workers, but Proposals to Broaden Retirement Savings for Other Workers Could Face Challenges. GAO-10-31. Washington, D.C.: October 23, 2009.

Retirement Savings: Better Information and Sponsor Guidance Could Improve Oversight and Reduce Fees for Participants. GAO-09-641. Washington, D.C.: September 4, 2009.

401(k) Plans: Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings. GAO-09-715. Washington, D.C.: August 28, 2009.

Private Pensions: Alternative Approaches Could Address Retirement Risks Faced by Workers but Pose Trade-offs. GAO-09-642. Washington, D.C.: July 24, 2009.

Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans. GAO-09-503T. Washington, D.C.: March 24, 2009.

Private Pensions: Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors. GAO-08-774. Washington D.C.: July 16, 2008.

Private Pensions: GAO Survey of 401(k) Plan Sponsor Practices (GAO-08-870SP, July 2008), an E-supplement to GAO-08-774. GAO-08-870SP. Washington, D.C.: July 16, 2008.

Private Pensions: Low Defined Contribution Plan Savings May Pose Challenges to Retirement Security, Especially for Many Low-Income Workers. GAO-08-8. Washington, D.C.: November 29, 2007.

Private Pensions: Information That Sponsors and Participants Need to Understand 401(k) Plan Fees. GAO-08-222T. Washington, D.C.: October 30, 2007.

Private Pensions: 401(k) Plan Participants and Sponsors Need Better Information on Fees. GAO-08-95T. Washington, D.C.: October 24, 2007.

Employer-Sponsored Health and Retirement Benefits: Efforts to Control Employer Costs and the Implications for Workers. GAO-07-355. Washington, D.C.: March 30, 2007.

Private Pensions: Increased Reliance on 401(k) Plans Calls for Better Information on Fees. GAO-07-530T. Washington, D.C.: March 6, 2007.

Employee Benefits Security Administration: Enforcement Improvements Made but Additional Actions Could Further Enhance Pension Plan Oversight. GAO-07-22. Washington, D.C.: January 18, 2007.

Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees. GAO-07-21. Washington, D.C.: November 16, 2006.

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The CHAIRMAN. Thank you very much.
Mr. Donohue.

STATEMENT OF ANDREW J. DONOHUE, DIRECTOR OF INVESTMENT MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. DONOHUE. Chairman Kohl, Ranking Member Corker, thank you for the opportunity to testify before you today. My name is Andrew Donohue and I am the Director of the Division of Investment Management at the Securities and Exchange Commission, and I am pleased to testify on behalf of the commission about target date funds.

Today's hearing occurs against the backdrop of recent turmoil in financial markets.

Today workers are increasingly dependent on participant-directed vehicles such as 401(k) plans and responsible for managing their own retirement portfolios.

Target date funds are designed to make it easier for investors to hold a diversified portfolio of assets that is rebalanced automatically among asset classes. Today assets of target date funds registered with the commission total approximately $227 billion. Target date funds have become more prevalent in 401(k) plans as a result of the designation of these funds as a qualified default investment alternative under the Department of Labor pursuant to the Pension Protection Act of 2006.

On June 18, 2009, the commission and the Department of Labor held a joint hearing to explore issues relating to target date funds. While some of the hearings spoke of the benefits of target date funds, for example, as a means to permit investors to diversity their holdings and prepare for retirement, a number also raised concerns.

One concern that has been raised is the degree to which communications to investors in target date funds have or have not resulted in a thorough understanding by investors of those funds and their associated risks. Losses in target date funds incurred in 2008 raise questions about the extent to which investors understand the risk of target date funds.

Recent variations in returns among target date funds with the same target date also have raised questions about the extent to which differences among target date funds have been effectively communicated to investors.

Marketing materials for target date funds typically portray the funds as offering a simple solution for investors' retirement needs. The marketing materials frequently are less nuanced than the disclosure found in the target date funds' prospectuses. To the extent that an investor relies primarily on a fund's marketing materials, the investor may develop unreasonable expectations regarding target date funds and their ability to provide for retirement.

Often target date funds contain a year, such as 2010, in their name. These names provide a convenient mechanism by which an investor may identify a fund that appears to meet his or her retirement needs. However, investors may not understand from the name the significance of the target date in the fund's management or the nature of the fund's asset allocation to and after that date.

For example, investors may expect that at the target date most, if not all, of the fund's assets will be invested conservatively to provide a pool of assets for retirement needs.

At Chairman Schapiro's request, the commission's Division of Investment Management has undertaken a review of target date funds with a view to recommending steps that the commission may take to address concerns that have been raised. Because many individuals invest in target date funds through 401(k) plans and other defined contribution plans that are not regulated by the commission, we have been cooperating closely with our counterparts at the Department of Labor.

The Division of Investment Management is focusing on two areas where enhanced regulation of target date funds may be appropriate: funds' names and on funds' sales material.

Section 35(d) of the Investment Company Act makes it unlawful for any mutual fund to adopt, as part of its name, any word or words that the commission finds are materially deceptive or misleading. One approach that we are examining closely is whether there are circumstances where the use of a date in a fund's name should be restricted in any way or prohibited.

The division also is considering whether we should recommend that the commission amend its rules governing mutual funds sales materials to address issues raised by target date funds.

The division is concerned that target date marketing messages be balanced and they not suggest uniformity or simplicity of target date funds where they are not present.

Finally, together with the commission's Office of Investor Education and Advocacy, the division is developing outreach efforts to investors that could help address potential misconceptions about target date funds. This is an area where we are hopeful that we can leverage our partnership with the Department of Labor to enhance the effectiveness of our efforts.

Thank you for this opportunity to appear before the Special Committee, and I would be pleased to answer any questions you may have.

[The prepared statement of Mr. Donohue follows:]

Testimony Concerning Target Date Funds

by

Andrew J. Donohue
Director, Division of Investment Management
U.S. Securities and Exchange Commission

Before the United States Senate Special Committee on Aging

October 28, 2009

Chairman Kohl, Ranking Member Corker, and Members of the Committee:

Thank you for the opportunity to testify before you today. My name is Andrew Donohue, and I am the Director of the Division of Investment Management at the Securities and Exchange Commission. I am pleased to testify on behalf of the Commission about target date funds.

I. Introduction

Today's hearing occurs against the backdrop of the recent significant turmoil in the financial markets and its effect on the ability of Americans to meet their financial goals at retirement. This issue is particularly acute for those individuals who are retired or close to retirement.

Over the past couple of decades, there has been a sizable shift in how Americans provide for their retirement needs. Previously, many Americans were able to rely on a combination of Social Security and company-sponsored defined benefit pension plans. Today, however, defined benefit pension plans are less common and workers are increasingly dependent on participant-directed vehicles, such as 401(k) plans, that place the responsibility for accumulating sufficient assets for retirement squarely on the shoulders of participants.

As a result, Americans are increasingly responsible for constructing and managing their own retirement portfolios. Given the complexities inherent in concepts such as diversification, asset allocation, rebalancing, and volatility, such responsibilities can pose a challenge for many and also require a significant commitment of time, knowledge, and interest by plan participants to effectively manage their retirement portfolios.

Target date funds are designed to make it easier and less-time consuming for investors to hold a diversified portfolio of assets that are rebalanced automatically among asset classes over time without the need for each investor to rebalance his or her own portfolio. A target date fund is typically intended for investors whose retirement date is at or about the fund's stated target date. Target date funds generally invest in other funds representing a diverse mix of asset classes, including stocks, bonds, and cash. As the target date approaches and sometimes continues for a period thereafter, a target date fund shifts its asset allocation to investments that are intended to be more conservative – usually by decreasing the percentage allocated to stock.

Since the inception of target date funds in the mid-1990s, assets held by these funds have grown considerably. Today, assets of target date funds registered with the Commission total approximately $227 billion.[1] Target date mutual funds received $42 billion in net new cash flow during 2008 and $56 billion during 2007, compared to $22 billion in 2005 and $4 billion in 2002.[2]

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1 Based on Commission staff analysis of data as of October 14, 2009, obtained from Morningstar Direct.

2 Public Hearing on Target Date Funds and Other Similar Investments before the U.S. Securities and Exchange Commission and the U.S. Department of Labor (June 18, 2009) (statement of Investment Company Institute).

Recently, target date funds have become more prevalent in 401(k) plans as a result of the designation of these funds as a qualified default investment alternative ("QDIA") by the Department of Labor pursuant to the Pension Protection Act of 2006. The QDIA designation provides liability protection for an employer who sponsors a defined contribution plan and places contributions of those plan participants who have not made an investment choice into a target date fund or other QDIA.[3] Since their designation as a QDIA in late 2007, target date funds have become an increasingly common addition to 401(k) plans. According to one recent study, 70 percent of U.S. employers now use target date funds as their default investment.[4]

II. Concerns

On June 18, 2009, the Commission and the Department of Labor held a joint hearing to explore issues relating to target date funds. Representatives of a wide range of constituencies participated at the hearing, including investor advocates, employers who sponsor 401(k) plans, representatives of the financial services industry, and academics. While some at the hearing spoke of the benefits of target date funds (for example, as a means to permit investors to diversify their holdings and prepare for retirement), a number also raised concerns, particularly regarding investor understanding of the risks

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3 See Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 FR 60452, 60452-53 (Oct. 24, 2007). As an alternative to a target date fund as a QDIA, Department of Labor regulations permit a plan sponsor to select a "balanced fund" that is consistent with a target level of risk appropriate for participants of the plan as a whole or a "managed account" that operates similarly to a target date fund.

4 Margaret Collins, Target-Date Retirement Funds May Miss Mark for Unsavvy Savers, Bloomberg (Oct. 15, 2009) (citing a Mercer, Inc. study of more than 1,500 companies).

associated with, and the differences among, target date funds and the manner in which target date funds are marketed, including the use of target dates in fund names.

A. Investor Understanding

One concern that has been raised is the degree to which communications to 401(k) plan participants and other investors in target date funds have – or have not – resulted in a thorough understanding by investors of those funds and their associated risks and designs. As discussed below, target date fund losses incurred in 2008, particularly losses in funds with near-term target dates, raised questions about the effectiveness of the communications about those funds and the extent to which investors understand the risks of target date funds.

In the market turmoil of 2008, investment losses for funds with a target date of 2010 were as high as 41 percent, with an average loss of almost 25 percent.[5] These losses raised the question of whether information provided to participants in 401(k) plans who were approaching retirement successfully communicated that losses of this magnitude could occur so close to the target retirement date. During the same period, pure equity indices such as the S&P, NASDAQ Composite and Wilshire 5000 were down 37, 41 and 45 percent respectively. Current year-to-date returns for 2010 target date funds have been as high as 30 percent, with an average return of approximately 20 percent.[6] During the same time frame, the above equity indices rose 22, 38 and 27 percent respectively. While 2009 has been a much better year than 2008 in the markets and for target date fund investors, the volatility demonstrated by the contrast between

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5 Based on Commission staff analysis of data obtained from Morningstar Direct.

6 Based on Commission staff analysis of data obtained from Morningstar Direct (performance information calculated through October 19, 2009).

2008 and 2009 returns reflects a level of risk that may have been unexpected by many investors as they approached retirement in or around the year 2010.

Recent variations in returns among target date funds with the same target date have also raised questions about the extent to which differences among target date funds have been effectively communicated to investors. In 2008, the losses for 2010 target date funds ranged from approximately 4 percent to 41 percent.[7] While these differences can be explained by a number of factors, one key factor is the use of different asset allocation models by different funds, with the result that target date funds sharing the same target date have significantly different degrees of exposure to riskier asset classes, such as stocks.

The schedule by which a target date fund's asset allocation is adjusted is commonly referred to as the fund's "glide path." Glide paths of different target date funds diverge widely both in length and in asset allocations along the way. For example, some glide paths end at the target retirement date; other glide paths continue for as long as 30 years past the target retirement date. As another example, stock exposures of target date funds have ranged from as low as 15 percent to as high as 65 percent at the target date.

B. Marketing

Marketing materials for target date funds typically portray the funds as offering a simple solution for investor retirement needs. While marketing materials for target date funds often include some information about associated risks, they typically encourage investors to choose a fund that most closely matches their anticipated retirement date and then "set it and forget it," hit "cruise control," or the like.

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7 Based on Commission staff analysis of data obtained from Morningstar Direct.

While these marketing messages are generally consistent with the intended design of target date funds to make it easier for investors to hold a diversified portfolio of assets that are rebalanced automatically over time, the simplicity of the messages at times belies the fact that target date fund managers have adopted very different asset allocation strategies and that investments that are appropriate for an investor depend not only on his or her retirement date, but on other factors, including other investments, expected longevity, and appetite for risk. The marketing materials frequently are less nuanced than the disclosures found in target date fund prospectuses, which tend to provide more thorough discussions of a particular target date fund's strategies and associated risks. To the extent that an investor relies primarily on a fund's marketing materials, the investor may develop unreasonable expectations regarding target date funds and their ability to provide for retirement.

C. Target Date Fund Names

Often target date funds contain a year, such as 2010, in their name. The year is intended as the approximate year of an investor's retirement. Like the "set it and forget it" and "cruise control" advertising message, these names provide a convenient mechanism by which an investor may identify a fund that appears to meet his or her retirement needs.

This naming convention, however, is believed by many as contributing to investor misunderstanding of target date funds. Investors may not understand, from the name, the significance of the target date in the fund's management or the nature of the glide path up to *and after* that date. For example, investors may expect that at the target date, most, if not all, of their fund's assets will be invested conservatively to provide a pool of assets for retirement needs. They also may mistakenly assume that funds that all have the same date in their name are managed according to a uniform asset allocation strategy – when in fact one such fund might hold 15 percent of its portfolio at the target date in stocks while another fund might hold as much as 65 percent.

III. Commission Activities

At Chairman Schapiro's request, the Division of Investment Management has undertaken a review of target date funds, with a view to recommending steps that the Commission may take to address concerns that have been raised with respect to these funds. We are concentrating particularly on the expectations of the millions of Americans who increasingly rely on target date funds to invest for retirement needs.

Our focus is on target date funds that are organized as mutual funds. With respect to those funds, the Commission has jurisdiction under the Securities Act of 1933 and the Investment Company Act of 1940. The Commission does not, however, regulate 401(k) plans and other defined contribution plans or the QDIA designation, nor does the Commission prescribe the disclosures that are required to be provided to participants in 401(k) plans. In addition, some plan investment options that may operate as target date funds, such as bank-sponsored collective investment trusts, are not subject to Commission jurisdiction.[8]

Cooperation with Department of Labor

Because many individuals invest in target date funds through 401(k) plans and other defined contribution plans that are not regulated by the Commission, we have been

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8 Collective investment trusts are a type of pooled investment vehicle qualifying for the exclusion from the Investment Company Act pursuant to Section 3(c)(11) thereof [15 U.S.C. 80a-3(c)(11)], and whose securities are excepted from the registration requirements of the Securities Act pursuant to Section 3(a)(2) thereof [15 U.S.C. 77c(a)(2)].

cooperating closely with our counterparts at the Department of Labor. We believe this collaborative approach will better enable the concerns that have been raised to be addressed in a comprehensive manner that does not create regulatory gaps.

As discussed above, the Commission and the Department of Labor held a joint hearing this past June to explore issues relating to target date funds. The testimony at the hearing and comments submitted in connection with it contained numerous suggestions and observations as to how the concerns with respect to target date funds can be addressed. We are continuing to work with our counterparts at the Department of Labor as we move forward with our efforts.

Prospectus Disclosure

The federal securities laws require every mutual fund, including target date funds, to disclose material information in the fund's prospectus regarding its investment objectives, strategies, and risks, and to include a table containing comprehensive information about the costs of investing. In meeting their prospectus disclosure requirements, target date funds typically include a glide path illustration, information on what happens after a fund reaches the target date and whether the glide path continues, a description of how the asset allocation becomes increasingly conservative, and the specific risks associated with an investment in a target date fund such as asset allocation risk. Target date fund prospectuses are required to disclose both the costs imposed by the target date fund itself and the costs associated with any underlying funds in which the target date fund invests. We are considering whether any changes to existing requirements could enhance the disclosures that are provided in fund prospectuses and provide better information to target date fund investors.

Earlier this year, the Commission adopted amendments to the disclosure requirements for all mutual funds that permit the use of a new Summary Prospectus that is intended to result in a presentation of key fund information that is concise and easy to read.[9] We believe that the Summary Prospectus will be helpful to investors in target date funds. Last month, the Department of Labor provided guidance on the use of Summary Prospectuses by retirement plans, which should facilitate the use of Summary Prospectuses by retirement plans to the benefit of participants who invest in target date and other funds.[10]

Options to Address Target Date Fund Concerns

The Division of Investment Management is focusing on two areas where enhanced regulation of target date funds may be appropriate, with a view to making recommendations to the Commission: fund names and fund sales materials. In addition, we are developing investor education initiatives to assist target date fund investors.

Section 35(d) of the Investment Company Act makes it unlawful for any mutual fund to adopt, as part of its name, any word or words that the Commission finds are materially deceptive or misleading. As noted above, some believe that the naming conventions of target date funds may contribute to investor misunderstanding of those funds. As a result, one approach that we are examining closely is whether the use of a particular target date in a fund's name may be materially misleading and whether there are circumstances where the use of a date in a fund's name should be restricted in any way or prohibited.

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9 See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 FR 4546, 4564 (Jan. 26, 2009).

10 U.S. Department of Labor, EBSA Field Assistance Bulletin No. 2009-3 (Sept. 8, 2009) available at http://www.dol.gov/ebsa/regs/fab2009-3.html.

The Division also is considering whether we should recommend that the Commission amend its rules governing mutual fund sales materials to address issues raised by target date funds. Marketing materials that portray target date funds as offering a simple solution for investor retirement needs may create unreasonable investor expectations regarding the ability of such funds to provide for retirement. As we consider target date fund sales materials, we have consulted with the Financial Industry Regulatory Authority (FINRA), which reviews mutual fund sales materials, and we expect to work closely with FINRA to address any concerns in this area. In scrutinizing fund sales materials, the Division is concerned that target date marketing messages be balanced, that they contribute to investor understanding, and that they not suggest a uniformity or simplicity of target date funds where these are not present.

The Commission's Office of Investor Education and Advocacy is committed to furthering the Commission's mission of investor protection through the complementary missions of financial literacy and educating those seeking to invest. Together with that Office, the Division of Investment Management is developing outreach efforts to investors that could help to address potential misconceptions about target date funds. We are considering outreach through materials and media that would effectively reach 401(k) plan participants at all points in the investment cycle, from newly hired workers in their first jobs to those nearing retirement and seniors who may be in, or entering, the distribution phase. This is an area where we are hopeful that we can leverage our partnership with the Department of Labor to enhance the effectiveness of our outreach efforts.

IV. Conclusion

In recent years, target date funds have assumed a position of increasing importance in the financial security of Americans throughout their retirement years by providing a means for investors to diversify their holdings. At the same time, significant concerns have been raised about the varied performance of target date funds, their marketing, and investor understanding of these funds and their associated risks. We are committed to taking steps to address those concerns and to working with the Special Committee on these important issues.

Thank you for this opportunity to appear before the Special Committee. I would be pleased to answer any questions you may have.

The CHAIRMAN. Thank you very much.

Ms. Borzi.

STATEMENT OF PHYLLIS C. BORZI, ASSISTANT SECRETARY OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, U.S. DEPARTMENT OF LABOR, WASHINGTON, DC

Ms. BORZI. Good afternoon, Mr. Chairman and Ranking Member Corker. Thank you so much for inviting me to discuss target date funds and the Department of Labor's activities in connection with these funds and retirement plans.

I am Phyllis Borzi, the Assistant Secretary of Labor for the Employee Benefits Security Administration, also called EBSA. EBSA's mission is to protect the security of retirement, health, and other employee benefit plans for America's workers and to support the growth of employer-sponsored benefits.

Mr. Chairman, as you have already noted, the growth of target date funds as an investment option in participant-directed individual account plans over the past few years has been really significant. At the end of 2008, an estimated 75 percent of 401(k) plans offered target date funds as an investment option.

Target date funds are designed to simplify the burden that workers have in 401(k) plans to finance their own investments, their own retirements with little or no investment expertise. These funds, however, have been under scrutiny for the past few years for exposing investors and plan participants to unexpectedly large losses, particularly in 2008. Funds with the same target retirement date have investment allocations that differ significantly and thus produce different results. These differences in target date funds and the associated differences in their investment performance have prompted questions about whether plan fiduciaries and workers adequately understand these funds, how they operate and what their benefits, risks, and costs are.

The Department shares the committee's interest in examining whether target date funds provide workers with a secure retirement. As you know, in June we held a joint hearing with the SEC on target date funds. The hearing consisted of nine panels testifying on a variety of issues. Many panelists discussed the importance of disclosure and the challenges that exist with regard to clear communication about the sometimes complicated aspects of these funds.

Since the June hearing, the Department has been reviewing the testimony, the additional submissions, and any other data that we have received on target date funds, and we have also been working with our colleagues at the SEC to explore what we can do together or what each individual agency can do to improve the understanding by both ERISA fiduciaries and participants of how target date funds operate.

The remainder of my statement will focus on the Department's outreach and oversight role related to target date funds. I want the committee to understand that these are an important priority of mine and a priority of the Secretary. We think the issues and concerns that you raised are very important and we take them very seriously and we are working diligently to carry out this investigation.

So let me tell you a little bit about the Department of Labor's oversight. EBSA is responsible for administering and enforcing the fiduciary, reporting and disclosure provisions of title I of ERISA. ERISA protects participants and beneficiaries by holding plan fiduciaries accountable for prudently selecting the service providers and the plan investments. In carrying out this responsibility, plan fiduciaries must follow a prudent process, and they have to take into account all relevant information. But most importantly, they must act solely in the interest of plan participants and beneficiaries.

In 2006, Congress included in the Pension Protection Act provisions that were designed to promote the broader use of automatic enrollment in 401(k) plans. The new law provided statutory fiduciary relief for investments in certain types of default alternatives in the absence of participant direction.

In 2007, the Department published a final regulation that described the types of investments that constituted qualified default investment alternatives, or QDIAs, and target date funds were included as a QDIA. Importantly, however, under the final regulation, even though target date funds are an acceptable form of QDIA, the fiduciary continues to have the obligation to prudently select, evaluate, and monitor any of these investment alternatives, including the target date funds. So the QDIA reg does not give the fiduciary a pass from the basic fiduciary responsibility to prudently select, evaluate, and monitor these funds.

EBSA assists plan fiduciaries and others in understanding their obligations under ERISA through comprehensive education and outreach and our regulatory programs. Of course, we also provide oversight through our enforcement program. Under ERISA, plan fiduciaries are personally liable for losses if they acted imprudently in selecting and monitoring the investment choices they offer to their participants. So when EBSA investigators review the fiduciary selection of investments, rather than focus on how the asset performed, they are going to focus on the procedures used by the fiduciary to select and monitor the performance of the investment.

To help educate plan fiduciaries about their obligations under ERISA, our education and outreach program provides information on specific topics such as selecting and monitoring service providers and investment options and automatic enrollment. We have numerous publications on our website, and we have also sponsored seminars and webcasts to help plan fiduciaries understand the law. Similarly, we have publications that help participants understand the choices that are offered through their plans.

The Department is considering a number of additional initiatives to further assist plan fiduciaries and participants in understanding the benefits, the risks and the costs of plan investment options, including, of course, target date funds. One of our current regulatory initiatives involves transparency—improving disclosure to plan participants concerning their investment options and the fees that are charged.

In addition, we are specifically considering what kind of disclosures need to specifically be made about target date funds. At the same time, we are evaluating our QDIA regulation to see whether additional types of meaningful disclosure might be necessary when a target date fund is selected as a QDIA.

We are also considering whether the Department can assist plan fiduciaries by providing more specific guidelines as to how they should go about selecting and monitoring target date funds for their plans regardless of whether the target date fund is a default investment or simply one of the investment options that are offered by the plan.

Similarly, we have a regulatory initiative on investment advice. That was, as you probably remember, a pretty controversial regulation issued by the last administration. The Department intends to withdraw the final rule and the accompanying class exemption, and issue a new proposed rule that will support affordable and unbiased investment advice. This will help participants in choosing the investments, including target date funds.

Finally, we do share the committee's concern about the fee levels associated with some target date funds. As part of our regulatory project dealing with the disclosures of fees to plan sponsors and participants, we are working through the issues as they relate to target date funds and paying particular attention to them. I look forward to working with you on this and many other issues.

Finally, thank you so much for the opportunity to testify at this important hearing. We remain committed to protecting plan participants and assuring the growth of retirement benefits and adequate security for America's workers, retirees, and their families. I will be happy to answer any questions later on.

[The prepared statement of Ms. Borzi follows:]

**TESTIMONY OF PHYLLIS C. BORZI
ASSISTANT SECRETARY OF LABOR
EMPLOYEE BENEFITS SECURITY ADMINISTRATION
BEFORE THE
SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE**

October 28, 2009

Introductory Remarks

Good afternoon Chairman Kohl, Ranking Member Corker, and Members of the Committee. Thank you for inviting me to discuss target date funds and the Department of Labor's activities with regard to the use of target date funds in retirement plans. I am Phyllis C. Borzi, the Assistant Secretary of Labor for the Employee Benefits Security Administration (EBSA). Our mission is to protect the security of retirement, health, and other employee benefits for America's workers, retirees and their families and to support the growth of our private-sector employee benefits system.

EBSA is committed to promoting policies that encourage retirement savings and protect employer-sponsored benefits. The growth of target date funds as an investment option in participant-directed individual account plans over the past few years has been significant. At the end of 2008, an estimated 75 percent of 401(k) plans offered target date funds as an investment option.[1] Target-date funds have been under scrutiny this past year for exposing investors and plan participants to the market downturn. Many funds with the same target retirement date have investments that differ significantly. Some are invested more aggressively in stocks. Such differences in target date funds, and associated differences in recent investment performance, have prompted questions about whether plan fiduciaries and workers have an adequate understanding of target date funds, and their benefits, risks and costs.

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[1] *See e.g.*, Jack VanDerhei et al., 401(k) Asset Allocation, Account Balances, and Loan Activity in 2008, Employee Benefit Research Institute Issue Brief No. 335 (Oct. 2009).

The Department shares the Committee's interest in examining whether target date funds provide workers with a secure retirement. The retirement security of American workers increasingly depends upon their individual investment decisions as employers are sponsoring more self-directed defined contribution plans. My testimony today will discuss the steps that the Department has taken to review issues relating to the use of target date funds in retirement plans, including the Department's activities related to the designation of target date funds as qualified default investment alternatives. I will discuss what the Department learned at the June joint hearing with the SEC on target date funds. Most importantly, I will explain the Department's oversight role and outreach activities, as well as initiatives that the Department is considering to provide further guidance on target date funds.

Background

EBSA is responsible for administering and enforcing the fiduciary, reporting, and disclosure provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). EBSA oversees approximately 700,000 private pension plans, including almost 460,000 participant-directed individual account plans such as 401(k)-type plans and approximately 49,000 defined benefit plans, and millions of private health and welfare plans that are subject to ERISA. As of 2006, at least 60 percent of private-sector employees participated in defined contribution plans that allow for participant direction, with these plans covering more than 58 million active participants and holding about $2.7 trillion in assets.[2]

Growth of Target Date Funds

Target date funds (also called "lifecycle" funds) generally are investment products that allocate their investments among various asset classes and automatically shift that allocation toward more conservative investments as a "target" retirement date approaches. This shift in asset allocation, often referred to as a fund's "glide path," may

[2] Based on 2006 filings of the Form 5500.

differ significantly among funds with the same target date; even among investment professionals, there is no "perfect" mix.

At year-end 2008, 75 percent of 401(k) plans offered target date funds as an investment option.[3] These plans offered target date funds to 72 percent of participants in section 401(k) plans. Among participants offered target date funds, 42 percent held at least some portion of their plan account in them at year-end 2008.

At the end of the first quarter of 2009, the amount of employer sponsored defined contribution plan assets invested in target date funds totaled $145 billion.[4] This figure was down from the second quarter of 2008, when the amount of employer-sponsored defined contribution plan assets invested in target date funds totaled $186 billion. Even with this difference, the amount of employer-sponsored defined contribution plan assets invested in target date funds has grown significantly over the past decade from $18 billion in 2000, $37 billion in 2003, and $87 billion in 2005.

Qualified Default Investment Alternatives Guidance

In 2006, Congress—in an effort to increase retirement savings by those workers generally reluctant to take an active role in their retirement plans—included in the Pension Protection Act (PPA) provisions to encourage 401(k) plan sponsors to implement automatic enrollment programs. Among other encouragements, the PPA promoted the broader use of automatic enrollment in self-directed defined contribution plans by providing new fiduciary relief under ERISA for plan fiduciaries investing participant assets in certain types of default investment alternatives in the absence of participant investment direction. Under longstanding ERISA provisions, fiduciaries are generally relieved from responsibility for participants' exercise of control over their own accounts, as long as those participants are provided with prudently selected investment options.

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[3] *See e.g.*, Jack VanDerhei et al., 401(k) Asset Allocation, Account Balances, and Loan Activity in 2008, Employee Benefit Research Institute Issue Brief No. 335 (Oct. 2009).
[4] *See e.g.*, Investment Company Institute, The U.S. Retirement Market, First Quarter 2009, ICI Research Fundamentals, Volume 18, Number 5-Q1 (Aug. 2009).

Under this PPA provision, a participant is deemed to have exercised control over assets in his or her account if, in the absence of investment direction from the participant, the plan fiduciary invests the assets in a qualified default investment alternative (QDIA).

In 2007, the Department published a final regulation describing the types of investments that constitute qualified default investment alternatives (QDIAs) and providing relief under ERISA for fiduciaries that select a QDIA for their plan. The regulation specifies three categories of investments that can qualify as QDIAs. One of the categories is an age-based investment fund that changes over time such as a lifecyle or target-date fund that is selected for a participant based on the participant's age, target retirement date or life expectancy. The QDIA regulation defines a target date fund as an investment that: (1) applies generally accepted investment theories; (2) is diversified so as to minimize the risk of larges losses: and (3) is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date, or life expectancy.

The regulation does not contain any requirements regarding the composition of target date funds. Nor does it specify a required ratio of stocks and bonds as the fund nears its target. The preamble to the final regulation reiterates that a fiduciary continues to have the obligation to prudently evaluate, select and monitor any investment option that will be made available to the plan's participants and beneficiaries, regardless of whether the plan includes an automatic enrollment feature or whether the fiduciary seeks to comply with the QDIA regulation. When the Department proposed the QDIA regulation in 2006, it received more than 120 comments, which were generally favorable toward target date funds being included as a QDIA.

Impact of the Economic Downturn on Target Date Funds

The design of target date funds was intended to simplify investing for the typical American, who may not have the time, interest, or expertise to sort through dozens of funds to determine the right mix of investments to suit their retirement needs or risk tolerance. Following the enactment of the Pension Protection Act and issuance of the Department's QDIA regulation, many 401(k) plans changed their default investment funds for their automatically-enrolled participants to QDIAs. For example, in 2007, 22 percent of Vanguard's defined contribution pension plans were utilizing a QDIA and 84 percent of these plans used a target date fund as their automatic enrollment vehicle.[5]

The financial downturn that started in 2008 increased volatility and lowered returns of target date funds.[6] Many target date funds designed for people recently in or near retirement had large losses. For example, funds with target dates labeled 2010 lost as much as 41 percent last year. On average, participants invested in target date funds dated 2010 and 2015 lost about a quarter of their value in 2008. Many of these funds typically held about half of the holdings in stocks, following glide paths that did not significantly reduce that percentage for 5 years or more after the average investor retired. The average fund in the 2050 category declined 39 percent in 2008, while the S&P 500 Index dropped 38 percent.

Responding to these developments, the Senate Aging Committee began an investigation of certain target date funds marketed to 401(k) plans. In preliminary findings shared with the Department and the Securities and Exchange Commission (SEC), the Committee found a wide range of objectives, portfolio compositions, and risks among same-year target date funds. In particular, Chairman Kohl expressed concern over what he called "significant differences" in equity holdings among eight "2010" target date funds, which ranged from eight to 68 percent of assets in funds designed to match risk and return goals

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[5] *See e.g.*, The Vanguard Group, Inc., *How America Saves 2008: A Report on Vanguard 2007 Defined Contribution Plan Data* (2008). See Figures 30 & 31.

[6] Deloitte Financial Advisory Services LLP, *Target Date Funds: Historical Volatility/Return Profiles*, unpublished presentation to the U.S. Department of Labor, Employee Benefits Security Administration (Sept. 30, 2009). In particular, the research found that the 1-year volatility was generally greater than the 3-year volatility and the 1-year returns were lower than the 3-year returns. Deloitte also found that funds with target date 2010 were more volatile in 2008 than they were in 2007. In addition, Deloitte reports that volatility among 2010 target date funds correlated with the fraction of the funds that are invested in stock and small 2010 funds are more heterogeneous in rates of return and in volatility than large funds.

for a worker intending to retire in 2010. In relaying this information, the Committee expressed concern that, given these variations, some investors may be investing in target date funds without being aware of the financial risk. In letters to both the Department and the SEC, Chairman Kohl urged the two agencies to commence a review of target date funds.

Joint DOL/SEC Hearing on Target Date Funds

On June 18, 2009, the Department and the SEC held a joint day-long hearing on issues relating to investments in target date funds and similar investment options by 401(k) plan participants and other investors. The purpose of the hearing was to determine whether additional guidance by either agency would be helpful. The hearing addressed a variety of topics, including: investor and plan participant considerations; exploration of glide paths and underlying investments; plan sponsor considerations; utilization of target date funds in defined contribution plans; understanding, selecting and monitoring target date funds; and disclosures relating to target date funds. The hearing consisted of nine panels, with 39 organizations testifying. A variety of organizations also submitted supplemental testimony and other materials.

A variety of issues, problems and options were discussed at the hearing with certain themes emerging from the testimony. Nonetheless, the panelists generally believed that target date funds continue to be an extremely beneficial investment option for the majority of plan participants. One common concern related to the widely divergent allocations to equities and fixed-income investments, with some concerns expressed as to whether strict limits should be imposed on equity and fixed-income allocations within target date funds. A majority of the panelists were against any sort of mandated one-size-fits all or "range" requirement for target date funds; rather, some argued that customization and choice were ultimately good for the participant.

Several issues were raised with regard to the "glide path," which refers to the shift in asset allocation as the target date approaches. One panelist discussed that while a glide path generally implements the principles of diversification, rebalancing, and reallocation, glide path variations generally reflect the preferences and judgment of the individual investment manager. Some panelists agreed that target date funds should contain some equity exposure at the point of retirement, and that glide paths should continue to progress after the target date. This further led to a discussion of whether target date fund glide paths should continue to change "to" the target date or "through" the target date, with some panelists arguing that glide paths should continue to vary beyond the target date.

Many panelists focused on the importance of disclosure and the challenges that exist with regard to full and clear communication about the sometimes complicated aspects of these funds. In particular, it was suggested that target date funds disclose whether the fund's glide path is designed to manage assets to or through retirement.

Several panelists suggested that the Department should consider reviewing the QDIA language and determining whether a higher standard should be established for fiduciaries when selecting a particular QDIA. Some panelists suggested that the Department and the SEC set mandatory glide path parameters.

Department of Labor Oversight, Recent Regulatory Projects, and Next Steps

Since the June hearing, the Department has been reviewing the testimony presented and the other materials submitted for the public record, collecting additional data on target date fund characteristics and performance, and considering possible initiatives to ensure that plan fiduciaries and participants have an adequate understanding of target date funds, and their benefits, risks and costs. In order to ensure a coordinated approach, we have been working with the SEC, which is responsible for administering federal securities laws that address disclosures to investors in target date funds structured as mutual funds.

Of the target date funds available, mutual funds comprise approximately 78 percent of target date funds.[7]

In EBSA's oversight role, we assist plan fiduciaries and others in understanding their obligations under ERISA through comprehensive education and outreach, and regulatory programs. EBSA also provides oversight through its enforcement program. EBSA investigates issues related to plan investments focused on plan fiduciaries and service providers such as investment advisors, pension consultants, and investment managers.

Enforcement

Title I of ERISA establishes standards of fiduciary conduct for persons who are responsible for the administration and management of benefit plans. ERISA protects participants and beneficiaries by holding plan fiduciaries accountable for prudently selecting service providers and plan investments. In carrying out this responsibility, plan fiduciaries must follow a prudent process taking into account relevant information relating to the plan and the investments available under the plan.

EBSA identifies potential investigations related to a number of investment issues. These range from the prudence of investments, to improper receipt or payment of fees relating to plan assets, to self-dealing, or conflicts of interest. For selection of investments an investigation would focus on whether the plan fiduciary acted prudently in selecting or recommending the investment. An investigator would review whether the plan fiduciary performed proper due diligence in selecting an investment for the plan and followed a prudent process.

Under ERISA, plan fiduciaries are not liable for plan losses merely because an investment lost money but because they acted imprudently in selecting and monitoring the investment. Accordingly, when investigators review the selection of investments,

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[7] 52nd Annual Survey, Reflecting 2008 Plan Experience, Profit Sharing / 401k Council of America, September 2009.

they will generally focus on the procedures used by a plan fiduciary, rather than the ultimate performance of the asset.

Education and Outreach

To help educate plan sponsors and fiduciaries about their obligations under ERISA, EBSA's education and outreach program provides information to fiduciaries about their responsibilities, focusing on specific topics such as selecting and monitoring service providers and investment options, and automatic enrollment. These initiatives include publications as well as seminars. Specific publications include "Meeting Your Fiduciary Responsibilities," "Understanding Retirement Plan Fees and Expenses," "Automatic Enrollment 401(k) Plans for Small Businesses" and "Adding Automatic Enrollment to Your 401(k) Plan." EBSA also provides two tip sheets to help plan sponsors select plan service providers: "Selecting and Monitoring Pension Consultants - Tips For Plan Fiduciaries" and "Tips For Selecting and Monitoring Service Providers For Your Employee Benefit Plan."

Our campaign, "Getting It Right – Know Your Fiduciary Responsibilities," includes nationwide educational seminars and webcasts to help plan sponsors understand the law. The campaign focuses on fiduciary responsibilities. EBSA has conducted 31 fiduciary education seminars since May 2004 in different cities throughout the United States. EBSA also has conducted 65 health benefits education seminars, covering nearly every state, since 2001. Beginning in February 2005, these seminars added a focus on fiduciary responsibilities. EBSA will continue to provide seminars in additional locations under each program.

In order to help participants understand investment choices offered through their plan and automatic enrollment, EBSA has recently updated the publication "What You Should Know About Your Retirement Plan" and "Savings Fitness – A Guide to Your Money and Your Financial Future." Other publications providing education in this area include "A

Look at 401(k) Plan Fees for Employees" and "Taking the Mystery Out of Retirement Planning."

EBSA continues to expand available information, including adding seminars, webcasts and other outreach, and updating our materials as new guidance is issued.

Regulatory and Other Initiatives

The Department is considering a number of initiatives to assist plan fiduciaries and participants and beneficiaries in understanding the benefits, risks, and costs of plan investment options, including target date funds. For instance, one of our ongoing regulatory initiatives involves improving disclosure to plan participants concerning their plan investment options. As part of this initiative, we are considering what disclosure should be made about target date funds. We are similarly re-examining the Department's QDIA regulation to ensure that meaningful disclosure is provided to participants when the plan's default investment is a target date fund.

We also are considering whether the Department can assist plan fiduciaries by providing more specific guidelines for selecting and monitoring target date funds for their plans, whether as a default investment or more generally as one of investment options offered by the plan.

A related regulatory initiative is the Department's activity related to investment advice. The Department intends to withdraw the final rule implementing the investment advice provisions of the Pension Protection Act of 2006 (PPA) and accompanying class exemption that the Department published in January 2009. We intend to issue a new proposed rule that will support affordable and unbiased investment advice for 401(k)-type plans and IRAs. The new rule will provide participants access to quality investment advice that will assist participants in choosing investments, including target date funds.

Finally, we understand that this Committee is concerned about fee levels associated with some target date funds. As you know, the Department is engaged in regulatory projects relating to the disclosure of fees to plan sponsors and participants, and it is our hope that adequate disclosure will be an added step in protecting participants in these plans. I appreciate your leadership in advocating for better fee disclosure and look forward to working with you on this and other important consumer protection issues.

Conclusion

Thank you for the opportunity to testify at this important hearing. The Department remains committed to protecting the security and growth of retirement benefits for America's workers, retirees, and their families.

The CHAIRMAN. Thank you.
Mr. Rekenthaler.

STATEMENT OF JOHN REKENTHALER, CFA, VICE PRESIDENT OF RESEARCH, MORNINGSTAR, CHICAGO, IL

Mr. REKENTHALER. Hello. My name is John Rekenthaler. I am Vice President of Research for Morningstar. Thank you for inviting me to talk to the committee today.

Morningstar is a leading provider of independent investment research and is the largest mutual fund research firm in the United States.

I would like to state up front that Morningstar is generally supportive of target date funds. Throughout its history, Morningstar has frequently criticized entire categories of funds for being gimmicky or overpriced. We are considerably more positive about target date funds. We regard target date funds as being a sound invention that meets a true investor need. By offering broadly diversified portfolios that change over time, target date funds are a suitable choice for those who wish to delegate their investment decisions. They also are well suited for inactive owners who will not be making trades as they grow older and their situations change.

That said, there are certain concerns, given the extraordinary position that target date funds now occupy as the default investment choice for America's new retirement model.

One concern lies with fees. Overall, annual expense ratios for target date funds mutual funds compare favorably with the expense ratios charged by other types of mutual funds. For example, on an asset-weighted basis—that is, with the larger funds counting proportionately more in the calculation than the smaller funds—target date funds have an average annual expense ratio of 0.69 percent. This is lower than the 0.82 percent figure for so-called allocation funds, which are a competitor to target date funds that also invest in a broad mix of stocks and bonds.

However, that average conceals a very wide range among the 48 target date fund families we track. On the low end, one target date family has an expense ratio of only 0.19 percent. On the high end, another has an expense ratio of 1.82 percent, more than nine times higher than the first family. The issue of expenses is particularly important with target date funds because of their very long time horizons. Several fund families today offer funds with a 2055 date, 46 years into the future. As the committee well knows, the power of compounding greatly magnifies small differences over such a long time period.

For example, let us assume two target date funds that invest in identical underlying assets, returning 7 percent annually. One fund boasts the industry's low expense ratio of 0.19 percent and, one, the industry's high expense ratio of 1.82 percent. Over the 46-year time horizon mentioned above, an initial investment made in a low-expense fund would become worth more than twice as much as the one made in the high-expense fund. Few employees who are defaulted in target date funds through their 401(k) plans will be aware of either the expense differences or their powerful implications.

Another concern is the tendency of target date funds to invest solely in their company's underlying funds. No reputable institutional investor would hand over his or her entire portfolio to a single asset management firm. Instead, the institutional investor sifts among many investment managers seeking to purchase the best and lowest-cost options for various slices of the portfolio. One firm gets a portion of the portfolio's large-company stocks, another manages its short-term Treasuries, and so forth. The institutional investor would not expect a single firm to excel at all types of investing. Yet, that is implicitly the position taken by most fund families in running their target date funds. It is difficult to square such a practice as being the best outcome for an investor, although of course from a business perspective, it is understandable that a target date fund family would like to keep all of the assets collected in-house.

Third, we are worried by the low level of conviction placed by the industry's target date investment managers in the funds that they run. Morningstar tracks how much money a target date manager or any mutual fund manager invests in his or her own funds, as this is an item listed in each fund's Statement of Additional Information. After all, target date funds would seem to be the ideal way for a fund manager to eat his own cooking or her own cooking, as they saying goes, given that target date funds are openly marketed as being suitable for every possible type of investor. Yet, only 2 out of 58 target date managers whom we track list $500,000 or more invested in their own funds. Even more strikingly, 33 of the managers, or 57 percent, show no investment at all.

Overall in the fund industry, managers who invest heavily in their own funds tend to out-perform those who invest less. We would like to see target date fund managers embrace their funds more enthusiastically.

In summary, target date funds are a useful and productive addition to the fund industry and a clear benefit to employees who own 401(k) plans. They must improve, however, if they are to fully earn their position of being at the heart of America's retirement future.

Thank you.

[The prepared statement of Mr. Rekenthaler follows:]

Statement of John Rekenthaler

Vice President, Research, Morningstar, Inc.

Before the U.S. Senate Committee on Aging

Washington, DC

October 28, 2009

My name is John Rekenthaler. I am Vice President of Research for Morningstar. Thank you for inviting me to speak today before the Senate Committee on Aging.

Morningstar is a leading provider of independent investment research and the largest provider of mutual-fund research in the United States. Recently, Morningstar published a detailed report on target-date mutual funds, creatively titled *Target-Date Series Research Paper: 2009 Industry Survey*. My presentation today contains key findings from that report.

I would like to state upfront that Morningstar is generally supportive of target-date funds. Throughout its history, Morningstar has frequently criticized entire categories of funds for being gimmicky and/or overpriced. We are considerably more positive about target-date funds. We regard target-date funds as being a sound invention that meets a true investor need. By offering broadly diversified portfolios that change over time, target-date funds are a suitable choice for those who wish to delegate their investment decisions. They also are well suited for inactive owners who will not be making trades as they grow older and their situations change.

That said, there are certain concerns, given the extraordinary position that target-date funds now occupy as the default investment of choice for America's New Retirement Model. These concerns include:

1) Variation in fees
2) The use of proprietary (in-house) funds
3) Lack of manager ownership
4) Variation in glide paths among the shorter-dated funds
5) Lack of transparency

The first concern lies with fees. Overall, annual expense ratios for target-date mutual funds compare favorably with the expense ratios charged by other types of mutual funds. For example, on an asset-weighted basis, that is with the larger funds counting proportionately more in the calculation than the smaller funds, target-date funds have an average annual expense ratio of 0.69%. This is lower than the 0.82% figure for so-called "allocation" funds, which also invest in a broad mix of stocks and bonds.

However, the average conceals a very wide range among the 48 target-date fund families that we track. On the low end, one target-date family has an expense ratio of only 0.19%. On the high end, another has an expense ratio of 1.82% -- more than 9 times higher than the first family. The issue of expenses is particularly important with target-date funds because of their very long time horizons. Several fund families today offer funds with a 2055 date – 46 years into the future! As the Committee well knows, the power of compounding greatly magnifies small differences over such a long time period.

For example, let's assume two target-date funds that invest in identical underlying assets, returning 7% annually. One fund boasts the industry's low expense ratio of 0.19% and the other has the industry's high expense ratio of 1.82%. Over the 46-year time period mentioned above, an intial investment made in the low-expense fund would become worth more than twice as much as the investment that was made in the high-expense fund. (A lump-sum investment of $1,000 in the two funds would grow to $20,708 and $10,208, respectively.) Few employees who are defaulted into target-date funds through their 401(k) plans will be aware of the expense differences that exist among funds, and fewer still will understand their very powerful effects.

The second concern is the tendency of target-date funds to invest solely in their own company's underlying funds. No reputable institutional investor would hand over his or her entire portfolio to a single asset-management firm. Instead, the institutional investor sifts among the many investment managers that make up the industry, seeking to purchase the best and lowest-cost options for various slices of the portfolio. One firm gets a portion of the portfolio's large-company stocks, another manages its short-term Treasuries, a third takes control of its emerging-market investments, and so forth. The institutional investor would not expect a single firm to excel at all types of investing. Yet that is implicitly the position taken by most fund families in running their target-date funds. It is difficult to square such a practice as being the best outcome for an investor – although of course from a business perspective, it is understandable that a target-date fund family would like to keep all of the assets collected in-house.

Third, we are worried by the low level of conviction placed by the industry's target-date investment managers in the funds that they run. Morningstar tracks how much money a target-date manager invests in his or her own funds, as this is an item listed in each fund's Statement of Additional Information. After all, target-date funds would seem to be the ideal way for a fund manager to "eat his own cooking" (as the saying goes), given that target-date funds are openly marketed as being suitable for every possible type of investor. Yet only two out of 58 target-date managers whom we track list $500,000 or more invested in their own funds. Even more strikingly, 33 of the managers, or 57%, show nothing at all.

It is true that there are mitigating circumstances. In some cases, target-date managers can only invest in their funds through 401(k) plans, as those funds are not available in a retail account. In other cases, the managers hold a different version of their fund, one that is not a registered mutual fund but is instead an institutionally priced separate account that is available only for larger 401(k) plans. (However, this does beg another question, as the typical investor will not necessarily be able to avail himself of this lower-cost option.) But the point remains: Manager ownership is light. Overall in the fund industry, managers who invest heavily in their own funds tend to outperform those who invest less. We would like to see fund managers more enthusiastically embrace target-date funds.

Fourth, there is a great disparity in the "glide paths" – the ratio of stocks to bonds that is held by a target-date series, as it changes over time – among the shorter-dated funds. The longer-dated funds tend to look quite similar. For example, the allocation to stocks for the 2040 funds in Morningstar's database runs from 80% as a minimum to 95% as a maximum. Absent any mistakes from implementing the asset allocation, those funds will tend to perform fairly similarly. As the target-date series age, however, the funds drift apart. Some fund families focus on longevity risk, that is the risk that the retiree may outlive his or her assets. Therefore, they hold more equities. Other fund families are more concerned about market risk, and wish to minimize volatility by greatly reducing their funds' stock positions.

As a result, the glide paths for the 2010 funds diverge sharply. At the upper end, two fund families have more than 70% of their 2010 funds' assets placed in equities. Conversely, three families have fewer than 30% of their 2010 investments in stocks. This divergence in asset allocation resulted in a wide difference in performance during the dramatic 2008 market, when losses in the 2040 category ranged from a modest 9% to a breathtaking 41%. Morningstar's point is not to praise those families that were positioned most conservatively, nor to condemn those that were hurt by their high equity exposure, but rather to consider the investor's perspective. An employee defaulted into the first fund would have lost 9% on year, while one defaulted into second fund would lose 41%. Yet each employee would consider herself invested in an identical fund –as both funds carryied the same "2010" label and were aimed at employees of exactly the same age. Who knew?

Fifth, transparency about target-date funds' strategies can and must improve. In gathering the data for its *Industry Survey*, Morningstar struggled to collect even the basic stock/bond/cash information for some of the target-date funds. Details such as the allocations between domestic and international stocks, or corporate and government bonds, were even harder to obtain. If Morningstar with its market presence and staff of data experts scrambled to learn the characteristics of the industry's target-date funds, then surely the everyday employee who seeks to learn more about his default investment, faces real difficulties.

Finally, we should note the tendency of the fund industry's secondary providers to "swing for the fences" in the attempt to distinguish themselves from the pack. This is a pattern that exists in all segments of the mutual-fund marketplace. The companies that offer a category's biggest funds are quite naturally interested in protecting their market share, and thus are relatively risk-averse when it comes to making investment innovations. The smaller providers, however, have little to lose and much to gain by trying something bold. Over the fund industry's history, such an attitude has led to many fund-industry innovations – but also to the industry's biggest flops.

The tendency of the smaller players to take big chances has been implicitly accepted by the industry, by regulators, and even by fund shareholders. The question is, whether such experimentation is appropriate for a default investment in a company-sponsored retirement plan. Morningstar worries when target-date funds purchase heavily leveraged bond funds that conducted over-the-counter derivative swaps, or when they buy new, opaque, and high-cost funds that use complex investment strategies. It is one thing to experiment in a defined-benefit plan, when the company rather than the employee is on the hook for any failures. It is a second thing to experiment as a retail mutual fund, when the investor actively chooses to buy the fund. But it is a a third and altogether different thing t experiment on behalf of a default investor, and it is the default investor who directly bears the risk.

For the most part, Morningstar recommends improved disclosure as the prescription for addressing its five concerns. The principles for improved disclosure include:

1) Creating three new, selected data tables that would be used only for target-date funds (thereby acknowledging both the unusual investment

characteristics of target-date funds, and also their position of privilege within employee-sponsored retirement plans)

a. A fee table comparing the fund's fees against the industry median fee, and the industry's cheapest fees. The table would illustrate the effect of compounding by showing how similar gross returns diverge on an after-cost basis over long time periods.
b. A table showing the fund's use of proprietary mutual funds, again comparing to the industry median and the industry's lowest use. This would be accompanied by standardized language discussing the pros and cons of target-date funds using proprietary funds.
c. A glide-path table that compares the fund's glide path against the industry median. In the discussion section, the fund company would be required to mention areas where it differs significantly from the median, and (briefly) the reasons for those differences. (It is fine for target-date families to differ from the consensus – but the investor should know when that is occurring, and understand why.)

2) Moving the manager ownership information that is currently contained within the obscure Statement of Additional Information to a position of greater prominence by being placed in the prospectus.

These changes would address all five of the concerns noted at the beginning of my testimony. They would not, however, address the final item of potential risk-taking by the smaller target-date families. That issue must await either a market solution – whereby fund families that disappoint are ruthlessly chased out of the business by a well-informed community of plan sponsors – or a tightened notion of the fiduciary responsibility engendered by target-date providers. But the latter is a subject for another discussion.

In summary, target-date funds are a useful and productive addition to the fund industry, and a clear benefit to employees who have 401(k) plans. They must improve further, however, if they are to fully earn their position of being at the heart of America's retirement future.

The CHAIRMAN. Thank you.
Mr. Derbyshire.

STATEMENT OF RALPH DERBYSHIRE, SENIOR VICE PRESIDENT AND DEPUTY GENERAL COUNSEL FOR FMR LLC, THE PARENT COMPANY OF FIDELITY INVESTMENTS, MARLBOROUGH, MA

Mr. DERBYSHIRE. Chairman Kohl, Ranking Member Corker, thank you for the opportunity to testify before you today. My name is Ralph Derbyshire. I am Senior Vice President and Deputy General Counsel for Fidelity Investments.

Since the advent of the 401(k) plan in the early 1980's, Fidelity has been a leading provider of investment and administrative solutions for plan sponsors and participants. Today, Fidelity record keeps 19,000 workplace retirement plans with more than 14 million plan participants. We are also the leading provider of target date funds with more than $93 billion in target date assets.

My testimony will focus on three areas: first, how target date funds help investors address improper asset allocation; second, how automatic enrollment plans and target date funds have helped increase retirement savings; and third, some suggested improvements to increase understanding of target date funds.

Target date funds were created to address one of the biggest problems with defined contribution investing: improper asset allocation. Across all age groups, the majority of plan participants hold equity allocations that do not align with the amounts that most investment professionals recommend. You can see in figure 1—and these figures are in the appendix to my written testimony—that as participants approach retirement age, there is almost an even split, with approximately 40 percent invested too aggressively and 40 percent invested too conservatively. That means that less than one-quarter of the retirement age participants are in an appropriate allocation.

In 1996, Fidelity introduced the Freedom Funds as one of the first mutual fund target date investment offerings to help address this asset allocation problem. As with most target date funds, Freedom Funds have an asset allocation mix that is more aggressive when the investor is younger and becomes more conservative as the investor grows older. The funds' managers set the target asset allocation mix and achieve that mix by investing in as many as 24 underlying Fidelity mutual funds. We employ a rigorous process of selecting those underlying funds based on an analysis of performance, risk, style consistency, and how well the funds complement each other. This provides sophisticated, long-term asset allocation in a simplified, straightforward investment vehicle for participants.

It is also important to note that for the Freedom Funds the target date is the date when the individual plans to retire and not when they plan to liquidate their holdings in the fund. Our target date funds are designed to last well into an investor's distribution phase, which for the typical investor will extend for at least 20 years beyond retirement. Figure 2 shows the asset allocation or the "glide path" of Freedom Funds over this entire life cycle.

As has been noted, target date funds have increased in popularity in recent years, due in large part to changes made to the automatic plan features in the Pension Protection Act of 2006. The percentage of plans at Fidelity that use a target date fund as the default option has increased from 38 percent before the effective date of PPA to 64 percent in 2009. Among plans at Fidelity that offer automatic enrollment, over 95 percent use a target date fund as the default option.

Our data also shows that the PPA automatic programs have had a dramatic effect on employee participation in retirement plans, particularly among lower compensated and younger workers. Figure 3 demonstrates how automatic enrollment impacts employee behavior. Overall, 76 percent of eligible employees are automatically enrolled into the plan with an additional 19 percent of employees opting affirmatively to enroll in the plan. Counting those few who then opt out at a later date, the overall participation rate for these plans is 89 percent, which compares very favorably to participation rates of 50 to 60 percent in plans without automatic enrollment. So this combination of a large number of participants coming into plans with automatic enrollment, combined with a default into the target date fund has had a powerful impact on participant asset allocation. That is demonstrated in figure 4.

There has been a lot of discussion about how target date funds have performed during last year's market downturn, and in this difficult environment, many individuals take dramatic action with their portfolios, often selling at depressed levels only to buy back later at a higher price when the market rebounds. But if an investor stuck with their target date fund investments, they would be well on their way to recovering their losses from last year.

For example, while the Fidelity Freedom 2010 fund was down about 25 percent for the 2008 calendar year, it is back up about 22 percent year to date in 2009. While that is not a complete recovery, these funds are designed for investing throughout retirement, again an additional 20-plus years, and over the long term, the 2010 fund has produced a greater than 6 percent average annual return since it was launched in 1996.

While we feel that target date funds are an important and valuable investment tool, we agree that improvements can be made to help enhance investor understanding. The Investment Company Institute earlier this year released a set of principles aimed at improving the disclosure, communications, and education around target date funds. Among the suggested recommendations include the clear and concise disclosure of the relevance of the target date when it is used in a fund name, the funds' assumptions about the investor's withdrawal intentions, the targeted age group and an explanation of the funds' glide path. These disclosures can enhance understanding by investors which will help assure that the funds are being used appropriately, and we fully support those recommendations.

I thank you for the opportunity to address this important topic, and I would be pleased to take your questions.

[The prepared statement of Mr. Derbyshire follows:]

Senate Aging Committee Hearing on target date funds
October 28, 2009
Testimony by Ralph Derbyshire

Chairman Kohl, Ranking Member Corker and members of the Committee, thank you for the opportunity to testify before you today. My name is Ralph Derbyshire and I am Senior Vice President and Deputy General Counsel for Fidelity Investments.

My testimony today will focus on three areas:

- How target date funds help investors address improper asset allocation
- How automatic enrollment plans with target date funds as the default investment have helped increase retirement savings, and
- Suggested improvements to help both plan sponsors and plan participants better understand target date funds.

Since the advent of the 401(k) plan in the early 1980s, Fidelity has been a leading provider of investment solutions and administrative services to plan sponsors and participants. Today, the 19,000 workplace retirement plans recordkept by Fidelity cover over 14 million plan participants. We are also the industry's leading provider of target date funds with 47 funds and more than $93 billion in assets under management.

Target date funds were created in the mid 1990s to help solve one of the biggest problems with defined contribution plan investors – improper asset allocation. Across all age groups, the majority of participants hold equity allocations that do not align with the amounts that most investment professionals recommend. Figure 1 demonstrates that as participants approach retirement age, there is an almost even split among those who are too aggressive and too conservative.

Target date funds are an important tool to help participants achieve better asset allocation. These funds offer investors the power of a diversified set of mutual funds in a single fund, with the added benefit of professional asset allocation. Through target date funds, investors avoid the risks of excessive caution early in life and excessive risk-taking as retirement approaches. It is a powerful offering for investors who lack the time, knowledge or interest needed to manage their retirement savings.

Fidelity was one of the first mutual fund firms to offer target date funds specifically designed to meet the needs of retirement investors. Known as the "Freedom Funds", Fidelity's target date funds have helped investors save for retirement since their debut in October of 1996 and have been tested during two market cycles over the last 13 years.

Our commitment to investors through these funds is to provide a disciplined and well-diversified approach to saving and investing for retirement. Freedom Funds have an asset allocation mix among stocks, bonds and short-term instruments that is more aggressive when an investor is younger and becomes more conservative as the investor nears retirement. The funds' managers set the target asset allocation mix for all of the Freedom Funds.

Each Freedom Fund invests in as many as 24 underlying Fidelity mutual funds. We employ a thorough, rigorous process of selecting the underlying funds, based on an analysis of performance, risk, style consistency, and how the funds complement each other. Although the Freedom Fund portfolio managers take a long-term approach to asset allocation decisions, they also review the portfolio on a daily basis and adjust or rebalance as needed.

Three elements are required for a retirement investor to meet his or her objectives: (1) adequate and consistent contributions, (2) a disciplined investment strategy that meets performance expectations, and (3) time. While no asset allocation approach will be successful if individuals do not contribute enough towards retirement savings, we believe the best-suited strategy for reaching a retirement goal is one that balances the trade-offs among required contributions, investment volatility, and time. Target date funds provide this balance and offer sophisticated long-term asset allocation strategies in a simplified, straightforward investment vehicle.

It is important to note that for the Freedom Funds, the "target date" is the date when the individual plans to retire and not when they plan to liquidate their holdings in the fund. Target date funds are designed to last well into an investor's distribution phase. For the typical investor, this will extend for 20 years beyond retirement, and could reach 30 years or longer for some retirees. The asset allocation for the Freedom Funds at the target date and in the retirement years takes into account several risks that can be grouped into four broad categories: longevity risk, market risk, withdrawal rate risk, and inflation. The Fidelity Freedom Funds currently have an allocation of about 50% to equities at the target date and this gradually declines until reaching 20% equities about 15 years after the target date. Figure 2 shows the asset allocation of Freedom Funds over the entire lifecycle.

The target date fund fee – like other mutual funds – is typically expressed in an expense ratio. The Freedom Fund expense ratio is derived from the proportional summation of the fees of the underlying funds in which the target date fund is invested. Fidelity does not charge an additional "wrap fee" on top of the Freedom Fund expense ratio.

Target date funds have increased in popularity in recent years due in large part to the changes made to automatic retirement plan features in the Pension Protection Act. While automatic enrollment of participants into 401(k) plans was available before 2006, the passage of PPA provided fiduciary plan relief to plan sponsors who select a "qualified default investment alternative" or "QDIA" for automatically-enrolled employees. In regulations issued in December of 2007, the Department of Labor included target date funds when it designated investments that were eligible to be QDIAs.

Since then, the growth of target date funds in plans has been significant. The percentage of plans at Fidelity that use a target date fund as its default investment option has increased from 38% in December of 2007 to 64% in September of 2009. Among plans at Fidelity that offer automatic enrollment, 96% use a target date fund as the default.

Our data shows that automatic enrollment has had a dramatic affect on employee participation in retirement plans, particularly among younger and lower paid workers. Figure 3 demonstrates how automatic enrollment impacts employee behavior. Overall, 76% of eligible employees are automatically enrolled into the plan. An additional 19% enroll by making a pro-active choice to contribute a different amount to the plan. Only 5% opt-out of the plan entirely before enrollment, and an additional 6% opt-out during the 12 months following enrollment, for an overall participation rate of 89%.

The combination of automatic enrollment and target date investing has had a powerful impact on participant asset allocation. The chart on the left of Figure 4 shows participant asset allocation in March 2000 vs. March 2009. The green bars on either end of the spectrum show the number of participants invested in either all equities or all fixed income. The bars in the middle show the number of participants at different asset allocations in 1% increments. The blue line represents the Freedom Funds' glide path and the yellow area is where we feel participants should be allocated with a glide path that becomes more conservative as the employee nears retirement age. Clearly, more participants in 2009 have a more balanced allocation between equity and fixed income than in 2000. Investment professionals can perhaps disagree over the precise mix of equity and fixed income that is appropriate, but I think most would agree that it is better to be somewhere in the middle rather than at the ends of this spectrum.

There has been much discussion around how funds have performed during the market downturn last year. After the worst year for the stock market since the Great Depression, it is understandable that investors are concerned about significant losses in their retirement accounts. In this type of environment, many individuals take dramatic action with their investment portfolios, often selling at depressed price levels only to buy back later at higher price levels. To avoid these pitfalls, we believe that it is important for investors to stay committed to their plan for retirement savings. Target date funds are designed to help participants maintain this discipline.

For example while the Fidelity Freedom 2010 fund was down 25.32% for the 2008 calendar year it is back up 22.40% YTD (as of10/23) in 2009. That means that $1 invested in 2008 is worth $.90 today. If we go back even further, we find that the 2010 fund has produced a greater than 6% average annual return since it was launched in 1996 – and this includes a lost decade for stocks. I think it's reasonable to assume that most investors will need at least 13 years to save for retirement.

While we feel target date funds are an important investment tool and we have actively engaged in educating investors about the many benefits of target dates funds, we agree that improvements can be made to help enhance investor understanding. The Investment Company Institute has been actively working with regulators on this issue over the past nine months and earlier this year released a set of principles aimed at improving the disclosure, communications and education of target date funds. We support these efforts.

Among the suggested recommendations include the clear and concise disclosure of the relevance of the target date used in a fund name, the funds' assumptions about the investor's withdrawal intentions, the targeted age group and an explanation of the funds' glide path. Such disclosures should be used to enhance understanding by investors and would not be meant to replace disclosures required by law.

Fidelity appreciates your concerns regarding the appropriate use of target date funds and the role they play in helping Americans achieve their retirement goals. As America's retirement leader, Fidelity is committed to helping solve the retirement savings challenge. We believe that the investment principles used by target date funds provide a critical foundation for individuals saving for retirement, and are an effective solution for participants who lack the time and inclination to apply lifecycle investing principles to their own retirement portfolios.

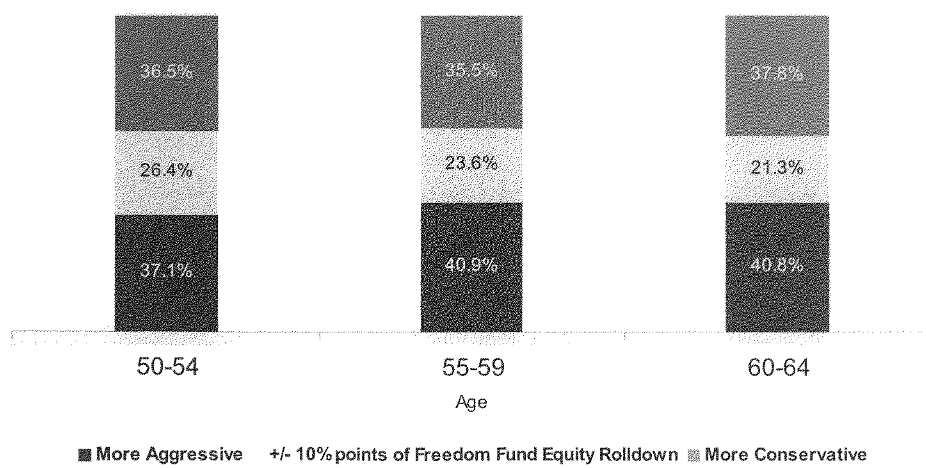
Thank you for the opportunity to address this important topic. I'd be pleased to take your questions.

Ralph Derbyshire
Senior Vice President, Deputy General Counsel
Fidelity Investments

Appendix

Equity Allocation +/- 10% Fidelity Freedom Fund Equity Rolldown

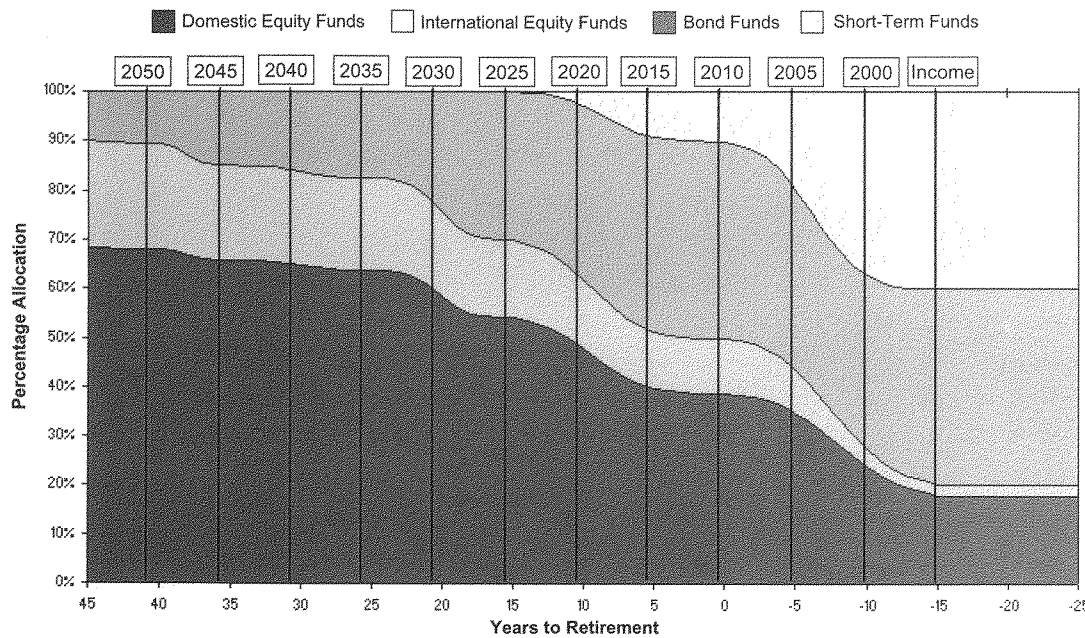
There is roughly an even split of participants near retirement with equity allocations more aggressive or more conservative than the +/- 10% Fidelity Freedom Fund equity allocation



Fidelity Investments recordkept data of corporate DC Plans (over 17, 500 plans and 11.3M participants) as of 3/31/2009.

Figure 1

Asset Allocation: Fidelity Freedom Fund Rolldown



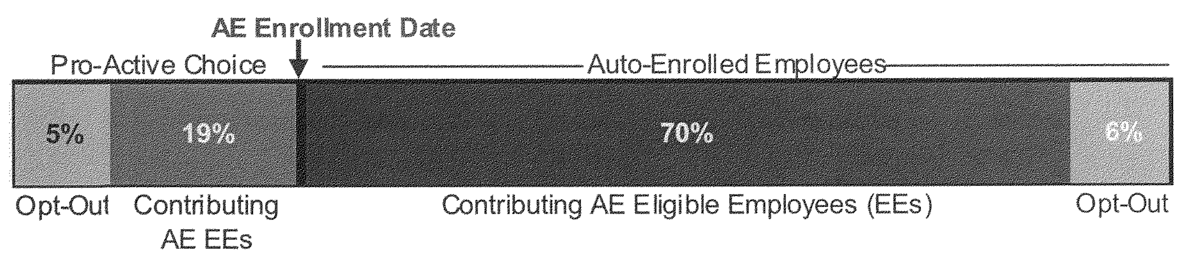
This chart illustrates the Freedom Funds' target asset allocations among Domestic Equity, International Equity, Bond, and Short Term funds. This chart also illustrates how these allocations may change over time. The Freedom Funds future target asset allocations may differ from this approximate illustration. Changes authorized by the Board, but not yet fully implemented. Rolldown as of 10/1/2009

Source: FMRCo.

Figure 2

Auto Enrollment Behavior

76% Overall, seventy-six percent of AE eligible employees are auto enrolled – only 6% opt out after being auto enrolled

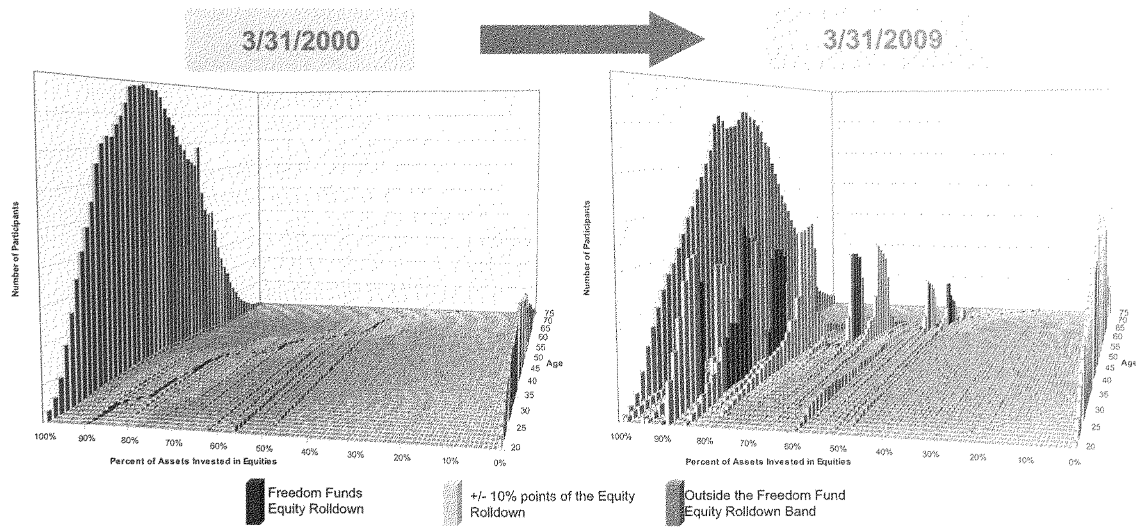


Fidelity Investments recordkept data of corporate DC qualified AE plans (over 2,690 plans and 5.2M participants) as of 3/31/09. Depicts the four categories of AE eligible employees as of 3/31/09 (percentages add to 100%). "Contributing" refers to making an employee pre-tax contribution in the 12 months period ending 3/31/09. % and represent portion of AE employees in each category who were still actively employed by plan sponsor as of 3/31/09.

Figure 3

Participant Plan Accounts Are More Diversified

1) Plans offering lifecycle, 2) Utilizing as the Plan Default, and 3) Participant Adoption of Lifecycle have created many more diversified participant plan accounts.



The Fidelity Freedom Funds® are target-date lifecycle funds designed to become more conservative and to hold a smaller percentage of equities as investors approach their retirement date. This chart assumes that participants will retire in the year they turn age 65. The equity rolldown schedule line is as of May 30, 2006, and it would continue down to 20% at age 80. Investors should allocate assets based on individual risk tolerance, investment time horizon, and personal financial situation. A particular asset allocation may be achieved by using different allocations in different accounts or by using the same one across multiple accounts. The equity rolldown shown is not intended as a benchmark for individual investors; rather, it is a range of equity allocations that may be appropriate for many investors saving for retirement and retiring at age 65. See the Exhibit Methodology section at the end of this deck for the definition of equities and an explanation of participant data included.

Figure 4

Additional Important Information

Additional Information About Charts Showing Participant Equity Holding versus Freedom Funds' Equity Rolldown

For the equity rolldown chart, "Equities" are defined as domestic equity, international equity, company stock, and the equity portion of blended investment options. A random sample of 5,000 participant data points are plotted on this chart. Percentage of assets invested in equities is based on data for participants in the defined contribution plans recordkept by Fidelity with a balance as of quarter end. These plans included both qualified and assetized nonqualified plans (i.e., nonqualified plans informally funded with mutual funds and other securities), as well as single-fund plans, which include Employee Stock Ownership Plans (ESOPs). Plans sponsored by Fidelity Investments for the benefit of its own employees are excluded. The Fidelity Freedom Funds® rolldown schedule on both Exhibits illustrate the Freedom Funds' target asset allocations among equities and was created by Strategic Advisers, Inc. This rolldown schedule also illustrates how these allocations may change over time. The Freedom fund future target asset allocations may differ from this approximate illustration.

Other Information:

The investment risks of each Fidelity Freedom Fund changes over time as its asset allocation changes. They are subject to the volatility of the financial markets, including equity and fixed income investments in the U.S. and abroad and may be subject to risks associated with investing in high yield, small cap and foreign securities. Principal invested is not guaranteed at any time, including at or after their target dates.

Fidelity Freedom Funds are designed for investors expecting to retire around the year indicated in each fund's name. It is important to keep in mind that the Freedom Funds are designed to become more conservative as they near their target retirement date.

Before investing in any mutual fund, please carefully consider the investment objectives, risks, charges and expenses. For this and other information, call or write Fidelity for a free prospectus. Read it carefully before you invest.

The CHAIRMAN. Thank you.

Mr. Smith.

STATEMENT OF MICHAEL CASE SMITH, SENIOR VICE PRESIDENT, INSTITUTIONAL STRATEGIES, AVATAR ASSOCIATES, NEW YORK, NY

Mr. SMITH. Good afternoon, Chairman Kohl, Ranking Member Corker.

My name is Michael Case Smith and I am not a lawyer. I am a target date fund manager. I am with Avatar Associates. Avatar was founded in 1970.

We have target date funds to 401(k) plans and profit sharing plans. Avatar willingly accepts and acknowledges it is a fiduciary for the allocation of the variable fee funds that we use to construct our target date funds. We can do this because we have limited the ability to self-deal and the conflicts of interest by constructing the target date funds with exchange-traded funds with which we have no economic interest. I will note that according to an article earlier this week, about 2 percent of the target date funds follow that non-conflicted model.

I have been asked today to talk about conflicts of interest in target date funds, primarily proprietary target date funds. These are mutual funds that are constructed with shares of other mutual funds, typically mutual funds from the same company. We believe, our clients believe that target date funds allocated in this manner embed conflicts of interest. This is because the fund company determines its own mix of mutual funds. Since each underlying fund has its own fee structure, controlling their allocation may directly or indirectly affect the company's compensation.

Fund companies take the position that since target date allocations occur within the mutual fund, ERISA laws against self-dealing do not apply, and since ERISA does not apply, they are not fiduciaries. Since they are not fiduciaries, they are perfectly free to self-deal and put in their portfolio things like new funds that do not have long track records that would attract investment as a standalone option on the fund roster, poor-performing funds that, again, perhaps would not attract assets as a stand alone fund on a 401(k) roster or funds with a higher fee structure such as equities compared to bonds.

But for the Department of Labor's interpretation that shares of an underlying mutual fund do not constitute plan assets, such self-dealing within a target date fund would clearly constitute a prohibited transaction under ERISA. We do not believe that the exemption was meant to apply to proprietary asset allocation in mutual funds because such investment structures either did not exist at the time of the designing of ERISA or virtually unheard of, therefore certainly not contemplated by Congress.

The committee is aware of Avatar's request to the Department of Labor to answer a simple question: Should this exemption to rules against self-dealing apply to target date funds? If not, shares of the underlying proprietary funds and the target date fund of funds will be seen as what they are when they are offered as a stand alone option: plan assets under ERISA. If they are found to be plan assets under ERISA, fund companies would be prohibited from self-dealing and have to put the interest of the participants and beneficiaries ahead of their own. This is something many plan sponsors and participants frankly would be surprised to learn that fund companies are not required now to do when they select, monitor, and allocate their own variable-fee funds.

ERISA section 3(21) and 401(b) provide that under most scenarios assets underlying a mutual fund do not constitute plan assets. But these provisions carried qualifications back in 1974 such as "shall not by itself" or not "solely by reason of." The wording of these statutory provisions shows us that the exception applicable to the underlying assets of a mutual fund—that is, the underlying fund of funds—is not absolute.

An interesting piece of legislative history shows that the Department of Labor's ERISA exemption on this matter was premised on the applicability of protections against self-dealing, self-interested transactions that are part of the Securities and Exchange Commission's Investment Company Act.

As Senator Long stated in a 1973 Committee on Finance report—and I will quote—"Mutual funds are currently subject to substantial restrictions on transactions with affiliated persons under the Investment Company Act of 1940." This would argue against the extension of the exemption to tiered asset allocation of mutual funds from ERISA rules against self-dealing.

Now is the perfect time for Congress to clarify that such conflicts of interest are prohibited and in that way protect plan participants and our Nation's private pension system. Once this conflict is eliminated, target date funds that have embedded conflicts of interest have a number of easy ways to comply.

One way of doing so would be to simply adopt the protections for the exemption of investment advice, one-on-one advice, that Assistant Secretary Borzi spoke of that Congress already passed in the Pension Protection Act. I am glad to hear that she is looking to upgrade those protections and they will be unbiased and affordable. In that example, an algorithm would be used from a non-conflicted third party to review the in-house glide path and allocations of the fund company.

Another way that a company can comply is turn over the allocation to an independent third party, something I would note that fund companies already do in their managed account options under Sun America Advisory.

I would like to conclude by saying that Avatar's goal in being here is to encourage and support a robust and equitable target date market by having asset allocation determined in a non-conflicted manner. Our goal to be here is to encourage Congress to clarify what respectfully probably seems like common sense to 435,000 plan sponsors and 70 million Americans: Parties-in-interest should be prohibited from self-dealing in target date funds.

Thank you for your time. I welcome any questions.

[The prepared statement of Mr. Smith follows:]

"Default Nation: Are 401(k) Target Date Funds Missing the Mark?"

Good afternoon, Senator Kohl, Ranking Member Corker, and Members of the Committee. Thank you for inviting me to appear before you today.

I am Michael Case Smith, Senior Vice President for Institutional Strategies and Target Date Portfolio Manager with Avatar Associates. Avatar, founded in 1970, is an investment management firm that specializes in asset allocation and uses ETFs, in which we have no economic interest, as the underlying investments for strategies offered to 401(k) and profit sharing retirement plans. Avatar customizes its products to meet client objectives, using a process that employs quantitative, top-down, macro-economic models that are proprietary to Avatar. These models are refined qualitatively by Avatar's seasoned research and portfolio team with the result that each fund is managed to suit a particular level of risk ranging from conservative to aggressive. As an un-conflicted investment manager, Avatar willingly accepts responsibility as a 'fiduciary' within the meaning of Section 3(21) of ERISA.

The Committee is aware of our efforts to seek clarification from the Department of Labor on whether the fund of mutual funds structure used by retirement plans creates a scenario where the underlying funds become plan assets under ERISA and subject to the fiduciary standards of ERISA.

Today, I would like to offer my views on a topic of critical importance to the retirement income security of Americans, namely the ever-increasing use of default investment alternatives, such as target date investment funds, not only in the absence of participant investment direction, but also as an affirmative choice by millions of Americans who lack the experience, confidence and/or time to exercise direct control over the investment of assets in their pension plan accounts. This has resulted in a heavy reliance on target date investment funds that are generally structured using a fund of funds approach.

I would like to briefly repeat an observation I made at the recent Securities and Exchange Commission/Department of Labor hearings on target date funds, namely, that Avatar believes a participant's retirement date is like no other date. It is when the participant ceases to contribute to his 401(k) plan account, when the employer ceases to contribute and when he begins to withdraw funds. We believe the closer the retirement date, the more conservative the investment allocations should be. Other investment organizations effectively minimize the importance of the retirement date and argue that because the participant is expected, on average, to live many more years, a much more aggressive investment allocation is called for. Unfortunately, the last few years of market experience have exposed this approach as very risky, particularly for those nearing retirement. I hope that the law moves toward requiring more clear and simple disclosure of which investment philosophy is being used in the management of the target date fund.

I would now like to turn to the question at hand: We believe many target date funds have embedded conflicts of interest. Some mutual fund companies create a "fund of funds" that invests in shares of other mutual funds that are funds of the same mutual fund family.

Technically, a mutual fund is a separate corporation registered under the Investment Company Act of 1940 with its own board of directors that is charged with protecting the interests of the fund's shareholders. In practice, however, the adviser to the mutual fund that manages its assets tends to dominate the fund's board of directors. The adviser may collect management fees, not only from the underlying funds, but also from the fund of funds itself, resulting in a tiering of fees. These fees reduce investment returns, and, thus, are ultimately paid for by the fund's shareholders.

Importantly, in a fund of funds, the adviser determines the mix of underlying mutual funds, each of which has its own fee structure, and in so doing may directly or indirectly affect its own compensation.

A fund of funds offers opportunities for an adviser to enhance its profits by engaging in self-dealing. The goals of the fund adviser, as opposed to the best interest of plan participants, may be furthered by including new funds in the mix of underlying funds, thereby providing the new funds with start-up capital. A fund of funds could also serve as a means to direct: (i) assets to those funds that are unable to attract investment on their own because of poor performance or other issues, and (ii) investments toward funds with a higher fee structure such as equities compared to bonds.

Now is the opportune moment for Congress to clarify that conflicts in the allocation process are prohibited. A conflict of interest, which may result in the skewing of plan asset allocations to allocations that are more profitable or beneficial for the adviser or fund family than is reasonable, prudent or comparatively efficient is not currently regulated or even required to be disclosed. This raises a number of issues under ERISA. But for the Department of Labor's interpretation that the assets underlying a tiered mutual fund do not constitute plan assets, the embedded conflict regarding asset allocation in a fund of funds would constitute a prohibited transaction under ERISA.

Avatar believes that the statutory provisions that address whether the underlying assets of mutual funds are plan assets are not particularly clear. Section 3(21) of ERISA provides that a plan's investment in a mutual fund "shall not by itself cause such investment company [i.e., mutual fund] or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest" for purposes of ERISA. In addition, Section 401(b)(1) of ERISA provides that if a plan invests in a mutual fund, the plan's assets shall not "solely by reason of such investment, be deemed to include any assets of such investment company." The wording "shall not by itself" and "solely by reason of" begs the question that the exception applicable to the underlying assets of mutual funds, that is, to the underlying funds in a fund of funds, is not absolute. We at Avatar suggest that this exception to ERISA's remedial scheme was not meant to apply to tiered asset allocation mutual funds where the adviser does the allocation, because such an investment structure either did not exist at the time of ERISA's passage or, if it existed at that time, was virtually unheard of and therefore not contemplated by Congress. Further, the legislative history concerning the relevant statutory provisions, which indicates that the underpinning for this exception was premised on the applicability of protections against self-interested transactions that are part of the Investment Company Act, supports the conclusion that no relief should be provided from the self-dealing that is inherent in tiered mutual fund asset allocations.

Now is the perfect opportunity for Congress to clarify that such conflicts are prohibited, and, in that way, protect plan participants and our nation's private pension system.

In conclusion, given the demand for default investment alternatives, such as target date funds, it is important to ensure the integrity of such investment offerings. One practical way of doing so would be to adopt the protections in the exemption for investment advice contained in the Pension Protection Act of 2006 to reduce and disclose conflicts of interest. For example, a mutual fund adviser of a tiered asset allocation mutual fund could be required either to: (i) use algorithms of an independent third party for asset allocation, or (ii) at least have its own algorithms certified by an independent person as not biased, and then have the actual asset allocation audited to ensure that allocations are made consistently with the independent or certified algorithms. While some may say this could result in additional, unnecessary cost, this position is not credible given the billions of dollars recently lost as a result of the over concentration in equities which could have been caused by conflicted asset allocation.

The goal is to encourage and support a robust and equitable target date fund market by having the asset allocation determined in an un-conflicted manner -- this would lead to a win-win situation for all: less fiduciary exposure for plan sponsors, better rates of return and more reasonable administrative fees for plan participants, more satisfied clients for mutual fund families, and amore robust pension system for all of America.

I thank you for your time and consideration and would be happy to answer questions.

The CHAIRMAN. Thank you, Mr. Smith.

Questions from the panel? Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. I appreciate the courtesy of that, and I certainly appreciate all of your testimony. I find this to be a pretty fascinating hearing.

I want to start by saying I hope that we will not get into the mode of trying to legislate returns. My guess is one of the main reasons we are having this hearing is we have had a downturn in the market, and all of a sudden, people's expectations were not met. I doubt many of the people on this dias up here had their expectations met. I doubt many people in the country did.

So I will just set the stage from my own point of view to say that I realize that there have been lots of tragedies, lots of disappointments, lots of people who reached retirement age who have not met their expectations. Again, I do not think we can legislate returns, and I am sure that is not what the Department of Labor is hoping to do.

I would ask this question. Why would we not have as a default investment something like Treasury bonds or something like that and allow people to opt into more risky investments down the road if they choose to do that? The Labor Department.

Ms. BORZI. Unfortunately, I was not around a couple of years ago when the qualified default investment regulation was passed, but I am sure that those kinds of safe investments were considered as part of the default investment approach.

I think at the time people certainly thought that a target date fund was a relatively easy way for a participant to be able to get the diversification and not have to deal with the constant rebalancing in asset——

Senator CORKER. Well, that is what it is.

Ms. BORZI. But I think your point is very well taken.

Senator CORKER. But it is that. Right?

Ms. BORZI. We are going to be looking back at the qualified default investment alternative regulation in the context of target date funds, and maybe that is an issue we need to look at.

Senator CORKER. I am not necessarily in any way saying that is a good idea. I am just asking the question.

John?

Mr. REKENTHALER. Well, if I may, a few years back stable value funds I believe, which were a form of a cash fund and a more conservative investment, were the primary default—when defaults were used. They came under quite a bit of academic criticism from the academic community and others, the main point being that people who were defaulted into 401(k) plans through automatic enrollment plans tended not to move. They tended to be inactive and inert, and therefore, they were stuck in cash, the lowest-performing investment. Well, at least that was the theory, that cash was the lowest-performing investment a few years back.

I mean, the main concern was that people who were defaulted into an overly conservative investment would miss participating in a market growth over the years and would not make the change because they tended to be the least active of investors. I think target date funds were intended as a middle ground.

Senator CORKER. Of course, that is what we have done with Social Security. Right? We put people in the lowest-performing asset for life.

But, Mr. Derbyshire, let me ask you this. There is a whole lot being made of fees, and I am in some investments where we pay huge fees. They happen to be, by the way, the greatest returns also. I wonder if you would like to talk a little bit about the focus on fees. In essence, should we not be looking at the overall return of the portfolio in relation to other investments? Is there some concern that if we focus only on fees—I mean, the fact is you could have some very poor performers, people who really do not do much work who charge a very little fee, but in essence, their performance is not particularly good. I wonder if you might enlighten us in that regard.

Mr. DERBYSHIRE. Well, I think at the end of the day, obviously, performance net of fees is the single most important criteria for evaluating whether a fund has performed well.

In looking at target date funds, I think what Morningstar would tell you about fees is that there are some outliers, but for the most part, the fees within target date funds are actually well within the mainstream of mutual funds as a whole. So I am not sure that there is a particular problem overall with the level of fees in target date funds. After all, most of these funds are themselves made up of other mutual funds that have an existing fee structure in them. So I do not think for most target date funds there is a special issue regarding fees.

Senator CORKER. Do you have any idea how your portfolio has performed as opposed to Mr. Smith's which just invests in indexes? Has there been a marked difference? I mean, obviously, Mr. Smith is touting—and by the way, I think it is a very good point—not having a conflict of interest. Obviously, you think your funds are the very best funds there are, and that is why you invest in them. You all create them. Has there been a marked difference in return between the two?

Mr. DERBYSHIRE. I am not familiar with Mr. Smith's product and its returns, so I really could not comment on that.

Senator CORKER. But at the end of the day, I guess the question is we are trying to—I worry a little bit about the involvement that we are considering putting ourselves into here as it relates to what we are going to be telling people to invest in and not invest in. I understand the conflicts issue. But again, at the end of the day, what we are hoping to happen is that people will save and that they will invest in funds that give them the greatest return. Sometimes that can be done through the exchange route. Sometimes that is done proprietarily. I hope that we will not over-involve ourselves.

Mr. DERBYSHIRE. Well, I would just comment I think Mr. Smith's remarks were mostly directed at the conflict of interest issue as opposed to the aggregate, overall fee level. I would be happy to speak to the conflict issue, if that is your question.

Senator CORKER. That would be great.

Mr. DERBYSHIRE. Sure.

So the point that is being made essentially involves two propositions. One is that because of the fee structure in these funds, the fiduciaries that are managing these funds are going to make different and worse investment decisions. In other words, the managers will invest in higher-paying funds in order to pay more revenue to themselves or to prop up an under-performing fund with additional assets. The second proposition is that we should use ERISA rules to regulate that conduct. I would dispute both of those propositions.

The first one about the investment advisor's conduct, Mr. Smith said the investment advisor is not a fiduciary. Well, he is correct that it is not a fiduciary under ERISA, but it is a fiduciary under the Investment Advisors Act. So that fiduciary has to manage the fund in the best interests of the shareholders, and it would be a clear breach of that duty to invest in a fund solely to generate more revenue for the advisor itself.

The second point I would make is that mutual funds, because of the Investment Company Act of 1940, are regulated by a board of directors and that board has to include independent directors. In fact, in the case of Fidelity's Freedom Funds, 75 percent of the directors on the target date board are independent. The board provides oversight over the activities of the investment advisor, which is an additional protection.

In terms of the second proposition about using ERISA's fiduciary rules to provide some layer of additional protection, what I would say is it is not an accident of history that ERISA was not imposed on mutual fund managers and the mutual fund assets. It was a purposeful decision made by Congress in 1974, and it was precisely for the reasons I cited, which is that there are two securities laws enacted in the 1940's that were specifically designed to govern mutual fund conduct. To introduce ERISA into that framework would result in both duplication and potential inconsistencies.

An important point here is that mutual funds include many different investors. They are not all employee benefit plan investors. What is the rationale for imposing ERISA, which is an employee benefit plan statute, into an investment vehicle that includes nonretirement plan investors?

So I think both of the propositions are false, and the evidence I think bears out that these funds are not being used in the way Mr. Smith would allege.

Senator CORKER. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Corker.

Senator Bennet.

Senator BENNETT. Thank you, Mr. Chairman.

Thank you very much, all of you, for your testimony. I was watching it before I came over. I just wanted to ask a couple of questions, one along the lines of Senator Corker's question about these two funds.

Can somebody speak to the overall return in this downturn that we had of target date funds versus other kinds of mutual funds? I mean, was the performance the same, worse, better?

Mr. REKENTHALER. I guess that is my job.

Broadly speaking, target date funds performed as a somewhat more aggressive version of balanced funds. So, in other words, they performed somewhat better than pure stock funds, definitely a lot worse than conservative, fixed-income Treasury-type portfolios. The prototypical balanced fund is 60 percent stock, 65 percent stock. A lot of the target date funds with the assets being in the longer-dated funds were a little bit heavier in stock than that and did a little bit worse. Just as an example, the stock market was down 37 percent, and I think the typical target date fund was down in the upper 20's. It depended upon age, the longer-dated funds. But they certainly were mortal. No question about that.

Senator BENNETT. Everything was.

Mr. REKENTHALER. Yes.

Senator BENNETT. One of the things that just was so striking to me when I was starting to have town hall meetings in January and February and March is that everyone was deeply concerned about where the economy was. I think the people most concerned about it in my view actually were young folks coming out of school who felt like they were going to be the last people hired into this economy. They still continue to worry about it. People in their 70's who had seen, in many cases, half their net worth vanish at Dow 6500. It looks a little better at 10,000.

I also agree with Senator Corker that we need to be very careful about how we legislate these kinds of things. We cannot legislate returns.

I was really struck, as I read some of the written testimony and also heard some of the earlier testimony by Chairwoman Schapiro about how huge the variation was in balancing in these funds. I think some of the funds have 21 percent equities. Some have 79 percent equities, and then there are a lot in between. If you were right on the cusp of your retirement and free to choose, obviously, to have 100 percent in equities, but if these funds are meant for retirement and people are not moving in or moving out of them very much, it just worried me to see that huge a distribution. I wonder if anybody has got thoughts about that.

Mr. REKENTHALER. I would like to address that a little bit. One is that the variation among the target date funds is really pronounced in the near-dated funds near retirement. Actually the longer-dated funds all look, broadly speaking, the same. A 2040 fund and a 2050 fund are pretty much—the 2040 funds range from 80 percent stock to 95 percent stock. They are stock funds. They tend to perform similarly. The 2010 funds are where you have the range from 26 percent in equity on the low end to 72 percent in equity on the high end.

There really is not an investment consensus—and I would say this is clearly an investment issue—among the fund families as to how you should be positioned. If you emphasize, as many do, that a 65-year-old married couple—you know, the odds are that somebody is going to live 25 years or so more, at least one party in the marriage—and you think about longevity risk and protection against inflation and so forth, you emphasize equities. There has been a whole lot of research done on that in financial planning journals and everything else saying that that is reasonable and sound and not—at least from published and reasonable journals saying that this is a fair approach. It is not somebody just inventing something.

On the other hand, there are those who take a more conservative approach, concerned about market risk. A lot of it depends upon the assumptions of the withdrawal rate of the investor which we do not know what the withdrawal rate of the investor is.

So there are a lot of assumptions built into this, and it is tricky on the retirement age. I would say—I think we all feel—that this is about the top of the first inning almost in terms of thinking about how funds behave during retirement, and if you are going to take somebody through retirement in a target date fund or another kind of investment, how should that be structured. We are much later in the game in that than we are in the accumulation phase where there has been much more of a consensus.

Senator CORKER. Phyllis.

Ms. BORZI. I want to echo that, Senator. One of the things that we are so concerned about at the Department of Labor is that not only do participants not understand the choices in front of them when they have target date funds, but oftentimes it appears the fiduciaries do not understand, when they select these funds, the variation.

Why is that? Well, I think in part it has to do with the fact that many of the employers who choose a target date fund as part of their investment platform do so because they think they are doing the right thing for their employees. They understand that one of the biggest mistakes that people make is in allocation, and that it is the most difficult decision that the participant has to make when faced with how to allocate his or her own portfolio. So the target date fund is an attractive option.

One of the things that we are trying to do—and we are working with our colleagues at the SEC about this—is to try to figure out how we can structure better disclosure so that fiduciaries, particularly small- and medium-sized employers, have the information that they need to make more intelligent decisions. I have to commend my co-panelist from Fidelity. Many of the mutual fund companies themselves have been working very hard to try to focus on this disclosure issue. It is a concern that we all have. Unfortunately, one of the other things that we know is we can have the best disclosure in the world, but that will not make people read it. So I do not know how we are going to overcome that problem of participant understanding.

But our first job is to educate the fiduciary so that as they select these funds, they are in a better position to be able to evaluate the relative risks and rewards and then try to help communicate these choices to the actual participants.

Senator BENNETT. Do you have a view?

Mr. DERBYSHIRE. Well, Ms. Borzi actually picked up on what I was going to say, which is that even if we cannot educate all the participants, we can certainly educate fiduciaries around the assumptions that go into building a target date fund.

As Mr. Rekenthaler mentioned, I think the most critical assumption around these near-retirement date funds is the withdrawal assumption that goes into the funds. That probably accounts for most of the variation in the asset allocation. Part of the ICI's recommendations are to make sure that that information is available to both plan sponsors and participants so they can make an appropriate decision around the funds.

Senator BENNETT. Thank you. Thanks to the panel and thank you, Mr. Chairman, for holding this hearing.

The CHAIRMAN. Thank you, Senator Bennet.

Ms. Borzi, some have suggested that the regulations be changed to require the investment manager of target date funds to assume fiduciary responsibility in order to qualify as a default investment. Do you think this is a good idea? Can it be done within the Department or we must we do it legislatively?

Ms. BORZI. If you are specifically asking about the question that Mr. Smith raised as to whether or not the mutual funds need to take fiduciary responsibility for how they structure the underlying investment option, I think that is a difficult question to answer. As he pointed out and as Mr. Derbyshire pointed out, we are constrained by the statute. What we regulate is conflicts of interest and issues related to the fiduciaries, not the underlying investment asset. I know that a number of witnesses at our hearing suggested that we need to look into this question and maybe make some changes.

I would just be cautious about this. I am not ruling it out or ruling it in. I am just saying at this point I think it is a little too early to make that decision. I think it has ramifications. It does involve our colleagues at the SEC who typically regulate the mutual fund itself. We regulate the fiduciaries. But I think that there are a lot of short-and long-term effects that have to be evaluated in order for me to answer that in a straightforward manner.

The CHAIRMAN. OK.

Mr. SMITH. If I may?

The CHAIRMAN. Yes, sir, Mr. Smith.

Mr. SMITH. Mr. Derbyshire laid out an argument that as long as we are doing the allocation of shares that are recognized as plan assets, it is perfectly OK. It sort of begs two questions. No. 1, the fiduciary relief he points to was exactly the loophole I was speaking of, pointing to another area of fiduciary relief. The question it begs is, if it is perfectly OK to do it within the life cycle fund, why did they not do it for the previous 25 years when those shares of their mutual funds, which are plan assets, were standing alone on the investment roster? Did they not because it is against the rules for a party-in-interest to self-deal and take discretion over participant assets and skew them to portfolios of which they receive variable fees.

But if it is the case, I would challenge Assistant Secretary Borzi. What is the point of upgrading the investment advice rules under the Pension Protection Act if those are meant to remove conflicts of interest from somebody giving advice to a participant in a one-on-one setting? Do not bother if it is OK in an embedded mutual fund. But those are two very different things.

Ms. BORZI. They are two very different things. The point of the investment advice rule is to be sure that people get accurate, straightforward advice regarding their investment choices. Again, part of the problem here is that we have a statutory provision. Our regulation is supposed to be consistent with the statutory provision.

As you probably know, this issue, the issue of what kind of investment advice could be given, was the last issue that Congress addressed in the context of its discussion of the Pension Protection Act. There was a fundamental policy disagreement as to whether or not any form of conflicted advice was permissible or whether there were sufficient safeguards that could be crafted so that in a potential conflict-of-interest situation, participants can be protected.

Unfortunately for the point of view that you are expressing, Congress made a different policy choice, and the policy choice Congress made was to craft an exemption from ERISA that allowed, under certain narrow circumstances, advice to be given by an entity that was already a service provider with respect to a plan. The reason that we are rethinking the investment advice regulation is because we want it to be much closer to the intent expressed by Congress to make sure that the safeguards are there.

As I pointed out a minute ago, the underlying statutory authority for the Department is pretty clear. I think the statute is clear that we have the ability to regulate the fiduciaries but that we do not have the ability to regulate the mutual funds in creating these investment options.

Congress could, of course, as the chairman pointed out before, always change the law, and all I am suggesting is I think that there are a lot of things you need to think about before we move forward in that direction.

Mr. SMITH. My only point, and the last one, is the statutory language gives what we will call wiggle room, and they use words like "not solely of" and what have you.

Ms. BORZI. My lawyers disagree. While I am a lawyer myself, the one thing I learned in private law practice is that clients are better off listening to their lawyers than going off on their own. So that is the legal advice I am getting from my lawyer.

Mr. SMITH. Fair enough. But on the one-on-one advice side, you pulled it from the previous administration. Let us assume it was to make it a higher level of safety for the plan sponsor. The words you use, Assistant Secretary, were "unbiased," and that is all we are asking. That is all we are saying. If it is unbiased in one-on-one advice, it should be unbiased in the mutual fund——

Ms. BORZI. I am using "unbiased" in the context of the statutory provision that we are charged with interpreting.

The CHAIRMAN. Mr. Donohue.

Mr. DONOHUE. I hesitate to jump in here but I will.

I just would like to make the point that for investment companies, it is a comprehensive regulatory regime, that independent directors in particular put in place to help oversee conflicts that exist that advisors have in any number of areas, and this may be one. So boards have responsibilities. Investment advisors are fiduciaries to the fund. Board of directors are fiduciaries. They have responsibilities not just to the fund but also to the fund shareholders which would include investors and do include all investors into those funds.

Among other things that the board will wind up approving, the board will wind up approving the overall fees that are being received by the manager for what they are performing. They have obligations to do that under section 15. The manager has obligations to provide to the board all information that has been requested or is relevant to that determination of whether or not the fees are appropriate. Then there are remedies available under 36(b) for either the SEC or individual investors to sue where they think that the fees may be inappropriate.

So if the concern is that there may be conflicts in terms of moving assets into certain underlying funds because of higher fees, there is a regulatory regime that is in place that should be overseeing that and should be doing that effectively. So I think that is one aspect of it.

The second thing is having been set up as fund of funds, these funds hopefully are taking advantage of economies of scale that are occurring at the underlying funds. You could set up a target date fund where you invest directly in the underlying assets without going through another fund, and doing that in that manner would not raise any of the concerns that were raised by Mr. Smith because that is what mutual funds do.

So in doing that, the statutory regime for fund of funds actually has a preference for in-house funds because of some of the conflicts that arose prior to 1940 where funds were investing in unaffiliated funds and could put a certain amount of pressure on the non-affiliated funds to do certain things for them. So there is a preference that is built into the statute, into the regulation for investing in underlying funds in excess of what would have been permitted otherwise under the 1940 act.

So without getting into the issues relating to the application of ERISA, which I am not an expert in, I would say that I do think there is a comprehensive scheme that is in place.

The CHAIRMAN. Thank you.

Senator Corker.

Senator CORKER. Yes, sir, thank you. I think Mr. Derbyshire wanted to respond to your question.

Mr. DERBYSHIRE. Well, I just wanted to add one final point about the overall notion that there is somehow a deep conflict in Fidelity or some other provider choosing its own funds, and that is the fact that when an investor chooses a Fidelity target date fund, they are asking us to manage their assets for them. It would almost be contrary to common sense to say, "Well, we should be required to invest in someone else's funds." As Mr. Donohue noted, we could manage these funds as a total pool of assets without having a fund of funds structure, and if they have asked us to do that, it should be OK for us to invest in our underlying funds if that in fact results in economies of scale and better investment results for the participants.

Senator CORKER. Just to follow on that thinking, I suppose that—and I know this is not something that we in essence regulate, but you potentially feel a greater obligation to the people investing to ensure that your funds perform than you would if you were just getting a fee, if you will, for putting it in a fund you were unrelated to. I would assume that would be the case.

Mr. DERBYSHIRE. Yes, well, I think that would be fair. We want to understand what we are buying and what we are investing in and we certainly would know more about our own funds than we would about anyone else's.

Senator CORKER. Then if you want to give a counter point, Mr. Smith.

Mr. SMITH. I do. Here is what the industry has done on this point. They have said let us disclose this. The problem is we deal with small business owners and small businesses. Small businesses do not do a 401(k) plan based on the life cycle fund. They do it on the platform and the services and what have you. So the question for the small business owner is, if I do what the industry tells me to do, and I do my evaluation, and I say specifically, if I may, I am in a Fidelity plan and I say I want to fund X life cycle fund, I frankly do not have the choice. So we talk a lot about all the options out there, but when I am employee at a small business, which represents the vast number of the 401(k) plans out there, I do not have choice on my platform. Right?

Mr. DERBYSHIRE. I would say that we are an open-architecture shop where we will allow people to put whatever investments we can administratively operate on our platform. There may be economic consequences to that because, of course, we rely on the revenue from our funds to run our business. But we are an open shop and if plan aduciaries want to put different assets on our platform, we will do that if we can accommodate them.

Senator CORKER. Go ahead, John.

Mr. REKENTHALER. If I may speak to this without touching on any of the legal issues, if that is possible, because I am apparently the only non-lawyer here or there is a well-versed non-lawyer there. But I am definitely not a well-versed non-lawyer.

I guess our view—and I discussed these proprietary funds. Just step back and looking from a high level is that when 401(k) plans began, they tended to be so-called closed architecture where the organization, the record keeper would bring in only its own funds, and the large plans fought against this and made them be open and unbundled. Those same large plans now are—you know, it is quite in vogue to create so-called custom target date funds where target date funds at a large plan are constructed for a low cost using a variety of funds from a variety of providers in an open-architecture setting.

So my view is large plans have generally led the way because they are large institutions that are well informed and have buying power and they have pushed for open architecture and they have pushed for low costs. It seems to me that is where the target date industry overall needs to be doing and not just for employees in large plans but for employees in companies across the country of all sizes.

Senator CORKER. A response, Mr. Derbyshire?

Mr. DERBYSHIRE. Well, I would certainly agree that large plans have led the way, and I think that is normally the case in most developments. There is nothing different about target date funds in this vein. Large plans have, obviously, more economic power to negotiate the deals that they want and they are very, very demanding at every level. What I would say is that the entire 401(k) industry, small and large employers as well, benefit from those developments. So the extent that these large employers are negotiating better arrangements for target date funds in their plans, those get extended to the rest of the market as well. It takes time but I think everyone benefits.

Senator CORKER. So, Mr. Chairman, I am going to be 100 percent honest and say that I do not know that I understand all the arcane issues of ERISA. I know our staff and I are going to talk more fully about this after the hearing.

I think this has been, though, really enlightening, and it seems to me that what Labor has said is that we need to make sure that employers are far more educating employees. I absolutely agree. I know, having been an employer, making these decisions is excruciating, and you want to make sure that your employees 20 years later who have invested in these funds and you have invested funds for them have a retirement. I think there is a tremendous lack of education in that regard. I know that we had seminars each year to sort of let our employees know. But that needs to happen. It needs to happen a lot more. I applaud your efforts in trying to make sure that that occurs.

I think from the standpoint of employers, I think some of them may decide to go with the funds that they feel like have no conflicts and they may, on the other hand, decide to go with funds that they just have faith in because of a track record. At the end of the day, you want to make sure that those returns are there.

I think the other issue I would take from this or the other point is this target date fund—making sure people understand what that means. If they plan to withdraw all of the money when they are 65, that means one thing, and if they plan to live off of it, they hope they have good genes and they are going to be around for another 20 years after that, that means something totally different. It seems to me that that is another piece. Obviously, the strategies vary widely in that case when you have to go on another generation versus ending at a date.

So I think this has been a great hearing, Mr. Chairman. I appreciate you raising this issue. I hope, on the other hand, we do not overreact to a tremendous downturn in the market and try to do some things that over time might hurt the very people that we would all like to see retire with greater savings in hand.

So thank you all for your testimony, and I think each of you have provided a lot of information.

The CHAIRMAN. Thank you, Senator Corker.

Senator LEMIEUX.

Senator LEMIEUX. Mr. Chairman, I apologize for being a little delayed. I was at another committee meeting. I do not have a lot to add because I, unfortunately, did not get to hear the presentations.

But certainly the 401(k) programs are tremendously important for the people of this country, and as Senator Corker just said, a lot of downturn in the economy has caused a lot of consternation among people who were about to retire specifically, people who were a few years away and thought that they were on a specific path and may not have had the information they needed to make sure that they were investing in more stable investments as they got to the end of their retirement.

So I have read over the materials and the information about transparency and making sure there is enough information for people who are in these plans. Like Senator Corker, I too was an employer prior to coming to the Senate in charge of a law firm where we had about 300 employees, and these programs are tremendously important. We did our best every year to try to give information to all the folks so that they knew that they had in their options and knew the different plans. It is very difficult for the average employee, no matter how well educated, to go through these issues. They are very cumbersome. Usually someone comes into your board room and says, OK, here are three plans. This one does this. This one does that. You kind of check a box and maybe you go with it.

So I just appreciate the chairman for having this meeting. I hope to listen and learn more about it. I thank all the witnesses for their testimony.

The CHAIRMAN. Thank you very much. This has been a great hearing on a very important topic. Your coming here to bring your experience and your perspective has made this very informative. Thank you very much.

[Whereupon, at 3:20 p.m., the hearing was adjourned.]

APPENDIX

CERTIFIED FINANCIAL PLANNER
BOARD OF STANDARDS, INC.

STATEMENT OF

CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.

BEFORE THE

UNITED STATES SENATE

SPECIAL COMMITTEE ON AGING

ON

DEFAULT NATION:
ARE 401(k) TARGET DATE FUNDS MISSING THE MARK?

October 28, 2009

Chairman Kohl, Ranking Member Corker, and Members of the Special Committee, thank you for the opportunity to submit this statement as part of the record for the Special Committee on Aging hearing on October 28, 2009, titled "Default Nation: Are 401(k) Target Date Funds Missing the Mark?" Certified Financial Planner Board of Standards, Inc. (CFP Board) appreciates the opportunity to address the use of target date funds in 401(k) plans.[1] CFP® professionals are heavily involved in retirement planning, and many are employees, agents, or registered representatives of fiduciary advisers under ERISA. Target date funds have been around for over ten years, but their increased popularity is directly related to their treatment as a qualified default investment alternative under the Pension Protection Act of 2006.

Target date funds, appropriately managed, can be beneficial to investors. They generally have low minimum investment requirements, professionally managed portfolios, and low maintenance requirements. Absent target date funds, employers would likely default employees into money market funds, which have proven to be inadequate retirement savings tools as they generally fail to keep pace with inflation. However, we have serious concerns that target date funds are fundamentally misleading to investors because they are allowed to be managed in ways that are inconsistent with the reasonable expectations created by the name of the funds. The recent financial crisis has only magnified these concerns, as in 2008, thirty-one funds with a 2010 target date—presumably intended for individuals nearing retirement—averaged losses of 25%.[2] Accordingly, we commend the Special Committee for its work in reviewing the use of target date funds and the need to protect investors from misleading and harmful practices.

I. Target Date Funds Are Misleading to Investors in 401(k) and Other Retirement Plans

At the joint hearing held by the Securities and Exchange Commission (SEC) and the Department of Labor's Employee Benefits Security Administration in June 2009, there was much discussion of whether a target date fund's glide path should be designed to change "to" or "through" the target date, with many panelists arguing that a fund's glide path should continue to change through the target date. CFP Board believes, given the reasonable expectations created by the name and marketing of the fund, that a target date fund's glide path should be designed to change "to" the target date. First, investors understand the target date in a fund's name to mean the date at which they expect to access the savings in the fund. The focus on a "to" or "through" determination should focus on investor expectations and not on the desires of fund managers.

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[1] CFP Board is a non-profit organization that acts in the public interest by fostering professional standards in personal financial planning through setting and enforcing education, examination, experience, and ethics standards for financial planner professionals who hold the CFP® certification. CFP Board's mission is to benefit the public by granting the CFP® certification and upholding it as the recognized standard of excellence for personal financial planning. CFP Board currently regulates over 60,000 CFP® professionals who agree, on a voluntary basis, to comply with our competency and ethical standards and subject themselves to the disciplinary oversight of CFP Board under a fiduciary standard of care. Financial planning professionals provide services that integrate knowledge and practices across the financial services industry. Financial planners work with their clients to determine whether and how they can meet their life goals through the proper management of their financial resources. Financial planning typically covers a broad range of subject areas including investment, income tax, education, insurance, employee benefits, retirement, and estate planning.

[2] Mary L. Schapiro, Chairman, Securities and Exchange Commission, Address to Mutual Fund Directors Forum Ninth Annual Policy Conference: Critical Issues for Investment Company Directors (May 4, 2009), *available at* http://sec.gov/news/speech/2009/spch050409mls.htm [hereinafter Schapiro Address].

Second, target date funds are marketed as "cruise control" retirement savings tools that will meet the investor's retirement goals at the target date. However, these marketing materials do not clearly explain that investment decisions by the fund managers often take into account factors beyond the retirement date, including other investments, time horizon, and risk aversion, and thus continue an aggressive investment strategy past the target date. Finally, the name of the fund is the most important consideration to investors as even if they read and comprehend disclosure materials, no amount of disclosure can override the misleading nature of a target date fund's name.

The use of a target date in a fund's name carries with it a generally understood message to investors. For example, the name "Target Date 2010" says to the investor: "This fund will invest in an appropriate mix of investments for someone retiring around the year 2010."[3] The use of the year 2010 in the name of the fund implies that, by 2010, the fund will contain an asset allocation of equity and fixed-income investments that will be subject to relatively low market volatility and will provide the investor with ready access to cash assets. In contrast, a Target Date 2050 Fund would be expected to contain an allocation of equity and fixed-income investments that would subject the fund to substantially more risk, which is necessary to allow for growth in the fund over time that will, at a minimum, outpace inflation.

In simplest terms, we can all agree that an 80% stock/20% fixed-income allocation in a Target Date 2010 Fund would be inappropriate for a 65-year-old retiree, just as an 80% fixed-income/20% stock allocation in a Target Date 2050 Fund would be inappropriate for a recent college graduate. The asset allocations in these types of plans should reflect the anticipated timeframe in which the investor will need to access those funds. Yet target dates are being used to label funds that have combinations of investments that are well outside expected, generally accepted asset allocations for the targeted investor. In fact, as SEC Chairman Mary Schapiro has recognized, target date funds are subject to widely varying strategies among fund managers, with 2010 target date funds ranging in performance from minus 3.6% to minus 41% in 2008.[4] A person who planned to retire in seven months who thought he was invested in a safe Target Date 2010 Fund with low volatility but who lost 41% last year would be devastated. A loss of up to 41% of assets from a fund labeled 2010 is completely inconsistent with an investor's reasonable expectation that his or her assets would not be subject to such high market volatility. We recognize that less than one year later, these losses have been partially recovered as the market has rebounded from historic losses. However, this type of volatility—losses of up to 41% one year followed by gains of up to 30% the following year—is exactly what target date funds are supposed to avoid as the target date approaches.

We must underscore an important point: it can be perfectly appropriate for investors approaching retirement to employ aggressive investment strategies with their 401(k) funds. Such investors may have a variety of other assets that can be tapped for their living expenses and they can legitimately choose to expose themselves to risks in their 401(k) plans in order to grow their assets enough to last thirty years after retirement. These are the very types of judgments that

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[3] Letter from Fund Democracy & Consumer Federation of America to Mary Schapiro, Chairman, Securities and Exchange Commission (Apr. 7, 2009) (on file with author).
[4] Schapiro Address, *supra* note 2.

financial planners—taking into consideration an investor's complete financial history and goals—help their clients make on a daily basis.

That is not what is at stake with target date funds. Such funds are marketed as "auto pilot" or "cruise control" investments pegged to an investor's expected retirement date. They are aimed at investors who do not have a financial planner or advisor, or the time, desire, or ability to monitor their investments themselves. By their very name, they create a reasonable expectation that such a fund will have sufficiently reduced volatility and its assets will be available for the investor's use as of the target date. Target date funds are not the appropriate vehicles for implementing aggressive retirement investment strategies for those nearing retirement.[5]

It is not an answer to say that misleading fund names can be cured with effective disclosures. Appropriate disclosures must be required and provided; but we must recognize, in determining appropriate investor protections, the reality that disclosures are very often not read and more often not fully understood. Despite our ongoing education and efforts to engage consumers in reading disclosures, CFP Board continues to hear from CFP® professionals who explain that their clients do not want to receive, let alone read, disclosure documents. If they receive disclosures by mail, they just throw them away; if they receive them electronically, they complain that they must delete them. Under current rules, a Target Date 2010 Fund could have an 80% stock/20% fixed-income allocation as long as the fund's extremely aggressive investment objectives and strategies are disclosed in the fund's prospectus. We believe that this is fundamentally misleading to investors and that no amount of disclosure is adequate to counteract the reasonable expectations created by a fund's name.

II. Industry Standards for Asset Allocations in Target Date Funds Can and Should Be Established to Protect Investors

The SEC can and should take steps to strengthen its securities regulations to protect investors from the use of misleading target date fund names. In 2001, the SEC adopted a misleading fund names rule—Rule 35d-1—that defines four types of funds for which the name may be materially deceptive and misleading. Because of the latitude under the rule for fund managers to correct misleading fund titles through disclosures in the fund's prospectus, the rule has not been enforced as to target date funds in a manner that provides adequate investor protection. We recommend that the SEC amend Rule 35d-1 to provide that a target date fund's

[5] While not a focus of this hearing, we must note that inappropriate asset allocations in target date funds affect not only 401(k) plans, but also 529 plans. Just as overly aggressive investment strategies can be inappropriate for those nearing retirement, an 80% stock/20% fixed-income allocation would be wholly inappropriate for a target date fund underlying a 529 plan for a 2010 high school senior. The parents of such a child would reasonably expect a stable funding source as college tuition payments near. Instead, many parents were left with insufficient funds to pay college tuition for their children, primarily because of the misleading nature of certain 529 plan investment options. As with target date funds, the asset allocations in 529 plans should reflect the anticipated timeframe in which the investor will need to access those funds. To go one step further, as Chairman Schapiro recognized, "A target date fund underlying a college investment or so-called 529 plan . . . would need to more closely track its target date since it is far more likely that investors would need access to their investment at or near the fund's target date." *Id.*

name is materially deceptive and misleading unless the fund's investments fall within an acceptable range of asset allocations consistent with its name.

We recognize that there are differing viewpoints among investment professionals regarding the appropriate allocation of assets as investors approach retirement, and agree that some variation is entirely appropriate and that there is no such thing as a "perfect" allocation. Nevertheless, we believe that appropriate ranges of asset allocations, based on reasonably accepted industry practices, can be established for each date reflected in a target date fund. The goal would be to align target date funds' glide paths and asset allocations with investor expectations—namely that a target date fund's glide path is designed to change *to* the target date.

Establishing industry standards for asset allocations in target date funds is a reasonable undertaking. A panel of experts in retirement planning and investment allocation could be established from the financial services industry, including experts in ERISA, registered investment advisers, and CFP® professionals. They could be tasked with developing a schedule that lists acceptable ranges for categories of investments that are consistent with reasonable industry practices for each date reflected in a target date fund. The ranges of allocations would identify acceptable industry parameters that would reduce the fund's exposure to market volatility consistent with the fund's target date.

The Thrift Savings Plan Lifecycle Funds established for employees of the United States Government and members of the armed services are an example of such reasonable industry standards. The Lifecycle Funds have asset allocations that reduce exposure to volatility over time, with the understanding that greater risk can be taken the longer one has before making withdrawals from the account. As of January 1, 2009, an L Income fund was invested in 80% government securities and bonds and 20% securities, with the time horizon for immediate access to the funds. Similarly, an L 2010 fund was invested in 70% government securities and bonds and 30% equity securities, with a time horizon between 2009 and 2014. In contrast, an L 2040 fund had an allocation of 80% securities and 20% government securities and bonds, with a time horizon of 2035 or later.

CFP Board is not advocating that the Lifecycle Funds represent the only acceptable allocation of assets; rather, they can serve as a baseline upon which ranges of allocations that reflect acceptable industry standards can be established. With the establishment of acceptable ranges, target date fund managers will be able to implement investment strategies within those ranges of asset allocations to enhance the fund's performance. This will allow for the promotion of competition among funds, while at the same time protecting target date fund assets from exposure to inappropriate risk that is inconsistent with an investor's reasonable expectation.

III. Stricter Regulations Are Especially Important Given the Default Investment Status of Target Date Funds

Establishing acceptable ranges of asset allocations for target date funds is especially important given that target date funds qualify as qualified default investment alternatives, also known as QDIAs, under the Pension Protection Act of 2006. The fact that the federal government has qualified target date funds as QDIAs sends two important messages. First, it conveys to employers that the government believes that the allocations in target date funds are appropriate for individuals based on their expected date of retirement. An employer generally defaults its employees into target date funds based on an employee's age and work history with that employer. Such defaults are based on the assumption that the employee will be living off the account's lump sum when the employee reaches retirement age. Target date fund options—if they are to qualify as QDIAs under the Pension Protection Act—should reflect appropriate asset allocations consistent with this assumption.

Second, qualification of target dates funds as QDIAs conveys to employees that the government is making an appropriate investment decision on their behalf. Employees who are defaulted into a target date fund often make no further decisions related to that fund. The presumption of government approval leads many investors to assume that their retirement funds are invested in a fund designed to ensure their retirement security. Yet without additional government guidelines, many default target date funds have proven to have inappropriate asset allocations for individuals approaching retirement age.

Qualifying target date funds as default investment alternatives serves an important public policy goal. It allows employers to place their employees in default investment options that are designed to outpace inflation—something that defaulting funds into money market funds proved incapable of doing. In fact, over the past four years the percentage of employers using target date funds as a default contribution option has increased from 5% to 60%.[6] However, if target date funds are to be used as default investments, the funds themselves must be managed so as to provide appropriate asset allocations consistent with their titles.[7]

IV. Conclusion

We urge the Special Committee to work closely with the SEC and Department of Labor to establish appropriate protections to ensure that target date funds can continue to be used as QDIAs with confidence that they reflect appropriate, industry-sanctioned investment decisions on behalf of plan participants. While we commend the SEC and the Department for the actions they have taken to enhance disclosures to investors in target date funds, enhancing disclosures is not the sole answer and more must be done.[8] In June, we urged the Department to work with the

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[6] *Id.*

[7] The same issue arises in the context of 529 plans: because they are offered by government entities, 529 plans create the appearance of government approval. This in turn causes investors to assume a fund is appropriate to ensure the availability of funds as of the target date to pay college tuition without scrutinizing the fund's asset allocation. As we have seen, some states permit dangerously aggressive asset allocations in 529 plans, which can result in catastrophic losses in a bear market. *See* Jason Zweig, *Did Your College Savings Plan Blow Up on You?*, WALL ST. J., Mar. 20, 2009, *available at* http://online.wsj.com/article/SB123758112211598861.html (noting the equity exposure possible in several states for college-aged students, including Maine (0% cash), New Mexico (0% cash), North Carolina (43% stocks and bonds), Oregon (40% stocks), Rhode Island (40% stocks, 55% bonds, and 5% cash), and Utah (65% stocks)). If 529 plans are to come with a government "stamp of approval," they must have asset allocations that are in line with investor's reasonable expectations.

[8] *See* U.S. Department of Labor, EBSA Field Assistance Bulletin No. 2009-3 (Sept. 8, 2009), *available at* http://www.dol.gov/ebsa/regs/fab2009-3.html; Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4546, 4564 (Jan. 26, 2009).

SEC to put in place a process to develop accepted industry standards that would ensure that target date funds are not misleading to consumers on either extreme—too much cash for the young investor or too much equity for the investor near retirement. Should the SEC fail to move toward needed investor protections in the management of target date funds, we believe the Department should proceed on its own to regulate target date funds, or alternatively, should rescind such funds' eligibility as QDIAs.

CFP Board stands ready and willing to provide assistance to the Special Committee, as well as the SEC and the Department of Labor, in the development of needed industry standards for target date funds. CFP Board's Public Policy Council recently established a strategic public policy goal to promote practices in the delivery of financial services that protect our nation's investors and consumers. The creation of industry standards for target date funds sold through 401(k) or other retirement plans is squarely in line with this strategic objective. CFP Board is well positioned to support such a standards setting effort by contributing professional resources. CFP Board could facilitate the participation of CFP® professionals who are experts in retirement fund allocations as well as serve as a catalyst for the participation of other industry experts.

CERTIFIED FINANCIAL PLANNER
BOARD OF STANDARDS, INC.

Kevin R. Keller, CAE
Chief Executive Officer

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November 10, 2009

Senator Herb Kohl
United States Senate
330 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Kohl:

Certified Financial Planner Board of Standards, Inc. (CFP Board) writes to express its strong support of the Senior Investment Protection Act of 2009 (S. 1661), as incorporated into Chairman Dodd's financial regulatory reform discussion draft. CFP Board appreciates Senator Kohl's recognition of the need to protect seniors from misleading and fraudulent marketing practices. Seniors are often targeted by salespersons and advisers who use misleading designations and play on sympathies to convince them to purchase unsuitable investment products. Many CFP® professionals have witnessed the disastrous effects these deceitful and fraudulent practices can have on the retirement savings of seniors. Unfortunately, the damage to the senior investor's treasured nest egg is often substantial and permanent, and no private remedies are available.

While the general population is facing more complex financial decisions and being required to take on increasing responsibility for those decisions, seniors may face some of the most complex issues. Some approaching retirement are offered complicated pension buy-out plans with important details that need an expert's eye to catch. Those who made concerted efforts to save for retirement must make the sometimes difficult shift from diligent saving to careful spending. Many are living longer, healthier lives and must adjust their spending plans to stretch their dollars further; others face chronic medical issues that require them to finance expensive long-term care needs.

Commercials featuring senior-friendly television actors advertise reverse mortgages as "safe" and "easy," but do not describe the effects such loans may have on an individual's estate and heirs, or on eligibility for certain government assistance programs. With United States demographics steadily trending older, and with the baby boomer generation rapidly approaching retirement, the need to help seniors understand their financial options and locate trustworthy professional assistance has never been greater.

Unfortunately, there are many financial service providers who market themselves to seniors using credentials that purport to convey expertise in financial matters affecting seniors. Some of those credentials are earned through attending a weekend seminar and paying a membership fee—hardly the training needed to qualify someone to call himself an expert on senior financial issues. Unfortunately, many senior consumers understandably assume that these credentials equate to expertise. CFP Board believes that a client's best interests are served by a financial adviser who has earned a reputable credential and adheres to an enforceable code of ethics. Seniors can and should demand transparency, accountability, and honesty when choosing how to invest their life savings.

Thank you for the opportunity to express our support for this important bill. CFP Board has enjoyed working with you on this issue over the past two years. Please do not hesitate to contact me if CFP Board can be of further assistance.

Sincerely,

Kevin R. Keller

Kevin R. Keller, CAE
Chief Executive Officer

CFP Board Consumer Experience Survey, Spring 2009

Narratives about clients who have worked with a *Certified Senior Advisor*

Narrative 1: Playing on Sympathies
Colorado

"My client was the widow of a dear friend and colleague who had a substantial amount of money she wanted to invest. After placing her in some well-diversified American Funds and a variable annuity with a guaranteed income benefit, everything seemed fine. The investments were doing well as of the summer of 2003. About eight months later, I noticed some movement in her account and called her to find out what was going on. She said she had met a 'nice man' who was a 'financial advisor' who stated what I had placed her in was very risky. He proceeded to rip the money out of what I had placed her in (that carried a surrender charge) and also a Vanguard fund that she had inherited from her husband, thereby exposing her to about $40,000 worth of gains. He was placing her in an equity-indexed annuity[1] with a sixteen-year surrender period.[2] He told her not to worry about the surrender charge from the annuity I had placed her in because his product had a bonus that would offset the charge (it actually did not and she was still several thousand dollars down). Ultimately, I did get everything placed back but not before she had to recognize a substantial gain on her mutual funds. I figured that he would have made around $40,000 from this transaction. She also told me she felt sorry for him because he was battling cancer."

Client Age Group: 40 to 60 years

License, Designation, or Certification Used by Advisor: "None except that credential you can get in a day: CSA, 'Certified Senior Advisor.'"

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[1] Equity-indexed annuities can often be unsuitable for seniors due to long surrender periods (typically nine to eleven years) and large surrender fees (up to 25%, but usually 9% to 15% during year one decreasing over time). While these products "purport to provide risk-free returns based on the performance of a securities market index, the policies are often laden with a variety of devices designed to reduce the real rate of return." Investors typically cannot take part in dividends accumulated on the securities represented in the index. Equity-indexed annuities are frequently "so complicated that it is virtually impossible for a lay senior citizen to understand how they truly work and, as a result, the investor has to rely on the 'advisor' who is recommending the purchase to explain the terms." Massachusetts Securities Division, Discussion of Reasons for, and Objectives of, New Regulations Regarding Use of Senior Designations 8–9, *available at* http://www.sec.state.ma.us/sct/sctpropreg/adminrec.pdf.

[2] When withdrawing money from an equity-indexed annuity within a certain period after a purchase payment (typically within six to eight years, but sometimes as long as ten years), the insurance company usually will assess a surrender charge, which is a type of sales charge. This charge is used to pay the sales person a commission for selling the variable annuity. Generally, the surrender charge is a percentage of the amount withdrawn, and declines gradually over a period of several years, known as the surrender period.

Narrative 2: Repeat Offender
Utah

"The individual uses the CSA credential. He regularly advertises in our local paper about how to save seniors taxes they are paying on their social security (although most of the people he talks to do not have to pay taxes on their social security). He does seminars and also uses his church affiliation to sell products. One of my clients has such a small amount of income he was not paying any taxes to begin with but the recommendation was made to buy an indexed annuity.[1] My client is in his mid-80s and this is his only significant liquid investment. I convinced him not to buy the annuity. In another situation, the individual recommended that an elderly client (in the early stages of Alzheimer's) and his wife, cash out a mutual fund position in bonds and growth and income with a reputable mutual fund family. The money was invested in multiple indexed annuities (2 or 3 I think) instead of one annuity. As far as I can tell it was done to max out the compensation to this guy. He has only an insurance license and no securities license. He recently advertised that no clients have ever lost money investing with him. Another friend's mother bought an indexed annuity from him with the bulk of her retirement assets. She changed her mind and she had a real challenge getting her 1035 exchange[2] reversed within the free-look period.[3] He offered to pay the surrender charges[4] from the company that exchanged the annuity if she would keep it with him. As far as I can tell, the state of Utah is not willing to do anything. I have reported him, as have other brokers in the area, but to no avail. It is very frustrating as we all are embarrassed at how he holds himself out, the things he does, and the credential he uses."

Client Age Group: 61 to 75 years

License, Designation or Certification Used by Advisor: "CSA, Life and health license"

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[1] Equity-indexed annuities can often be unsuitable for seniors due to long surrender periods (typically nine to eleven years) and large surrender fees (up to 25%, but usually 9% to 15% during year one decreasing over time). While these products "purport to provide risk-free returns based on the performance of a securities market index, the policies are often laden with a variety of devices designed to reduce the real rate of return." Investors typically cannot take part in dividends accumulated on the securities represented in the index. Equity-indexed annuities are frequently "so complicated that it is virtually impossible for a lay senior citizen to understand how they truly work and, as a result, the investor has to rely on the 'advisor' who is recommending the purchase to explain the terms." Massachusetts Securities Division, Discussion of Reasons for, and Objectives of, New Regulations Regarding Use of Senior Designations 8–9, *available at* http://www.sec.state.ma.us/sct/sctpropreg/adminrec.pdf.

[2] A 1035 exchange refers to a provision in the tax code which allows for the direct transfer of accumulated funds in a life insurance policy, endowment policy, or annuity policy to another life insurance policy, endowment policy, or annuity policy, without creating a taxable event.

[3] The free-look period is the time period allowed the newly insured to look over the terms and conditions of the final policy after delivery, during which the insured may cancel the policy with full premium refund. The free-look period is often ten days after delivery of the policy for life and health, or up to thirty days on property and liability.

[4] When withdrawing money from an equity-indexed annuity within a certain period after a purchase payment (typically within six to eight years, but sometimes as long as ten years), the insurance company usually will assess a surrender charge, which is a type of sales charge. This charge is used to pay the sales person a commission for selling the variable annuity. Generally, the surrender charge is a percentage of the amount withdrawn, and declines gradually over a period of several years, known as the surrender period.

Narrative 3: Driven by Commissions
California

"Under the guise of full financial planning, a married couple was directed by their 'advisor' to rollover a 401(k) plan into an equity-indexed annuity.[1] It had a ten-year surrender period[2] and about a 10% commission payout. The entire amount was put there; they did not see or hear from the advisor for a couple years. About three years later, the same advisor resurfaced and recommended that they 1035 exchange[3] the annuity into a different indexed annuity because 'it was better.' There was a substantial penalty coming out of the first annuity which was, according to the advisor, going to be made up by a bonus from the new company. The clients never had any idea that the bonus was only given to them upon annuitization.[4] The new annuity has a seventeen-year surrender period. The clients were led to believe the money was available and the seventeen-year surrender did not really impact them. Shortly thereafter they became clients of ours. Recently, one of the clients passed away. The only settlement options for the beneficiary are annuitization, lump sum withdrawal with 22% penalties being assessed, or continuation of the contract with the same penalty/surrender charge period."

Client Age Group: 61 to 75 years

License, Designation or Certification Used by Advisor: "CSA, CES, Life Insurance"

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[1] Equity-indexed annuities can often be unsuitable for seniors due to long surrender periods (typically nine to eleven years) and large surrender fees (up to 25%, but usually 9% to 15% during year one decreasing over time). While these products "purport to provide risk-free returns based on the performance of a securities market index, the policies are often laden with a variety of devices designed to reduce the real rate of return." Investors typically cannot take part in dividends accumulated on the securities represented in the index. Equity-indexed annuities are frequently "so complicated that it is virtually impossible for a lay senior citizen to understand how they truly work and, as a result, the investor has to rely on the 'advisor' who is recommending the purchase to explain the terms." Massachusetts Securities Division, Discussion of Reasons for, and Objectives of, New Regulations Regarding Use of Senior Designations 8–9, *available at* http://www.sec.state.ma.us/sct/sctpropreg/adminrec.pdf.

[2] When withdrawing money from an equity-indexed annuity within a certain period after a purchase payment (typically within six to eight years, but sometimes as long as ten years), the insurance company usually will assess a surrender charge, which is a type of sales charge. This charge is used to pay the sales person a commission for selling the variable annuity. Generally, the surrender charge is a percentage of the amount withdrawn, and declines gradually over a period of several years, known as the surrender period.

[3] A 1035 exchange refers to a provision in the tax code which allows for the direct transfer of accumulated funds in a life insurance policy, endowment policy, or annuity policy to another life insurance policy, endowment policy, or annuity policy, without creating a taxable event.

[4] Annuitization converts part or all of the money in an annuity contract into a stream of regular income payments for the lifetime (or the lifetimes) of the annuitant. Once annuitized, the payment schedule and the amount are generally fixed and cannot be altered. Annuitants have a choice of annuitizing, taking a lump sum, setting up a systematic withdrawal plan, or arranging some other payout method that the contract allows.

Narrative 4: High Pressure Sales
Ohio

"The advisor held a seminar that the client attended and followed up with a phone call, saying he was 'in the area' and wanted to stop by her house. She allowed and he came to show her rates on two annuities for which he could lock in rates, but only if she would sign her name on two lines—one for each annuity. He literally drew the lines on a legal pad, putting an 'X' next to each line on which he wanted the client to sign. She reluctantly signed the two lines on the yellow legal pad. Before leaving, the advisor asked for a drink of water, and when the client left the living room to head for the kitchen, the advisor stole her statements off the living room table. I later found out by total accident that my client was 'transferring $750,000 via liquidation to two different annuities,' but luckily we were able to stop it in time. Needless to say, the client was horrified. She felt stupid for listening to and trusting this man, who seemed trustworthy, was 'also Catholic,' and showed her pictures of his kids. I reported him to the NASD and Ohio Department of Insurance."

Client Age Group: Over 75 years

License, Designation or Certification Used by Advisor: "CSA (Certified Senior Advisor). I believe this person was also Series 6 or 7 licensed, as well as Life/Health."

Testimony Before the
Securities and Exchange Commission and the
Department of Labor's Employee Benefits Security Administration

By Ms. Marilyn Capelli Dimitroff
Chairman, Certified Financial Planner Board of Standards, Inc.
President, Capelli Financial Services, Inc.

June 18, 2009

Thank you very much for the opportunity to testify today. I am Marilyn Capelli Dimitroff, Chairman of Certified Financial Planner Board of Standards and President of a financial planning firm in Detroit, Michigan. I am pleased to be here to testify on behalf of CFP Board.

CFP Board is a non-profit organization that acts in the public interest by fostering professional standards in personal financial planning through setting and enforcing education, examination, experience, and ethics standards for financial planner professionals who hold the CFP® certification. CFP Board's mission is to benefit the public by granting the CFP® certification and upholding it as the recognized standard of excellence for personal financial planning. CFP Board currently regulates nearly 60,000 CFP® professionals who agree, on a voluntary basis, to comply with our competency and ethical standards and subject themselves to the disciplinary oversight of CFP Board under a fiduciary standard of care.

Financial planning professionals provide services that integrate knowledge and practices across the financial services industry. Financial planners work with their clients to determine whether and how they can meet their life goals through the proper management of their financial resources. Financial planning typically covers a broad range of subject areas including investment, income tax, education, insurance, employee benefits, retirement, and estate planning.

CFP Board appreciates the opportunity to address the use of target date funds in participant-directed retirement plans such as 401(k) plans. CFP® professionals are heavily involved in retirement planning, and many are employees, agents, or registered representatives of fiduciary advisers under ERISA. Target date funds have been around for over ten years, but their increased popularity is directly related to their treatment as a qualified default investment alternative under the Pension Protection Act of 2006.

Target date funds, appropriately managed, can be beneficial to investors. They generally have low minimum investment requirements, professionally managed portfolios, and low maintenance requirements. Absent target date funds, employers would likely default employees into money market funds, which have proven to be inadequate retirement savings tools as they generally fail to keep pace with inflation. However, we have serious concerns that target date funds are fundamentally misleading to investors because they are allowed to be managed in ways that are inconsistent with the reasonable expectations created by the name of the funds. The recent financial crisis has only magnified these concerns, as in 2008, thirty-one funds with a 2010 target date—presumably intended for individuals nearing retirement—averaged losses of 25%.[1] Accordingly, we recommend that the SEC and the Department of Labor institute regulatory safeguards in connection with the use of target date funds designed to protect investors from current misleading and harmful practices.

I. Target Date Funds Are Misleading to Investors in 401(k) and Other Retirement Plans

The use of a target date in a fund's name carries with it a generally understood message to investors. For example, the name "Target Date 2010" says to the investor: "This fund will invest in an appropriate mix of investments for someone retiring around the year 2010."[2] The use of the year 2010 in the name of the fund implies that, by 2010, the fund will contain an asset allocation of equity and fixed-income investments that will be subject to relatively low market volatility and will provide the investor with ready access to cash assets. In contrast, a Target Date 2050 Fund would be expected to contain an allocation of equity and fixed-income investments that would subject the fund to substantially more risk, which is necessary to allow for growth in the fund over time that will, at a minimum, outpace inflation.

In simplest terms, we can all agree that an 80% stock/20% fixed-income allocation in a Target Date 2010 Fund would be inappropriate for a 65-year-old retiree, just as an 80% fixed-income/20% stock allocation in a Target Date 2050 Fund would be inappropriate for a recent college graduate. The asset allocations in these types of plans should reflect the anticipated timeframe in which the investor will need to access those funds. Yet target dates are being used to label funds that have combinations of investments that are well outside expected, generally accepted asset allocations for the targeted investor. In fact, as SEC Chairman Mary Schapiro has recognized, target date funds are subject to widely varying strategies among fund managers, with 2010 target date funds ranging in performance from minus 3.6% to minus 41% in 2008.[3] Put yourself in the place of a person who is retiring in seven months who thought he was invested in a safe Target Date 2010 Fund with low volatility and then lost 41% last year. Devastating! A loss of up to 41% of assets from a fund labeled 2010 is completely inconsistent with an investor's reasonable expectation that his or her assets would not be subject to such high market volatility.

Let me underscore an important point. It can be perfectly appropriate for investors approaching retirement to employ an aggressive investment strategy with their 401(k) funds. Such investors may have a variety of other assets that can be tapped for their living expenses and they can legitimately choose to expose themselves to risks in their 401(k) plans needed to provide growth in their assets needed by someone expected to live thirty years after retirement.

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[1] Mary L. Schapiro, Chairman, Securities and Exchange Commission, Address to Mutual Fund Directors Forum Ninth Annual Policy Conference: Critical Issues for Investment Company Directors (May 4, 2009) (hereinafter Schapiro Address).
[2] Letter from Fund Democracy & Consumer Federation of America to Mary Schapiro, Chairman, Securities and Exchange Commission (Apr. 7, 2009) (on file with author).
[3] Schapiro Address, *supra* note 1.

These are the very types of judgments that financial planners—taking into consideration an investor's complete financial history and goals—help their clients make on a daily basis.

That is not what is at stake with target date funds. Such funds are marketed as "auto pilot" or "cruise control" investments pegged to an investor's expected retirement date. They are aimed at investors who do not have a financial planner or advisor, or the time, desire, or ability to monitor their investments themselves. By their very name, they create a reasonable expectation that such a fund will have sufficiently reduced volatility and its assets will be available for the investor's use as of the target date. Target date funds are not the appropriate vehicles for implementing aggressive retirement investment strategies for those nearing retirement.

Inappropriate asset allocations in target date funds affect not only 401(k) plans, but also 529 plans. Just as overly aggressive investment strategies can be inappropriate for those nearing retirement, an 80% stock/20% fixed-income allocation would be wholly inappropriate for a target date fund underlying a 529 plan for a 2010 high school senior. The parents of such a child would reasonably expect a stable funding source as college tuition payments near. Instead, many parents were left with insufficient funds to pay college tuition for their children, primarily because of the misleading nature of certain 529 plan investment options. As with target date funds, the asset allocations in 529 plans should reflect the anticipated timeframe in which the investor will need to access those funds. To go one step further, as Chairman Schapiro recognized, "A target date fund underlying a college investment or so-called 529 plan . . . would need to more closely track its target date since it is far more likely that investors would need access to their investment at or near the fund's target date."[4]

It is not an answer to say that misleading fund names can be cured with effective disclosures. Appropriate disclosures must be required and provided; but we must recognize, in determining appropriate investor protections, the reality that disclosures are very often not read and more often not fully understood. Despite our ongoing education and efforts to engage clients in reading disclosures, my clients continue to ask how they can shut off receipt of prospectuses. If they receive them by mail, they tell me they just throw them away and it is a waste of trees. If they receive them electronically, they still complain that they must delete them. Under current rules, a Target Date 2010 Fund could have an 80% stock/20% fixed-income allocation as long as the fund's extremely aggressive investment objectives and strategies are disclosed in the fund's prospectus. We believe that this is fundamentally misleading to the investor and that no amount of disclosure is adequate to counteract the reasonable expectations created by the fund name.

II. Industry Standards for Asset Allocations in Target Date Funds Can and Should Be Established to Protect Investors

The SEC can and should take steps to strengthen its securities regulations to protect investors from the use of misleading target date fund names. In 2001, the SEC adopted a misleading fund names rule—Rule 35d-1—that defines four types of funds for which the name may be materially deceptive and misleading. Because of the latitude under the rule for fund

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[4] *Id.*

managers to correct misleading fund titles through disclosures in the fund's prospectus, the rule has not been enforced as to target date funds in a manner that provides adequate investor protection. We recommend that the SEC amend Rule 35d-1 to provide that a target date fund's name is materially deceptive and misleading unless the fund's investments fall within an acceptable range of asset allocations consistent with its name.

We recognize that there is variation among investment professionals regarding the appropriate allocation of assets as investors approach retirement, and agree that some variation is entirely appropriate. Nevertheless, we believe that appropriate ranges of asset allocations, based on reasonably accepted industry practices, can be established for each date reflected in a target date fund. The goal would be to align target date funds' glide paths and asset allocations with investor expectations.

Establishing industry standards for asset allocations in target date funds is a reasonable undertaking. A panel of experts in retirement planning and investment allocation could be established from the financial services industry, including experts in ERISA, registered investment advisers, and CFP® professionals. They could be tasked with developing a schedule that lists acceptable ranges for categories of investments that are consistent with reasonable industry practices for each date reflected in a target date fund. The ranges of allocations would identify acceptable industry parameters that would reduce the fund's exposure to market volatility consistent with the fund's target date.

The Thrift Savings Plan Lifecycle Funds established for employees of the United States Government and members of the armed services are an example of such reasonable industry standards. The Lifecycle Funds have asset allocations that reduce exposure to volatility over time, with the understanding that greater risk can be taken the longer one has before making withdrawals from the account. As of January 1, 2009, an L Income fund was invested in 80% government securities and bonds and 20% securities, with the time horizon for immediate access to the funds. Similarly, an L 2010 fund was invested in 70% government securities and bonds and 30% equity securities, with an appropriate time horizon between 2009 and 2014. In contrast, an L 2040 fund had an allocation of 80% securities and 20% government securities and bonds with a time horizon of 2035 or later.

CFP Board is not advocating that the Lifecycle Funds represent the only acceptable allocation of assets; rather, they can serve as a baseline upon which ranges of allocations that reflect acceptable industry standards can be established. With the establishment of acceptable ranges, target date fund managers will be able to implement investment strategies within those ranges of asset allocations to enhance the fund's performance. This will allow for the promotion of competition among funds, while at the same time protecting target date fund assets from exposure to inappropriate risk that is inconsistent with an investor's reasonable expectation.

III. Stricter Regulations Are Especially Important Given the Default Investment Status of Target Date Funds

Establishing acceptable ranges of asset allocations for target date funds is especially important given that target date funds qualify as qualified default investment alternatives, also known as QDIAs, under the Pension Protection Act of 2006. The fact that the federal government has qualified target date funds as QDIAs sends two important messages. First, it conveys to employers that the government believes that the allocations in target date funds are appropriate for individuals based on their expected date of retirement. An employer generally defaults its employees into target date funds based on an employee's age and work history with that employer. Such defaults are based on the assumption that the employee will be living off the account's lump sum when the employee reaches retirement age. Target date fund options—if they are to qualify as QDIAs under the Pension Protection Act—should reflect appropriate asset allocations consistent with this assumption.

Second, qualification of target dates funds as QDIAs conveys to employees that the government is making an appropriate investment decision on their behalf. Employees who are defaulted into a target date fund often make no further decisions related to that fund. The presumption of government approval leads many investors to assume that their retirement funds are invested in a fund designed to ensure their retirement security. Yet without additional government guidelines, many default target date funds have proven to have inappropriate asset allocations for individuals approaching retirement age.

Qualifying target date funds as default investment alternatives serves an important public policy goal. It allows employers to place their employees in default investment options that are designed to outpace inflation—something that defaulting funds into money market funds proved incapable of doing. In fact, over the past four years the percentage of employers using target date funds as a default contribution option has increased from 5% to 60%.[5] However, if target date funds are to be used as default investments, the funds themselves must be managed so as to provide appropriate asset allocations consistent with their titles.

The same issue arises in the context of 529 plans: because they are offered by government entities, 529 plans create the appearance of government approval. This in turn causes investors to assume a fund is appropriate to ensure the availability of funds as of the target date to pay college tuition without scrutinizing the fund's asset allocation. As we have seen, some states permit dangerously aggressive asset allocations in 529 plans, which can result in catastrophic losses in a bear market.[6] If 529 plans are to come with a government "stamp of approval," they must have asset allocations that are in line with investor's reasonable expectations.

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[5] *Id.*

[6] *See* Jason Zweig, *Did Your College Savings Plan Blow Up on You?*, WALL ST. J., Mar. 20, 2009, *available at* http://online.wsj.com/article/SB123758112211598861.html (noting the equity exposure possible in several states for college-aged students, including Maine (0% cash), New Mexico (0% cash), North Carolina (43% stocks and bonds), Oregon (40% stocks), Rhode Island (40% stocks, 55% bonds, and 5% cash), and Utah (65% stocks)).

IV. Conclusion

We urge the Department of Labor to work closely with the SEC to establish appropriate protections to ensure that target date funds can continue to be used as QDIAs with confidence that they reflect appropriate, industry-sanctioned investment decisions on behalf of plan participants. We urge the Department to work with the SEC to put in place a process to develop accepted industry standards that will ensure that target date funds are not misleading to consumers on either extreme—too much cash for the young investor or too much equity for the investor near retirement. Should the SEC fail to move toward needed investor protections in the management of target date funds, we believe the Department should proceed on its own to regulate target date funds, or alternatively, should rescind such funds' eligibility as QDIAs. Further, the SEC should encourage FINRA to prohibit brokers from selling 529 plans unless investments are made consistent with industry-sanctioned asset allocations appropriate for someone starting college on the target date.

CFP Board stands ready and willing to provide assistance to the SEC and the Department of Labor in the development of needed industry standards for target date funds. CFP Board's Public Policy Council recently established a strategic public policy goal to promote practices in the delivery of financial services that protect our nation's investors and consumers. The creation of industry standards for target date funds sold through 401(k) or other retirement plans, as well as 529 plans, is squarely in line with this strategic objective. CFP Board is well positioned to support such a standards setting effort by contributing professional resources. CFP Board could facilitate the participation of CFP® professionals who are experts in retirement fund allocations as well as serve as a catalyst for the participation of other industry experts.

PSCA.org PROFIT SHARING/401k COUNCIL OF AMERICA

The Profit Sharing and 401(k) Advocate • Sharing the Commitment since 1947

STATEMENT FOR THE RECORD

SPECIAL COMMITTEE ON AGING

Default Nation: Are 401(k) Target Date Funds Missing the Mark?

October 28, 2009.

The Profit Sharing / 401k Council of America (PSCA) is a sixty-year-old non-profit association representing companies that sponsor profit sharing and 401(k) plans. PSCA speaks for over 1,200 companies who employ approximately five million plan participants throughout the United States. PSCA's members range in size from very small firms to conglomerates with hundreds of thousands of employees. All regard their profit sharing or 401(k) plans as vital factors in their business success.

Employers sponsor 401(k) and other defined contribution retirement plans to help attract, retain, and motivate high quality workers. It is critical in today's competitive environment that the interests of employers and their employees be as closely aligned as possible. One way to reinforce that alignment is to deliver the very best defined contribution program possible.

More and more employers are deciding that target date funds are a beneficial investment offering and are rapidly adding them to their 401(k) plans. PSCA's 52nd Annual Survey, reflecting 2008 plan experience, finds that fifty-eight percent of private employer defined contribution plans offer target date funds; up from twenty-five percent in 2005 and virtually none in 2000. Sixty percent of plans with automatic enrollment have a target date fund as the default investment. Mutual fund products continue to be the product of choice for qualified plans. Our survey indicates that eighty percent of plan target date investments are mutual fund products.

In April 2009, PSCA and Casey, Quirk & Associates, a management consultancy focused on the global fund management industry, conducted a survey of target date fund practices in employer sponsored defined contribution plans. More than four hundred companies of various sizes participated. Twenty-one percent have fewer than 200 hundred participants and twenty-seven percent have 5,000 or more participants. Eighty-seven percent use a packaged target date fund program. Thirteen percent of the programs are custom designed.

Most plan sponsors in the survey are satisfied with their target date investment options, despite weak performance during the recent market crisis. Only thirteen percent of sponsors are dissatisfied and only one percent is very dissatisfied. Such support, however, reflects neither apathy nor blind approval. Nearly two-thirds (sixty-four percent) of the sponsors are considering changes to their target date investments. The focus on improvements to target-date funds under consideration is concentrated in two key areas – diversifying the assets in the investment and selecting top quality investment managers to oversee investments. Only thirteen percent are considering consider making changes to the glide path.

As with other aspects of their defined contribution programs, plan sponsors are driving innovation and improvement in their target date funds. The resulting evolution of target date retirement funds will significantly affect how America's defined contribution plan assets are managed in the future.

Financial investment experts, by an overwhelming majority, recommend three basic principles for long-term capital appreciation, the method used to accumulate retirement assets. First, diversification among bonds, equities, and cash-like investments provides the maximum balance between risk and return. Second, once an investment allocation is determined, periodic rebalancing is necessary to preserve the allocation ratio. Finally, the asset allocation ratio should be altered as an investment horizon shortens to favor risk aversion over returns. These three principles are the bedrock that defines a prudent overall investment policy for a defined contribution plan. Target date funds embrace these principles and apply them automatically to individual plan participants based on the participant's age and assumed retirement date. We hope that this hearing results in a reaffirmation of these principles and recognition of the efficacy of target date funds in achieving these investment goals.

The selection and monitoring of an investment fund offered within a plan is subject to the fiduciary requirements of ERISA. The responsible plan fiduciary must act with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims." When selecting and monitoring plan investments, PSCA believes that a prudent process is required. Fees related to the investment, if paid with plan assets, must be reasonable. The selection must be made solely for the benefit of plan participants. Once an investment is selected, the fiduciary must monitor it to ensure that it remains a suitable plan investment. What absolutely is not required is to ensure that a plan investment always results in positive returns. Even prudent investors can suffer an investment loss! Plan investments are for long-term investing, and questioning their propriety based on short-term performance will create havoc for the employer provided retirement plan system.

All target date funds have different "glide paths," the ratio of the three asset classes for each age cohort. A glide path automatically implements the three investing principles previously discussed – diversification, rebalancing, and reallocation. Glide path variations reflect the preferences of the individual investment manager. A plan fiduciary must be familiar with the glide paths of plan target date investments and determine that they are prudent. How is this achieved? Some plans, usually larger plans, will hire an expert to assist them. Others will conduct a survey of the glide paths of several target date funds. Benchmarks may be utilized to assist in this process. A plan fiduciary, absent any evidence to the contrary, should be able to consider that a particular fund's glide path being within a general range of similar funds is an indication that the glide path is a reasonable. In fact, ignoring this data may require documented justification. The fiduciary must also consider the performance and fees of the target date fund. Again, this is achieved by comparing similar products. It is important to note that the fiduciary process is generally limited to the universe of existing financial products. Only the most sophisticated plans have the ability or resources to invent their own products in a cost-effective manner. Ninety-five percent of the 694,550 plans reporting under the 2006 Form 5500 Abstract have assets of $10 million or less. These plans are maintained by small and mid-size businesses.

The current controversy about target date funds centers on the appropriate glide path as a participant reaches the assumed retirement age, usually age 65. For the most part, there is little debate whether a 65-year old retiree should hold equities in their retirement account. The question is "how much?" That brings us back to the fiduciary process. The overwhelming body of financial advice indicates that a new retiree should hold a substantial percentage of equities in their retirement account, in the general area of fifty percent. This position is not influenced by a short-term value fluctuation at retirement. It is based on the twenty to twenty-five year investment horizon for a recent retiree. A plan fiduciary is, to a large degree, bound by this body of expert knowledge, and ignores it at considerable risk.

The impacts of social security and other retirement assets are often overlooked when analyzing glide paths. An individual receiving half of their retirement income from social security, a common scenario, and half from their retirement account invested fifty percent in equities can be viewed as having an overall portfolio containing twenty-five percent equities. Another important factor is whether the employer also provides a defined benefit plan to the same participants, resulting in further dilution of the ratio of equities in the participant's overall retirement assets. PSCA suggests that a prudent plan fiduciary should be able to make general assumptions about social security income and other retirement plans offered by the employer when assessing a target date fund glide path. The preamble to the Department of Labor's final rule on qualified default investment arrangements (QDIA) embraces this interpretation. A target date fund is not required to be the optimal investment for each individual participant; it must be a prudent plan investment for the participant population in whole.

Another debate regarding target date funds is whether the glide path should be frozen at the target retirement age. PSCA believes that it should extend throughout the life of the participant or beneficiary if the plan permits retired participants, terminated employees, or beneficiaries to remain in the plan beyond the normal retirement age. A case in point is that a retiree may remain in a target date fund plan investment long after retirement. The investment must be prudent for this individual and freezing a glide path at retirement age may violate this principle.

Some are concerned that the Department of Labor has not issued requirements regarding the composition of target date funds and an appropriate glide path in the QDIA regulations. PSCA respectfully disagrees. The Department's rule specifically states that it "does not provide any relief from the general fiduciary rules applicable to the selection and monitoring of a particular qualified default investment or from any liability that results from a failure to satisfy these rules." The rule describes the target date fund default investment as one that "applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capitol preservation through a mix of equity and fixed income exposure based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy." These are firm requirements, and we have described the process used to meet them.

Some have also suggested that the Department of Labor and the Securities and Exchange Commission set actual glide path parameters. We urge Congress not to mandate any prescriptive actions regarding glide paths in target date funds.. This approach would require these agencies to set numerical limits on glide path allocations. Their judgment will replace the body of expert knowledge. Should this approach be pursued, plan fiduciaries must be relieved of any responsibility regarding selection and monitoring of a glide path in a target date fund. On one level, this has certain appeal – plan sponsors will be relieved of liability for this decision. However, PSCA does not recommend this course of action. It will substitute government agency preferences, which are inherently political, for generally accepted investment principles. It will also result in a one-size-fits-all product that precludes the ability to select a target date fund that recognizes the unique situation of a particular plan's participants.

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nairpa
National Association of Independent
Retirement Plan Advisors

Comments to the U.S. Senate Special Committee on Aging

Default Nation: Are 401(k) Target Date Funds Missing the Mark?

October 28, 2009

The National Association of Independent Retirement Plan Advisors ("NAIRPA") appreciates the opportunity to submit our comments for the record to the U.S. Senate Special Committee on Aging on the very important issue of target date funds.

NAIRPA is a national organization of firms which provide independent investment advice to retirement plans and participants. NAIRPA's members are registered investment advisors whose fees for investment advisory services do not vary with the investment options selected by the plan or participants. In addition, NAIRPA members commit to disclosing expected fees in advance of an engagement, reporting fees annually thereafter, and agreeing to serve as a plan fiduciary with respect to all plans for which a member serves as a retirement plan advisor.

This testimony includes a discussion of how Target Date Funds ("TDF's") are being used as investments in 401(k) plans, how in our experiences TDF asset allocation strategies, and the associated risks, are being communicated to participants and plan fiduciaries, and ways this process could be improved. We also discuss the benefit of review of TDF performance by an independent investment expert, and close with a proposal to improve the use of TDF's as Qualified Default Investment Alternatives (QDIA's).

Current utilization of TDF's

Target date retirement funds, although relatively new, are growing in popularity. The Department of Labor's regulation sanctioning the use of TDF's as an acceptable QDIA has been a significant driver in their expansion. One of our members has estimated that 90 percent of the 401(k) plans that his firm works with include TDF's as an investment alternative and over 80 percent of the assets in those plans are invested in various TDF products.

There are a number of reasons why TDF's have become so popular, but chief among them is their simplicity. Conventional investment theory suggests that a participant's mix of investments

National Association of Independent Retirement Plan Advisors

should grow more conservative as the participant gets closer to his or her retirement. This result can be achieved through periodic "rebalancing" of the investments in the participant's account. However, many participants do not actively manage their accounts and as a result have less than ideal asset allocations.

TDF's provide an easy solution to this problem by automatically rebalancing the fund's asset allocation to become more conservative over time. This should result in a rate of return and risk that is appropriate for the investor as he or she grows older. Participants are attracted to TDF's because they are an easy alternative to the many, sometimes bewildering, investment choices offered in a typical 401(k) plan. TDF's allow for the "set and forget" approach to investing. Although not ideal, TDF's are a good choice for participants who are unwilling or unable to manage their own investments.

Communication concerns

NAIRPA strongly agrees with the concept and theory behind offering TDF's as 401(k) plan investments. For most participants, it is the most easily accessed mechanism to ensure an appropriate selection and ongoing rebalancing of their investment portfolio. However, there are some significant problems with how TDF's are presently marketed to plan fiduciaries and participants. In particular, what is lacking is clear and understandable information on the TDF's investment strategy and the potential risks associated with that strategy.

The experience of our members is that the TDF prospectuses for the major mutual fund families generally describe the fund's investment objectives as simply to "...provide capital appreciation and current income consistent with its current asset allocation."[1] This wording, which comes from a Vanguard prospectus, is used to describe the investment objective for the mutual fund family's target date funds ranging from a 2005 "target date" through to the 2050 fund. Similar language can be found in the prospectuses for TDF's offered by ING, Schwab, AllianceBernstein and others. Yet the 2050 fund might be invested 99 percent in equities and the 2005 fund only one percent. Plan fiduciaries and unsophisticated plan participants need a clearer, more understandable description of how the fund invests and the investment risks that are attendant thereto. Only then will it be possible for participants to clearly understand the different asset allocation strategies employed by different TDF's.

We would suggest that communications could be greatly improved by a "truth-in-labeling" approach to how TDF's are sold and marketed. Although most TDF's do have a nominal target date, there are wide differences in what that date really means. For example, the prospectuses for

[1] Vanguard Target Retirement Funds Prospectus, January 28,2009

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many TDF's simply say that the fund's investment strategy is designed for someone who is retiring in or within a few years of the target date. What is not clear is whether this means the investment strategy assumes the investor will need a lump sum liquidation distribution from the TDF at that time or instead will begin to draw down the investment through periodic withdrawals over their retirement years. The difference in these two time periods could be as much as thirty years.

We believe that for plan fiduciaries to fulfill their responsibilities and for participants to understand their alternatives, there must be new, plain English disclosures of how the TDF invests, and what that means to the average, unsophisticated 401(k) investor. Merely providing the prospectus information required under current securities law is not enough, as evidenced by the communication practices used today. There is widespread confusion as to what the "target date" really means for any particular TDF. We believe there must be consistent standard. Although we don't believe there should be a mandatory mix of investments, nevertheless, fund managers should disclose in plain English what the "landing point" will be for their TDF's glidepath. In other words, at what point does the fund no longer need to be rebalanced because it has reached the appropriate mix of stocks, bonds and cash? With this information, participants will be in a better position to make an "apples-to-apples" comparison between TDF providers.

Benefits of independent review

Another concern we have in regard to the use of TDF's in 401(k) plans is the potential conflict that arises when a TDF is constructed as a "fund-of-funds", particularly when constructed using only proprietary funds of the fund manager. The concern is that the fund manager has conflicting loyalties. On one hand, there is a desire to achieve performance results that makes the TDF attractive to investors. On the other hand, when proprietary funds are used as the sole basis for constructing the TDF, the fund manager may be forced to use a lower rated proprietary fund rather than a higher rated, unaffiliated investment. We do not believe there is anything inherently wrong with using proprietary funds to construct the TDF. However, our experience has shown that investment performance significantly improves if an independent investment manager is retained to review the TDF program and recommend changes if warranted. For example, consider an environment where two TDF's funds with the identical retirement year were made available to participants, with the identical asset allocation between stocks and bonds. Further consider that one TDF was constructed solely of one fund family's proprietary funds and the other TDF was constructed using only the top rated funds from several fund companies. There would be a very high probability that the TDF constructed only of top rated funds from several different mutual funds families would provide a much better return than the TDF constructed of only the mutual fund's own proprietary funds.

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We'd like to tell you about a recent experience one of our members. Freedom One Financial Group, based in Clarkston, Michigan, had in meeting with a plan sponsor. This Michigan employer sponsored a 401(k) plan with nearly 5,000 participants and over $220 million in assets. For many years, the plan sponsor had been hiring independent retirement plan advisors and employing a sophisticated process to ensure only high quality mutual funds from various fund companies were offered as 401(k) investment alternatives. With the assistance of an independent retirement plan advisor, the plan sponsor's investment committee carefully researched current and potential investment options as they decided which options would remain in the plan and which needed to be replaced. As a result, the available investments contained only top quality, low cost investment options.

Several years ago, the plan sponsor determined that their employees were not doing a very good job in allocating their assets among the plan's investment options. This primarily resulted from the lack of investment sophistication of the plan participants. As a result, the plan sponsor looked to the mutual fund company that was already providing many of the funds, as well as the recordkeeping services for the plan, and requested if TDF'S were available. The TDF option that was available was the mutual fund's own TDF, constructed as a "fund-of-funds" using their proprietary products. The plan decided to include the mutual fund family's TDF's as both a QDIA and an investment alternative that participants could affirmatively select. In addition, the plan sponsor allowed the mutual fund company to heavily promote the new TDF offering. Within twelve months, over 35 percent, or nearly $100 million, was invested in the mutual fund family's TDF's.

Freedom One, an independent retirement plan advisor, was asked to perform an evaluation of all the mutual funds being offered as investment alternatives. The vast majority of the funds in the menu were logical and competitive choices to offer to the employees. During their discussions, the plan sponsor described to us the process by which they had evaluated various funds over the years and replaced those that were underperforming as measured against their peers. The sponsor was clearly proud of how much better off the participants were as a result the process they had employed.

Freedom One then turned to the TDF's, which as mentioned earlier, were constructed as "funds-of-funds". As it turned out, the underlying proprietary funds that made up the TDF were largely made up of the very funds that had previously been removed by the plan sponsor because they were underperformers. Yet because these funds were the only funds used by the TDF, participants who wanted the benefit of automatic rebalancing were forced to invest in inferior funds. The plan sponsor had been completely unaware of this issue until we raised it based upon our independent review.

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Recommendation

Under the QDIA regulation, an investment fund can qualify to be a QDIA only if the fund is managed by an ERISA (3)(38) manager or trustee, or by a named fiduciary of the plan. However, mutual funds are exempted from this requirement. As a result, the investment manager of the mutual fund is *not* required to assume any fiduciary responsibility for the investment decisions made with regard to the fund's asset allocation or "glidepath" strategy. This leaves the plan sponsor with the task of trying to evaluate the mutual fund's investment strategy without the tools to do so.

NAIRPA recommends that the QDIA regulations be changed to provide that in the absence of an ERISA (3)(38) independent expert, the investment manager of the mutual fund must to agree to assume fiduciary responsibility with respect to the plan's investment in the TDF in order to qualify it as a QDIA. This would put the fiduciary responsibility for the quality of the funds selected for investment in the TDF, as well as the asset allocation decisions made with respect to a particular TDF, on the entity actually making those decisions. This is consistent with the sentiment expressed in the preamble to the QDIA regulation:

> "[T]he Department continues to believe that when plan fiduciaries are relieved of liability for underlying investment management/allocation decisions, those responsible for the investment management/allocation decisions must be fiduciaries and those fiduciaries must acknowledge their fiduciary responsibility and liability under ERISA ."[2]

The quoted language is in reference to the required fiduciary status of an investment manager of a TDF QDIA that is not a mutual fund. We believe those same policies are equally applicable when a mutual fund TDF is used as the QDIA. We do not believe there is a policy justification for treating mutual fund TDF's and non-mutual fund TDF's differently in this context. In both cases, a package of funds are put together to achieve a "target date" investment objective. Fiduciary status for the mutual fund TDF investment manager is needed even more because of the conflicting loyalties the fund manager may have due to the existence of the proprietary funds. By requiring a mutual fund TDF to acknowledge, in writing, that it is acting as an ERISA fiduciary, plan sponsors who use mutual fund products will get the same unbiased decision making that TDF's managed by independent ERISA (3)(38) investment managers already receive. NAIRPA believes this will greatly assist plan sponsors and participants by providing that all TDF managers stand behind the investment decisions they make.

Thank you for your consideration.

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[2] 72 FR60459 (Oct. 24,2007)

NEW FRONTIER

Target-Date or Target Risk: Toward Effective Default Retirement Funds

Testimony Submitted to the Special Committee on Aging

by

Richard O. Michaud and Robert O. Michaud

An earlier version of this paper was presented to the joint SEC-DOL hearing held on June 18, 2009 on the topic of target date funds..

Working Paper
October 28, 2009

Abstract

Target date funds (TDFs) are marketed as age-appropriate diversified portfolios and promoted as sophisticated easy-to-use funds. The Department of Labor (DOL) currently provides fiduciary relief for TDFs as qualified default investment alternatives (QDIAs) in individual account plans such as 401(k)s. Because they are diversified, investors are often advised to invest in TDFs rather than invest on their own. Recent events have demonstrated, however, that TDFs are not no-brainer investments. In addition, TDF glide paths are a risky bet on declining markets relative to fixed risk diversified funds. TDFs are not default investments, and DOL regulatory relief needs to be rescinded. In contrast, a properly managed, balanced target risk fund (TRF) is an appropriate default investment for many investors. A spectrum of well-managed, low fee TRFs with supporting educational materials may provide an effective retirement framework for meeting many default fund objectives.

Introduction

Lifecycle or target-date funds (TDFs) are attractive to employers who are attempting to implement Pension Protection Act (PPA) recommendations for automatically enrolling employees in 401(k) plans and provide appropriate default retirement funds unless they opt out. The Department of Labor (DOL) grants fiduciary relief for funds that are defined as qualified default investment alternatives (QDIAs) in individual account plans such as 401(k)s. A QDIA is a diversified fund that serves as a default investment option for investors who do not want to choose or feel they do not have the expertise to properly do so. QDIAs are popular among employers and advisors because they limit liability from the "know thy client" rule. The objective is to provide a suitably diversified fund that helps investors avoid excessive risk taking or risk avoidance that commonly occurs when individuals invest on their own.

TDFs are diversified asset allocation portfolios that use an age-based glide path to decrease equity risk as the investor ages and the retirement-date approaches. Current DOL regulations allow TDFs as default investments in 401(k)s. Investors are advised to invest in a TDF rather than on their own.[1] TDFs are popular among fund management companies because age-based choice and QDIA status greatly facilitates the sales process. Brokers and advisors need only determine a client's retirement date in order to recommend a TDF. DOL sponsorship promotes the notion that a TDF is a safe and appropriate investment for meeting long-term retirement objectives. However, recent events highlighted the fact that TDFs are not no-brainer investments but require deliberate analysis of many factors for appropriateness.[2] In addition TDFs are risky retirement funds relative to simpler more transparent alternatives.

DOL TDF sponsorship is a well-intentioned, but ill-advised, regulatory proposal for defining a retirement default investment option. Age-based risk is a myth and investing based on it is often counterproductive. Investors need to understand TDF the riskiness inherent in glide paths, total fees, and less than optimal risk management practices.[3] TDFs are not default investments, and DOL regulatory relief needs to be rescinded. Targeted risk funds (TRFs) supplemented educational materials may provide a more appropriate and effective framework for default retirement investing for many investors.

Why Stock/Bond Ratio?

TDF risk level is defined by percent of equities or the stock/bond ratio of the asset allocation.[4] Empirically, the stock/bond ratio is associated with long-term investment risk. More than 90% of the long-term performance of institutionally managed portfolios was

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[1] Updegrave (2009a,b).
[2] Carlson et al (2009).
[3] Consumers Union (2009).
[4] This definition of risk may have limitations if alternative assets such as real estate, commodities, hedge funds, or private equity are included in the asset allocation.

found attributable solely to the average stock/bond ratio of the fund.[5] An optimal long-term investment is not structured the same as one that invests short-term. Effective diversification is critically important for long-term investing. In addition there are limits to the level of risk that is appropriate for long-term investing.[6] TDFs may often be inappropriately structured as long-term retirement investments.

Which Glide Path?

TDF glide paths vary widely across fund families for the same target date. In 2008, equity exposures for TDF 2010s ranged from 26% to 72% while 2040s ranged from 80% to 95%.[7] This wide variation reflects the fact that there is no consensus or standard – in theory or in practice – for defining age-based stock/bond ratio risk level for long-term retirement investing.

The variation in glide paths helps explain the wide range of desultory performance experienced by investors in 2008. The performance of 2010 TDFs averaged -23%; the worst (-42%) was more than the -37% loss of the S&P 500.[8] Ambiguity in TDF structure resulted in many disappointments as effective retirement investments.[9]

Do Glide Paths Matter?

Given recent performance it seems important to carefully consider the glide path of a TDF prior to investment.[10] But all traditional TDF glide paths are inherently risky relative to simpler alternatives. The sequence of experienced returns over the investment horizon dominates TDF glide path performance.[11] TDFs perform well when market returns start high and decline over the investment horizon relative to an equivalent risk fixed stock/bond ratio fund. Conversely, TDF performance will be poor when markets start low and rise over the investment horizon relative to a fixed stock/bond ratio fund.

TDF glide paths imply path dependent performance and are a risky bet on a particular way the market performs over the investment horizon. A fixed stock/bond ratio investment is less risky because it is path independent relative to sequences of market returns. Interestingly, a recent historical study found that investors were better off if the definition of glide path risk with age was inverted.[12]

Assessing Investor Risk Levels

[5] Brinson et al (1986, 1991).
[6] Michaud (1981, 2003).
[7] Carlson et al (2009).
[8] Carlson et al (2009).
[9] Lewis (2009).
[10] Carlson et al (2009).
[11] Obrien and Galacios (2009).
[12] Basu et al (2009).

Age or target-date is often used by brokers and advisors to recommend a reduction in equity exposure near retirement. The objective is to avoid last minute downturns in the market when an individual is about to retire. Another reason for age's association with risk level is the notion that stocks tend to outperform bonds on average over time. Consequently, brokers tend to recommend significant equity exposure as long as an investor has enough of an investment horizon to ride out troughs and peaks. Neither argument rationalizes retirement date glide path risk over an investor's lifetime.

Declining age-based risk is potentially perversely related to properly defining long-term risk for many investors. TDFs may often encourage recklessness for the young and excessive conservativeness for the elderly: An unemployed 25 year old may rightfully be far more conservative than a wealthy octogenarian.

Recent empirical data can be helpful in shedding light on the relationship of long-term risk with age.[13] On average, the relationship of age with equity exposure is an inverted U. However, risk is increasingly unrelated to age as level of education increases. For better informed investors, objectives and liabilities dominate considerations of appropriate risk level and age tends to be irrelevant.

Properly defining an appropriate level of risk for long-term investing for individuals (or institutions) is a complex multidimensional and situational consideration. Standard theoretical approaches include classical utility theory and psychological multidimensional scaling theory. Many financial economists devote much of their careers to the study of appropriately defining investment risk. Even small changes in estimates of parameters in the same family of utility functions that define investor risk aversion can lead to very different investor behavior.[14]

No credible formal financial theory exists that rationalizes declining risk for long-term investing based solely on age. Theoretically, defining an investor-appropriate long-term risk level is one of the most complex practical open questions in modern finance.

In practice, various approximations are used to define investor risk level. Some financial institutions use questionnaires of dubious validity and reliability.[15] Sophisticated approaches consider many factors including wealth, investments, income sources and volatility, risk aversion, health, marital status, long-term objectives, legacies, and investment horizon.[16] In depth studies for determining an appropriate long-term investment policy or stock/bond ratio are often costly and resource intensive and typically include customized Monte Carlo simulation and advanced analytics.[17] Age is often a minor consideration.

[13] Smetters (2009) finds empirically that the age to stock/bond ratio has an inverted "U" shape that diminishes as educational level increases.
[14] A classic theoretical study of the choice of risk for investment is given in Rubinstein (1973).
[15] Grable and Lytton (1999).
[16] See Michaud (2003) for a review.
[17] Michaud (1976) provides an example of such a study.

Lock-In and Target-Through

TDF age-based rules promote the notion that the same fund is an appropriate investment until the target date, or beyond. While a major benefit for fund sales, client lock-in ignores the important issue of lifestyle changes over time. As individuals age, many factors that affect an appropriate investment risk level change, including marital status, income level, investments, health, and objectives. TDF lock-in can be a very high price to pay for inappropriate risk management over an individual's investing life.

Some TDFs are marketed as appropriate for investing in retirement. The glide paths for these "target through" TDFs continue to evolve past retirement. Because many investors rely on income from investments, investing in retirement is not the same as prior to retirement. In retirement, an appropriate investment framework needs to consider short-term, medium-term and long-term income, lifestyle, and legacy needs. A mixture of targeted funds may be appropriate for addressing various objectives. In particular, lifestyle risk may often require substantial equity exposure well into retirement. A single TDF is unlikely to satisfy the multiple objectives of distribution phase investing for many, if not most, investors.

Fees

Expense ratios are one of the most important determinants of long-term performance and a major consideration for fund choice. Fees are on average inversely related to long-term return. Currently, TDF asset weighted expense ratios average over 1% and range from 0.19% to 1.82%.[18]

TDFs are often critiqued for double-dipping. Fund managers may charge fees to allocate assets among in-house managed funds that also charge management fees. The impact of fees on the retirement value particularly for long-term investors may be very substantial.

DOL regulations should mandate disclosure of total fees. A simple proposal to limit the impact of fees on investors is to recommend that QDIAs invest in low cost index funds or index fund Exchange Traded Funds (ETFs). Such a proposal has the additional advantage of reducing long-term investment risk.

Risk Management

DOL QDIA regulations ignore important aspects of TDF risk management. These include glide path management, fund quality, and diversification engineering.

TDF managers may deviate from glide path risk in order to time the market. While market timing is an attempt to enhance short-term return and to be competitive with other fund families, it increases risk relative to meeting long-term objectives. Market timing is also

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[18] Carlson et al (2009).

inconsistent with empirical studies that define the relationship between stock/bond risk and long-term performance. Moreover, many academic studies have demonstrated that, on average, market timing is negatively related to long-term performance. Transparency about the allowable range of deviation from long-term risk is an important consideration for proper regulation and investment choice.

TDF fund quality and management policies are important factors in investor choice. Limiting allocations to in-house funds may not always be in investors' best interests. In addition, TDF managers do not always allocate assets to their most popular in-house funds or best managers.[19]

The basic rationale for investing in TDFs is diversification. How portfolio diversification is engineered is an important consideration. Many fund managers use ad hoc portfolio construction methods that often ignore basic principles of modern risk management. Other managers use software associated with the classical theory of optimal diversification that is known to be ineffective on average in practice.[20] New technologies are available that are consistent with modern principles of risk management and provide more effective diversification.[21]

A Balanced Default Fund

A balanced target-risk-fund (TRF) is a diversified asset allocation portfolio where the stock/bond risk level is set at approximately 60/40. The DOL provides fiduciary relief for balanced diversified portfolios as QDIAs in individual account plans.

In contrast to TDFs, a balanced TRF features risk transparency as well as long-term capital market risk neutrality. In aggregate, investors hold claims to the economic productivity of the economy. Mathematically, the average asset allocation is roughly equal to a 60/40 risk-target portfolio of capitalization weighted index funds.[22] Deviations from a balanced TRF represent under-weighting of the risks for some segments of the economy and an over-weighting of others.[23] An effectively diversified, low fee, balanced TRF is often an appropriate default investment for meeting long-term retirement objectives for many investors. In addition, as noted earlier, a balanced TRF is less risky because performance does not depend on a declining market over the investment horizon.

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[19] Carlson et al (2009).
[20] Jobson and Korkie (1981), Michaud (1989).
[21] Chernoff (2003), Michaud and Michaud (2008a, 2008b).
[22] The concept of the market portfolio is central in modern finance (Sharpe 1964, Lintner 1965).
[23] Sharpe (2009) notes that the market portfolio may vary significantly from a stylized 60/40 asset mix during periods of extreme market volatility as in recent periods.

TRF Investments

In order to meet a wide variety of risk preferences, turnkey asset management platforms (TAMPs) often provide a family of diversified TRFs with risk levels ranging from conservative to aggressive. TRF families may offer a number of advantages for retirement investing. TRFs are long-term risk transparent; an investor knows exactly the risk level associated with investments. TRFs do not encourage lock-in investing; investing may evolve naturally over time as lifestyle and financial status changes. They encourage neither reckless investment for the young nor overly conservative investment for the elderly. Combinations of TRFs may often be appropriate for meeting the multiple objectives of investing for and in retirement.

Conclusion

TDFs are unsuitable for DOL default investment regulatory relief in individual account plans. Age-based risk management is a dangerous myth that is not only irrelevant for many investors but is often perversely related to their interests. Recent investment experience has confirmed that TDFs are not well defined and are not no-brainer investments. In addition, TDF glide paths are path dependent relative to the sequence of experienced returns representing a risky bet on a declining market over the investor's investment horizon. In contrast, a properly managed balanced TRF is a valid default less risky investment option for many investors. More generally, TRFs offer similar diversification and investment benefits without the illusion of age-based risk defining an appropriate investment choice or the need of a bet on a sequence of market returns for good performance. A family of TRFs--fee disclosed, effectively diversified, and accompanied by appropriate educational materials--may provide a much safer investment framework for meeting DOL default fund objectives.

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Fees in Target Date Funds

How much are target date fund fees and how are they charged?

- As of May 2009, the asset-weighted average expense ratio for target retirement date mutual funds was 0.66 percent of assets. ICI research finds that the comparable average for equity funds was 0.84 percent at year-end 2008; for bond funds, 0.63 percent.

- Most target retirement date mutual funds are organized as funds of funds. They typically do not charge any additional fee for asset allocation. Investors in target retirement date mutual funds pay proportionate expenses of the underlying funds in which the target retirement date fund invests.

- Regardless of whether or not a fee is charged for asset allocation, all fees are reflected in the expense ratio.

What oversight is there of target date fund fees?

- Target retirement date mutual funds are subject to the same comprehensive regulation under the 1940 Act that applies to all mutual funds. They must also comply with the 1940 Act's strict rules relating to fund of funds structures.

- Mutual fund boards of directors (most of which have a majority or more of independent directors) have a fiduciary duty to assure that funds operate in the interests of their investors, including duties to assure that funds are not overcharged for services to the fund provided by its investment manager.

- The 1940 Act's fund of funds rules limit the sales charges and service fees that can be charged and generally have the effect of assuring that fund investors are not charged twice for the same service.

- The SEC requires all fund of funds to disclose an aggregated expense ratio for underlying funds in their prospectuses as a required line item in the fee table, which is required to appear near the front of the prospectus. Additional, more detailed information about the expenses of the underlying funds is readily available to plan sponsors and investors.

- When target retirement date funds are used in 401(k) plans, plan participants have the additional protection provided by plan fiduciaries, who are subject to duties of prudence and care in selecting target retirement date funds as plan investments.

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Use of Proprietary Funds in Target Date Funds

Are 401(k) plan sponsors required to use target date funds offered by their plan's recordkeeper?

- No. A 2008 survey by Financial Research Corporation, *Future Outlook for Lifecycle Funds,* found that nearly three-quarters of all surveyed recordkeepers indicated they offer non-proprietary target retirement date fund series on their platforms, and two-thirds of such firms with proprietary target retirement date funds make non-proprietary families available to plans.

- The survey covered 11 defined contribution plan recordkeepers representing more than $600 billion in assets and nearly 62,000 plans in early 2008.

Why do fund managers use proprietary funds for their target date funds?

- There are business and legal reasons that favor the use of proprietary funds in target date funds.

- Helping to assure that a target date fund maintains the asset allocation described in its glide path is one reason to use proprietary funds. Target retirement date funds invest in multiple asset classes, ranging from domestic large and small cap stocks and international stocks to corporate and government bonds to cash. To avoid overlap between asset classes, some fund managers use proprietary funds consisting of pure asset classes as their underlying funds. Others select from among their existing families of funds with a view towards assembling underlying funds to meet the target date fund's objective. In both cases, managers using their proprietary funds have the benefit of knowing the investment policies of these funds and have easy access to their portfolio managers. Thus, they may reduce the costs of monitoring underlying funds to assure they continue to meet the fund's objectives.

- Legal factors also favor creation of target retirement date mutual funds comprised primarily of proprietary funds. Most target retirement date mutual funds operate as "funds of funds" that invest in a selection of underlying funds. The 1940 Act generally prohibits fund of funds arrangements unless they qualify for a statutory exception or apply for and receive an individual exemption from the Securities and Exchange Commission. Target retirement date funds comprised of proprietary funds can rely on the statutory exception in Section 12(d)(1)(G) of the Act. A provider organizing a target date fund comprised of non-proprietary funds would have to seek an individual exemption from the SEC.

Don't target date fund managers have an incentive to include their company's funds that are otherwise not performing well in target date funds?

- No. Mutual fund managers have no incentive to use underperforming funds in their target retirement date funds because doing so would harm the performance of the target retirement date fund itself.

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Key Benefits of Target Date Funds

- Target date funds provide a convenient, well-priced asset allocation. As of May 2009, the asset-weighted average expense ratio for target retirement date mutual funds was 0.66 percent of assets. ICI research finds that the comparable average for equity funds was 0.84 percent at year-end 2008; for bond funds, 0.63 percent.

- Target date funds provide investors asset allocation that becomes more conservative over time. To achieve the same benefits with a self-managed portfolio, an investor would have to monitor the individual funds in his or her portfolio and regularly transfer money between them.

    - Target date funds provide diversification across asset classes. They invest in a mix of asset classes, including stocks (equity), bonds (fixed income), and cash.

    - Target date funds avoid extreme asset allocations. Research shows that some young workers invest very conservatively, by allocating all or almost all of their accounts to fixed income investments, while some participants nearing retirement invest very aggressively, allocating all or almost all of their accounts to equity. Target date funds follow professionally designed asset allocation models to eliminate such extremes.

    - Target date funds provide automatic rebalancing. Target date funds are automatically rebalanced periodically to maintain their target asset allocation, so that swings in the markets do not throw a participant's allocation off course. Research shows that systematic rebalancing tends to improve a portfolio's long-term performance.

    - The asset allocation of a target date fund is adjusted to become more conservative over time to account for factors that affect an investor's risk profile: a shorter time horizon, fewer chances to make contributions to savings, and greater sensitivity to capital market swings.

- Target date funds do not take into account the individual risk tolerance of any particular investor or any investor's individual circumstances, including any holdings of other assets. An individual investor may have more or less tolerance for investment risk than the investor for whom a fund with a particular target date is designed. Funds disclose the current asset allocation of each target date fund, and an investor who feels that the asset allocation mix associated with the investor's target date involves more risk than he or she wants to assume can choose a fund with a target date that will occur prior to the investor's expected retirement date. An investor who is less risk-averse than the fund's target investor might choose a fund with a target date that will occur after the investor's expected retirement date.

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