Congressional and Regulatory Changes to Target Date Funds

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Background on Target Date Funds

- Popular default investment vehicle for 401(k) plans.
- Typically, formed as open-end investment companies registered under the Inv. Co. Act.
- Defining characteristic – "glide path" which determines the overall asset mix of the fund.
- Performance issues in 2008 raise concerns, especially for near-term TDFs.
  - Based on SEC analysis, the average loss for TDFs with a 2010 target date was -25%.
  - Individual TDF losses as high as -41%.

Administration's Proposals for TDFs

- Improving transparency of TDFs and other default retirement investments.
- DOL and SEC at Senate Special Committee on Aging hearing on TDFs (Oct. 28, 2009).
- DOL's new guidance on TDFs.
  - DOL announces proposal for QDIA regulations.
  - Investor Bulletin jointly released by DOL and SEC.
  - "Best practices" fiduciary checklist is pending.
- SEC proposal for TDF advertising materials.
  - If name has target date, "tag line" disclosure needed.
  - Advertising must include glide path information.

Conflicts of Interest in TDFs

- Conflicts arise when a “fund of funds” invests in affiliated underlying funds.
  - Fees are payable to underlying fund managers.
  - TDF uses affiliated underlying funds for every single asset class.
- Conflicts regarding mix of funds also exist.
  - Equity funds typically pay higher fees.
  - Certain 2010 TDFs invested up to 68% of assets in underlying equity funds.
- TDF-related conflicts found in mutual funds would not be permitted if fund managers were subject to ERISA.

Fund Managers Are Exempt from ERISA

- ERISA Section 401(b)(1)

  When a plan invests in a security issued by a mutual fund, "the assets of such plan shall be deemed to include such security but shall not, solely by reason of such investment, be deemed to include any assets" of such fund.

- ERISA Section 3(21)

  A plan's investment in a mutual fund "shall not by itself cause such [fund] or such [fund's] investment adviser" to be deemed a fiduciary.

- Combined effect of these provisions is to create a carve-out from ERISA's fiduciary requirements for fund managers.

Are Mutual Fund Managers Ever Subject to ERISA?

- Fund managers are not automatically deemed to be fiduciaries.
  - But can they be ERISA fiduciaries in certain circumstances?
- ERISA Section 401(b)(1)

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Request for DOL Guidance

- Firm requested clarification on scope of exemption for TDF mutual fund managers.
  - Adv. Op. 2009-04A on behalf of Avatar Associates.
  - DOL declined to rule that the TDF mutual fund managers should be viewed as fiduciaries.
- Implications of DOL guidance
  - Plan sponsors are alone in their fiduciary obligation.
- Fiduciary duty to evaluate plan's QDIA.
  - Participants responsible for default allocation choice.
  - Plan sponsors must ensure QDIA is prudent choice.
  - Must ensure TDF's underlying investments are appropriate and monitor TDF on ongoing basis.

Congressional Proposal for TDFs

- Senator Kohl announced his intent to introduce new legislation (Dec. 2009).
  - Concerns over high fees, low performance or excessive risk in many TDFs.
  - Would impose ERISA fiduciary status on TDF managers when TDF used as QDIA in 401(k) plans.
- Senator Kohl's proposal differs from DOL approach to improve disclosures to employers and participants.

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The Current State of Target Date Funds: A Historical and Fiduciary Perspective

BNA Webinar on Target Date Funds

October 27, 2010

Marcia Wagner, The Wagner Law Group

Joe Nagengast, Target Date Analytics LLC

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Target Date Analytics LLC

TARGET DATE ANALYTICS LLC

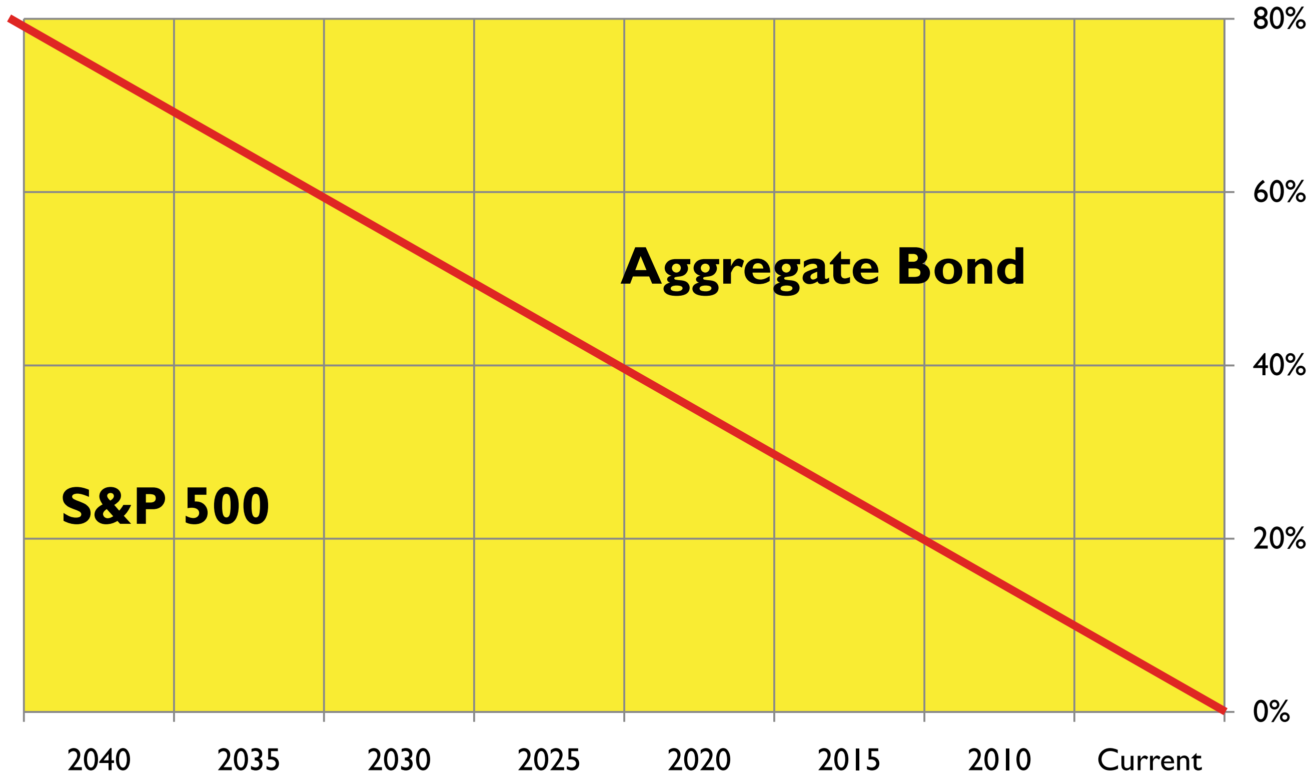
- **The home of 3 annual studies:** ***Popping the Hood, Analysis of Target Date Fund Families***
- **Advisor to ETF Advisor K target date models®**
- **Benchmark provider and analyst to CalSTRS**
- **Creator of the** BrightScope™ **On Target Indexes®**
- **Glidepath provider to the NRSP®**

A brief history of target date funds

- **In response to a persistent problem plaguing 401(k)s; i.e., participants charged with being their own CIOs,**
  - **Wells Fargo and BGI introduced 1st Target Date Funds in March, 1994 — 16 years ago**
  - **A stroke of genius: aggregate all participants by years to retirement, and use a glidepath to adjust risk over the accumulation period**
  - **Strategy: “do it for them,” (invest retirement savings) get them safely to the target date and then fold the assets into the “income” fund.**

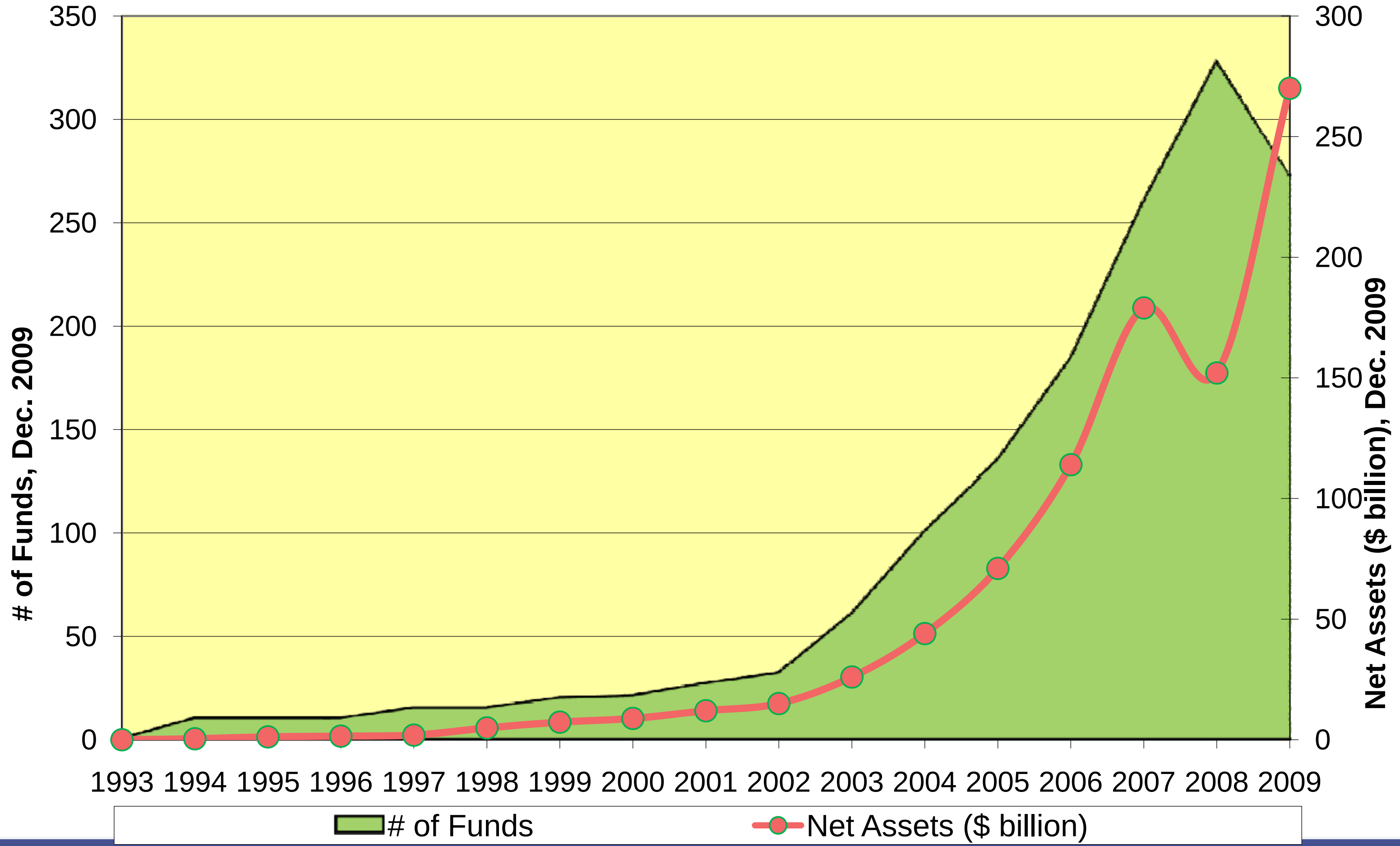
Glidepath

**The first glide paths and allocations were simple—
but still better than most do-it-yourself participant investors.**



Growth in Target Date Funds

December 31, 2009



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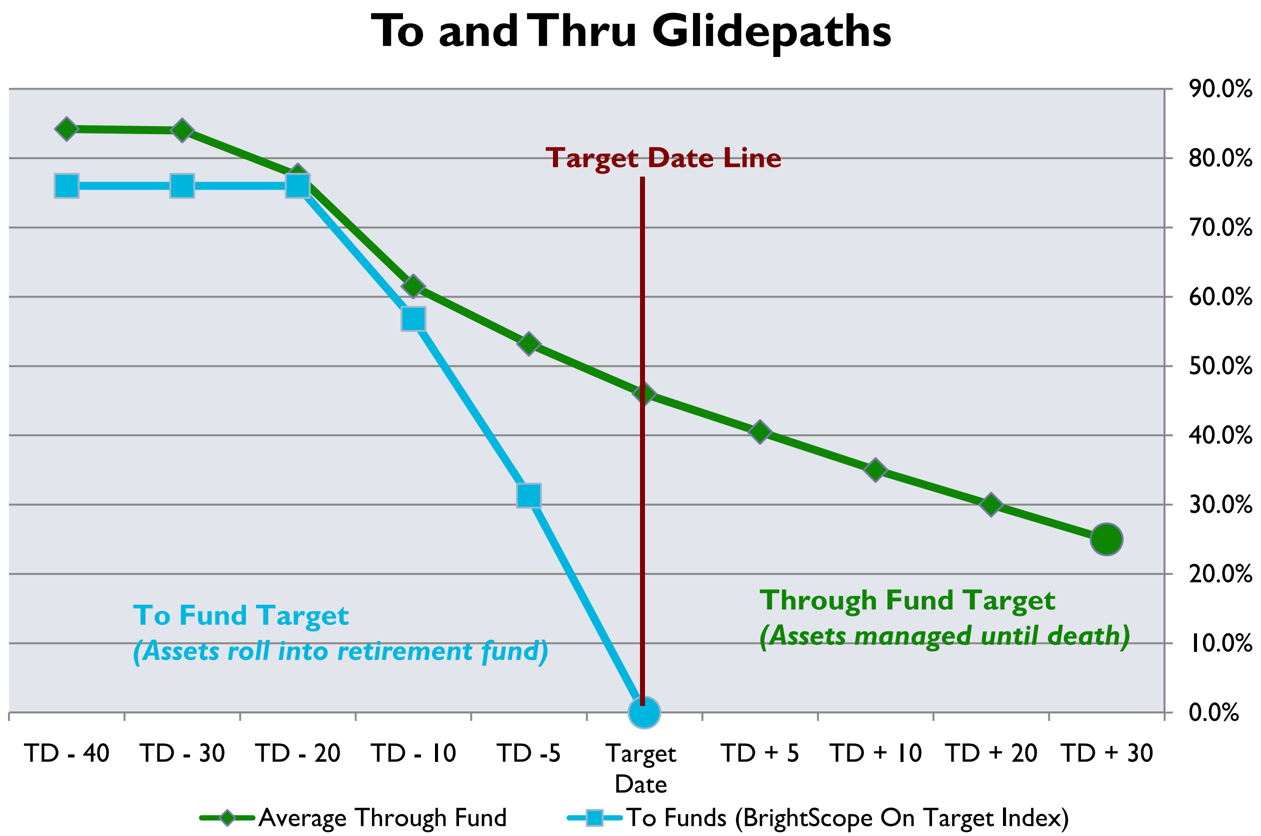
Beginning in 2005 – Competition Heats Up

… Leading to market saturation,

- Some improvement in diversification
- Minor drop in average expense ratios
- **— a lot of nonsense,**
- Image over substance (sizzle over steak)
- Obsession on pure short-term performance
- Abandonment of prudent risk management
- Touting novel asset categories—window dressing
- ***--- and the big switch:***
  - ***<u>from accumulation investing to a pretension of cradle-to-grave management</u>***

To and Through Glidepaths

"To" funds reach their most conservative allocation at the target date
"Through" funds don't do so until some time after the target date



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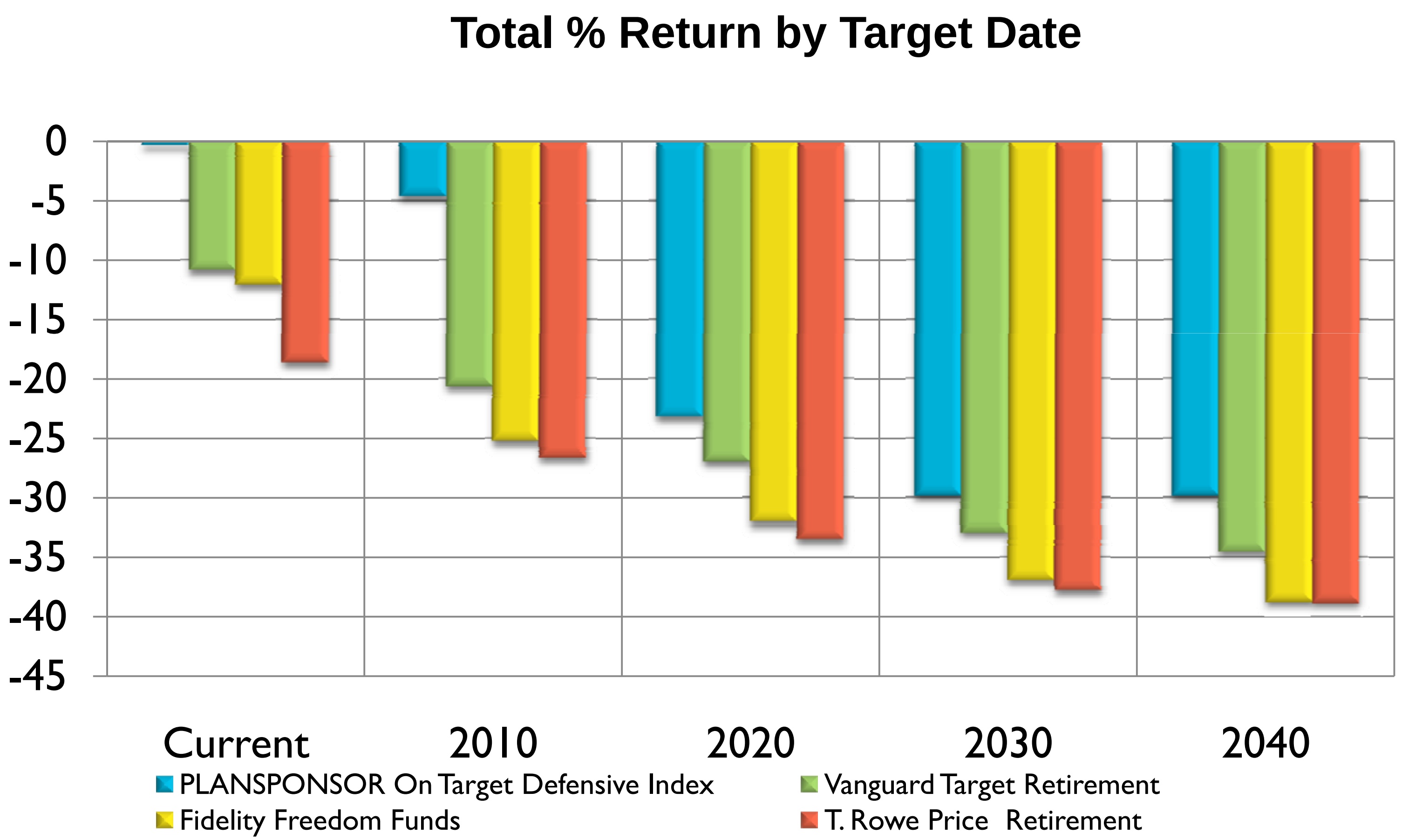
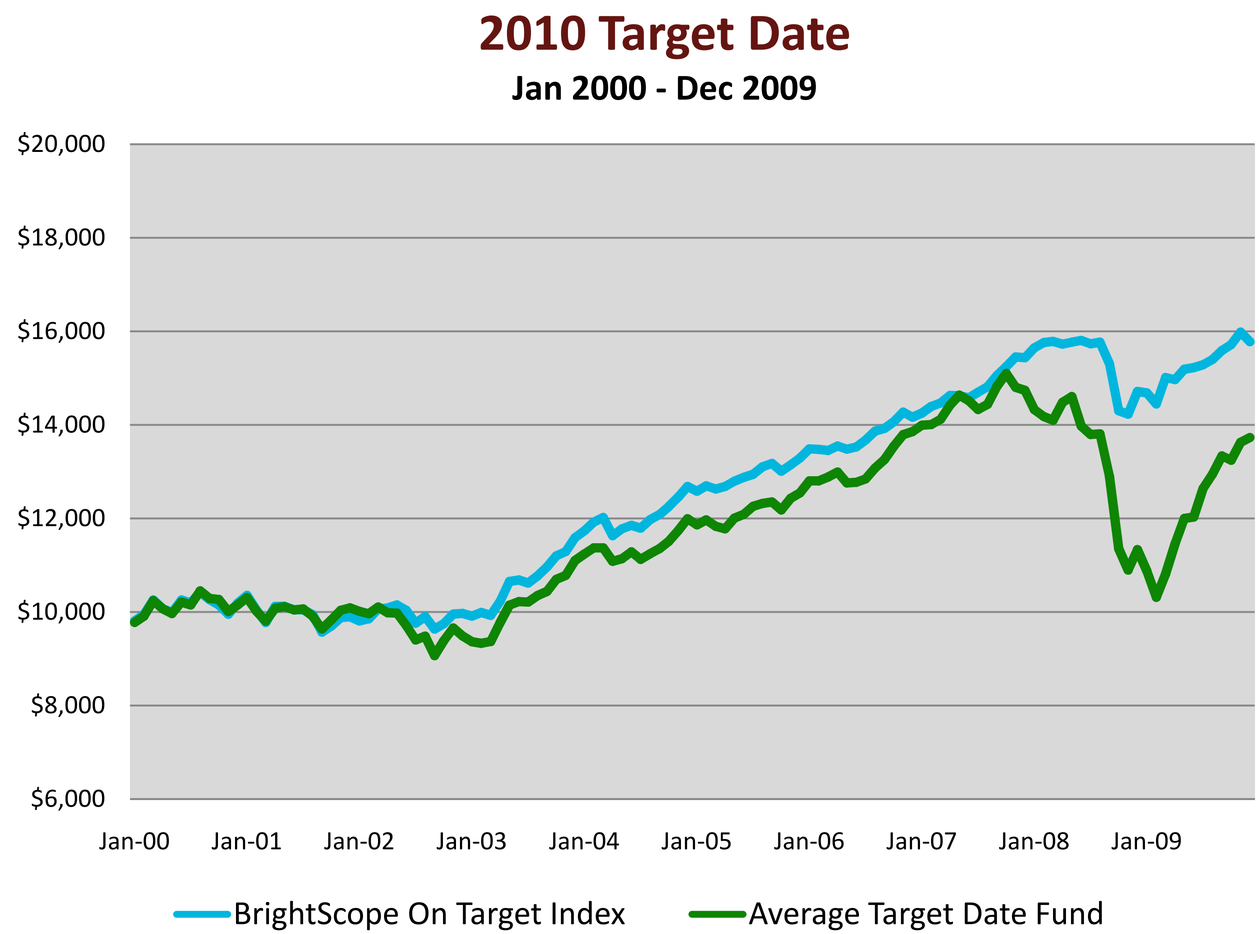
Results? Performance in 2008



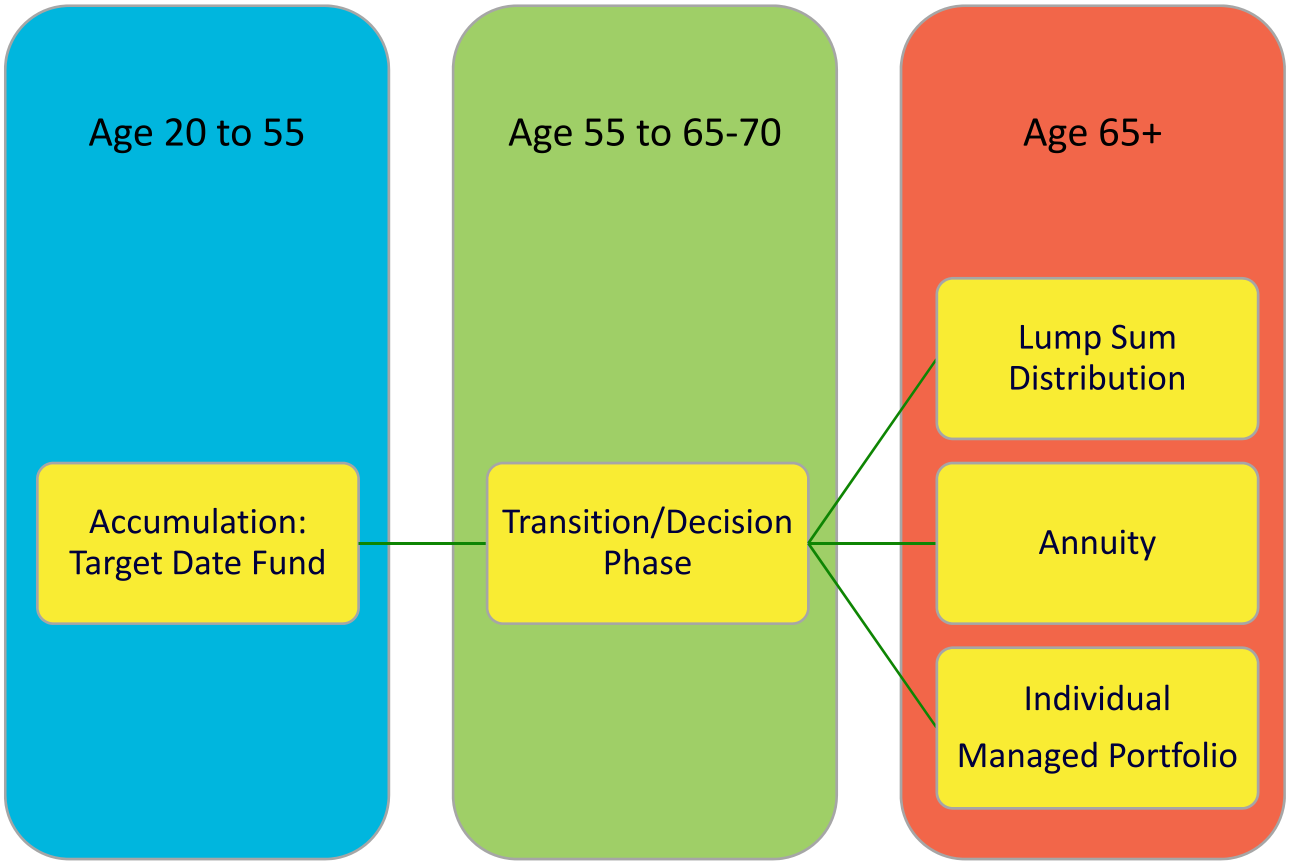
Ten-Year Growth of $10,000



What do participants do?
80% withdraw all their assets at the target date

- Vanguard, October 2008: 79% of participants who take a distribution, take it as a single lump-sum or several large (ad hoc) withdrawals, amounting to a lump sum
- 48% of participants take withdrawals to meet daily living expenses
- ICI Fact Book, 2009: 81% of participants take single lump-sum at retirement
- JPMorgan, 2009: 80% of participants take single lump-sum at retirement

Target Date Service of Tomorrow



What's a fiduciary to do?

- Don't look to the regulators for relief
  - Both the DoL and SEC have demonstrated an affinity for defending the fund industry and abandoning sponsors and participants
- Start your target date search with the basics—IPS language and clear objectives
- Utilizing your bundled providers tdfs because that's what they offer probably won't be considered prudent.

What's a fiduciary to do?

- Zero tolerance for conflicts—you're on the hook for the fund company's transgressions; they're exempt.
- Adopt an index series for benchmarking; there are now several. We manage the BrightScope OnTarget Index®
- Consider engaging an independent fiduciary, 3(21) or 3(38), to build appropriate, un-conflicted tdfs

Sources of information

Legal & regulatory:

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