Chapter 5

Establishing Criteria

As discussed in Chapter 3 on Demographics, the primary fiduciary objective for TDFs should be protection, because the risk tolerance demographic of defaulted participants is very low. Participants in TDFs think they are safe. Don't lose participant savings. The secondary objective is to earn as much as possible, without losing participant savings. In this chapter we establish criteria for achieving these objectives and, therefore, for choosing a specific TDF.

The benefits of target date funds are diversification and risk control (professional management), preferably at a reasonable cost, all of which a participant is unlikely to achieve on his or her own. The ideal TDF provides maximum diversification, especially at the longer dates when there is more risk. As the target date nears, rigorous risk controls guard against losses. These benefits should be provided at the lowest cost possible and should employ a glide path design that is comprehensive and reliable. Let's examine each of these criteria individually.

Diversification

The world market portfolio is the ultimate in risky asset diversification, encompassing the following:

- Global stocks
- Global bonds
- Global real estate
- Global commodities
- Global natural resources
- Other diversifying assets

This portfolio should be used for younger participants, at longer dates. Then as the target date nears, the brakes need to be applied using rigorous risk controls.

Risk Control

Safety at the target date is paramount. There are compelling reasons for no risk at the target date. By "zero risk" we mean no stocks and no bonds, just short term TIPS and T-bills.

Incontrovertible Imperatives for Zero Risk at the Target Date

1. There is no fiduciary upside to taking risk at the target date. Only downside. The next 2008 will bring class action lawsuits.

2. 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 and/or save more is limited. You only get to do this once; no do-overs.

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

4. 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 report on saving adequacy.

5. Prior to the Pension Protection Act of 2006, default investments were cash. Has the Act changed the risk appetite of those nearing retirement? Surveys say no.

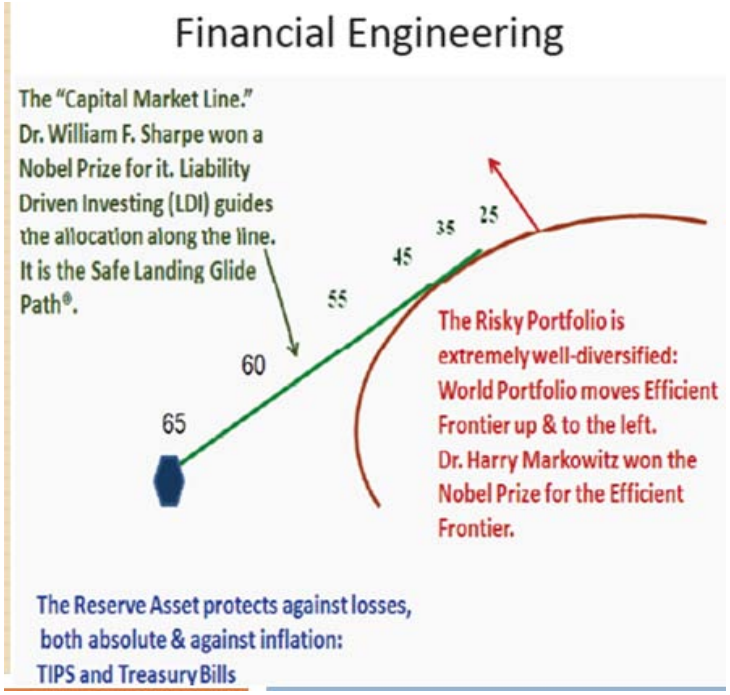
6. Ignoring the past (especially 2008) and hoping it's different the next time is not an option, and it's certainly not an enlightened view of risk management.

Fees

TDF fees currently average around 100 basis points (one percent). The ideal TDF should be provided for less than 50 basis points. This low fee is not hypothetical. It is well within the realm of possibility.

Sound Design

The patented Safe Landing Glide Path® (SLGP) sets a standard for TDF design. The SLGP integrates the tenets of Modern Portfolio Theory with the disciplines of risk management and liability-driven investing. When the target date is distant, a world portfolio (the 'Risky Asset") is used to optimize return per unit of risk, encompassing a globally defined mix of the major asset classes, including stocks, bonds, real estate and commodities. As the target date nears, account balances are increasingly placed in a safe "Reserve Asset" that is comprised of short term, inflation-indexed Treasury securities (TIPS) and 90-day Treasury bills. The SLGP estimates the worst-case loss on the Risky Asset from today's date to the target date, and allocates to Reserves to compensate for that loss. If a worst-case loss of Risky assets actually occurs, the fairly safe return on Reserves should make up for that loss. As a result, the SLGP is almost entirely in Reserves at the target date, an essential feature that is ignored in most target date funds. Put another way, substantial losses on Risky assets can happen very quickly, so those nearing retirement are in jeopardy unless they hold very little in Risky assets. Stuff happens.



Legal Guidance

As pointed out above, the most obvious problem with most TDF providers is that their fees are too high. 1 percent should not be an acceptable fee for a relatively passive investment option. So, let's focus on fees as an example of plan sponsor lack of

awareness and exposure to litigation. The next round of lawsuits could very well involve TDF selection.

Excessive fees are on the DOL hit parade, yet many plan sponsors simply aren't aware. It is a fundamental education problem. We already pointed out that too many plan sponsors are not even aware of their fiduciary responsibility, so they stumble along being willing prey for every advertisement, every sales pitch. The small plans are not even candidates for professional investment consulting advice. There's no money in it for the consultant.

In the past, ground-breaking ERISA lawsuits made headlines read by pension plans, unions and institutions. To date (March, 2014) there have been some really ground-breaking lawsuits on the fee issue, but the "little guy" plan doesn't know about them, and doesn't know its legal liability exposure.

Our real challenge as "educators" is to get this information out to everyone. Financial advisors should give back some of their time *pro bono* to help educate those who need it most. I'm betting that's unlikely.

Let's look at 408(b)(2) required fee disclosures and a couple of fee cases:

408 (b)(2) is a new rule that impacts 401(k) accounts in terms of the disclosure that must be provided to investors. Managers must disclose direct and indirect compensation, including soft dollars. Also sponsors must provide sufficient information to participants: returns, benchmarks, strategies and risks, and portfolio turnover. The penalty is breach of fiduciary duty, and personal liability. The issue is compensation "broadly construed". Advice: Err on the side of caution: is it compensation? If you don't know, better disclose it.

Tibbie v. Edison

Court ruled that the investment committee violated ERISA's duty of Prudence by "not properly investigating the differences between selecting Retail & Institutional share classes. "

Tussey v. ABE Inc.

"...the Court finds that the Plan overpaid for Fidelity Trusts record-keeping and administrative services ... Accordingly, the Court finds that the Plan suffered losses of $13.4 million as a result of ABE's failure to monitor record-keeping costs [...] All ABE defendants are held jointly and severally liable for this amount."

A court held that a fiduciary had an affirmative duty to inform participants about circumstances that could jeopardize benefits.

There are hundreds of cases against plan sponsors for allowing excessive fees, not monitoring performance, using proprietary funds from a fund company, etc.

No case is too small. Fiduciary duties are the same whether the plan has $275,000 or $8.5 billion.

Ethical Perspective

A prudent course of action, just like an ethical decision, is sometimes difficult to determine. Many philosophers have applied the *veil of ignorance* to these situations. Here's how it works. Imagine your intellect separate from all of your personal characteristics – your gender, age, religion, socio-economic status, whether you are a plan sponsor or a plan participant, etc. As such your intellect would have no bias or prejudice.

Now imagine your intellect buying a widget. What criteria would a reasonable person consider in buying a widget – obviously one key consideration is price. What if there were two identical widgets; identical in every characteristic except for price. Can you imagine a situation where it would be rational to pay more for a widget when you could pay less for the exact same widget? Unless someone can come up with a rationale where it made sense to pay more instead of less, then buying the more expensive widget is imprudent.