Second Quarter 2009

Special Commentary for Plan Sponsors Regarding Target Date Funds

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Target date mutual funds have become increasingly popular as 401(k) plan investment options. Three years ago, about 3% of 401(k) assets were in target date funds, according to the Senate Special Committee on Aging. That figure is expected to reach 20% next year and more than one-third by 2015. It is also estimated that over 60% of all 401(k) plans now offer target date funds and over 50% of all new 401(k) contributions flow into target date funds.

Over the last few months, however, target date funds have been the center of much controversy and criticism. As most posted double-digit losses in 2008 and at the start of 2009, commentators began to wonder about their aggressive construction and their appropriateness, both as a default investment as well as a core 401(k) investment option.

This commentary is designed to help 401(k) plan sponsors and committees understand the current target date fund concerns and what they should do about them.

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How Do Target Date Funds Work?

Target date funds are designed to be "one-stop shops" for participants who wish to simplify their 401(k) investment process. At a minimum, the funds are designed to provide the following investment structure and process:

Appropriate amount of risk for each participant

The risk of target date funds is primarily adjusted by the relative proportions of stocks, bonds and cash held by the target date fund. The further away a fund is from the target date (generally understood to mean the retirement date of the participant, or age 65), the greater the equity or stock exposure of the fund. As time passes and the fund closes in on the target retirement date, the percentage of equities held by the fund steadily declines according to a pre-set "glide path", as illustrated by "Figure 1" on page 3.

Diversification

Target date fund portfolios contain a ready-made asset allocation strategy consisting of a variety of investment asset classes and/or management styles; for example, US and foreign stocks, large, mid and small cap companies, fixed income investments, and so on.

Rebalancing

Target funds are automatically rebalanced in order to take advantage of the differing cycles of the individual investment asset classes and in order to maintain the intended level of portfolio risk.

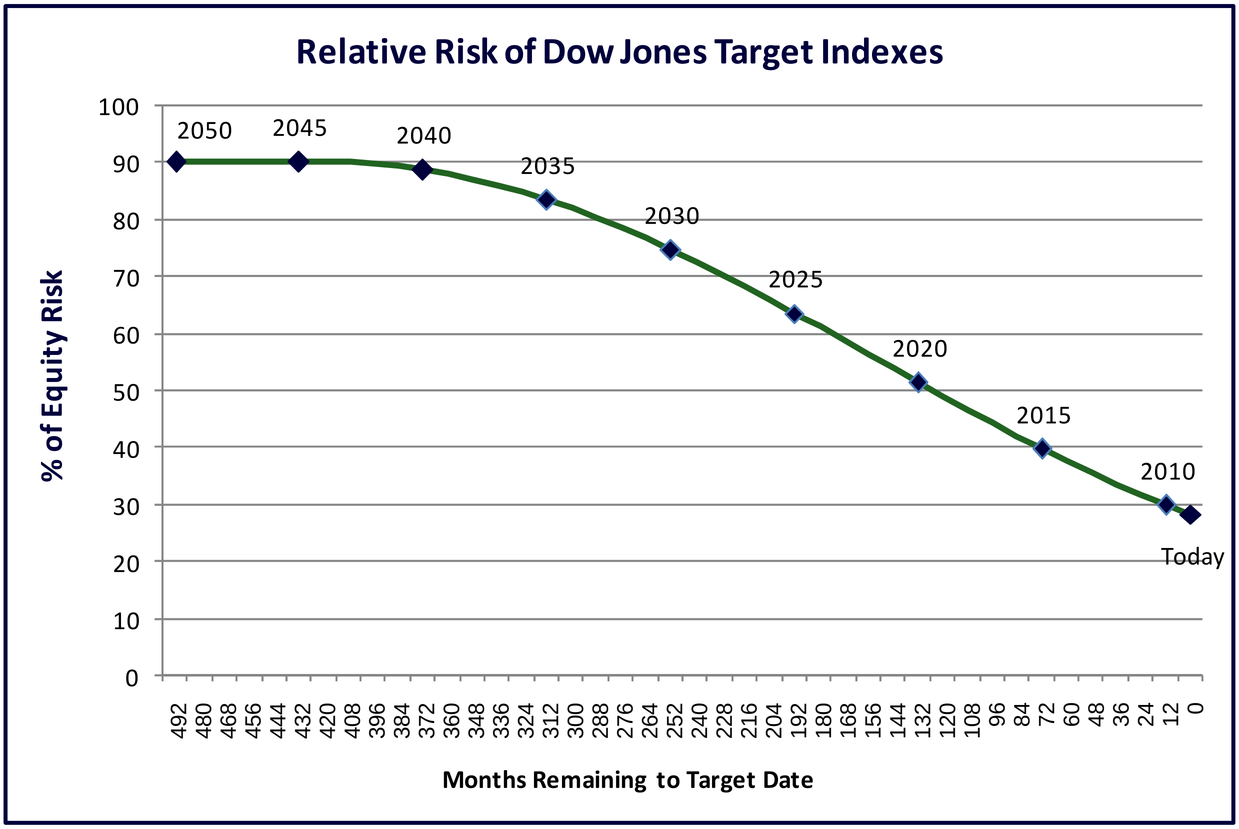
Commentary

If target funds accomplished no objective other than providing the structure and process illustrated by "Figure 1" on page 3, they would still deliver consistently better investment returns than those experienced by nearly all participants who are required to design their own customized portfolios. The problem with most of these non-target participant designed portfolios is that they are generally set at the wrong risk level, poorly diversified, and never rebalanced. Even the worst target date fund will most likely deliver a better long term investment outcome than participants who must construct their own portfolios. Consequently, target date funds play a very important role.

Another important benefit from target date funds is that participants tend to "stick with" their strategies more consistently in the face of market turbulence. According to a recent study by the Vanguard Group, 401(k) participants who used a target date fund as their sole investment option abandoned the equity market at half the rate of investors who designed their own portfolios.

Congress recognized the important role these funds could play and as a result, the Pension Protection Act of 2006 provided a fiduciary "safe harbor" for Plan Sponsors that offer target date funds as the plan's "Qualified Default Investment Alternative (QDIA)".

Figure 1. Overview of the Target Date Fund



Source: Dow Jones Target Date Indexes SM

Why then are target date funds the subject of much criticism?

Much of the media and political attention is due to the fact that most of the target date funds close to retirement date (e.g. Retirement Income, Target 2010, Target 2015) experienced losses in 2008 that many felt were unacceptable for an investor so close to retirement. For example, the 2008 calendar year losses in target 2010 funds ranged from -9% to -41%.

Commentary

While we are very concerned about a near-retiree with a 30% plus loss in their portfolio, it appears that relatively few 401(k) participants are actually facing this situation. In fact, we cannot find any examples among our clients' participant population (which numbers in the tens of thousands). The reason why the actual damage was probably not as high as many had feared is due to the fact that acceptance of target date funds among older plan participants has been relatively slow.

The real "elephant in the room" is that most 401(k) participants are woefully behind on their retirement savings path. We have received a number of phone calls from participants expressing sentiments similar to those of the woman interviewed in the now famous "60 Minutes" piece on 401(k) plans that aired a few months ago. That is, that the recent market decline has left them "unable to retire". With all sensitivity to the hardships being faced by these participants, the harsh reality is that due to an inadequate amount of 401(k) savings, most could not have retired if the market had gone up 40% - rather than down 40%. This example of financial illiteracy is a far greater problem than the recent declines in target date funds.

What was responsible for these large losses?

The primary cause of target date fund losses was the fact that the equity portion of these funds was crushed by the worst stock market in the last 60 years. Among the top selling target fund companies, the equity exposure in their 2010 funds ranged from a low of 35% of the portfolio to a high of 65%. It is interesting that within the equity portfolios of the funds themselves, there was not a large difference in performance. Overall losses on the various stock accounts differed by only 3% from the worst to the best performer. The big issue was just how much stock or equity was held by the fund.

A secondary cause of the losses can be attributed to the quality of the underlying bond holdings on the fixed income side of the portfolios. The 2008 market decline was unique in that panic swept over the fixed income (bond) markets as well as stocks, and this resulted in significant losses to virtually any fixed income security that was not issued by the US government. Within the fixed income segment there was a far greater variation in returns from one company to the next with the difference between the worst and best performers running as high as 16%.

Commentary

The overall issue was one of risk, as defined by stock exposure and fixed income quality. Each fund provider had a vision of the appropriate amount of risk that should be incurred by a participant at a certain age. It wasn't that the investment strategies did not necessarily work - it was that the amount of risk delivered and the amount of risk expected did not match up in the worst investment environment most participants had ever encountered.

Why did target date providers take so much risk inside near-term target funds?

As mentioned above, most of the target date risk and poor performance came from the product providers' decisions related to how much equity exposure a retired or near-retired investor should have in their portfolio. From the perspective of these providers, the risk of near-term market declines must be balanced against what generally is referred to as "longevity risk" — the risk of an investor outliving their money. The providers' philosophy is that if an investor enters retirement with a portfolio that is too conservative, the resulting low overall return could lead to a premature depletion of the account. The product provider solution to this challenge is to maintain significant equity exposure in order to increase the overall portfolio return.

Critics of this type of target date construction counter that because over 50% of all plan participants "cash out" their entire balance at retirement, it makes no sense to build a long-term portfolio strategy into a short date target fund. They contend that the typical 401(k) participant investing in a near-term target date fund expects the risk of that fund to be very low, regardless of the long-term investment return implications. They also believe that the decision to hold higher amounts of equity in a near-term portfolio may be the result of the fact that stock based mutual funds are typically more profitable to operate than fixed income based portfolios. In other words, they believe that a potential conflict of interest exists at the fund provider level.

Commentary

The main issue is whether target date funds are "accumulation" vehicles, or "accumulation and distribution" vehicles. While we do not fully accept the argument that the higher equity exposure is solely a profitability play by the fund companies, we do recognize that target date funds play an important role in the long-term business strategies of the fund providers. It is the providers' intention to keep participants invested in the target date funds as they move into and through retirement. Their hope is that the participant will maintain the target date fund as an investment in the plan or in a rollover IRA, and that this investment will be the participant's predominant source of retirement income. In other words, the fund providers see target date funds as both accumulation and distribution vehicles. In the context of that objective, a case can certainly be made for the significant amount of stock exposure in the near-date funds. But is that how the average participant views these funds?

If participants, currently invested in the typical near-term target date fund, see that fund as an investment that will glide them, without risk, into a safe portfolio that they can cash out at retirement, then they are in a challenging spot. To avoid suffering a substantial blow to their potential retirement income, they need to either maintain that target date fund by using an IRA and taking systematic distributions, or they need to attempt to replicate that same type of portfolio strategy elsewhere.

What are the legal implications for Plan Sponsors?

At the moment, target date funds occupy pride of place as "Qualified Default Investment Alternatives (QDIA)" under the Pension Protection Act, with the majority of plan sponsors selecting target date funds as their QDIA choice. Thus any plan sponsor using target date funds as a default investment (either with or without automatic enrollment) enjoys the fiduciary safe harbor protection afforded by the regulations. Furthermore, if the plan conforms to the provisions of ERISA section 404(c), then the inclusion of these "too risky" target date funds does not necessarily increase fiduciary risk.

That said, plan sponsors still retain the responsibility of choosing the most appropriate target date fund for their particular plan.

However, because of the recent losses, there is now a fair amount of governmental scrutiny aimed at target date fund construction, and it is possible that the QDIA requirements of funds or fiduciaries may change in the near future. Some of the changes being proposed include greater disclosure of risk and fees, limits on portfolio risk, independent fiduciary oversight, and so on.

Commentary

The real question is: who is responsible for the risk of the target date funds? Unfortunately, that answer is not easily found by most plan sponsors. The typical fund objective language in a target date fund prospectus reads something like:

> *"The Fund seeks to provide capital appreciation and current income consistent with its current asset allocation. The investment objective of each Strategy (fund) is to seek the highest total return over time consistent with its asset mix."*

The financial services lobby is very powerful and the stakes in this situation are very high for the mutual fund companies. Therefore, it is unlikely that Congress will be successful in enacting change in the law that will increase the fund companies' fiduciary risk. That said, the fiduciary burden assessing target date fund risk will remain squarely on the shoulders of the plan sponsor. Full compliance with ERISA section 404(c) does require that 401(k) investment options be prudently selected and monitored, so plan fiduciaries must be able to gauge the risk of the target funds being offered. They must also incorporate that risk profile into their Investment Policy Statement selection standards.

What Should Plan Sponsors Do?

Given the fact that the "horse is already out of the barn" with respect to the market declines, and the chance that despite industry pressure, Congress may force some changes in target date construction, we do not recommend that plan sponsors eliminate poor performing near-term target funds on a reactionary basis.

The debate over near-term target date fund risk will continue, with both sides making valid arguments in defense of their positions. The bigger question is whether or not the needs of near-retirement 401(k) participants are being met, and if those near-retirees truly understand their investment options.

We suggest that plan sponsors review their philosophy of target date funds and participant risk. Working with their advisors, they should take the following steps:

If your 401(k) Plan already has target date funds:

- Determine the relative risk and return of your near-term funds.
- Assess whether or not this risk has been adequately communicated to and understood by the plan participants.
- If the near-term target funds are deemed too aggressive, analyze the fund selection options to determine if more conservative near-retirement investment options are available. These options may include additional target funds that are less aggressive, risk-based allocation funds, or multi sector bond funds.
- Determine who is invested in the near term target funds and if this recent risk is negatively impacting their ability to retire.
- Working with you plan provider, communicate directly with those affected participants, explaining the risk of the funds and offering personalized assistance.
- Adjust the Investment Policy Statement (IPS) to describe the target fund selection process. Specifically note the that the risk profile and glide path of the target date funds is an active choice by the Committee.

If your 401(k) Plan does not already have target date funds:

- Do not blindly accept the target date funds recommended by your provider. Analyze all of the potential target date fund options and choose the risk profile that best suits the philosophy of the Committee as well as the demographics and behavior of the workforce.
- Adjust the Investment Policy Statement to describe the target date fund selection process. Specifically note the that the risk profile and glide path of the target date funds is an active choice by the Committee.

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