OFF TARGET

by Chris Tobe, CFA, CAIA

Target funds have been a disaster for participants in 2008. Many participants who would have had positive returns in 2008 in their old default option (stable value or money market) were strongly encouraged or even forced out by their employers into target funds with heavy equity exposures giving them losses of -10, -20, or even -30% for 2008. Anecdotal reports are that the higher losses now inflicted on the most vulnerable of 401k investors (those in defaulted options) have had a negative effect on participation. This was the opposite effect of the stated intent of the Qualified Default Investment Alternative (QDIA) decision by the Department of Labor. (DOL)

The Target Date marketing craze started in anticipation of a change in DOL rules that would allow or even encourage some “equity” in the default option based on very long term expectations in the equity market. The October 2007 QDIA decision by the DOL opened the floodgate for Target Date funds as the major target date funds aggressively pushed plans to adopt them by January 2008, a little over a 2 month window. Many plans adopted these new options and as their default option quickly without significant due diligence. Did plans got caught up in the buzz and actually harm many of their participants? It can be argued that many Plans did not dig deep into what the DOL QDIA really said; they only looked at the spin provided by the sales people at the target funds. The DOL clearly stated plans in this case have a duty to know the risk tolerances of their participants and make their own independent judgment as a fiduciary if it was prudent to shift them from a 0% to in some cases 70% equity exposure overnight. i[i] Plans also should have noticed letters to the DOL from many groups included the Profit Sharing / 401(k) Council of America (PSCA), ERISA Industry Committee the AFL-CIO, and the Pension Rights Center who fought to keep a capital-preservation option as a QDIA, that keeping their old default option could be prudent if it fit its participants.

Volatility can drive down Contribution Rates

There were many warnings prior to the 2008 stock crash that the risk levels for many of these products was too high for most participants.
Zvie Bodie Commenting on the QDIA rush to target funds said “We found that people with relatively high risk aversion and a high exposure to market risk through their human capital would experience a substantial gain in welfare from being offered a safe target-date fund instead of a risky one.” ii[ii]
Comprehensive studies by the Compass Institute a think tank that focuses on investment strategies conclude that formulaic asset allocation approaches to investing – such as those employed in lifecycle, target date and balanced funds – unequivocally fail to provide participants with adequate savings for retirement, citing exposure to just one down year in the market as one of the pitfalls. iii[iii]

The Department of Labor (DOL), which fleshed out the PPA through regulations, was warned of this potential effect by its own peer reviewer, Nellie Liang of the Federal Reserve. “In particular, the outcomes should be evaluated based not only on expected values from retirement balances but also utility since workers are likely to be risk-averse. For lower income workers with few other financial assets, the additional volatility in pension balances might be especially costly. For lower income workers, it could be the case that the additional expected income from the lifecycle fund may only come with an unacceptable additional amount of risk. The assumed equity premium may be too high.”iv[iv] One down year in an equity-heavy investment option can lead participants to lessen or halt contributions, which are the real key to accumulation, according to Putnam. Its recent study suggests that over 90% of accumulation in retirement plans is attributable to contributions, while less than 10% is attributable to investment returns. Putnam’s study shows that a one percentage point increase in contribution levels has twice the effect of moving from a conservative portfolio to a growth portfolio over a period of 16 years.v[v] Participants who fall under the default option in many cases are lower income workers with lower risk tolerances, something many plans looked over as they rushed to move to target funds.

The potential for less contribution by many participants is something plans should consider in picking a default option or even the type of target date fund. Information was out there but perhaps buried by the Target Date marketing avalanche.

Target Funds favor higher fee Mutual Funds over Collective Funds

Plan sponsors should have also been sensitive to the increase of fees inflicted on participants in many Target Funds. According to Hewitt Associates, the median expense ratio of some mutual funds can be as much as 35 basis points higher than a similar styled collective trust fund. “Low cost vehicles such as collective funds can help sponsors be better fiduciaries,” added Greg Allen, President and Director of research at Callan Associates, vi[vi] According to a 2004 study by IOMA, Inc., a business information firm, annual fees for the historic default fund - stable value average 42 basis points, compared to 74 basis points for target funds.vii[vii] Recent data on stable value pooled funds show average fees ranging from 29 basis points to 40 basis points (varying based on size), while several stable value pooled funds charge fees as low as 12 basis points. viii[viii] Laibson, in his peer review for DOL, warns that “fees that exceed 100 basis points will have a significant deleterious impact on accumulation of retirement wealth.”ix[ix] The Department has, in the past, emphasized that cost is an important consideration in selecting investment funds. *x****[x]***. Similarly, a more recent study focused on lifecycle funds found the total average expense ratio of such funds (including the costs of the underlying funds) to be 71 basis points.xi[xi] .

Government Target Funds Outperform Private Sector in 2008

DOL and other Federal Employees including Congress did much better than the typical participant that they forced into a target fund. We compared the performance of the identical target date funds in the Thrift Savings Program (TSP) with those of the largest target date fund provider Fidelity. For those nearest retirement in 2010 a -14% shortfall means while a Govt. employee may be able to retire, while a person in the private sector will have to work longer just to be even. Fees at the TSP are less than 10% of that of packaged target funds. Especially for risk averse investors or those nearing retirement certain target funds at 60% to 70% equity were imprudent, and that allocations of 30%-50% stocks like those in the Federal Govt's target plan are the prudent interpretation of QDIA. The TSP not only had less equity, but had a stable value like option which is excluded from the most popular target date funds because it's not in mutual fund form. Wharton Professor David Babbel has stated that target date mutual funds because they exclude stable value are not on the efficient frontier. xii[xii]

2008 Annual Returns

	L 2040 %	L 2030 %	L 2020 %	L 2010 %	L Income
TSP	**-31.53**	**-27.50**	**-22.77**	**-10.53**	**-5.09**
Fidelity	**-38.80**	**-36.93**	**-32.12**	**-25.32**	**-12.14**
	-7.27	-9.43	-9.35	-14.79	-7.05

Conclusion.

"DOL emphasized that the selection of the default investment option must be prudent. Therefore, a plan sponsor can still be liable for imprudently selecting a particular equity product even if it is a QDIA." Therefore, a plan sponsor can still be liable for imprudently selecting a particular equity product even if it is a QDIA. The compelling criterion of prudence is required for selecting all default investment options. xiii[xiii] By selecting options that are too risky for their individual participants plans can and did cause harm at least in the short run.

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i[i] *AEGON Letter to DOL on QDIA Regulation by Chris Tobe November 2006*

ii[ii] *Making Investment Choices as Simple as Possible but not Simpler, by Zvi Bodie & Jonathan Treussard, Financial Analysts Journal Vol.63 Number 3 May 2007*

*iii**[iii]** The Paradox of Asset Allocation for Retirement Plan Participants: A Blessing or a Curse™,July 2007, Compass Institute LLC*

*iv**[iv]** Peer Review for Default Investment Safe Harbor Regulation by Nellie Liang, Board of Governors of the Federal Reserve System, at 4 (June 2006).*

*v**[v]** Defined Contributions Plans – Missing the Forest for the Trees" Putnam Investments August 2006*

*vi**[vi]** Collective Funds Fuel Growth in Stable Value By Chris Tobe, AEGON Institutional Markets Stable Times Third Quarter 2007 • Volume 11 Issue 3*

vii[vii] Plans in Transition: IOMA's Annual Defined Contribution Survey (2004)

viii[viii] *Hueler Analytics Stable Value Pooled Fund Comparative Universe*

*ix**[ix]** Peer Review for Default Investment Safe Harbor Regulation Department of Labor by Prof. David Laibson Harvard University, at 1 (June 5, 2006).*

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*x**[x]** DOL "Understanding Retirement Plan Fees and Expenses" (May 2004), available at http://www.dol.gov/ebsa/publications/undrstndgrtrmnt.html*

xi[xi] Turnstone Advisory Group LLC, Popping the Hood: An Analysis of Major Life Cycle Fund Firms, Appendix B (2006).

xii[xii] A Closer look at Stable Value Performance by David Babbell SVIA. http://www.stablevalue.org

*xiii**[xiii]** DOL Finalizes Regulation on Qualified Default Investment Alternatives (QDIA) SVIA website October 23, 2007 –SVIA*