

SEC and DOL Guidance on Target Date Funds

By Fred Reish

Target date funds (TDFs) are the subject of great scrutiny because of the substantial and unexpected losses sustained during the recent market downturn. During 2008, the typical 2010 target date fund lost between 23% and 25% of its value. . . and, presumably, the 401(k) participants holding those funds in their accounts were within a year or two of retirement. If you place those losses in the context of the implicit, if not explicit, representations that the investments were age-appropriate, you can understand why the politicians and regulators are concerned about target date funds and the need for information for participants about the construction and use of those funds.

The government is issuing guidance to correct the perceived deficiencies. In fact, two pieces of guidance have already been released. The first is a joint Department of Labor (DOL) and Securities and Exchange Commission (SEC) Bulletin for investors and participants. The second is a series of proposed SEC amendments to the regulations governing marketing materials for TDFs. We expect that, in the near future, the DOL will be publishing a checklist to help plan sponsors select target date funds and, later in the year, will propose amendments to its 404(c)(5) regulation concerning qualified default investment alternatives (QDIAs).

This Bulletin discusses the two pieces of guidance that were recently issued.

Before getting into the specifics of the guidance, though, this Bulletin describes the issues. To do that, I have drawn from the description provided by the SEC staff in its June 16th proposal entitled “Investment Company Advertising: Target Date Retirement Fund Names and Marketing.” This 101-page document has been posted on our website at www.reish.com/publications/pdf/SEC_june2010.pdf.

I. THE ISSUES

A. Growth of Target Date Retirement Funds

As the SEC proposal explains:

Target date retirement funds (hereinafter “target date funds”) are designed to make it easier for investors to hold a diversified portfolio of assets that is rebalanced automatically among asset classes over

time without the need for each investor to rebalance his or her own portfolio repeatedly. A target date fund is typically intended for investors whose retirement date is at or about the fund’s stated target date. Target date funds generally invest in a diverse mix of asset classes, including stocks, bonds, and cash and cash equivalents (such as money market instruments). As the target date approaches and often continuing for a significant period thereafter, a target date fund shifts its asset allocation in a manner that is intended to become more conservative – usually by decreasing the percentage allocated to stocks.

Managers of target date funds have stated that, in constructing these funds, they attempt to address a variety of risks faced by individuals investing for retirement, including investment risk, inflation risk, and longevity risk. Balancing these risks involves tradeoffs, such as taking on greater investment risk in an effort to increase returns and reduce the chances of outliving one’s retirement savings. Further, target date fund managers have taken different approaches to balancing these risks, and thus target date funds for the same retirement year have had different asset allocations.

The schedule by which a target date fund’s asset allocation is adjusted is commonly referred to as the fund’s “glide path.” The glide path typically reflects a gradual reduction in equity exposure before reaching a “landing point” at which the asset allocation becomes static. For some target date funds, the landing point occurs at or near the target date, but for other funds, the landing point is reached a significant number of years – as many as 30 – after the target date. While there are some target date funds with landing points at or near the target date, a significant majority have landing points after the target date.

Recently, target date funds have become more prevalent in 401(k) plans as a result of the designation of these funds as a qualified default investment alternative (“QDIA”) by the Department of Labor pursuant to the Pension Protection Act of 2006.

The QDIA designation provides liability protection for an employer who sponsors a defined contribution plan and places contributions of those plan participants who have not made an investment choice into a target date fund or other QDIA. According to one study, 70% of U.S. employers surveyed now use target date funds as their default investment.

B. Recent Concerns about Target Date Funds

The SEC proposal explains the issues as:

Market losses incurred in 2008, coupled with the increasing significance of target date funds in 401(k) plans, have given rise to a number of concerns about target date funds. In particular, concerns have been raised regarding how target date funds are named and marketed.

Target date funds that were close to reaching their target date suffered significant losses in 2008, and there was a wide variation in returns among target date funds with the same target date. Investment losses for funds with a target date of 2010 averaged nearly 24% in 2008, ranging between approximately 9% and 41% (compared to losses for the Standard & Poor's 500 Index ("S&P 500"), the Nasdaq Composite Index ("Nasdaq Composite"), and the Wilshire 5000 Total Market Index ("Wilshire 5000") of approximately 37%, 41%, and 37%, respectively). By contrast, in 2009, returns for 2010 target date funds ranged between approximately 7% and 31%, with an average return of approximately 22% (compared to returns for the S&P 500, Nasdaq Composite, and Wilshire 5000 of approximately 26%, 44%, and 28%, respectively). Although the 2009 returns were positive, the differences between 2008 and 2009 returns demonstrate significant volatility. In addition, 2009 returns, like 2008 returns, reflect significant variability among funds with the same target date.

While the variations in returns among target date funds with the same target date can be explained by a number of factors, one key factor is the use of different asset allocation models by different funds, with the result that target date funds sharing the same target date have significantly different degrees of exposure to more volatile asset classes, such as stocks. Equity exposure has ranged from approximately 25% to 65% at the target date and from approximately 20% to 65% at the landing point. We note that opinions differ on what an optimal glide path should be. An optimal glide path for one investor may not be optimal for another investor with the same retirement date, with the optimal glide path depending, among other things, on an investor's appetite for certain types of risk, other investments, retirement and labor income, expected longevity, and savings rate.

In June 2009, the Commission and the Department of Labor held a joint hearing on target date funds.

Representatives of a wide range of constituencies participated at the hearing, including investor advocates, employers who sponsor 401(k) plans, members of the financial services industry, and academics. Some participants at the hearing spoke of the benefits of target date funds (for example, as a means to permit investors to diversify their holdings and prepare for retirement), but a number raised concerns, particularly regarding investor understanding of the risks associated with, and the differences among, target date funds. Some of these concerns revolved around the naming conventions of target date funds and the manner in which target date funds are marketed.

One concern raised at the hearing was the potential for a target date fund's name to contribute to investor misunderstanding about the fund. Target date fund names generally include a year, such as 2010. The year is intended as the approximate year of an investor's retirement, and an investor may use the date contained in the name to identify a fund that appears to meet his or her retirement needs. This naming convention, however, may contribute to investor misunderstanding of target date funds. Investors may not understand, from the name, the significance of the target date in the fund's management or the nature of the glide path up to and after that date. For example, investors may expect that at the target date, most, if not all, of their fund's assets will be invested conservatively to provide a pool of assets for retirement needs. They also may mistakenly assume that funds that all have the same date in their name are managed according to a uniform asset allocation strategy.

Another concern raised at the hearing was the degree to which the marketing materials provided to 401(k) plan participants and other investors in target date funds may have contributed to a lack of understanding by investors of those funds and their associated investment strategies and risks. A number of hearing participants expressed concern regarding target date fund marketing. For example, one participant stated that "there are significant problems with how [target date funds] are presently marketed," and that "what is lacking is clear and understandable information on the investment strategy and potential risks associated with that strategy." Another participant cited a survey that her organization had conducted, which involved showing a composite description of target date funds derived from actual marketing materials to survey subjects, the majority of whom perceived that those materials made "a promise that [did] not, in fact, exist."

According to that participant, some of the survey respondents who reviewed the marketing materials thought that target date funds made various promises, such as "funds at the time of retirement," a "secure investment with minimal risks," similarity to "a guaranteed investment" during a market downturn, or "a comfortable retirement."

Our staff has reviewed a sample of target date fund marketing materials and found that the materials often characterized target date funds as offering investors a simple solution for their retirement needs. The materials typically presented a list of funds with different target dates and invited investors to choose the fund that most closely matches their anticipated retirement date. Even though the marketing materials for target date funds often included some information about associated risks, they often accompanied this disclosure with slogan-type messages or other catchphrases encouraging investors to conclude that they can simply choose a fund without any need to consider their individual circumstances or monitor the fund over time.

The simplicity of the messages presented in these marketing materials at times belies the fact that asset allocation strategies among target date fund managers differ and that investments that are appropriate for an investor depend not only on his or her retirement date, but on other factors, including appetite for certain types of risk, other investments, retirement and labor income, expected longevity, and savings rate. The investor is, in effect, relying on the fund manager's asset allocation model, which may or may not be appropriate for the particular investor. The model's assumptions could be inappropriate for an investor either from the outset or as a result of a change in economic or other circumstances, such as job loss, unexpected expenditures that lead to decreased contributions, or serious illness affecting life expectancy . . .

II. THE GUIDANCE

A. Investor Bulletin

On May 6, 2010, the SEC and DOL jointly issued an "Investor Bulletin: Target Date Retirement Funds." The purpose of the Bulletin is to provide information to investors and participants about the selection of target date funds. (A copy of the Bulletin may be obtained from our website at www.reish.com/publications/pdf/InvestAlertTDFs.pdf).

The Bulletin instructs participants on issues they should consider and decisions they should make. To quote from portions of the Bulletin:

However, target date funds, even if they share the same target date, for example 2030, may have very different investment strategies and risks. They do not guarantee that you will have sufficient retirement income at the target date, and you can lose money. Target date funds do not eliminate the need for you to decide, before investing and from time to time thereafter, whether the fund fits your financial situation. Even if you plan to retire in 2030, you may decide, based on your investment objectives, tolerance for risk, and other assets, that a 2020, 2040, or other target date fund is more appropriate for you. Or

you may decide that you don't want to invest in a target date fund.

As with any investment, evaluate a target date fund carefully before investing. The target date may be a useful starting point in selecting a fund, but you should not rely solely on the date when choosing a fund or deciding to remain invested in one. You should consider the fund's asset allocation over the whole life of the fund and at its most conservative investment mix, as well as the fund's risk level, performance, and fees. This information is available in the fund's prospectus.

As noted above, funds with the same target date may have different investment strategies and levels of risk. These variations may occur before the target date, and also at the target date and after it. Some target date funds may not reach their most conservative investment mix until 20 or 30 years after the target date, . . . Others may reach their most conservative investment mix at the target date or soon after, . . .

As might be expected, the SEC and DOL are focusing on asset allocation as an important metric for selecting a target date fund. In addition, in the Bulletin, they emphasize the importance of determining whether the target date glide path is "to retirement" or "through retirement," although they do not use that terminology.

As a recommendation, plan sponsors should consider distributing the bulletin to participants. It would be evidence that a plan sponsor has educated its employees on these important issues.

B. SEC Proposals on Marketing Materials

The June 16th proposal would require that TDF marketing materials provide much greater information to investors (which, in the case of 401(k) plans, would be the participants).

Those changes include:

- The SEC's proposal would require marketing materials for a target date fund that includes the target date in its name to disclose the asset allocation of the fund among types of investments.
- The types of investments—such as equity securities, fixed income securities, or cash—would need to appear with the fund's name the first time the fund's name is used.
- The SEC's proposal would require target date marketing materials to include a prominent table, chart, or graph that clearly depicts the asset allocations among types of investments over the entire life of the fund.
- These proposals would also require a statement:

- explaining that asset allocation changes over time;
 - noting the asset allocation eventually becomes final and stops changing;
 - stating the number of years after the target date at which the asset allocation becomes final; and
 - providing the final asset allocation.
- The SEC’s proposal would require target date marketing materials to include a statement informing the investor:
 - to consider the investor’s risk tolerance, personal circumstances, and complete financial situation.
 - that an investment in the fund is not guaranteed and it is possible to lose money by investing in the fund, including at and after the target date.
 - whether, and the extent to which, the intended percentage allocations may be modified without a shareholder vote.
 - In addition, funds would be required to add a statement in their marketing materials warning that the funds come with risks and should not be chosen based solely on investors’ retirement dates.
- Further, the proposal would amend the commission’s antifraud guidance to state that marketing statements suggesting that investments can be chosen based on a single factor or that investments are simple and require no monitoring can be misleading.

CONCLUSION

We expect that the SEC proposals will be adopted much as proposed. We also expect that the DOL’s checklist and QDIA amendments will be consistent with the Bulletin and the SEC proposals. The initial effect should be to educate plan sponsors and participants about asset allocation, glide paths and target date differences. We believe the long-term effect will be that plan sponsors and advisers will focus on the needs and characteristics of the covered workforce and the design differences of TDFs. For example, is the TDF line-up designed to be aggressive, moderate or conservative? Is that appropriate for the particular workforce? Is it appropriate if most participants are defaulted (*e.g.*, an automatically enrolled plan)? Does the glide path go “to retirement” or “through retirement?” If “through retirement,” are the participants aware that the plan sponsor made that decision for them?

From a legal perspective, the critical point is that fiduciaries need to engage in a prudent—and documented—process to make each of those decisions. A prudent process can produce a range of acceptable decisions. The failure to engage in a prudent process is a fiduciary breach.

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