

Four Suggested Focus Areas to Complete a Prudent Fiduciary Review for the Selection and Monitoring of Target Date Funds

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IFLC's viewpoint on Target Date funds begins on p. 7.

When it comes to Target Date Funds, Securian recommends plan fiduciaries focus on:

1. Target Date Fund Risk
2. Risk-Adjusted Returns and Expenses
3. The underlying Funds of Target Date Funds
4. The Reliability and Repeatability of Investment Results

This paper provides a practical fiduciary approach to analyzing Target Date Funds by suggesting that plan fiduciaries focus on four specific areas: risk, risk-adjusted returns and expenses, underlying funds and reliability. It also includes a Target Date Fund perspective by the IFLC stating their significant concern with this fund.

Introduction

Plan sponsors have quickly added Target Date Funds to their retirement plan investment lineups over the last several years and it's expected that participant contributions will flow into them at a remarkable pace. According to the Casey Quirk analysis, *Target-Date Retirement Funds: The New Defined Contribution Battleground*, target-date funds will swell to \$2.6 trillion by 2018 – nearly half of the assets invested in defined contribution plans.*

While all Target Date Funds are constructed to have declining risk as the investment horizon shortens, the absolute level of risk within each Target Date Fund is not always apparent to plan sponsors and participants. Plan sponsor and participant concerns have come to the attention of the Department of Labor (DOL) because the extent of the 2008 investment performance declines surprised them with regards to the Target Date Funds being used in their retirement plans. Based on these concerns, the DOL held a Public Hearing on “Target Date Funds and Other Similar Investment Options” in June 2009. Seth Harris, Deputy Secretary of the DOL, previewed the focus of the discussions:

“Recent concerns have been raised about variation in the glide paths of Target Date Funds offered by different providers and how that variation may result in plan participants and investors unknowingly placing their retirement assets at risk, or at least not knowing exactly what risks they are bearing with respect to their particular investment, making choices without the full information that we would like them perhaps to have. We are here today to explore precisely those concerns.

*Additional information about Casey Quirk and this analysis can be obtained from their web site <http://www.caseyquirk.com>

We're going to hear about how Target Date Fund managers make decisions about their funds' glide paths and underlying fund investments, what information is disclosed to plan sponsors, plan participants and individual investors and how investors such as 401(k) plan participants are using these funds."

The entire transcript of these discussions is available on the DOL web site: (<http://www.dol.gov/ebsa/pdf/TDFhearingtranscript.pdf>).

The Pension Protection Act of 2006 provides plan sponsors fiduciary relief when using Target Date Funds as a Qualified Default Investment Alternative (QDIA). However, as fiduciaries, plan sponsors are still obligated to act "prudently" – neither QDIAs nor Target Date Funds change this fiduciary requirement. The DOL QDIA Guidance is quite clear that "the fiduciary must *prudently* select and monitor the fund or portfolio or investment management service within any category of QDIA." Without evidence of this prudent selection and monitoring, plan sponsors can be exposed to significant fiduciary risk and may not have the fiduciary relief under the Pension Protection Act of 2006 that they think they do.

To comply with the DOL's QDIA guidance, plan sponsors must consider the facts and circumstances affecting their participants and select a QDIA solution that best addresses those facts and circumstances in total. Target Date Funds are one possibility, but not the only QDIA solution that should be considered. If Target Date Funds are determined to be appropriate for the plan's participants, then the plan sponsor should do a thorough fiduciary evaluation of the available funds.

At the very least, Target Date Funds should be held to the same standards as other investment options in a plan's investment array. In fact, a case could be made that plan sponsors should apply extra scrutiny whenever participant usage (both defaulting participants and participants actively selecting to invest in them) is high (such as over 60%) and the proportion of assets invested in them is unusually high (e.g. over half of total plan assets). High concentration of assets warrants significant attention by plan sponsors. A plan sponsor should be willing to act appropriately when issues are identified with any plan investment option, QDIA or otherwise. Prudent monitoring requires a willingness to manage the QDIA solution. This translates into a willingness to replace problem funds with alternative investments.

When it comes to Target Date Funds, Securian recommends four areas for plan fiduciaries to focus on and evaluate:

1. **Target Date Fund Risk** across the target date time horizons so appropriate risk levels for participants can be identified.
2. **Risk-Adjusted Returns and Expenses** to determine which Target Date Funds, if any, have achieved strong returns relative to a valid benchmark and a reasonable level of expense related to other Target Date Funds.
3. **The Underlying Funds of Target Date Funds** to hold them to the same standards as other stand alone investment options offered in a plan's investment array.
4. **The Reliability and Repeatability of Investment Results**

At the very least, Target Date Funds should be held to the same standards as other investment options in a plan's investment array. In fact, the case could be made that they should be held to a higher standard whenever the participant usage (both defaulting participants and participants actively selecting to invest in them) is high (such as over 60%) and the proportion of assets invested in them is unusually high (e.g., over half of total plan assets). High concentration of assets warrants significant attention by plan sponsors.

Fiduciary Focus on Risk

The risk of a Target Date Fund is ultimately determined by the proportion invested in each investment strategy, the risk of the underlying investment strategies for different asset classes, and how well these strategies diversify away risk based on their correlations with each other. The asset allocation (glide path) is the generic asset class allocations that change over different target dates. While the glide path has an impact on the risk of the Target Date Fund, it does not *determine* the risk. The actual investment strategies within each asset class can have significant risk contributions that can only be assessed by looking at the historical results of the Target Date Funds. Fiduciaries that rely on the glide path to determine the underlying risk exposure of their Target Date Funds may not be getting an accurate view of their inherent risks.

... plan sponsors must appropriately address the needs of both younger and older plan participants and not put the needs of one group above those of another. If there is not a Target Date Fund available that meets the needs of the plan participants, the plan sponsor should evaluate other QDIA-eligible solutions.

Since more Target Date Funds have now achieved three year track records, it is easier to evaluate the risk profiles of each on a relative basis. In addition, Morningstar® has developed these three indices for each target date:*

- Morningstar Lifetime Conservative
- Morningstar Lifetime Moderate
- Morningstar Lifetime Aggressive

This provides better information to assess the risks of each Target Date fund family and classify them into different risk categories.

For each of the Morningstar Lifetime indices, standard deviation of returns for 3, 5, and 10 year periods are available. While longer periods are more reliable than shorter periods for assessing investment risk, many Target Date Funds only have a three-year track record to evaluate. Plan sponsors can approximate risk classifications for each Target Date Fund by assessing the Morningstar Lifetime Index with the closest standard deviation of returns for the evaluated time period.

The risks being taken by Target Date Funds vary dramatically. In general, more Target Date Funds are aggressive rather than conservative. Some that are conservative for longer time horizons (2040 target date) are aggressive for shorter time horizons (2010 target date) and vice-versa. This may present a challenge for plan sponsors who must appropriately address the needs of both younger and older plan participants while not placing the needs of one group above those of another. If there is not a Target Date Fund available that meets the needs of the plan participants, the plan sponsor should evaluate other QDIA-eligible solutions. No matter the QDIA option chosen, the plan sponsor should have a prudent process that justifies its QDIA selection.

* The “Morningstar®” name and logo are registered marks of Morningstar, Inc. Marks used in conjunction with Morningstar products or services are the property of Morningstar or its subsidiaries. You may not invest directly in an Index.

Fiduciary Focus on Risk-Adjusted Returns and Expenses

Fiduciaries should understand that investments that take more risk will often outperform when investment returns are positive, so returns must be risk-adjusted to achieve some consistency regardless of the recent market performance. For this reason, investment options are often measured against a reasonable benchmark with regard to their returns on a risk-adjusted basis. The Morningstar Lifetime Indices are reasonable benchmarks for the performance of Target Date Funds.

While some fiduciaries may use Sharpe Ratios or Alpha to measure and rank risk-adjusted returns, many plan sponsors will not understand these measures particularly well. A similar but less complex method is to graphically illustrate the returns relative to the standard deviations of the Target Date Funds and the Morningstar Lifetime Indices. As the three Morningstar Indices have different returns and standard deviations, a trend line can be used to more effectively evaluate the performance of the funds.

In general, Target Date Funds have had limited success beating the Morningstar Lifetime Indices on a risk-adjusted basis. It is important for plan sponsors to first assess the appropriate level of risk and then choose an investment that provides a suitable risk-adjusted return. Alternative QDIA solutions should be considered when both conditions cannot be met.

After evaluating the risk-adjusted returns, the fiduciary can compare the total overall investment management expenses of the Target Date Funds that have been found to have both an acceptable level of risk *and* risk-adjusted returns. Target Date Funds have a broad span of expenses. Some firms have utilized passive investment options which bring down the overall expenses. A fiduciary does not have to go with the lowest expense, but does need to determine if the expenses are reasonable for the quality of services received. This decision needs to include an understanding of how the costs compare to other Target Date Funds.

Plan sponsors need to understand that all investments must be held to a relatively consistent fiduciary standard. To the extent that other investment options in the plan's investment array are expected to perform well relative to their benchmark, Target Date Funds should be held to this same standard. Any evidence to the contrary has the potential to bring the prudent monitoring of the QDIA solution into question.

Fiduciary Focus on Underlying Funds

Many Target Date Funds are invested in a collection of the Investment Company's proprietary mutual funds. This "fund of funds" approach allows the investment company to maintain asset concentration in their investments and close oversight of the underlying funds, but could appear as a conflict of interest to plan sponsors when evaluating the merits of the underlying funds.

A valid fiduciary question for plan sponsors to ask is whether the underlying funds used in the Target Date Funds are appropriate. **While Target Date Funds often have a declared portfolio manager(s), each of the portfolio managers of the underlying funds makes investment decisions that clearly impact the results for plan participants.**

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Including guidelines in the plan's Investment Policy Statement about the underlying funds of a Target Date Fund is a prudent and reasonable task for plan sponsors. Plan sponsors must have a transparent fiduciary review process and do everything possible to help their participants understand their investments.

Plan sponsors, as fiduciaries, should hold these underlying funds portfolio managers to the same investment policy statement standards as stand-alone funds in the investment lineup. If there is clear evidence that any of the underlying funds of a Target Date Fund would not meet the standards of the plan's Investment Policy Statement, the plan sponsor should consider if they should be a part of the QDIA solution.

Fiduciaries often compare the performance of their plan's investment options to peer investment managers managing to the same investment category. Fiduciaries often expect reasonable success from their portfolio managers and evaluate this by determining if they outperform a majority of their peers or a benchmark. The underlying funds used by Target Date Funds should be held to a similar standard, as underperformance clearly has an impact on plan participants.

The number of mutual funds included in a Target Date Fund varies greatly between investment companies. Some use as few as six mutual funds to construct a portfolio, while others have used nearly 40. Because plan sponsors need to assess each of the underlying funds, more funds make the plan sponsor's job more difficult. Those Target Date Funds with more funds often do not display a greater diversification effect in reducing portfolio risk.

Some of the underlying funds of Target Date Funds do not reflect a 3 year track record which makes their historical performance less reliable. Of those underlying Funds with at least a three year track record, it is quite common to find more than one with bottom half performance relative to their peer investment managers. It is also common to find underlying funds that have experienced recent portfolio manager changes so the existing record is not directly attributable to the current manager.

Considering the prevalence of underperforming funds underlying Target Date Funds and the general struggles of the Target Date Funds to achieve risk-adjusted returns in excess of the Morningstar Lifetime Indices, plan sponsors need to ask if the simplicity Target Date Funds offer really delivers the best QDIA solution for plan participants. If plan sponsors believe that the QDIA solution is going to attract the bulk of the plan assets, than they should ensure that the QDIA is held to the same standard as the other investment options. If not, the plan sponsor should consider whether a lower standard is appropriate and prudent.

U.S. Senator Herb Kohl, chairman of the Senate Special Committee on Aging, is quoted on the Special Committee on Aging web site as saying, "The discovery that many 2010 target date funds contain junk bonds is troubling, but not surprising. Many target date funds are composed of hidden underlying funds that can have high fees, low performance, or excessive risk. With more than 90 percent of employers choosing off-the-shelf target date funds as their employees' standard option, there is no question that we need greater regulation and transparency of these products." Including guidelines in the plan's Investment Policy Statement about the underlying funds of a Target Date Fund is a prudent and reasonable task for plan sponsors. Plan sponsors must have a transparent fiduciary review process and do everything possible to help their participants understand their investments.

Fiduciary Focus on Reliability and Repeatability

Some QDIA solutions are static in nature while others are tactical and dynamic. For investment options that are more tactical and dynamic, performance of the investment process can be a less meaningful way to assess the historical risk characteristics. For periods of time, a tactical investment strategy can appear conservative or aggressive and then evolve to the other extreme. Tactical and dynamic investment approaches make it difficult for plan sponsors to prudently select and monitor investments as there is no clear risk profile to compare with the plan participants' needs.

Target Date Funds have a tendency to change their allocations to the underlying investment options and swap different mutual funds in or out of the investment portfolio without notice to plan sponsors. In addition, many mutual funds have portfolio manager turnover that limits the usefulness of the existing track records.

Plan sponsors should try to assess the reliability and repeatability of the historical investment process. If there is evidence of significant changes in the historical allocations to different mutual funds and turnover in underlying portfolio managers, plan sponsors should be cautious in putting too much reliance on historical performance in the hiring and retention decisions concerning a Target Date Fund. A prudent process should have reasonably high confidence in the fiduciary analysis of risk and risk-adjusted returns. If the repeatability of those results is in question, then it would not be prudent to use them.

Conclusion

As fiduciaries, plan sponsors must prudently serve the interests of their plan participants. With QDIA solutions possibly accumulating the bulk of many retirement plans assets, they should be held to a high fiduciary standard. To do this, plan sponsors should consider if:

1. The risk of the QDIA is appropriate for the plan participants' needs.
2. The risk-adjusted returns are held to the same high standards as other investment options and expenses are deemed to be reasonable relative to similar investment options.
3. The construction and management of the QDIA exhibits sufficient skill and care (and no conflicts of interest) to merit its inclusion in the retirement plan.
4. The QDIA solution can be accurately assessed with repeatable and reliable historical results.

If the QDIA solution cannot meet these prudent requirements, then the plan sponsor should consider other QDIA options.

VIEWPOINT - TARGET DATE FUNDS

Almost one-third of 401k plan contributions are going into target date funds, which may also be called lifecycle funds. Is this growth healthy? Are target funds prudent investments for all retirement plan participants? Do participants truly obtain the optimum investment return with this vehicle?

Risk Tolerance made too Simple?

Target date funds have a simplistic formula for determining risk tolerance; just decide when a worker wants to retire. For example, if the planned year of retirement is 2019 then a “2019 target date fund” would be selected. Such a fund assumes that everyone with a ten year time frame before retirement has exactly the same risk tolerance and financial goals. Everyone? Is that true? Absolutely not. Is it prudent portfolio planning? No, it is not.

Common sense will tell you just picking a year to retire should not be the basis for constructing an investment portfolio. The most important information you need to know about a plan participant is their risk tolerance, not which year they plan to retire. Target date funds assume everyone’s tolerance for risk is the same. This makes it easy from an administrative viewpoint but are plan sponsors making a prudent choice for their participants? Even more importantly, are plan sponsors making the right ethical decision in offering an investment to their participants which ignores their individual risk tolerance?

Plan sponsors need to find a way to discover the risk tolerance of each of their participants, since this is the most basic requirement before offering any investment. Target date funds, with their one size fits all approach, violates this rule in the name of simplicity. Not every employee has the same risk tolerance or financial goals as their colleagues. The importance of establishing risk tolerance is, by itself, enough to make everyone think twice about using target date funds as a form of retirement investing.

Rebalancing in Down Markets

Target date funds not only create the same portfolio for everyone that wants to retire in a certain year, but they also automatically rebalance the portfolio without regard to market conditions. For example, if a target date fund in 2009 lost value in its equity positions it would rebalance by buying more stocks in early 2010, regardless of market conditions. An employee invested in such a fund would have no ability to move to a more conservative position during the decline. The actions target date funds take while in a severe bear market will simply make losses greater for an existing portfolio.

This non-thinking approach to market rebalancing is easy to administer, since all portfolios automatically get rebalanced at the same time. Rebalancing in this way can produce dangerous outcomes because it lacks the input needed to react to market developments. This is another reason why making a financial product that is simple may not be in the best interest of all pension plan participants.

Are Internal Target Date Fund Investments the Best?

Often the investments inside a target date fund are mutual funds offered by the same investment firm that created it. Is this impartial money management selection? No. It serves the mutual fund company well, but what about the individual participants? Mutual fund companies are saying you can have any target date fund investment manager you want as long as they are employed by their company and it gets the fees for it.

Consider this ... certain investment managers are known to be shareholder friendly due to their low fees. But in target date funds offered by the least expensive managers, you only get access to mostly passive investments. This helps such firms make money even if the management fees are low. A small percentage of billions of dollars adds up to a lot of revenue for adding no value other than merely tracking a market index.



Asset Allocation Strategies Vary

How much should your plan participants hold in stocks when facing retirement in ten years? Does retirement mean they should go to all cash or bonds? Should they hold REITS no matter what the real estate market is doing? Everyone answers these questions differently and therefore different asset allocation models emerge.

Using ten years to retirement as an example, let's assume that for the first five years the stock market performance was awful. A target date fund would rebalance automatically into declining stock values resulting in a string of losses.

Now let's say that five years from retirement the markets turn around and soar. But since we are close to retirement the target portfolio is moving from equities into bonds and cash. Consequently, we would miss the opportunity to make some of our money back because the target date fund assumes we need to move to cash and bonds as we get closer to our target date. Can you imagine a worse timing scenario for someone who is depending on this money for their retirement?

Putting your retirement plan on autopilot with a target date fund and then hitting a market storm like 2008-2009 reveals the fact that there is no human pilot to back it up. Even airplanes have a pilot just in case something goes wrong. Target date funds are set up with the assumption that everything they do is ideal for every participant in the portfolio. That assumption can be appallingly wrong.

The Myth of the Automatic Portfolio

Plan sponsors, administrators, human resource departments and others who are involved in making decisions about the composition of their retirement plan investments should stop searching for the perfect automatic portfolio for their participants. There is no such thing, and never will be. There are too many variables in the market, risk tolerance parameters, and financial goals of your participants to ever come up with the perfect simple solution.

Target date funds are not the cure-all and, in fact, can be harmful to a pension participant's financial future. Investing is hard work. It takes time and effort. To provide the best retirement future for employees, employers must invest the work and effort needed to avoid costly errors in constructing investment options.

The value of pension participants' assets dropped by trillions of dollars over the last eighteen months while they stood on the sidelines in shock. Target date funds cost many employees a significant part of their nest eggs that will never be recovered. This alone should cause the retirement plan industry to rethink its initial infatuation with target date funds. There are better systems and more efficient ways to help your participants plan their retirement futures.

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IFLC is the leading global advocate for the certification of all organizations to whom people entrust the prudent handling of their financial assets. The certification programs that IFLC approves were independently developed. They are based on **pension laws, trust laws, the law that guides charities** on the management and investment of funds, court cases, and best practices. IFLC promotes aggressively the need for **Investment Stewards** and their **Service Providers** to be better **fiduciaries**.

When adhered to by Investment Stewards and Service Providers, Fiduciary Standards approved by IFLC improve competency, reduce conflicts of interest, and increase trustworthiness. As a not for profit entity, IFLC is ideally suited to fulfill its role as the global advocate for fiduciary excellence.

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