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Target Date Fund Controversy: Issues for Plan Fiduciaries

The [attached article](#) summarizes the **current controversy involving target date funds**. We provide an **overview of this controversy (below) and provide action steps for fiduciaries to protect themselves** from potential liability and exposure.

What's a Target Date Fund ("TDF")?

Target date funds ("TDFs") are premixed portfolios that automatically become more conservative as an investor's "target" retirement date approaches. The mix of equities to fixed income gradually shifts to lower risk fixed income investments as the retirement age gets closer. This is referred to as a TDF's "glide path."

We like TDFs. They are a useful tool to address a huge problem with 401(k) and 403(b) plans -- too many employees don't know or care how to make wise investment choices. With a TDF, all a participant needs to do is pick a "target retirement date" (the target retirement date is usually designed to be the date the participant attains age 65) and the fund's manager handles it from there. A well constructed TDF provides participants a simple way to save for retirement without having to fret over asset allocation decisions, mutual fund selection, or rebalancing.

TDFs received a boost when the U.S. Department of Labor ("DOL") approved TDFs as one of three "qualified default investment alternatives" ("QDIAs"). When participants are given an opportunity to direct their own investments, but fail to do so, plan fiduciaries are generally protected if the participants' contributions are invested in a QDIA. The plan fiduciaries will not be responsible for losses resulting from the investment of the participants' contributions in the QDIA.

We also recognize there's no perfect solution and TDFs may not be appropriate for every investor/participant. For example, TDFs do not generally take into account the risk tolerance, income needs and life spans of individual participants. Also, the TDFs offered by different providers differ greatly from one another in terms of risk and diversification; as a result, they are difficult to benchmark and evaluate.

The TDF Controversy

The current controversy surrounding TDFs **primarily involves** the "2010 funds" (i.e., a fund that would be selected by an employee expecting to retire in 2010). Various providers' TDFs for **participants who are close to their retirement age** differ dramatically in their asset mix and "glide path" (i.e., the rate at which the TDF's asset mix changes from equities to fixed income over time).

Last year, the 2010 funds lost 23.3% on average. This blindsided many participants investing in these funds who were expecting to retire next year or even earlier. The 2010 TDF with the best return lost just 3.6% in 2008 and the worst performing 2010 TDF lost 41.3%. This difference is largely attributable to the amount of equity exposure in different providers' TDFs at the target retirement age (the equity exposure ranges from as low as 14% to as high as 65%). Participants in TDFs with a higher percentage of equities at the target retirement age incurred the highest losses.

A TDF's equity allocation at the target retirement age is disclosed in its prospectus (and perhaps in other materials provided to the participants). **However, many (if not most) participants don't review the prospectus (or any other information provided to them)** and may have mistakenly concluded that a TDF with the looming retirement date would be heavily weighted towards fixed income investments such as bonds, money market funds, etc.

While there is a wide disparity in the equity allocation for the various 2010 TDFs, there is no consensus of opinion as to which allocation is better or more appropriate. Some TDF managers take a conservative glide path, downshifting to a relatively low percentage of equities (e.g., 20%) promptly at retirement age. Other TDF managers view the TDF as the lifetime strategy, and given current life expectancies, do not shift to a maintenance allocation the date a participant reaches age 65. A TDF with a conservative allocation at age 65 may provide more stability around the participant's retirement date, but it may not generate the growth needed to address one of a participant's most significant risks – the risk of outliving his or her retirement funds.

The DOL's position is that the selection of an investment option made available under a retirement plan, including a QDIA, is a fiduciary act subject to challenge as a fiduciary breach. Given the current controversy and the second guessing caused by the market turmoil, **a participant might challenge the fiduciaries' selection and retention of a particular TDF as inappropriate based upon the TDF's equity allocation at its target retirement age.**

Action Steps to Protect Plan Fiduciaries

To mitigate the potential fiduciary liability and demonstrate that the fiduciaries engaged in a **prudent process**, plan **fiduciaries should** work with their advisors and **analyze the TDF offering's asset allocation glide path, choice of investments, and overall fees.** The process will enable the fiduciaries to **assess the TDF's equity allocation at various stages in relation to retirement age and make a determination that the TDF's glide path is appropriate.** As noted, there is no right or wrong answer. The important thing

is to demonstrate that the plan fiduciaries engaged in a reasoned decision-making process (i.e., procedural prudence) in selecting and/or retaining the TDF.

The **results of the TDF analysis should be documented** in the plan fiduciaries' minutes or other records.

Communication/Education Helps

Following the analysis of a plan's TDF offering, the plan fiduciaries should consider participant communications. While an equity allocation of 50%, 55%, or 65% at a fund's target retirement date maybe "reasonable", not all participants who invest in the TDF will desire this level of risk. As such, **we recommend that plan fiduciaries work with their TDF vendors to ensure that the risks associated with the TDFs are adequately communicated.**

TDFs present other educational challenges. Many participants do not understand what they are or how to properly use them. A TDF is designed to be an "all or nothing" investment option; TDF holders have a tendency to over diversify (either by combining TDFs with different retirement dates or by combining TDFs with other mutual funds).

Some participants also mistakenly select TDFs based upon the year they expect to leave their employer instead of the year they intend to retire; some participants also mistakenly believe TDFs offer pension-like income guarantees.