Target Date Funds:
The Other 401(k) Scandal

Why We Care:
$1 Trillion Today
Growing to $4 Trillion by 2020

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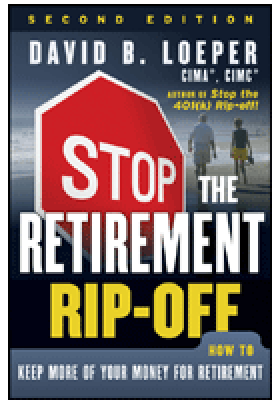
The First 401(k) Scandal: Fees



Sponsor Fee Disclosures – 408(b)(2) regulation

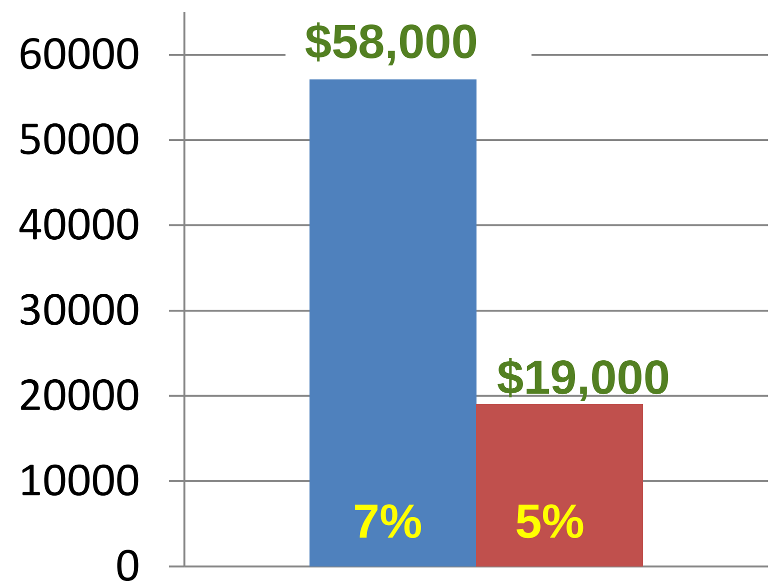
Effective July 1, 2012

<u>The Bogle Bomb</u>

2% fees on a 7% return portfolio reduces ending wealth by two-thirds.

$1000 invested at 7% for 60 years grows to $58,000.

That same $1000 invested at 5% grows to $19,000.

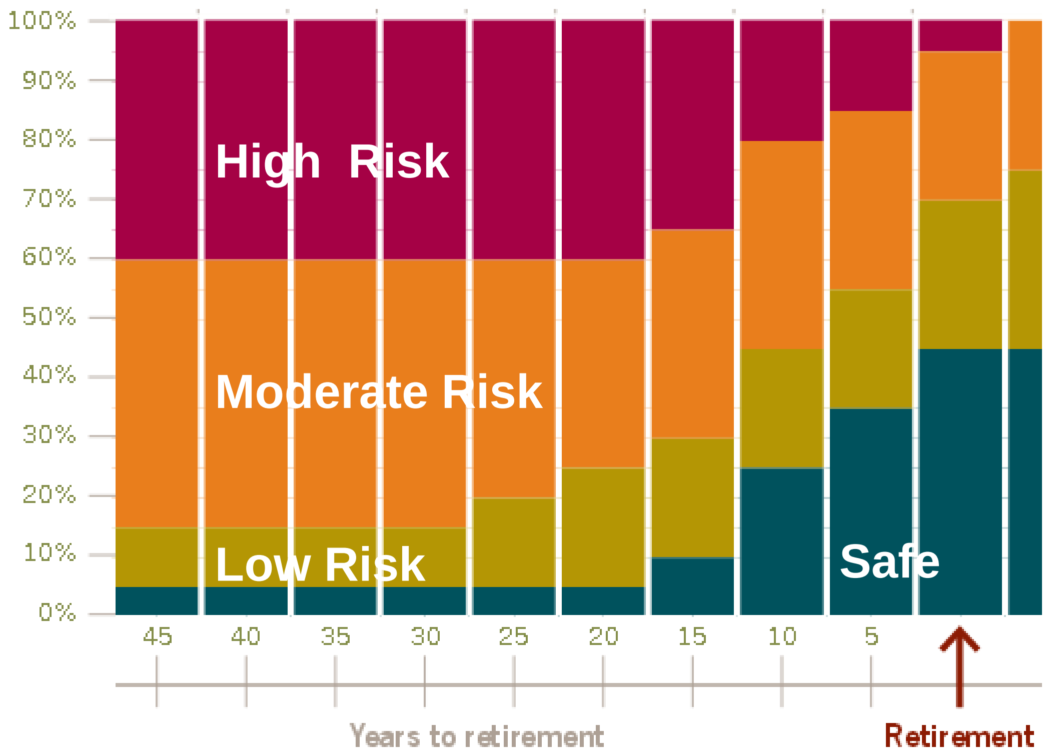


Agenda

- Definition of Target Date Fund
- Growth
- Scandal
- Solution

What is a Target Date Fund?

<u>Department of Labor Definition</u>:
A Target Date Fund automatically rebalances to become more conservative as an employee gets closer to retirement. The "target date" refers to a target retirement date, and often is part of the name of the fund.



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The Pension Protection Act of 2006

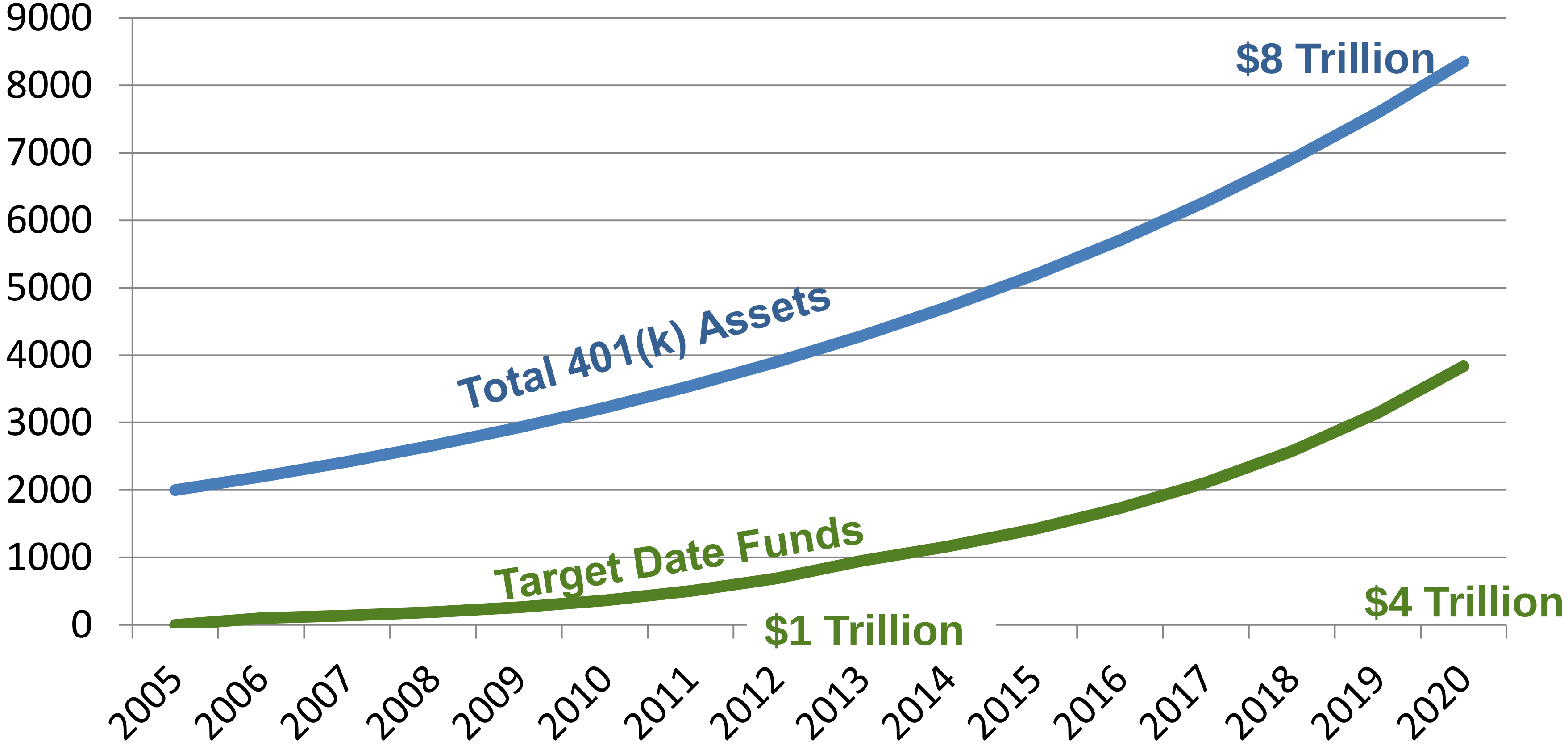
Establishes Qualified Default Investment Alternatives (QDIAs)

1. Target Date Funds

2. Balanced Funds (Includes Target Risk)

3. Managed Accounts

Projected to Grow to Half of 401(k) Assets



Source: Target Date Solutions

Agenda

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- **Scandal**
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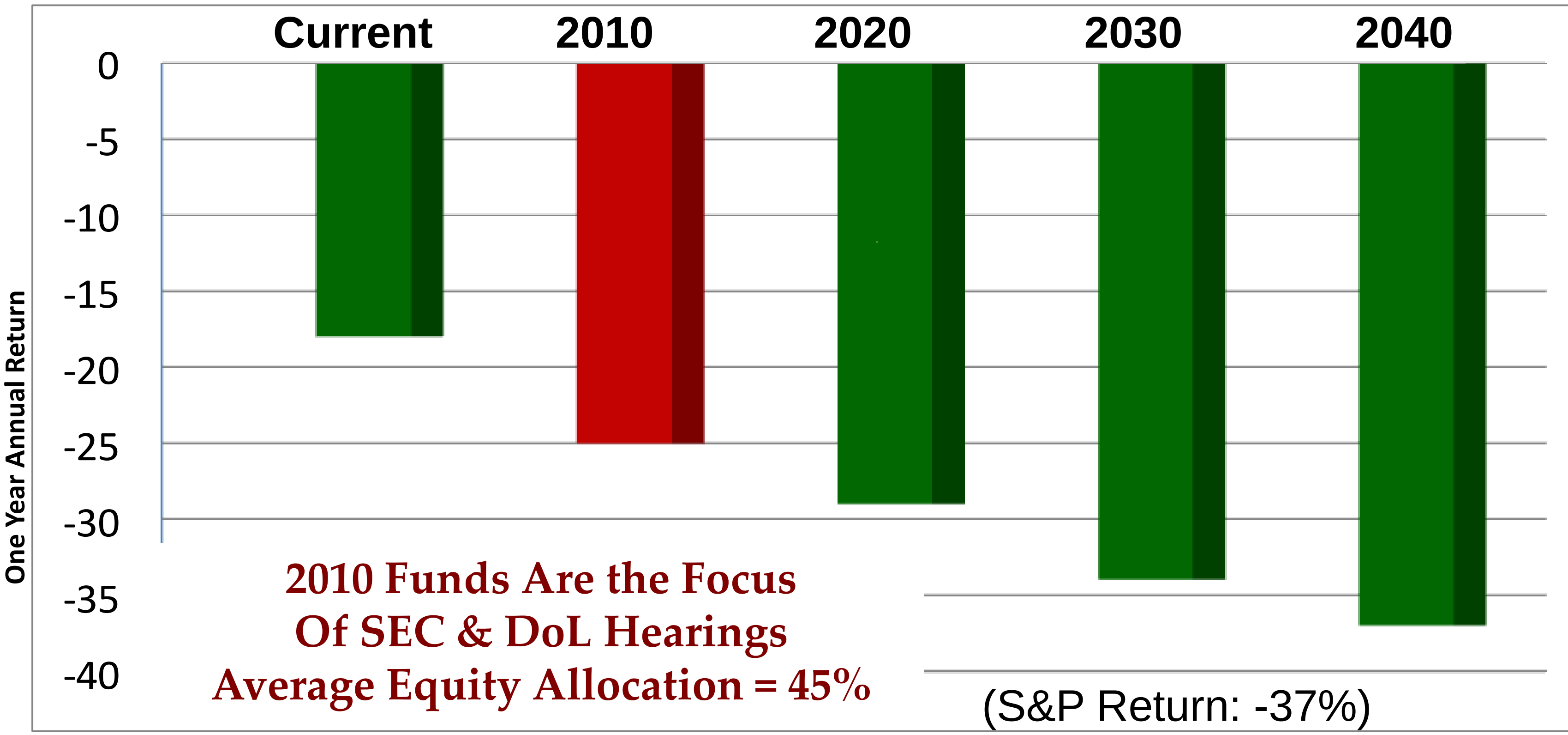
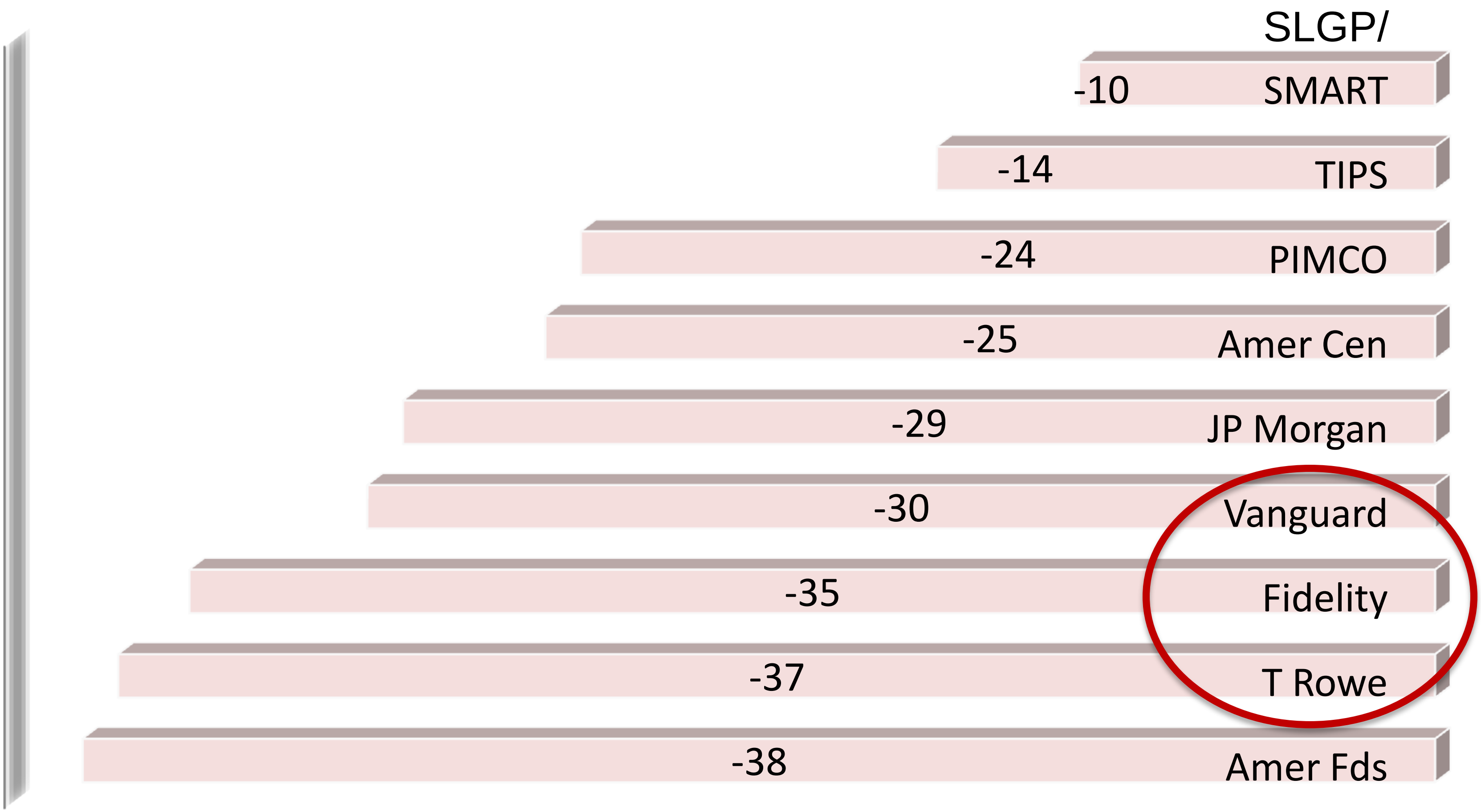
2008 Was a Wake-Up Call
Investors Should be Better Protected



Fund companies assure all is OK

You can watch the hearings at Hearings

Worst Draw-downs in 2010 Funds from 2007 – 2011 (5 Years)



The worst draw-downs for all funds except SMART occurred in the 16-month period 11/07-2/09. Most of the loss was in the 12 months of 2008.
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.

Source: MPI

The Scandal isn't 2008. It's today.

Fund Companies

- Nothing has changed to correct 2008
- Package Product for Profit
- Bogus objectives
- Confusing terms, like "To" versus "Through"

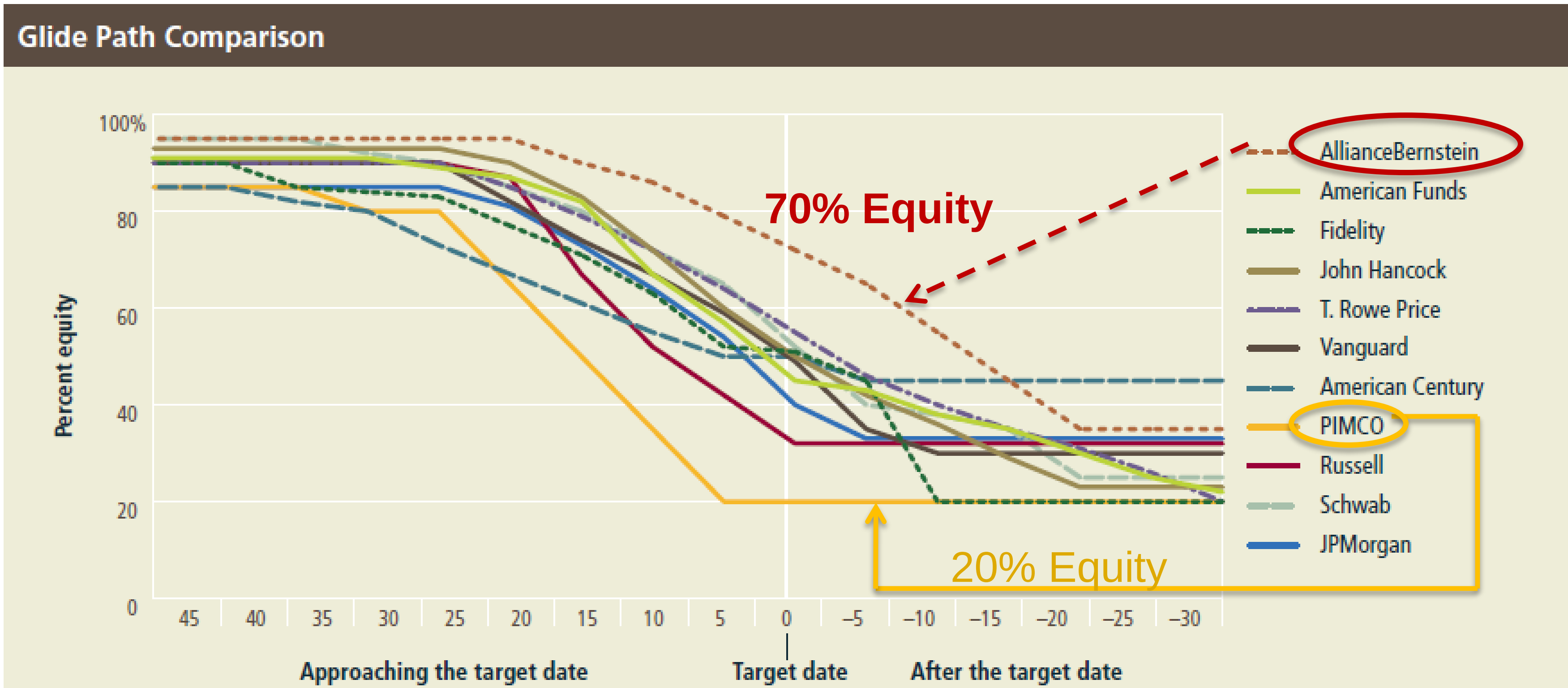
Fiduciaries: Sponsors and consultants

- Apathy & Laziness
- Breach of fiduciary duty

A Detailed Look at the Disagreements

We're landing above the ground !!

Products NOT Solutions



Source: John Hancock

Actions speak louder than words. Profits are the goal.

Equity shops pitch equities. Bond shops pitch bonds. What's best for the participant?

Types of Objectives

- **<u>Demographic based</u>: Compensate for inadequate savings: pay replacement and longevity risk**
    - ❑ An objective with an impractical plan (one size fits all) is a **<u>Hope.</u>**
    - ❑ Save more is the right plan.

- **<u>Universal</u>: To be discussed in "Solution" section**

High Risk Idiotic Objectives
Achievement is Unrelated to Investments

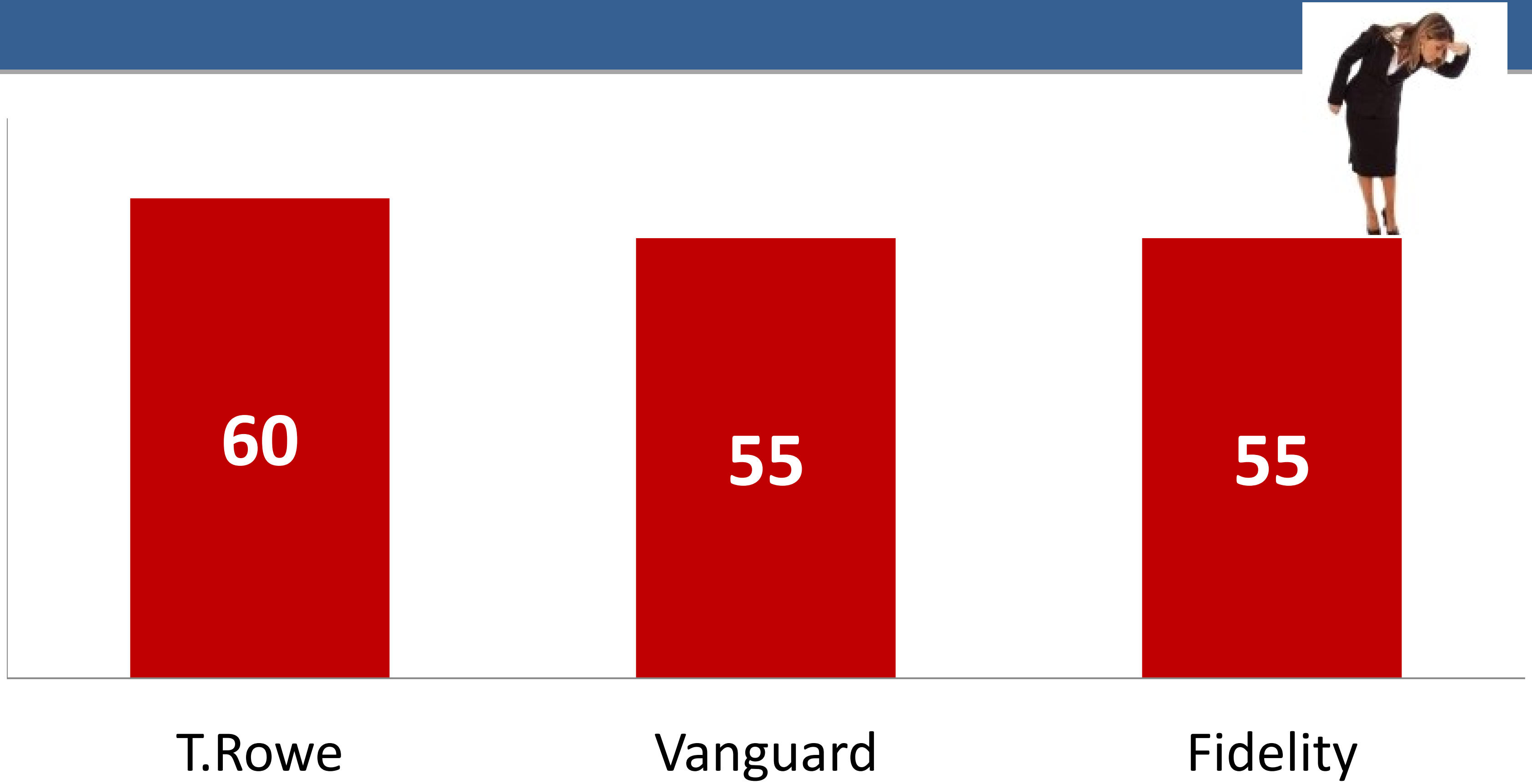
- **<u>Replace Pay</u>:**

  Savings, not investments, are key

- **<u>Manage Longevity Risk</u>: Try the Hemlock Fund**

It's a dark game that fiduciaries should not play. There's a reason that <u>factsheets & prospectuses never document these professed objectives</u>.

Risk at Target Date:
Equity Allocations of Big 3 are Way Too High



85% of Total TDF Assets are With These 3 Bundled Service Providers.

There is little or no vetting.

Have Fiduciaries Really Embraced This Much Risk at Target Date?

Regulatory Focus

1. Risk (Equity Exposure) at Target Date:
   End of the Glide Path

2. Underlying Assumptions: Shape of the Glide Path

Assumptions, DoL Recommends

- Savings for the Typical Participant
  (Pay Replacement Objective)
  - Current savings
  - Other sources of retirement income
  - Desired pay replacement at retirement
  - Current pay and projected pay increases
  - Savings pattern through time, employee plus employer

- Spending for the Typical Participant in Retirement (Longevity Risk Objective)
  - Spending discipline, perhaps as a fixed percent of current market value
  - Other assets, like Social Security
  - Life expectancy
  - Life events, like medical costs, college funding, whatever … stuff happens

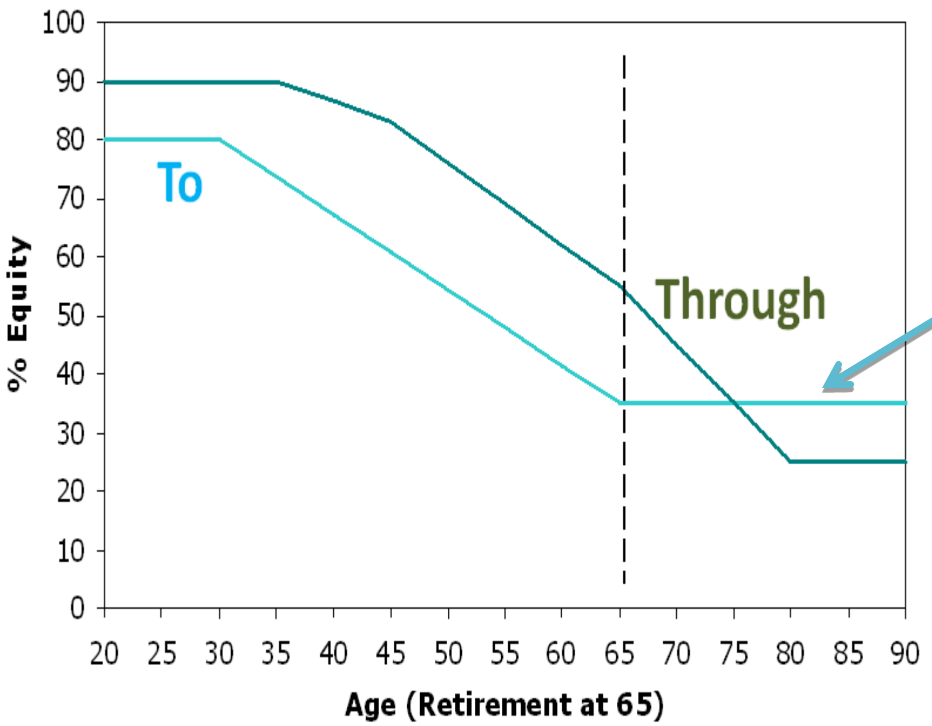
- Capital Markets
  - Asset classes: stocks, bonds, …
  - Sub-asset classes: styles, countries, alternatives
  - Risk & return & correlations
  - Glide path shape: linear, geometric, step, Mobius strip

> ***Everything should be as simple as possible, and no simpler.***
> Albert Einstein

Distinctions Without a Difference

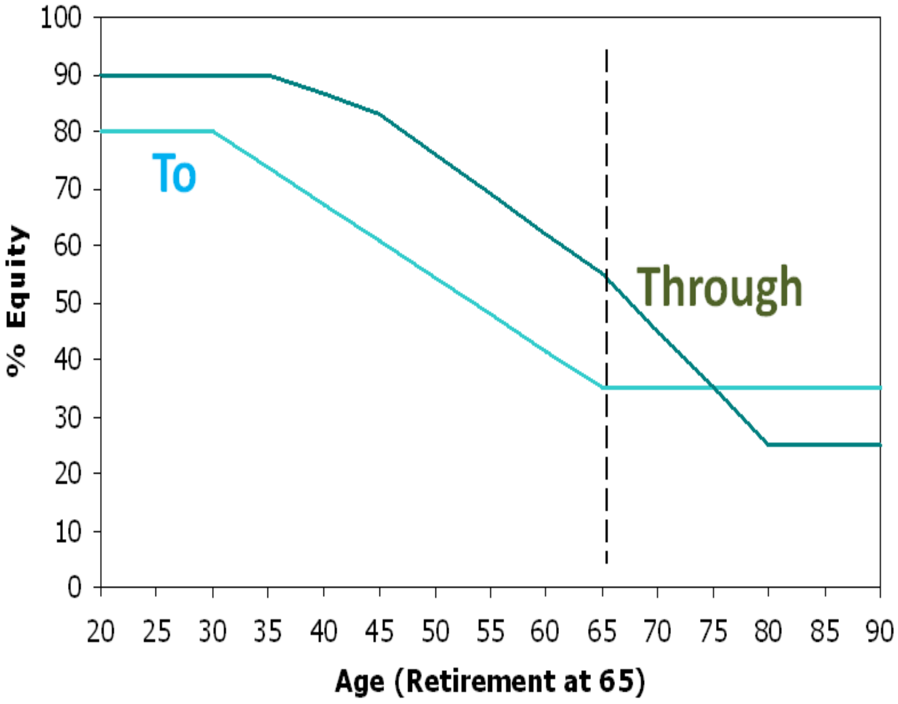
- “To” versus “Through”
- Active vs Passive
- Open vs Closed (Proprietary)
- Mutual fund or Collective or “Custom”
- Bundled service provider, or not (DCIO)

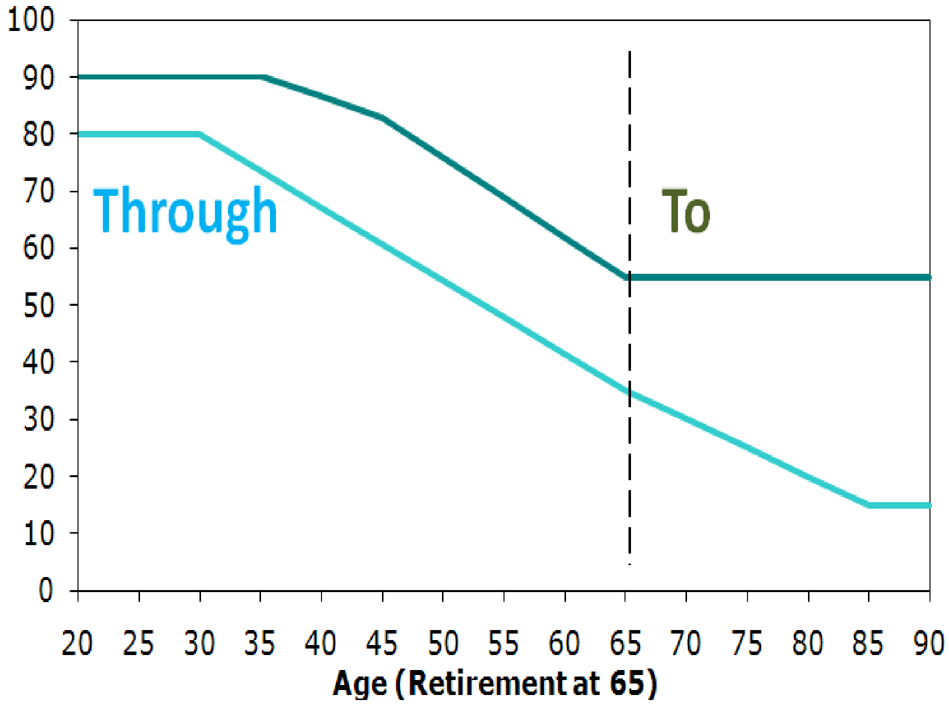
The “To – Through” Nonsense



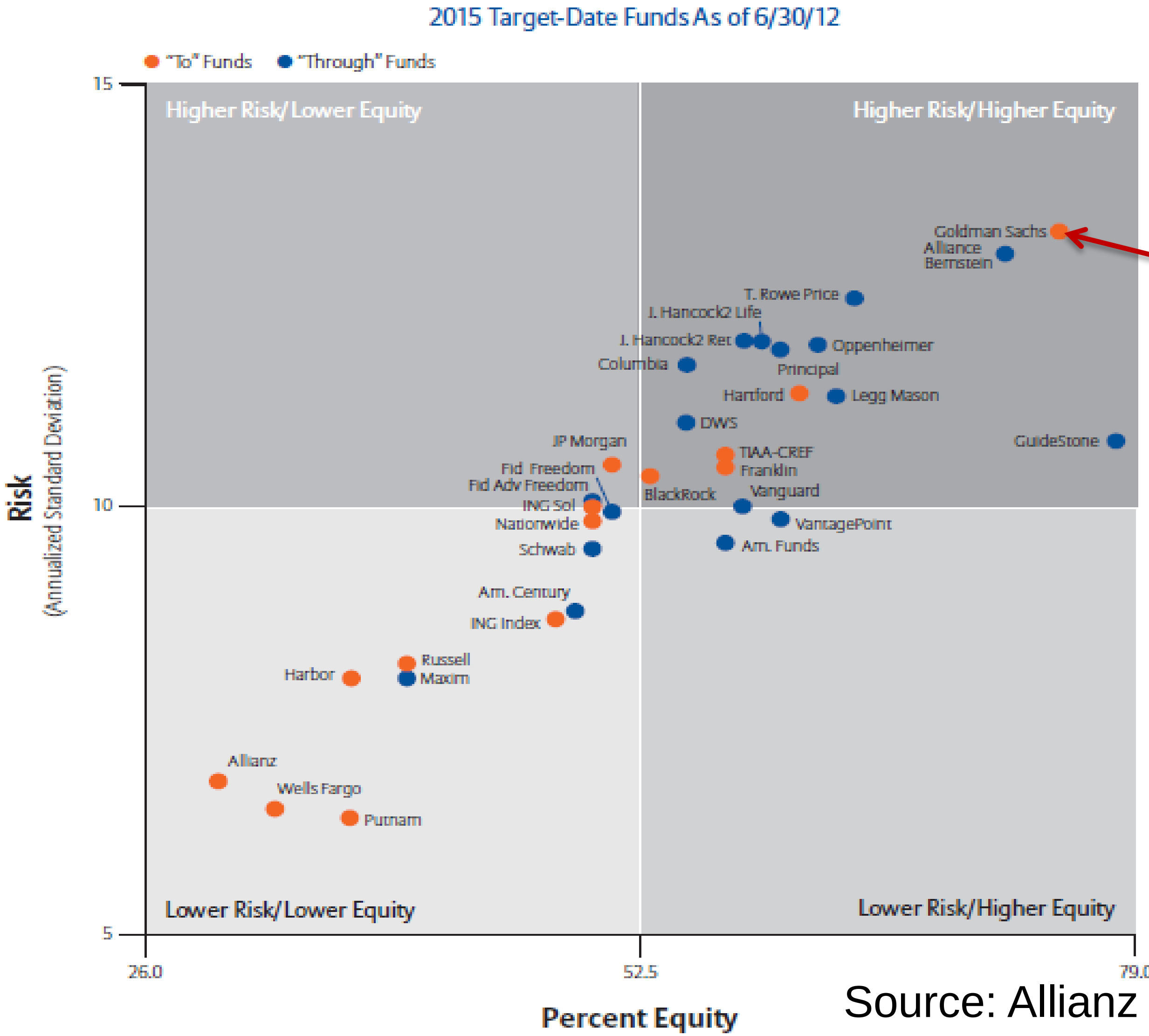
“To” is flat allocation after the target date

The “To – Through” Nonsense





Risks of "To" and "Through"



Some **TO** funds are riskier than **THROUGH** funds

Source: Allianz

The Scandal

Fund Companies

- Nothing has changed to correct 2008
- Package Product for Profit
- Bogus objectives
- Confusing terms, like “To” versus “Through”

Fiduciaries: Sponsors and consultants

- Apathy & Laziness
- Breach of fiduciary duty

Fiduciaries and Participants are Taking Most of the Risks While Fund Providers Enjoy Most of the Rewards

The BIG Question: <u>Why are fiduciaries allowing it?</u>
The foxes are watching the hen house.

(un)Safe Harbors

1) Properly structured TDFs are Qualified Default Investment Alternatives (QDIAs) under the Pension Protection Act of 2006. Form over substance.

Fiduciaries are obligated to actually vet their TDF selections and to establish objectives that are truly in the best interests of participants, like don't lose participant savings, especially near the target date.

ERISA attorneys and the Department of Labor have issued warnings, because TDFs are NOT being vetted.

2) There is safety in numbers. You can't go wrong with Fidelity, Vanguard or T. Rowe. Or can you?

"No misery" is preferred to "misery loves company." The Big 3 are 55% in equities at the target date. There is no fiduciary upside to risk taking near the target date – only downside. Beware another 2008.

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- ***Solution***

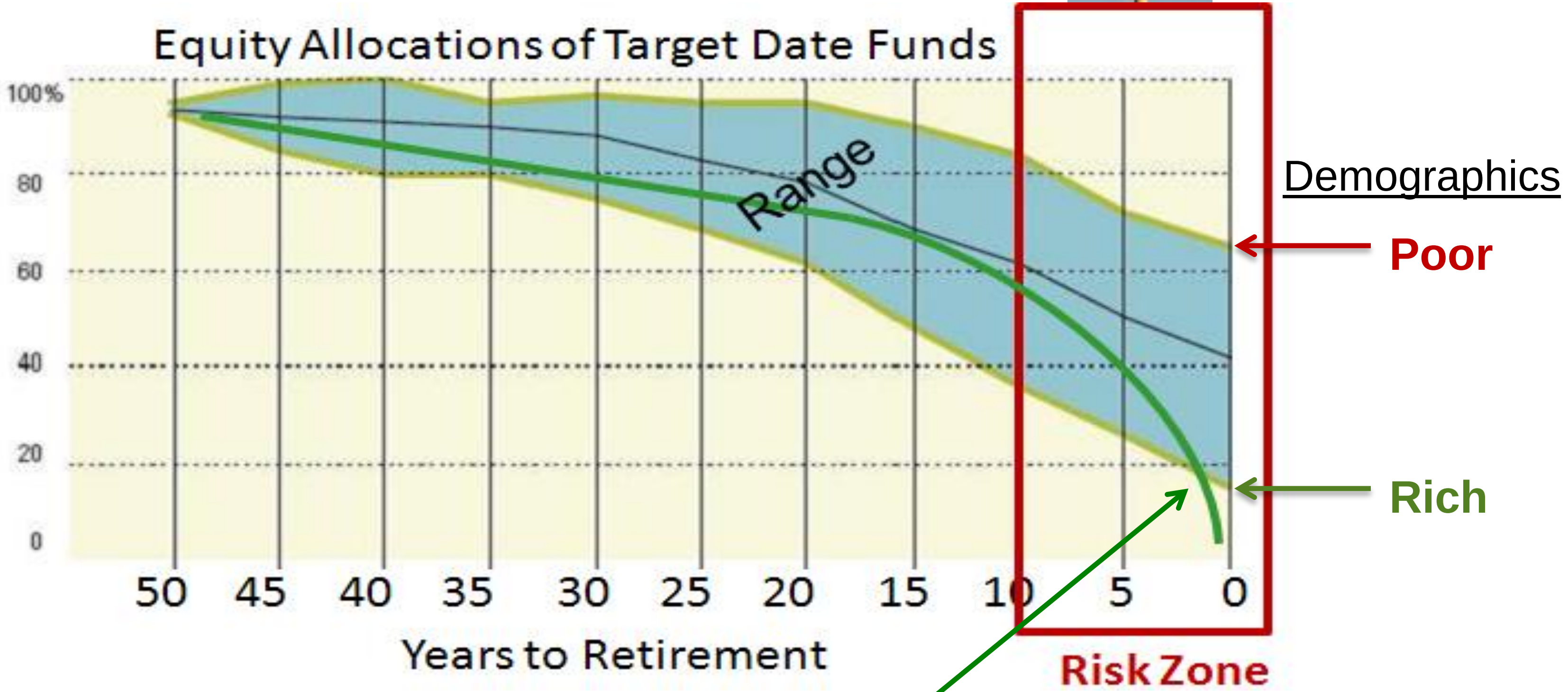
Adopt a Universal Objective

- **<u>Demographic based</u>: Compensate for inadequate savings: pay replaceme[illegible]d lon[illegible]risk**
    - ❑ An objective with an imprac[illegible]one size fits all) is a **<u>Hope.</u>**
    - ❑ Save more is the rig[illegible]an.

- **<u>Universal</u>: Bring participants safely to the target date with appreciated savings intact**

    Hippocratic Oath: Don’t lose money, especially near the target date.

Glide Paths Disagree Near Target Because of "Demographics"



Safe Landing Glide Path
Embraces a Universal Objective
Independent of Demographics: it's for All People

Low Risk Sensible Objectives

1. **Do not lose participant savings**

2. **Earn as much as you can without jeopardizing the preservation objective**

Show me how.

The Fiduciary Guide to Selecting a Target Date Fund

Safety Diversification Cost

Introducing the Patented Safe Landing Glide Path®

Criteria for Selecting Target Date Funds

Low Fees

Risk Control

Diversification

Inexpensive, Safe, Diversified + Well Designed

Let's examine each criterion using The patented Safe landing glide path® (SLGP) as the standard.

Inexpensive  SLGP Fees

Name	Asset-Weighted Expense Ratio %
Vanguard Target Retirement Series	0.19

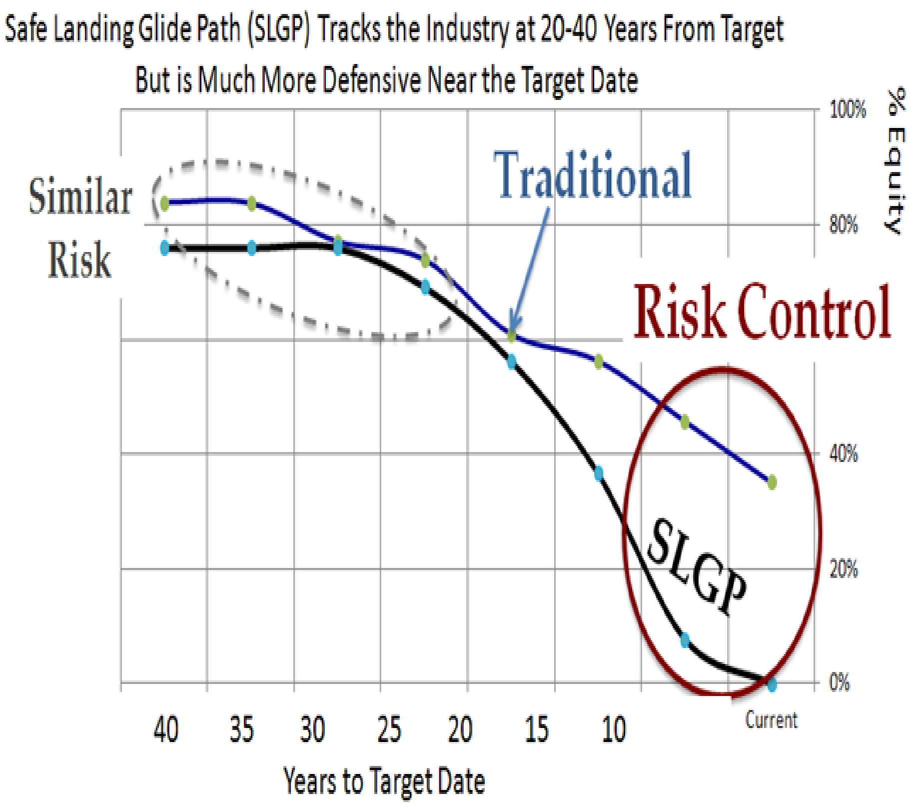
SMART Fund® Implementation of SLGP is 58 basis points

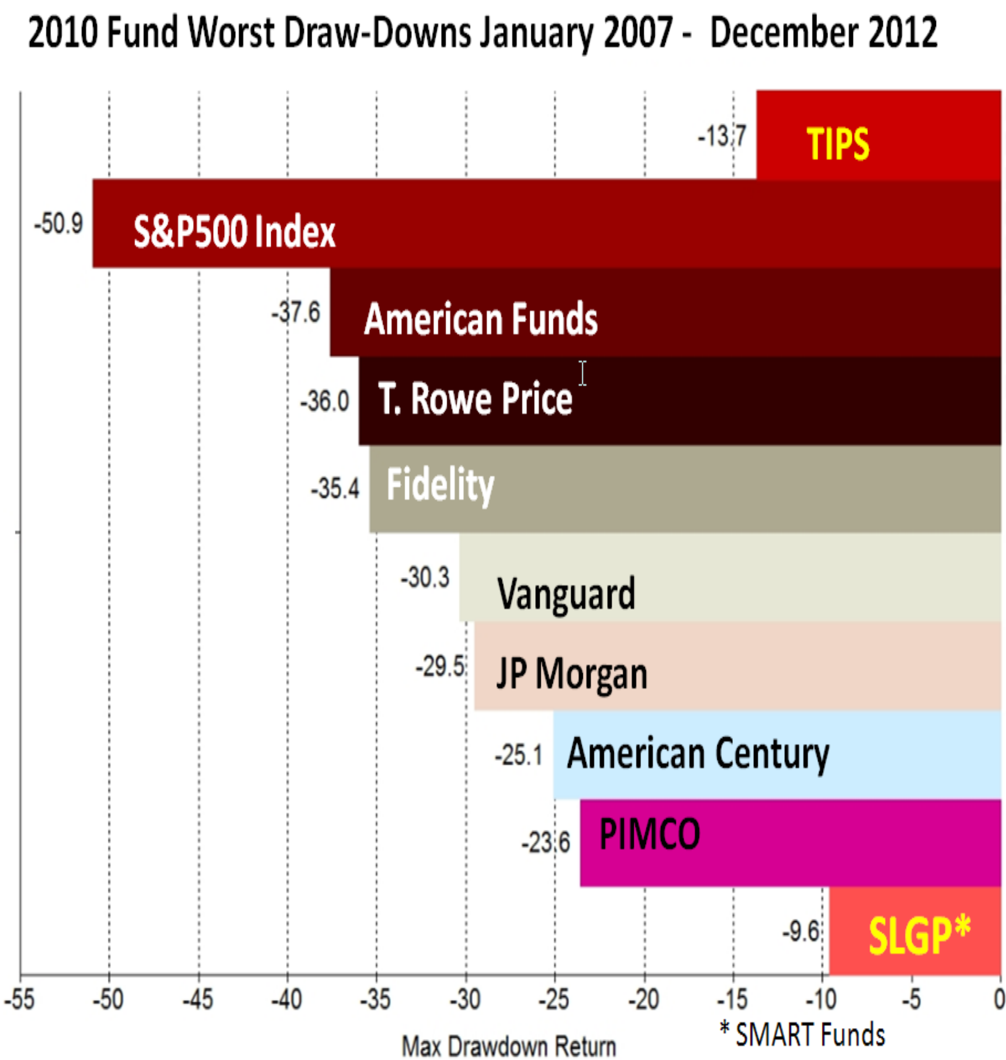
Fees Could be Reduced Below 30 basis points. Ask how.

Wells Fargo Advantage DJ Target Date Ser	0.62
TIAA-CREF Lifecycle Series	0.69
NestEgg Dow Jones Series	0.69
Fidelity Freedom Series	0.71
Schwab Target Series	0.72
T. Rowe Price Retirement Series	0.79
Columbia Retirement Portfolios	0.85
JPMorgan SmartRetirement Series	0.85

SMART Funds are collective investment funds on Hand Benefit & Trust. They started following the Safe Landing Glide Path in 2008.

Safe: SLGP Risk Control





You Cannot be Too Safe at the Target Date

- There is no fiduciary upside to taking risk at the target date. Only downside. Class action lawsuits are expected when the next 2008 occurs. “No misery” is far better than “misery loves company.”

- There is a “risk zone” spanning the 5 years preceding and following retirement during which lifestyles are at stake. Account balances are at their highest and a participant’s ability to work longer &/or save more is very limited. You only get to do this once; no do-overs.

- Most participants withdraw their accounts at the target date, so “target death” (i.e. “Through”) funds are absurd, and built for profit.

- Save and protect. The best individual course of action is to save enough and avoid capital losses. Employers should educate employees about the importance of saving, and they should report to employees on saving adequacy.

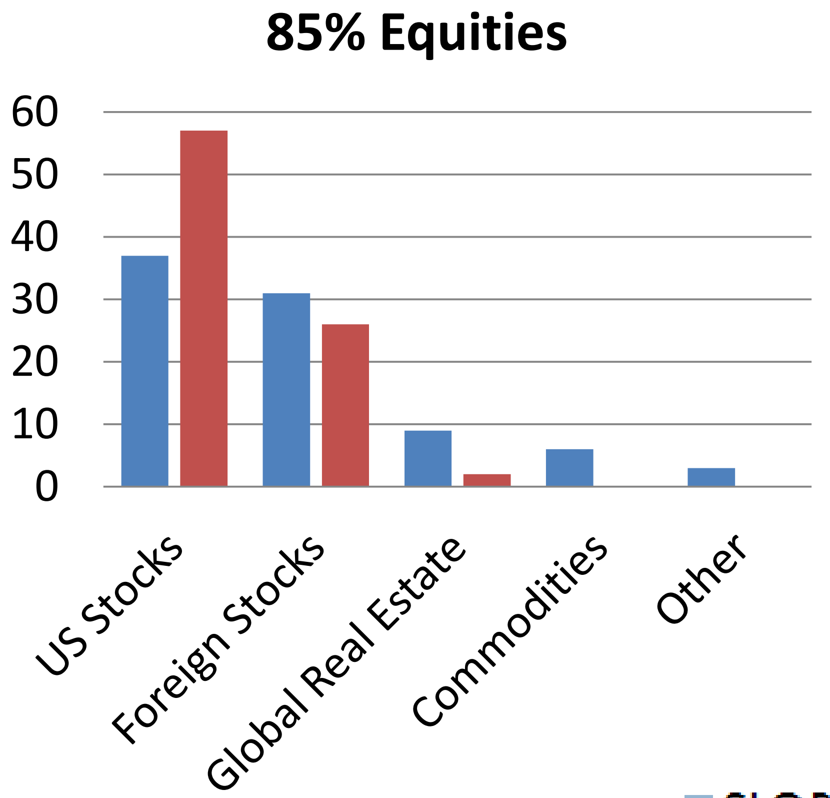
- Prior to the Pension Protection Act of 2006, default investments were cash and stable value, which was too safe for young participants, but about right for old participants. Has the Act changed the risk appetite of those nearing retirement? Surveys say no.

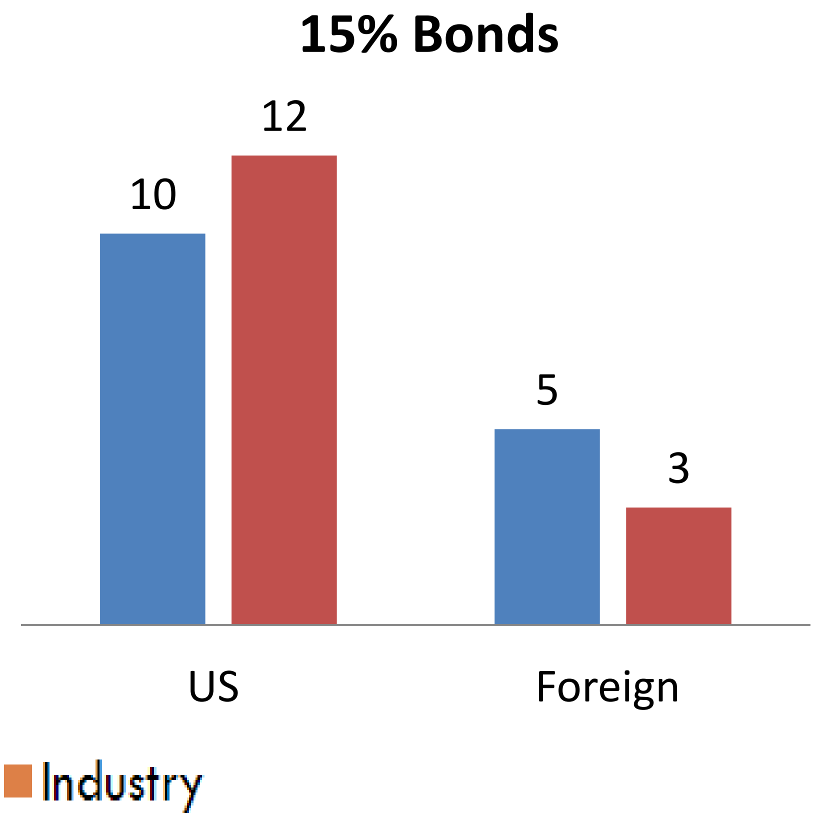
- The only relevant demographic is the financial unsophistication of defaulted participants.

Diversified  SLGP at Long Dates

18% Less in US stocks.

20% More in Diversifying Alternatives. **More Foreign Bonds.**





Add Sound Design to the Selection Criteria

Diversification

Risk Control

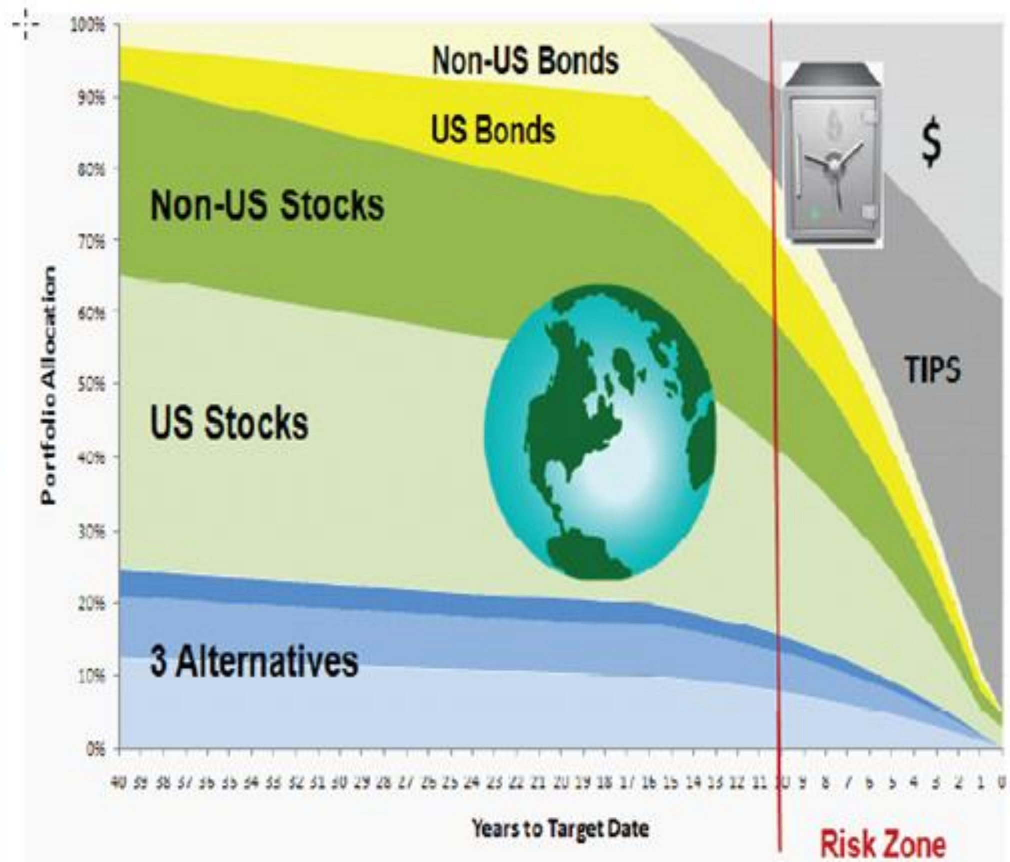
Low Fees

\+ Sound Design

= Patented Safe Landing Glide Path®

Financial Engineering

Global Multi-asset Allocations



Sound Design

[Patent 8352349]

Numbers indicated on the Capital Market Line are approximate ages. Allocations are established as a 2-asset combination: Reserve-Risky. We estimate the worst-case loss on the Risky Asset from the indicated age to the target date, and allocate to Reserves to compensate for that loss. If worst-case Risky loss occurs, the fairly safe return on Reserves should compensate.

Add Performance, but note that the history of TDFs is short -- only 5 years

SLGP is SMART Fund performance. **Industry** is represented by the S&P Target Date Index

A Few Concluding Remarks

Agenda

- Growth: $1 Trillion, moving to $4 Trillion in 7 years
- Scandal: Designed for profit. Fiduciaries breaching duty, believing in unsafe harbors.
- Solution: Universal objectives. Each dollar should be at least $1 dollar at the target date (floor), plus earn all you can (target).

This says it all

THE TARGET-DATE Conundrum

How much custom is enough? *aiCIO reports.*

September, 2012

It was ever thus in asset management: If you want to understand the future, look less at what plan sponsors are interested in buying and look more at what asset managers are interested in selling.


Credit Crisis
CIO
Common Joe
Inflation