What's in a Name?

By Ron Surz

The Pension Protection Act of 2006 established Qualified Default Investment Alternatives (QDIAs) as safe harbors for investing non-allocated defined-contribution assets. The Department of Labor's guidelines for QDIAs advance three investment options: target date funds, balanced funds, and managed accounts.

"Managed accounts" in this context means that a service provider tailors diversified portfolios of the plan's investment options on behalf of individual participants. Managed accounts hold the most promise for advisors, but they require adherence to an audited prudent investment process—a process that could take years to achieve scale.

Target date funds (TDFs) are a set-it-and-forget-it one-size-fits-all approach; they begin aggressively, when the target date is distant, and then reduce risk through time. TDFs are the most popular choice of QDIAs now. Currently, more than 40 investment companies provide TDFs, with total assets in excess of $300 billion. A 2009 study by Casey Quirk and Associates predicts that TDF assets will grow to $2.6 trillion by 2018, when they will represent about half of all defined-contribution plan assets. This is a growth of approximately 30 percent per year.

Advisors have been called upon to select TDFs, so a solid understanding is important. TDFs are a reasonably good idea, but many of them have been executed poorly because they have been designed to serve beneficiaries beyond the target date—that is, to death. Such funds have come to be known as "Through" funds, as contrasted to "To" funds, which are designed to end at the target date. A secondary issue with "To" funds is the amount of equities held at the target date; I believe zero is the correct answer, for reasons described below.

Advisors might not be surprised to learn that 2008 was disastrous for TDFs. The typical 2010-target fund lost 25 percent of its value because it held, on average, 45 percent in equities. Keep in mind that a 2010-target fund is intended for people retiring between 2005 and 2015.

We should have learned a lesson from that dismal performance in 2008, but little changed—until two months ago. On June 16, 2010, the SEC unanimously approved a proposal to incorporate ending asset allocation into the names of target date funds. For example, a 2020 fund might be rebranded as 2020 / 50% Stocks – 20% Bonds – 30% Cash. I applaud the SEC for trying to sensitize fiduciaries to the wide disparity in equity allocations at the target date. The comment period for the SEC proposal ends on Aug. 23, after which the SEC will issue a final statement.

Individuals face a "risk zone" in investing for retirement. It's the five to 10 years leading up to and immediately following retirement. This is the period when savings are at their highest level and the employee's only response to loss is a reduced standard of living, since going back to work is generally not an option. TDF providers disagree on what to do in the risk zone, and they have equity exposures that range from 30 percent to 70 percent. Even the low end of this range is too high for the risk zone, in my opinion.

The selection of a target date fund is a risk decision that matters most when one is at or near retirement. The selection is made by plan fiduciaries—sponsors and their advisors. Participants do not choose target date funds; even those who elect a TDF are limited to the TDF family approved by the plan's fiduciaries.

Fiduciaries should be held accountable for defaulting participants into anything other than safe assets as they near retirement, since this is the most critical time for locking in lifestyles. There's a lot of fiduciary downside (and no upside) to having 30 percent or 70 percent of retirement assets in equities at the target date, especially since most people withdraw their accounts from QDIAs at retirement. Fiduciaries need to choose between 1) setting their clients on a glide path that lands safely, or 2) accepting the current industry practice of exposing people to substantial, unnecessary risk.

Before TDFs became a QDIA, the most popular default in a qualified plan was a stable-value fund. Now the pendulum has swung too far for those nearing retirement. And yet, TDFs haven't adapted; there is currently only one TDF family that ends entirely in safe assets.

My comments are directed more to fiduciaries of qualified plans than to those serving individual investors. Individual investors have the luxury of tailored solutions, whereas target date funds are a one-size-fits-all approach. That said, individual investors could find TDFs useful for allocating assets to specific future events, like college funding. The funds should end at the target date in entirely safe assets, because that is their purpose—to deliver appreciated accumulated investments safely to the target date.

The Hippocratic Oath of target date investing should be "First, lose no money." The SEC proposal has the potential to enforce this oath. NA

Ron Surz is president of Target Date Solutions. He can be contacted at ron@TargetDateSolutions.com.