Target Date Fund Safe Harbors Attract A Minefield of Imminent Litigation

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Fiduciaries generally believe that they are protected from litigation by two safe harbors in their selection of target date funds (TDFs):

1. Properly structured TDFs are Qualified Default Investment Alternatives (QDIAs) under the Pension Protection Act of 2006. Form over substance.
2. There is safety in numbers, so choosing one of the most popular TDF providers is prudent. Fidelity, T. Rowe Price and Vanguard manage 75% of the blossoming TDF market. You can't go wrong with a brand name. Or can you?

There's more to selecting TDFs than these two simple rules. Reliance on these trifling shields can lead to breaches of fiduciary duty that will bring lawsuits (loss-suits) when we experience the next 2008, which will happen sometime. Most TDFs are ticking time bombs because they are too risky at the target date. For an examination of fiduciary exposure to lawsuits, please see the Appendix to this paper.

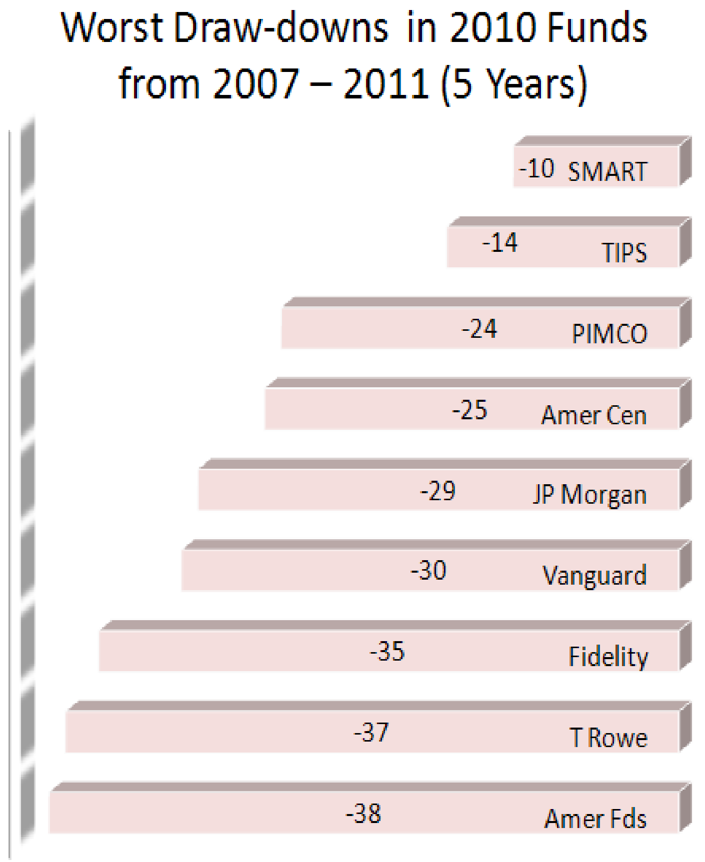
The Minefield

Fiduciaries are exposed to lawsuits because they have the duty of care, so they are obligated to actually vet their TDF selections and to establish objectives that are truly in the best interests of participants. Fiduciaries are duty bound to seek solutions rather than settling for high-risk products that are oblivious to history. Ignoring the past (especially 2008) and hoping its different the next time is not an option, and it's certainly not an enlightened view of risk management.

Contrary to popular participant need and belief, TDFs do not protect the vulnerable from equity loss. They sure didn't in 2008, and nothing has happened to change that. Most participants in TDFs are defaulted into this product, which means that most participants rely upon their employers to do the right thing by protecting savings, especially near retirement (even though they are not). At a recent TDF conference* Steven Ryan of Mercer Investment Consultants shared a survey of participants over 55. The vast majority -- 85% --

* Financial Research Associates Target Date Funds Forum, Boston Harvard Club, February 23-24.

want no risk in their 401(k) account. 10% would risk a loss of 5% if it meant there was a potential to gain 10%. And only 5% would risk a 10% loss to earn a possible 20% return.



The worst draw-downs for all funds except SMART occurred in the 16-month period 11/07-2/09.
The SMART 10% draw-down occurred in the 5 months 7/08-11/08.
TIPS 14% draw-down is for the 7 months 4/08-10/08.

Older participants are not getting the protection they want and deserve. The history of TDFs in 401(k)s, albeit a short 5 years, demonstrates that these funds are very risky near the target date. The table on the right lists the worst draw-downs (cumulative losses) in 2010 funds over the past 5 years. It's shocking. SMART Funds are described below. It's no surprise that SMART has defended best because it is designed for safety.

Resisting reform, the industry has forgiven itself for these losses by noting that these draw-downs were subsequently recovered. "Forget 2008" is the industry's Jedi mind trick (Star Wars Chapter 1, 1977). Fiduciaries have fallen for this insult to their intelligence, choosing to believe that "no harm no foul" constitutes vindication. The fact is that many who suffered these losses did not participate in the subsequent recovery. See our short movie at **The Sad Comedy of Target Date Funds** .

Real Safety

Safety in glide path design is preferred to safety in numbers because "no misery" is preferred to "misery loves company." Most importantly, **there is no fiduciary upside to risk taking near the target date – only downside.** In 2007, before the 2008 debacle, I designed the patent-pending Safe Landing Glide Path® (SLGP) to achieve the following objectives:

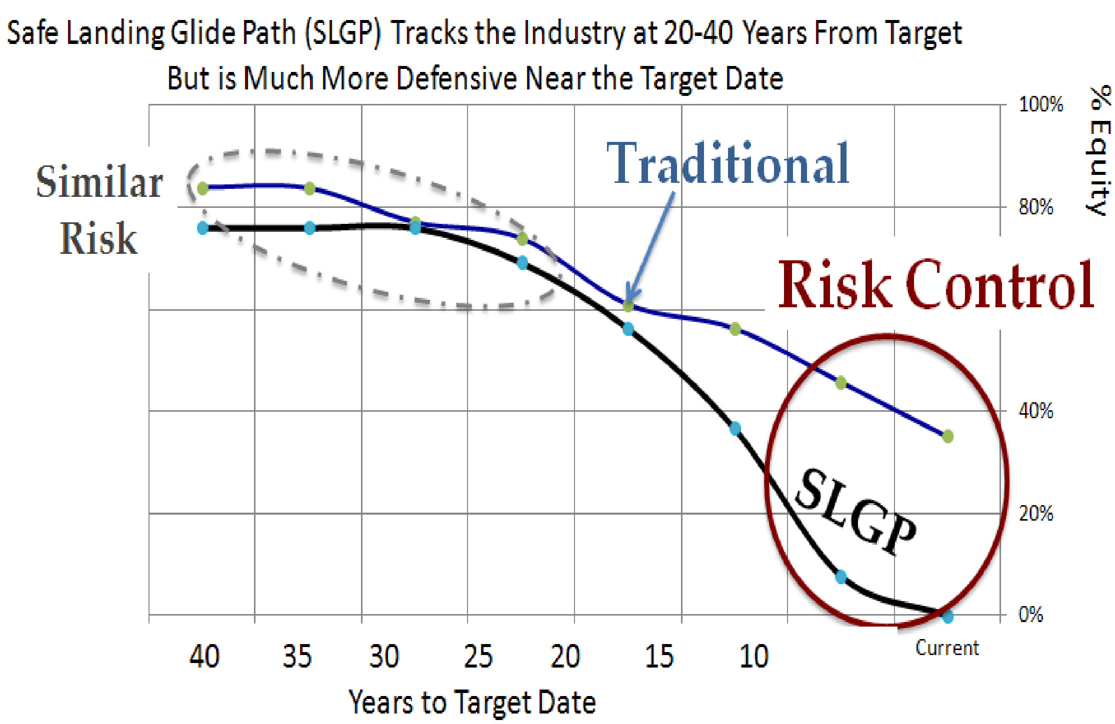
(1) Don't lose participant savings, and
(2) Make as much as you can but don't lose participant savings

These contrast to the traditional objectives of replacing pay and managing longevity risk, both of which are hopes rather than objectives. An objective without a reasonable plan of action is merely a hope. One-size-fits-all-set-it-and-forget-it TDFs bear no relationship to these individualized objectives. Saving enough is the right plan of action for achieving these objectives.

The SLGP integrates the tenets of Modern Portfolio Theory (MPT) with the disciplines of Liability Driven Investing (LDI). Yes, this one-size-fits-all-set-it-and-forget-it glide path is designed to achieve the straightforward objective of preserving accumulated savings. The SLGP is a concept, a blueprint, for target date funds. It's like an "ideal gas" in physics. It is not a product *per se* – you can't buy the SLGP target date fund. But you can design a TDF to follow the SLGP. For example, the SMART Funds® are collective investment trusts that follow the SLGP, offered by Hand Benefit & Trust, Houston.

Importantly, the emphasis is placed on safety, as it should be, so asset allocation at target date is mostly TIPS and T-bills. The appropriate mission of a TDF is to get the beneficiary safely to the target date. Attempts to extend the mission beyond target date lead to the "hope" problem and ignore the fact that most withdraw their accounts at retirement.

This prudent Safe Landing Glide Path is in line with the industry at long dates but moves away from the pack to safety as the target nears, as shown in the next graph.

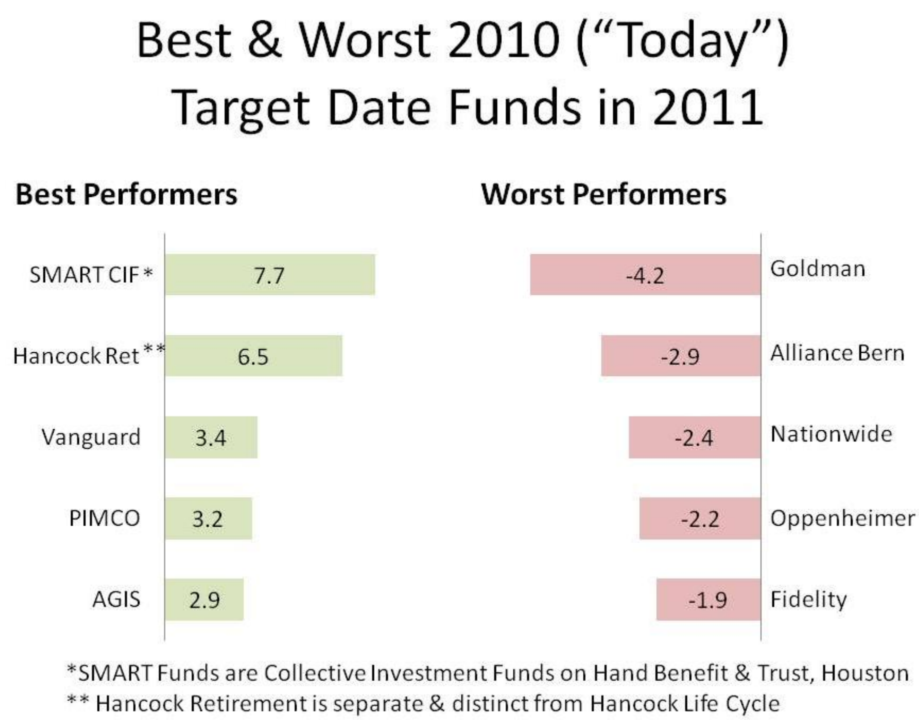


Enter the Tribe

Some have seen the light, and are moving toward the SLGP. A tribe is forming, although it is happening gradually. In February of 2010, John Hancock launched a "To" series of target date funds that ends at the target date with 8% in equities, which contrasts to its "Through" fund with 40% equities at target date. Similarly, both PIMCO and parent Allianz offer TDFs that end at 20% in equities. SMART Funds end with 5% in equities.

Other than these three members of the SLGP tribe, the industry has not responded to the outcry for reform caused by 2008 losses. Oh sure, fees have come down a little and some providers have moved to sham "To" funds but nothing of real substance is different. The 2011 performance of target date funds serves as a progress report on protecting the vulnerable, namely those in or near retirement. 2008 was a disaster with the typical 2010 fund losing 25%, so there was an outcry to avoid repeating this mistake in the future. 2011 shows that little has changed, principally because the objective of TDFs has not changed; making up for inadequate savings continues to be the flawed objective. For the most part TDFs did not defend in 2011. The critical funds for this test are 2010, or "Today", funds because they are for people retiring between 2005 and 2015.

As you can see, 4 of the 5 best performers in 2011 are members of our safety first tribe (Vanguard is not in our tent. AGIS is an Allianz product.). The SMART 2010 Fund performed best with a 7.7% gain.



As Peter, Paul & Mary sang*: "When will they ever learn? When will they ever learn?"

* Where Have All the Flowers Gone (1961)

APPENDIX

THE CENTER FOR DUE DILIGENCE
Information & Strategic Resources For Retirement Plan Advisors

Excerpts from

TARGET DATE FUNDS:
Pot Of Gold Or Baited Trap

Complete Article at
http://www.thecfdd.com/blasts/CFDD_120214_web.html

While the growth of TDFs has been nothing short of phenomenal, the lack of plan sponsor due diligence, re-introduction of the Kohl legislation and new initiatives by the Tort Bar could have a major impact on the retirement plans industry and the TDFs market. Target Date Funds are expected to capture 70% of DC plan assets in the next decade.

TDFs are complicated and in spite of a significant increase in usage, **less than half of all plan sponsors have performed any meaningful due diligence on their TDFs.**

This lack of due diligence is troubling and many view it as an accident waiting to happen. In addition to market risk, retirement plan **fiduciaries are duty bound to vet, establish objectives and seek TDF solutions that are in the best interest of their participants.**

At a minimum, **sponsors should review their goals & objectives, the process used to select the TDFs, the asset classes, the allocations, the glide path, fees and determine if they meet the needs of their participants.**

Given that the range of securities is all over the map, one has to conclude that credible income solutions have not yet developed.

QDIA solutions are clearly evolving, but **the fees and risk inherent in TDFs are still on the high side.**

The world has never been more complicated, dangerous or risk prone. As a result, **innovative risk management and low cost funds will be the wave of the future.**

Consistent with an evolving marketplace, strategies beyond proprietary families, fund-of-funds and traditional asset allocation will no doubt surface. The jury is out in terms of what will actually work over time, but some of the new strategies will no doubt be based on substance rather than pure marketing hype.

(Note from Target Date Solutions: The patent-pending Safe Landing Glide Path® (SLGP) is based on substance rather than marketing hype. The SLGP integrates the tenets of Modern Portfolio Theory (MPT) with the disciplines of Liability Driven Investing (LDI), emphasizing safety at the target date. Other target date funds are far more aggressive at the target date, averaging 40% in equities versus the SLGP's 5%. <u>There is no fiduciary upside to taking risk at the target date – only downside</u>.)

Nevertheless, given that TDFs are now the dominant asset class, it's hard to believe that **no independent single source solution to help advisors evaluate, select and monitor TDFs currently exists.**

The tort bar is aggressive, creative and oftentimes at the forefront of changes in the law and legal industry. Indeed, few now doubt that the fee transparency regulations were not significantly influenced by the onslaught of 401(k) fee litigation.

Where will the next litigation bonanza be? Some are saying it could well be against plan sponsors and fund managers who select and create, respectively, proprietary TDFs.

As noted, the majority of plan sponsors do not adhere to fiduciary standards or engage in prudent due diligence for the selection and retention of TDFs. Many fund managers also have affiliated RIAs who may have conflicts of interest in recommending TDFs to their plan sponsor clients.

The Kohl legislation is expected to be re-introduced and TDFs could be the new frontier of ERISA litigation.