Via e-mail

Friday, July 06, 2012

Elizabeth M. Murphy
Secretary Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

RE: **Comments on File Number S7-12-10**
**(Investment Company Advertising: Target Date Retirement Fund Names and Marketing)**

Dear Ms. Murphy:

Chao & Company, Ltd. respectfully submits this letter in response to the Securities and Exchange Commission's (the "Commission") request for public comment regarding proposed amendments to rules 156 and 482 under the Securities Act of 1933 and rule 34b-1 under the Investment Company Act of 1940. We thank the Commission for reopening the period for public comment on the proposed amendments as well as to submit comments on the findings of the "Investor Testing of Target Date Retirement Fund Comprehension and Communications " study sponsored by the Commission and conducted by Siegel + Gale ("Study").

Chao & Company, Ltd. (www.ChaoCo.com) is a SEC Registered Investment Advisor and offers fiduciary investment consulting to retirement plan sponsors. We provide ongoing analysis to plan sponsors regarding target date fund selection, benchmarking and monitoring.

**Concerns**

According to the Proposed Rule Release No. 33-9126 (pages 9-10), the Commission was concerned with (1) the 2008 market losses with target date funds demonstrating significant volatility and (2) how target date funds are named and marketed since there was a wide variation in returns among target date funds with the same target date.

The Commission recognizes (page 10) that, 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. 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 on, among other things, 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. Some participants raised concerns 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. Another concern raised was the degree to which the target date fund marketing materials provided may have contributed to a lack of understanding by investors of those funds and their associated investment strategies and risks. The simplicity of the messages presented in many fund 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.

**Proposed Rule**

The proposed rule, if adopted, would require (1) a target date retirement fund 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; (2) marketing materials for target date retirement funds 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; (3) a statement 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; and (4) additional guidance regarding statements in marketing materials for target date retirement funds and other investment companies that could be misleading.

The proposed rule would define a “target date fund” as an investment company that has an investment objective or strategy of providing varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures that changes over time based on an investor’s age, target retirement date, or life expectancy. The definition refers to the fund’s “investment objective or strategy” because funds are required to disclose their investment objectives and strategies in their statutory prospectuses.

**Questions & Responses**

The following are this firm's responses to a number of the questions posed in the proposed rule.

**Q1**: Does the proposed definition of “target date fund” cover the types of funds that should be subject to the proposal, or should we modify the definition in any way?

R1: Regardless of the specific investment objective or strategy, the *sine qua non* for all target date funds is to initially accumulate for and subsequently make retirement assets available for distribution to the investor. The proposed definition, at best, infers this distinguishing purpose. Investors simply interested in "long-term appreciation and capital preservation" can look to the abundantly available risk-based asset allocation funds or balanced funds. Thus the proposed definition fails to capture the distinguishing feature of a "target date fund".

**Q2**: The proposed definition requires that a target date fund have both equity and fixed income exposures. Is this condition too restrictive? For example, could a fund market itself as a target date fund, yet not include equity exposure and/or fixed income exposure, and therefore not be subject to the proposed amendments?

R2: The proposed definition limits portfolio to equity and fixed income exposure. The newer and future generations of target date funds will incorporate commodities and other real assets in their portfolio construction. Although investments in real assets may sometimes be in the form of equity securities, as an asset class, it is distinctive and provides traits that are both return enhancing and portfolio risk reducing. Additionally, cash and cash-equivalents should also be included as a basic asset class in the definition.

Further, defining a target date fund as a portfolio invested in both equity and fixed income securities is possibly too rigid. For example, the manager for the target date fund that is earmarked as the landing portfolio (i.e. the portfolio allocation ceases to change going forward) may elect to eliminate any equity exposure in an effort to maximize portfolio stability. The decision for the type and the number of asset and sub-asset classes to be included should be the purview of each fund manager. However, in order to assure that target date fund is at least diversified, the proposed regulation may consider requiring that all target date funds must at least invest in no less than two distinctive asset classes.

More consideration is encouraged in defining target date funds in order to minimize the restrictiveness to portfolio design, diversification and uniqueness while meeting certain minimal standards for portfolio diversification and to minimize the possibilities for large losses.

**Q3**: Would the proposed definition cover types of funds other than target date funds that are designed to meet retirement goals? If so, is this appropriate or should the definition be modified? Should our proposal cover any fund with a date in its name?

R3: One of the purposes of the proposed regulation is to improve investor understanding of target date funds. As such, the proposed definition should be limited to target date funds and should not be applicable to other funds that do not possess the unique design traits of a target date fund. Further, the proposed regulation should not extend its proposal to include any fund with a date in its name that is not a target date fund. For example, a fund that invests in zero coupon bonds that mature at a common year may elect to carry this common year in its name and should not be subject to this proposed regulation. This zero coupon bond fund does not intend to be an asset allocation fund that changes its asset allocation over time. The distinctive year in its name is for identity convenience purposes only.

**Q4**: The proposed requirement to disclose the target date (or current) asset allocation together with the first use of a target date fund's name would apply only if the fund's name includes a date. Should the proposed requirement apply to all target date funds, including those that do not include a date as part of their name?

R4: The proposed requirement should apply to all target date funds, including those that do not include a date as part of their name. The final target date fund or the fund containing the landing portfolio often does not contain a date as a part of its name since all other target date funds within

the same target date fund series eventually are folded or merged into this fund. It is important that the asset allocation for this fund be disclosed in a consistent manner as so envisioned under the proposed regulation. The new Rule should apply to each target date fund series that includes every fund vintage resides along the entire glide path.

**Q5**: For target date fund marketing materials that are submitted for publication or use prior to the target date, we are proposing to require disclosure of the fund's intended asset allocation at the target date. For materials that are submitted for publication or use on or after the target date, we are proposing to require disclosure of the fund's actual asset allocation as of the most recent calendar quarter ended prior to the submission of the materials. Is this appropriate? Should the proposed requirements apply only to marketing materials that are submitted for publication or used prior to the target date? Should marketing materials that are submitted for publication or used on or after the target date provide disclosure of the fund's asset allocation as of the target date, rather than the fund's actual asset allocation as of the most recent calendar quarter ended prior to the submission of the materials?

A5: Most commonly, a target date fund manager first establishes the dynamic asset allocation weightings ("Neutral Weighting") among a number of asset and sub-asset classes and further establishes the changes to this Neutral Waiting over time (typically in 5 year increments) along a glide path until the landing point where the target date fund's asset allocation ceases to change. Many target date fund managers overlay tactical asset allocation to take on an active portfolio management approach that increases or decreases the portfolio allocations to assets and sectors that are deemed to have a higher probability of gain or capital preservation.
For these funds, upper and lower investment bands or limits for each asset or sub-asset class are typically specified in the fund prospectus and can play an important role in portfolio performance and behavior. Since these tactical asset allocation changes can be sporadic and temporary, reporting only on the most recent calendar quarter asset allocation may be inadvertently causing the funds to express their asset allocation during or in anticipation of an event. An alternative is to always report the Neutral Weighting for each target date fund and to also provide the upper and lower investment bands or limits for each asset and sub-asset class. Such additional information in marketing material offers a more balanced and complete view of not only a fund's dynamic asset allocation weightings but also what the extremes of such allocation can be tactically at any one moment in time and from time to time.

**Q6 (a)**: Should marketing materials for a target date fund that includes a date in its name, as proposed, be required to include the fund's allocation across all types of investments, or should target date fund marketing materials be required to disclose some, but not all, of the fund's asset allocation, such as the equity allocation, the cash and cash equivalent allocation, or the non-cash allocation?

A6(a): Target date fund marketing materials should be required to disclose all of the fund's asset allocation, such as the equity allocation, the cash and cash equivalent allocation, or the non-cash allocation. Each asset class is material to the portfolio's risk and return experience.

**Q6(b)**: Would any of these approaches be more effective than the proposal at conveying investment risk at or after the target date? Alternatively, would any of the approaches confuse or mislead investors by conveying only a partial allocation or cause investors to rely excessively on information

about their exposure to a particular asset class? Are any of these approaches and/or the proposal easier for funds to implement, for example, because the necessary asset categorizations or computations would be simpler? Are there allocations for other categories or sub-categories of investments that should be required to be disclosed in target date fund marketing materials?

A6(b): The Proposed Rule unifies the disclosure on marketing materials of target date funds and, based on the Siegel + Gale Study, the change is impactful under most circumstances. However, to tie or express portfolio risk solely as the percentage of allocation or weight the fund has in equities is offering too simplistic a view to an investor. Even though an informed investor may understand generally that equity investments are relatively more risky than fixed income investments, such understanding or appreciation of risk is not exact and superficial. A more refined understanding beyond this risk relativity is lacking. Even for those investors who believe they are informed failed to grasp the complete risk ramifications on a portfolio level as they select a "less" equity alternative.

Using 5-year data provided by Morningstar as of 03-31-2012, Chao & Company conducted a simple risk weighting analysis to demonstrate that simply focusing on the portfolio allocation to equities is an insufficient disclosure about risk at best and likely fail to align expectation with reality. We assumed that the average of most far-dated target date fund vintages (e.g. 2050, 2045 and 2040) has an equity to fixed income allocation of 80% and 20% respectively and we further assume that the average of most near-dated target date fund vintages (e.g. 2005, 2010 and 2015) has an equity to fixed income allocation of 20% and 80% respectively. The exact glide path equity roll-down process is not significant for this discussion. We further assumed that target date funds have a mixture of U.S. and non-U.S. exposures and we use the following indexes as proxies for equity and fixed income exposure. Risk is defined in terms of degree of variance from the expected return and expressed in the form of standard deviation (1x). The higher the standard deviation value, the larger the volatility and thus the greater the historical risk.

| Index | 5 Year Annualized Total Return | 5 Year Standard Deviation |
|---|---|---|
| Russell 3000 Growth Index TR (U.S. Equity) | 5.02% | 19.67% |
| Russell 3000 Value Index TR (U.S. Equity) | -0.75% | 20.54% |
| MSCI World Ex USA GR (Non-US Equity in US$) | -2.46% | 22.99% |
| Barclays US Aggregate Bond TR (US Fixed Income) | 6.25% | 3.60% |
| Barclays Global Aggregate Ex US TR (Non-US Fixed Income) | 6.42% | 9.74% |

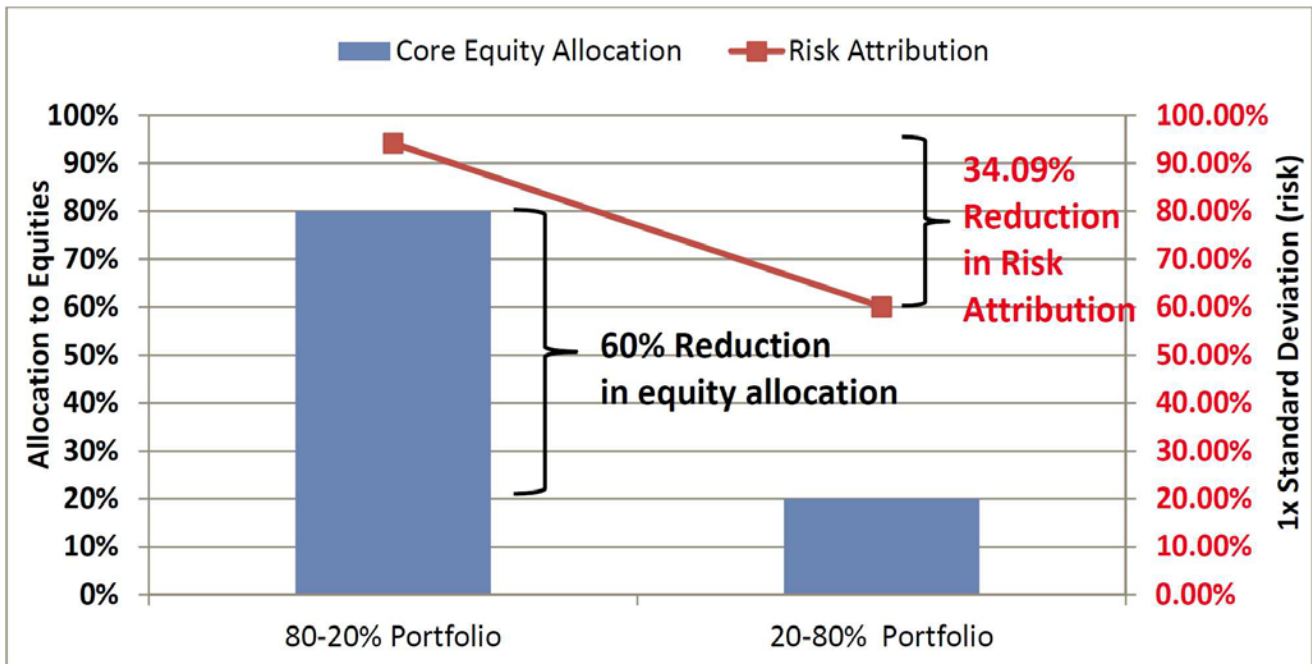
We then applied these 5 asset indexes and constructed the 80:20 Aggressive Portfolio and the 20:80 Conservative Portfolio. Under both cases, we have allocated more to the U.S. to better reflect the home bias allocations in most target date funds.

| 80%-20% (Aggressive Portfolio) | Asset Allocation | Return Allocation | Return Attribution | Risk Allocation | Risk Attribution |
|---|---|---|---|---|---|
| Russell 3000 Growth TR Index | 32.5% | 1.63% | 71.62% | 6.39% | 36.44% |
| Russell 3000 Value TR Index | 32.5% | -0.24% | -10.65% | 6.67% | 38.05% |
| MSCI World Ex USA Index | 15.0% | -0.37% | -16.21% | 3.45% | 19.66% |
| Barclays US Aggregate Bond TR Index | 15.0% | 0.94% | 41.14% | 0.54% | 3.08% |
| Barclays Global Aggregate Bond Ex US TR Index | 5.0% | 0.32% | 14.10% | 0.49% | 2.78% |
| Total | 100% | 2.28% | | 17.54% | |

During the 5-year measuring period, 80% allocation to equities represented 44.76% (71.62% -10.65% - 16.21%) of the annualized portfolio total return of 2.28% and represented 94.15% of the portfolio risk (36.44% + 38.05% + 19.66%).

| 20%-80% (Conservative Portfolio) | Asset Allocation | Return Allocation | Return Attribution | Risk Allocation | Risk Attribution |
|---|---|---|---|---|---|
| Russell 3000 Growth TR Index | 12.5% | 0.63% | 11.53% | 2.46% | 23.91% |
| Russell 3000 Value TR Index | 12.5% | -0.09% | -1.71% | 2.57% | 24.96% |
| MSCI World Ex USA Index | 5.0% | -0.12% | -2.26% | 1.15% | 11.18% |
| Barclays US Aggregate Bond TR Index | 60.0% | 3.75% | 68.85% | 2.16% | 21.00% |
| Barclays Global Aggregate Bond Ex US TR Index | 20.0% | 1.28% | 23.60% | 1.95% | 18.95% |
| Total | 100% | 5.44% | | 10.28% | |

During the same 5-year measuring period, 20% allocation to equities represented 7.56% (11.53% - 1.71% - 2.26%) of the annualized portfolio total return of 5.44% and represented 60.05% of the portfolio risk (23.91% + 24.96% + 11.18%).

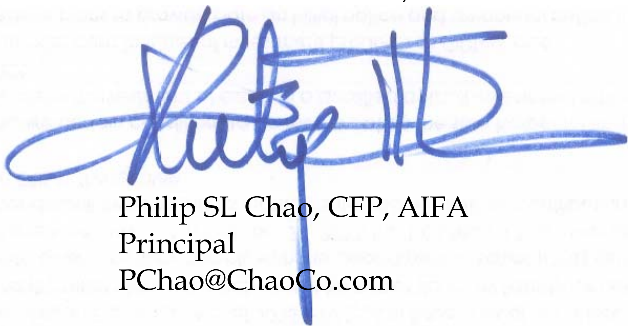


This simple analysis demonstrates that a reduction of a 60% exposure in equities (from 80% to 20%) resulted in a risk reduction (as measured by each portfolio's standard deviation) from 17.54% to 10.28% but only experienced a risk attribution reduction of 34.09%. This clearly points to the fact that the reduction in exposure to equities in a portfolio is not linear to the reduction in portfolio risk attribution. One reason for this inconsistency is that there is equity-like risk embedded in fixed income securities.

To align disclosure with investor experience/expectations, it is insufficient to simply increase information regarding portfolio asset allocation or, more specifically, allocation to equities. If the objective of the enhanced disclosure is to provide meaningful and usable information and data to an investor so that the investor can make a more informed and aligned decision, the additional disclosure material must contain risk allocation information and discussion. A description of general asset allocation or allocation band for each target date fund vintage is included in each target date fund prospectus currently. The amount of allocation to equities in a target date fund is currently disclosed in the fund's prospectus in one or more (table and pictorial) form. To repeat the same or substantially the same information, graphs or data in a uniform manner among all target date funds may improve an investor's ability to compare asset allocation among target date funds but not the ability to discern the differences in risk allocation.

We submit that the Commission examines and considers the inclusion of portfolio risk-related information, data or graphs along with asset allocation information as part of the enhanced disclosure effort. Thank you for the opportunity to offer comments regarding the proposed rulemaking. We are available to answer any questions you may have.

Sincerely yours,
CHAO & COMPANY, LTD.



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