Target Date Funds: Can One Just Glide Into Retirement?

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TARGET DATE FUNDS: CAN ONE JUST GLIDE INTO RETIREMENT?

By Jonathan Miller,
Martin J. Rosenburgh, CFA, Esq. and
Andrew C. Spieler

I. INTRODUCTION

Since its inception, the 401(k) retirement plan has presented plan sponsors and participants significant challenges, requiring both groups to act as financial planners and portfolio managers over retirement investments. Participants are expected to forecast their retirement income needs, arrive at an appropriate asset allocation and choose among contribution and investment options accordingly. Plan sponsors must create the universe of options to choose from and provide advice to participants, but only to the extent that such advice does not give rise to fiduciary responsibility under the Employee Retirement Income Security Act of 1974 (ERISA).

These challenges of the 401(k) have been addressed in two recent developments. One is the passage of the Pension Protection Act of 2006, enabling plan sponsors to provide certain types of investment advice as well as default investment options without incurring fiduciary liability. The other development has come from the investment management industry in the form of the target date fund (TDF) - an investment fund option designed and heavily promoted to be essentially the last decision a participant should ever have to make with respect to his or her 401(k) plan account. These funds deploy a dynamic asset allocation based upon the number of years remaining until a projected retirement date of the participant. The TDF offers a “glidepath” portfolio, gradually shifting from a higher-risk equities-weighted mix into a heavier fixed income weighting as the investor approaches, and then enters, retirement.

Once the plan sponsors were offered to put the target date fund in their 401(k) menus, they quickly overran the competition. The table below from Morningstar displays the growth of the target date mutual funds over the past five years. Beginning in the early 2000s, cash started flooding into target-date funds. Target date funds had a net $7 billion in 2003, $14 billion in 2004, $22 billion in 2005, $35 billion in 2006, $57 billion in 2007, and just more than $40 billion in 2008 and 2009. Furthermore at the end of 2008, $109 billion invested in target date mutual funds were held in defined-contribution plans.

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1. New Assets, Target-Date Mutual Funds, 15 Largest Fund Companies

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<tbody>
<tr>
<td>Fidelity Investments</td>
<td>43,109,726,477</td>
<td>63,643,750,218</td>
<td>88,281,653,907</td>
<td>68,332,696,076</td>
<td>99,329,305,385</td>
<td>38.73</td>
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<td>Vanguard</td>
<td>8,343,449,216</td>
<td>16,448,185,588</td>
<td>31,954,874,203</td>
<td>33,738,266,080</td>
<td>56,587,641,311</td>
<td>22.05</td>
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<tr>
<td>T. Rowe Price</td>
<td>8,305,268,085</td>
<td>17,257,266,495</td>
<td>30,049,545,111</td>
<td>25,139,872,438</td>
<td>42,092,035,956</td>
<td>16.41</td>
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<tr>
<td>Principal Funds</td>
<td>2,740,671,753</td>
<td>5,262,381,282</td>
<td>11,038,017,334</td>
<td>9,202,891,092</td>
<td>14,331,453,135</td>
<td>5.59</td>
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<td>American Funds</td>
<td>-</td>
<td>-</td>
<td>1,578,076,746</td>
<td>3,063,731,589</td>
<td>6,242,575,789</td>
<td>2.43</td>
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<td>Wells Fargo Advantage</td>
<td>1,146,956,773</td>
<td>1,286,716,723</td>
<td>2,324,374,618</td>
<td>2,330,833,462</td>
<td>6,047,001,369</td>
<td>2.36</td>
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<tr>
<td>TIAA-CREF Mutual Funds</td>
<td>39,508,311</td>
<td>424,749,391</td>
<td>1,473,639,811</td>
<td>1,886,134,873</td>
<td>4,080,581,773</td>
<td>1.58</td>
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<tr>
<td>ING Retirement Funds</td>
<td>30,717,678</td>
<td>1,235,385,773</td>
<td>2,694,968,745</td>
<td>2,403,062,939</td>
<td>3,935,895,203</td>
<td>1.53</td>
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<td>John Hancock</td>
<td>15,552,833</td>
<td>708,560,936</td>
<td>1,372,988,017</td>
<td>3,272,432,926</td>
<td>2,696,843,292</td>
<td>1.13</td>
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<td>BlackRock</td>
<td>1,290,073,727</td>
<td>1,550,923,821</td>
<td>2,305,419,981</td>
<td>1,553,145,182</td>
<td>2,686,043,292</td>
<td>1.28</td>
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<td>State Farm</td>
<td>821,426,723</td>
<td>1,335,511,823</td>
<td>2,176,642,129</td>
<td>1,610,584,609</td>
<td>2,564,748,612</td>
<td>1.04</td>
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<td>American Century Investments</td>
<td>235,815,541</td>
<td>513,005,190</td>
<td>759,989,136</td>
<td>753,894,657</td>
<td>2,124,451,070</td>
<td>0.03</td>
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<td>AllianceBernstein</td>
<td>10,306,337</td>
<td>341,053,831</td>
<td>1,298,763,846</td>
<td>1,350,232,327</td>
<td>2,694,968,745</td>
<td>0.79</td>
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<tr>
<td>JP Morgan</td>
<td>349,917,743</td>
<td>900,351,394</td>
<td>940,267,626</td>
<td>1,523,614,319</td>
<td>1,350,923,327</td>
<td>0.63</td>
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<td>MassMutual</td>
<td>1,235,655,892</td>
<td>1,675,133,328</td>
<td>1,886,459,522</td>
<td>1,134,346,550</td>
<td>1,550,923,327</td>
<td>0.42</td>
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<td>Industry Total</td>
<td>69,401,955,835</td>
<td>114,509,886,291</td>
<td>184,321,977,120</td>
<td>159,500,016,668</td>
<td>256,470,272,637</td>
<td>100.00</td>
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However, target date funds are now facing considerable scrutiny as the recent market turmoil has shed light on some glaring inconsistencies in their performance, design, asset allocation and marketing. In 2008, the average 2010 Target Date Fund (a fund designed for someone in retirement), lost 23%, with the largest loss being 41%.4 The risks and inconsistencies of TDFs, as well as what are considered suitable allocations and potential solutions, are issues now being grappled with by the industry and regulators.

In this paper we will delve further into the characteristics of a TDF, the issues raised by the industry and regulators, and how recent legislation is planning to resolve these issues.

II. DEFINITION

The definition of the Target Date Fund is not clear. The SEC itself has recently passed a proposal to explicitly define the TDF. As a natural starting point, the definition of the Target Date Fund is extracted directly from the SEC website:

Target date funds are designed to make investing for retirement more convenient by automatically changing the investment mix or asset allocation.

4 Morningstar, supra note 4.

http://scholarlycommons.law.hofstra.edu/jibl/vol10/iss2/7
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over time — and thus are intended to free investors from actively changing their asset allocations. Target date funds contain years in their names, which correspond to the year the investor plans to retire. The name of a target date fund often includes a date that reflects the year an investor plans to retire. For example, funds with names like “Portfolio 2030” or “Retirement Fund 2030” are designed for individuals who intend to retire in or near the year 2030.

Most target date funds are designed so that the fund's mix of investments will automatically change in a way that is intended to become more conservative as you approach the target date. Typically, the funds shift over time from a mix heavily weighted with equities in the beginning to a mix weighted more toward bonds.

However, target date funds, even if they share the same “target date” (e.g., 2030), may have very different investment strategies and risks. These variations may occur before, at, or even after the target date. Some target date funds may not reach their most conservative investment mix until 20 or 30 years after the target date, as shown in Example 1 below. Others may reach their most conservative investment mix at the target date or soon after, as shown in Example 2 below.

The fund in Example 1 holds 60% of its investments in stocks at the target date and 40% in bonds. The investment in stocks decreases until 25 years after the target date when it reaches an investment mix with 30% in stocks.

Example 1

The fund in Example 2 holds 25% in stocks at the target date, and reaches its final investment mix with 20% in stocks five years later. The fund in Example 2 also holds cash investments as part of its asset mix.

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6 Id.

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We see from the above two examples that TDFs with the same target dates can vary greatly. It’s not necessarily the “target date” that is relevant, but rather the glidepath; that is, the asset mix of the fund and when is the asset mix going to become more conservative. Since this is not clear from the title of the TDF, participants and plan sponsors seem to have been mis-marketed. As mentioned above in 2008, the average 2010 Target Date Fund lost 23%.\(^8\) This was due to the fact that most of these funds were still invested 50% or more in stocks. This issue has been raised with the SEC and will be discussed in detail below.

### III. LEGAL ISSUES

As mentioned above, the Pension Protection Act of 2006 enabled 401(k) plan sponsors to provide certain types of default investment options (known as Qualified Default Investment Alternatives or QDIAs) without incurring fiduciary liability for plan participant’s automatic selection. TDFs were among the classes of investments deemed a permissible choice as a “default option”, and subsequently became extremely popular as an investment choice by plan sponsors. The Pension Protection Act therefore removed a significant impediment to automatic enrollment plans and fueled the next several years of significant growth in the TDF market.

The significant losses in TDFs in 2008, however, raised serious questions as to the general appropriateness of TDFs as a QDIA and whether and to what extent additional requirements should be set which would adequately protect plan participants. Regulatory response to these TDF issues began with a series of hearings, first before an ERISA Advisory Council working group on Hard To Value Assets and Target Date Funds, in July and November 2008, then in an SEC/Department of Labor hearing, held in June 2009, finally culminating in proposed regulations by the SEC, published in June 2010 and by Department of Labor (DOL), published in November 2010.

Challenges in investment selection, implementation and monitoring, unique to TDFs, were highlighted before the ERISA Advisory Council in 2008.\(^9\) Witnesses were in

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\(^8\) Morningstar, supra note 4.

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general agreement that the unique characteristics of TDFs make it “difficult to apply the traditional evaluation criteria to TDFs that are used for standard or core options.” As Anne Lester, JPMorgan Chase testified, “… this is because a TDF is an investment solution rather than an investment product. The TDF and its glidepath has been designed by a manager and selected by the plan fiduciary to maximize the probability of generating a specific outcome.”

Considerations faced by fiduciaries when analyzing such investment solutions were recognized as significant, including (i) identifying the primary objective of the TDF, allowing the fiduciary to choose the strategic glidepath which fits its specific needs and (ii) evaluating the ability of various types of providers or implementation models (e.g., open architecture, active vs. passive, the specific asset class and type of investments employed and the various risks associated with each TDF fund) to deliver that primary objective while considering the target returns, risks and costs which may be borne by a participant.

At the June 2009 joint SEC/DOL hearing on TDFs within 401(k) plans, comments by hearing participants indicated a widespread recognition of the need for improved disclosures regarding the funds. There was, however, considerable debate over what constitutes an appropriate TDF portfolio design and glide path. Marilyn Capelli-Dimitroff, chair of the Certified Financial Planner Board of Standards, testified, “We have serious concerns that these funds are fundamentally misleading to investors because they’re allowed to be managed in ways that are inconsistent with reasonable expectations that are created by the titles and the use of the names.” SEC Chairman Mary Schapiro, also testifying at the hearing, said, “These varying results should cause all of us to pause and consider whether regulatory changes, industry reforms or other revisions are needed with respect to target-date funds. . . Of all of the issues that the SEC is examining at the moment, our review of target-date funds is one that may most directly affect everyday Americans seeking to access our securities markets to help build a better life and a greater sense of financial security for themselves and for their families.”

IV. DOL PROPOSED REGULATIONS

Pursuant to considerations raised in the hearings, the DOL published proposed regulations amending the safe harbor requirements for status as a QDIA, including provisions specifically applicable to TDFs. According to the proposal, in order for a TDF to qualify as a QDIA, a description of the TDF would be required to be provided to plan participants satisfying three requirements:

(i) Explanation of the fund’s asset allocation, how the asset allocation will change over time, and the point in time when the investment will reach its most “conservative asset allocation”. This explanation must include a chart,

10 Id.
11 Id.
13 Id.
14 Id.
(ii) If the TDF is named or described with reference to a particular “target” date, then the description must explain the age group for which the investment is designed, the relevance of the target date, and any assumptions about a participant’s contribution and withdrawal intentions on or after that date; and

(iii) The description must state that the participant may lose money by investing in the QDIA, including losses near and following retirement, and that there is no guarantee that the investment will provide adequate retirement income.\(^16\)

The DOL asked for comments on the proposed rule, including the extent to which this rule should take into account the disclosure elements or concepts in the SEC’s proposed TDF disclosure rules (discussed below). The proposed regulations elicited a variety of comments. A number of the comments addressed concerns that the new rules would cause plan participants to be subjected too much or irrelevant information or confusing presentations. Other comments addressed challenges in interpreting and/or implementing several of the requirements and requested clarification. In addition, some of the information required was viewed as too difficult to obtain.

All such concerns were raised in an important comment letter responding to the DOL proposed regulations, by The ERISA Industry Committee, dated January 14, 2011. For instance, The Letter recommended that the TDF rule not require an explanation of assumptions about a participant’s or beneficiary’s contribution or withdrawal intentions.\(^17\) The Letter pointed out, “A description of the underlying investments, the glidepath, the landing point, the risks, the age group for whom the TDF is designed, and the relevance of the target date should be sufficient to help participants understand the TDF alternative.”\(^18\) In addition, the Letter requested more detail on the requirements to explain the fund’s asset allocation and to disclose historical performance data. Id. Finally, the Letter suggested that information concerning participant behavior is “too difficult to obtain” and recommended that information required by the proposed rule be publicly available (i.e., SEC-required disclosures).

V. SEC PROPOSED REGULATIONS

In June 2010, the SEC proposed amendments to applicable securities laws, which are intended to enhance protections to the public in connection with the marketing of TDFs. The proposed regulation would amend rule 156 (Investment Company Sales Literature) and rule 482 (Advertising by an Investment Company as Satisfying Requirements of Section 10) under the Securities Act of 1933, and rule 34b-1 (Sales Literature Deemed to Be Misleading) under

\(^{16}\) Id.

\(^{17}\) Id.


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the Investment Company Act of 1940. The proposed amendments would provide the following:

- a requirement that a TDF that includes the target date in its name to disclose the fund’s asset allocation at the target date immediately adjacent to the first use of the fund’s name in marketing materials;

- a requirement that marketing materials for TDFs to include a table, chart, or graph depicting the fund’s asset allocation over time, together with a statement that would highlight the fund’s final asset allocation (or “landing point”);

- required statements in marketing materials to the effect that a target date retirement fund should not be selected based solely on age or retirement date, is not a guaranteed investment, and the stated asset allocations may be subject to change;

- prohibited statements, such as that the fund is an appropriate investment because of the emphasis it places on a single factor (i.e., an investor’s age or tax bracket), or that investing in the fund is a “simple investment plan” or requires “little or no monitoring by the investor”; and

- a requirement that TDF advertisements advise an investor make certain considerations, including: i) suitability factors in addition to age or retirement date (including risk tolerance and other personal factors), ii) that an investment in a target date fund is not guaranteed and may lose money, including at and after the target date, and iii) the extent to which the intended percentage allocation of the fund may be modified without a shareholder vote.\(^{19}\)

VI. COMMENTS

Similar to responses seen to the DOL proposed regulations, commentators to SEC proposed rules focused on what they viewed as effective solutions to the problem of educating plan participants. Once again, illustrations showing how the TDF worked and important factors concerning its “glidepath” were recommended. In SEC Proposed Rule Comment Letter from the Investment Company Institute, dated August 23, 2010, the ICI suggested that the glide path illustration “is the most effective way to communicate the features of a target date fund to investors and is the most important element of the Commission’s proposal because it presents all the information about changing asset allocation at a glance.”\(^{20}\)

\(^{19}\) Investment Company Advertising: Target Date Retirement Fund Names and Marketing, Securities and Exchange Commission, (June 16, 2010)(to be codified at 17 C.F.R. pts. 230 and 270).

In evaluating TDFs, there are several critical issues for both plan sponsors and participants to consider. At the Joint SEC/Department of Labor Hearing on TDFs, Karrie McMMillan has provided five due diligence questions for investing in a TDF (or selecting one as a plan option):

-What is the relevance of the date used in a fund name, and what happens on the target date?

-Will your money be shifted to more conservative investments as the target date approaches, or is the fund designed for an investor who plans to withdraw money gradually after the target date has been reached?

-What is the age group for whom the fund is designed?

-At what point does the fund reach its most conservative asset allocation?

-Is there sufficient disclosure to investors that investing in a target date fund does not guarantee a certain return?²¹

Ms. Mcmillan was quoted as further saying,

“Target date fund investors avoid extreme asset allocations that we often observe in retirement accounts; the 25-year-old holding all cash or the 60-year-old fully invested in equity funds,” Having a “set it and forget it” investment option is vital for people concerned that they won’t get the asset mix right as they near retirement. I’m a fan of the funds, because they allocate your money among various asset classes and automatically shift from riskier investments to more conservative ones as you reach a certain “target” period, such as retirement. It’s why the Department of Labor endorsed the funds, allowing them to be one of the default selections in 401(k) plans.”²²

Plan fiduciaries need to determine if the target date fund’s asset allocation and glide path are aligned with their agenda, so that it is appropriate for their plan participants. If they believe that the greatest risk faced by their participants/employees is outliving their retirement funds, they should choose TDFs that use a more equity-oriented glide path. A glide path more heavily weighted towards equities would be appropriate in order to continue to grow assets beyond the target year and overcome inflation. However, their participants need to be informed; they should be aware that these glide paths often do not find their final “landing spot” until as much as thirty years past the target date. On the other hand, plan fiduciaries that are concerned with protecting their participants’ assets should choose TDFs with more conservative glide paths have their “landing spot” earlier. Their participants should also be informed

²¹ Target Date Funds and Other Similar Investment Options: Public Hearing before the United States Securities and Exchange Commission, United States Department of Labor (June 18, 2009), available at http://www.sec.gov/spotlight/targetdatefunds/targetdatefunds061809.pdf

²² Id.
that the growth of assets up to and beyond the target date are important, however it does not outweigh the risk of unexpected capital loss due to a volatile market.\(^2\)

The DOL and SEC are striving to assert stricter regulations for funds that were originally deemed as a one-size fits all as a "set it and forget it" for retirees. Plan participants and plan sponsors alike, need be proactive and educate themselves as to what they are purchasing and investing. Ultimately, one cannot be a passive investor and simply glide into retirement.

\(^2\) Tom Bowler, Use of Target Date Funds in Qualified Plans: A primer, plus questions fiduciaries should be asking, PRIME TRUST ADVISORS.COM, available at http://www.primetrustadvisors.com/Portals/38/Articles/TDF%20short%20white%20paper.pdf