UNDERSTANDING THE HIDDEN RISKS IN TARGET DATE FUNDS

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Despite their growing popularity, there are a number of misunderstandings about Target Date Funds (TDFs). Some of these misunderstandings lead to bad decisions that can hurt plan participants and expose plan trustees to legal action. When well-intentioned, but misinformed trustees damage participants, restitution is warranted because trustees are fiduciaries who should know better. Here's a list of some of the risks:

- Thinking that all Qualified Default Investment Alternatives (QDIAs) are prudent
- Accepting the investment objectives promoted by fund companies
- Trusting the big brands – Fidelity, T. Rowe and Vanguard – to do the right thing
- Believing that mutual fund companies are co-fiduciaries
- Agreeing that risk at the target date should be greater today than it was in 2008
- Accepting guidance that is just not correct, even though it's common
- Omitting a Statement of Investment Policy

I describe each risk in the following. Caveat emptor. Forewarned is forearmed.

Any QDIA will do

The Pension Protection Act (PPA) of 2006 specifies three Qualified Default Investment Alternatives (QDIAs) that plan sponsors can use for participants who do not make an investment election: Target Date Funds, Balanced Funds, and Managed Accounts (accounts managed by outside professionals). By far the most popular QDIA has been TDFs. The PPA established certain forms of safe harbors, but the substance, i.e., the selection of a specific QDIA, remains a fiduciary responsibility. Under the Duty of Care, fiduciaries must decide which form is most appropriate for their plan and they must strive to select the best funds they can find. Fiduciaries can't just simply throw darts at the QDIA dartboard.

Most fiduciaries have selected target date funds (TDFs) as their preferred form, but they have not done their homework to find the best TDFs. Plus, the TDFs have not been vetted. For the most part, assets have been entrusted to the Big 3 bundled service providers – T. Rowe Price, Vanguard and Fidelity. These are fine firms, but the Duty of Care requires selection on the basis of superiority, rather than on convenience and familiarity. See the section below on the "Big 3." To select the best, trustees must set objectives for their TDF, as discussed in the next section.

Accepting faulty objectives

The objectives that are being sold are to replace pay and to manage longevity risk, and I challenge anyone to find these statements in any fund prospectus. You won't find them in prospectuses because these "objectives" are not true objectives; rather they're hopes and dreams. These hopes justify high risk so fund companies can charge high fees. The "solution" for inadequate savings is high risk. An objective without a reasonable course of action is a hope. No investment glide path can achieve these objectives. Saving enough is the right course of action for replacing pay and managing longevity risk.

The Duty of Care requires trustees to at least try to select the best and to guard against foreseeable harm. It's like the duty to protect our children; it's a moral imperative as well as a fiduciary duty. To select the best, trustees must establish objectives, rather than accepting the hopes that are being sold to them. What should the TDF achieve? Capital preservation is the universal objective – don't lose participant savings. This objective guards against foreseeable harm. The primary objective of TDFs should be to get the participant safely to the target date with accumulated savings and results intact.

Trustees should not choose TDFs with faulty objectives, like replacing pay and managing longevity risk. These are too risky at the target date so they do not protect against foreseeable harm, as mandated by the Duty of Care. To examine this extreme risk, we look at the Big 3 in the next section.

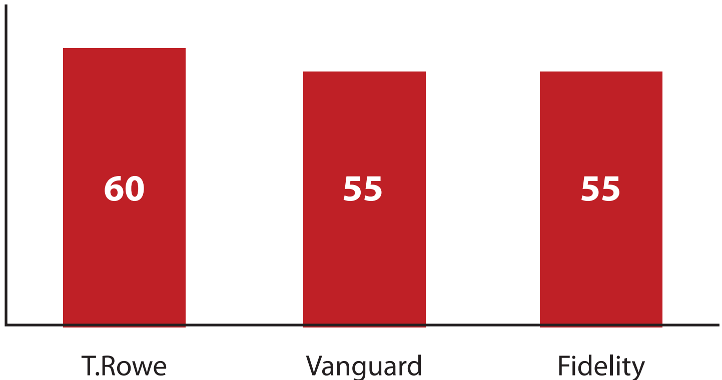
Trusting the big brands – Fidelity T. Rowe and Vanguard

The Big 3 manage about 65% of all target date funds, so the belief is that they are the safe and prudent choice, but a look at their risks, especially at the target date, shows otherwise. The Big 3 are making a bet that investing in the equity markets will pay off, until it doesn't.

Choosing one of the Big3 is tantamount to gambling with the savingsof older employees.

Risk at Target Date:

Equity Allocations of Big 3 are Way Too High



85% of Total TDF Assets are With These 3 Bundled Service Providers.

There is little or no vetting.

Have Fiduciaries Realy Embraced This Much Risk at Target Date?

The equity allocations of the Big 3 are more than 55% at the target date, and the balance of their allocation is mostly in long-term risky bonds. These allocations lost more than 25% in 2008, and there's no reason to believe it won't happen again, potentially worse the next time.

Big 3 TDFs have actually become riskier since the 2008 debacle. Ignoring the past (especially 2008) and hoping it will be different the next time is not an option for trustees, and it's certainly not an enlightened view of risk management. Employers who choose a Big 3 TDF are signing on for a lot of fiduciary risk, and it's their risk alone since fund companies are not fiduciaries, as discussed in the next section. In other words, choosing the Big 3 could be a Lose-Win for Employer-Big3 in the next market correction.

Believing that mutual fund companies are co-fiduciaries

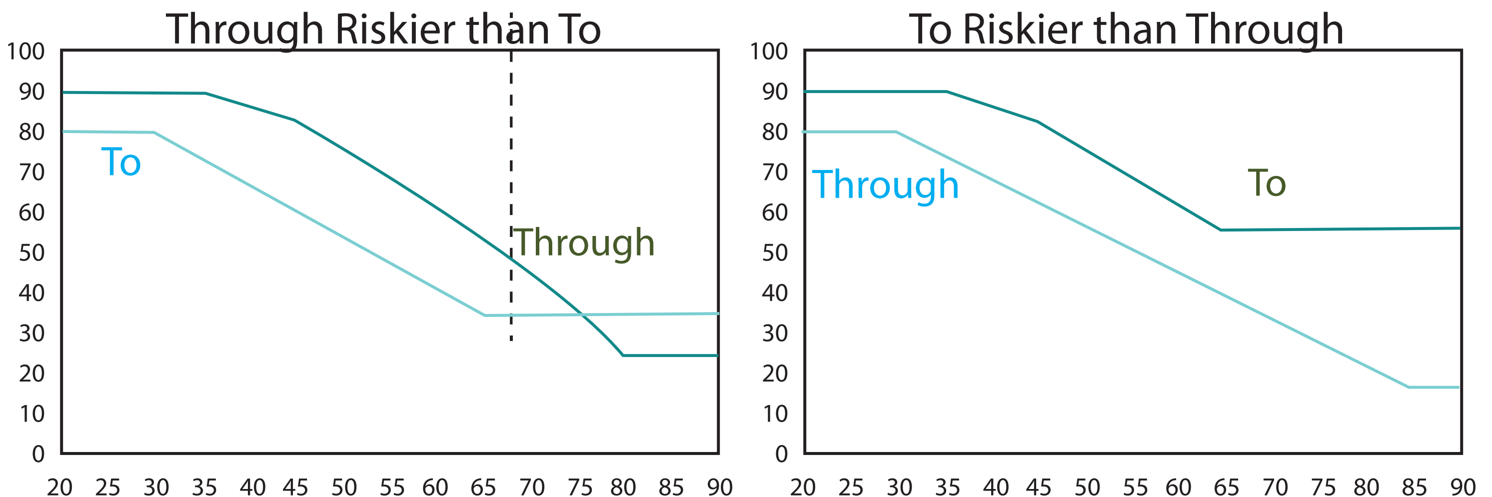
Following the 2008 debacle, the SEC and DOL held joint hearings in June of 2009. One of the many revelations that emerged from those hearings is the fact that mutual fund companies are not fiduciaries to the retirement plan, so they aren't held to fiduciary standards. By contrast, collective investment funds (CIFs) offered by bank trusts are fiduciaries, and CIFs are generally less expensive than mutual funds. CIFs have gained some market share, primarily from larger plans.

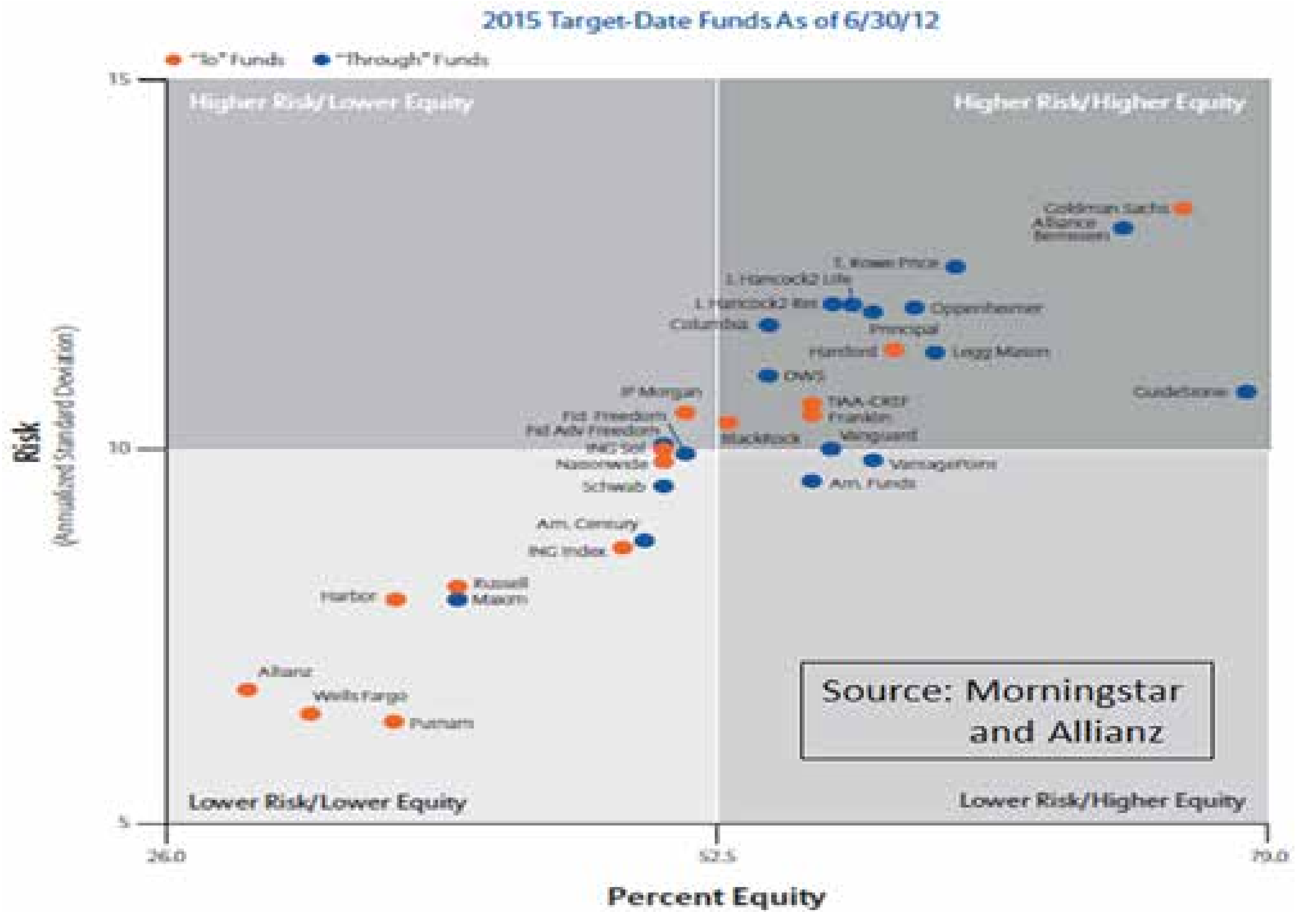
Agreeing to greater risk today than in 2008

If you watched the hearings on TDFs in 2009 (they were broadcast live on the Internet) you would have thought that risk at the target date would be substantially reduced going forward. The entire focus of the hearings was on 2010 funds, for those at or near retirement at the time, and how to avoid a re-occurrence of 25-35% 2008 losses. The unfortunate reality is that risk has actually increased in subsequent years, so those near retirement are in even more danger. The good news about 2008 was that not much was at stake, with $150 billion in TDFs, which was less than 10% of 401(k) assets. The next 2008 will be devastating by contrast, and it's not a matter of if – it's a matter of when. At the time of this writing, TDFs hold $1 trillion, which is about 25% of all 401(k) assets. There will be a public outcry if those nearing retirement suffer substantial losses.

Relying on misleading guidance

The DOL and other "experts" have advised fiduciaries to distinguish between "to" and "through" funds and to choose a glide path that best serves the "demographics" of the plan. This is bad advice that should be ignored. "To vs Through" is a distinction without a difference because the definition of "To" is absurd. A "To" fund is supposed to end at the target date, and is defined as having a flat equity allocation beyond the target date. Note that a static 100% equity is a "To" fund by this crazy definition. The common belief is that "To" funds hold less equity at the target date because they end there, but the reality is that many "To" funds are riskier than many "Through" funds as shown in the following graphs.





Demographics" have a similar problem. The only demographic that matters is the lack of financial sophistication on the part of those who defaulted into TDFs. This naiveté argues for safety – don't lose their money.

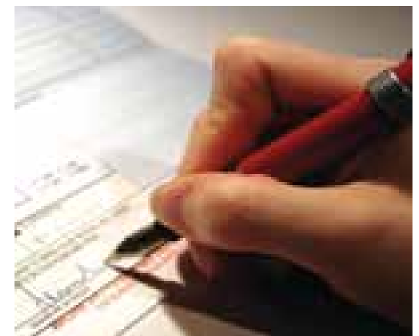
Omitting a Statement of Investment Policy

Because they are default investments, TDFs are employer-directed rather than participant-directed, so it's good fiduciary practice to document your decisions. The Statement of Investment Policy specifies the objectives you've established and the course of action you've taken to achieve those objectives. Every TDF should have a Statement of Investment Policy.

A Portal to More Details

We've written the Fiduciary Handbook for Understanding and Selecting Target Date Funds that covers the issues above in detail, plus addresses additional topics like the future of TDFs. You can quickly browse chapters of interest to you by clicking on the titles in the table below, or you can click on the images as well. Each chapter has 3 sections: Facts, Legal Considerations, and Ethical Perspectives.

History Automatic enrollment and the Pension Protection Act of 2006 are the driving forces behind the growth in TDFs. Like "Remember the Alamo", the battle cry for TDF reform is "Remember 2008."	
Duty of Care Throwing darts at the Qualified Default Investment Alternative (QDIA) dartboard is irresponsible.	
Demographics The only demographic that matters is the lack of financial sophistication on the part of those who default into TDFs.	
To or Through A distinction without a difference.	
Selection Criteria Price, Diversification, Risk Control, Glide Path, Performance, Reputable Provider, Goal Achievement	

Current Practices Like mere pawns, most fiduciaries choose their bundled service provider because of convenience and familiarity, rather than excellence. See "Duty of Care" above.	
Benchmarks Choose between procedural prudence and substantive prudence.	
Statement of Investment Policy The purpose of this statement is to document our goals and how we plan to achieve them.	
The Future The next 2008 will bring class action lawsuits that transform the industry. This "stick" will stir things up.	

About the Author

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Ron Surz is president of PPCA Inc. and it's wholly owned subsidiary, Target Date Solutions. He is a pension consulting veteran, having started with A.G. Becker in the 1970's. Ron earned an MBA in Finance at the University of Chicago and an MS in Applied Mathematics at the University of Illinois, and holds a CIMA (Certified Investment Management Analyst) designation. He has published regularly in such publications as The Journal of Wealth Management, The Journal of Investing, Journal of Portfolio Management, Pensions & Investments, Senior Consultant, Horsesmouth, and IMCA Monitor, as well as contributed to and edited several books. Ron's most recent co-authored book is the "Fiduciary Handbook for Understanding and Selecting Target Date Funds."

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