An open letter to the SEC and DOL (December 2018): Please clarify who the "client" is in target date funds

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Dear SEC and DOL,

At $2 trillion and growing, target date funds (TDFs) are now ten times larger than they were in 2009 when you held joint hearings on their 2008 losses. TDFs have become riskier since 2008: bond holdings are longer duration (more volatile) and allocations to equities have increased. Is that the reaction you expected?

Progress on the regulatory front could help remedy this increase, with your proposed prudence standards that require consultants to hold client best interests above their own, but it depends on your definition of "client."

There are two possible definitions of "client" in TDFs. As a practical matter, plan sponsors are the clients because they hire consultants and pay their bills. Sponsor best interests are served when all the legal work is properly completed and maintained. The other possible definition of "client" is the beneficiaries of the TDFs because they bear the investment risk. Beneficiary best interests are served when their stated needs are met. Beneficiaries say they want to be protected as they near retirement – they do not want to lose money, including those who have recovered from 2008.

Please make it clear that TDF beneficiaries are the "clients." These clients want to be protected from investment losses as they near retirement and they think they are being protected, but they are not. A recent MassMutual Retirement Savings Risk Study reports beneficiary risk preferences in 401(k) plans, and finds that the vast majority (83%) want to be protected from losses at the target date. Interestingly, a PIMCO survey of consultants ("2018 12th Annual DC Consulting Support & Trends Survey") agrees with this safety preference. The interesting, and puzzling, fact is consultants are not choosing safe TDFs. They're not putting their money where their mouth is.

"Safety" can be a matter of judgment. TDF providers have to trade off the desire to grow assets against the need to protect them. In 2008 most 2010 funds lost more than 25%, and the judgment at that time was that these losses were unacceptable. TDFs were judged to be unsafe, so your hearings were held. Now they are even more unsafe. Consequently, beneficiary best interests are not being served. It's important to recognize that TDFs are mostly selected by consultants on behalf of plan sponsors.

Here are the details of average TDF allocations at the target date. The typical TDF is allocated 97% to risky assets at the target date. But not all TDFs are this risky. Some are much safer, invested 90% in Treasury bills and short term TIPS at the target date, but these funds are rarely considered in TDF selection proceedings.

Are consultants fulfilling their duty of care in their selection of TDFs? They are not if the "clients" are beneficiaries, which they should be.

Why do consultant surveys express a preference for safety at the target date when they in fact select unsafe TDFs?