Chapter 7

Benchmarks

Fiduciaries are obligated to monitor and evaluate the performance of their TDFs, but relative to what? Much debate and controversy surround the benchmarking of target date funds (TDFs). The challenge revolves around the fact that the asset allocation and, therefore, risk of TDFs changes through time. But, if fiduciaries will take a step back to look at the big picture, they will recognize only two choices: Procedural Prudence or Substantive Prudence. The fiduciary can use a benchmark that captures common practice, which is a Procedural Prudence benchmark. Procedural Prudence is satisfied when a fiduciary acts as others in a similar capacity act, following commonly accepted processes: follow the herd. The S&P and Morningstar Target Date Indexes are good benchmarks for Procedural Prudence because they are composites of all TDF mutual funds – they are consensus indexes. By contrast, a benchmark of Substantive Prudence reflects best practices, doing what is right for the beneficiaries, regardless of common practices. This may sound like a high and mighty benchmark, but it's not. Its derivation ties directly to something quite simple: what are the appropriate objectives for a TDF.

Common practice objectives for TDFs are to replace pay and manage longevity risk. These are not objectives at all – they are mere hopes, and, even worse, they are hypes. An objective without a reasonable course of action is a hope. One-size-fits-all-set-it-and-forget-it TDFs cannot achieve these objectives. Saving enough is the right course of action for these common practice objectives.

The Substantive Prudence Benchmark

By contrast, reasonable objectives that represent best practices are capital preservation (don't lose money) and earn as much as you can without losing money. These Substantive Prudence objectives can be met by following the patented Safe Landing Glide Path® described in Chapter 5. This glide path is the other choice for benchmarking TDFs. It is provided by the BrightScope On Target Indexes® (OTI).

Legal Guidance

Procedural prudence benchmarks fail in the courts. Herd mentality is inadequate (The Lemming analogy). The better choice is substantive prudence because it is in line with the core principles of ERISA which direct that all activity must be conducted in the best

interests of participants and beneficiaries. Mechanically, the only “safe” prudent process would be to attach individual benchmarks to each participant, taking into account all the relevant facts and circumstances of each individual’s financial and personal circumstances. Of course, this is not practical in big plans.

The 1974 Conference Report on ERISA lists three ways a fiduciary can satisfy his responsibilities when investment management is allocated or delegated: a formal periodic review, day-to-day contact and evaluation or "other appropriate ways." While ERISA clearly requires a monitor and evaluation procedure, the method is not spelled out. It remains a case-by-case situation.

It is now established ERISA law that fiduciaries are required to perform regular performance reporting, monitoring and evaluating of plan assets. Cases that impose this strict standard include:

- Whitfield v. Cohen (11 EBC 1739) Trustee liable because he did not monitor the progress of investment manager.
- Martin v. Tower A detailed evaluation process as an integral part of the holding.
- Jones v. O'Higgins (11 EBC 1660) Performance monitoring a fiduciary duty.
- Dardaganis v. Grace Capital [11 EBC 2081 (CA 2d 1989)] Performance monitoring a fiduciary duty.

The law is clear, but the process to satisfy it is not. No advice here, other than establish a monitoring (see Benchmarking above) process and make it defensible. We’re open to suggestions.

Ethical Perspective

The distinction between substantive prudence and procedural prudence is similar to the distinction between the principle-based ethical theories and rule-based ethical theories.

Substantive prudence is based on principles and points us toward retirement income security. Procedural prudence is based on rules and provides specific directions on how

to achieve retirement income security. We have noted the advantages and disadvantages of both the rules-based approach and the principle-based approach. However, ERISA offers no rules specific to TDF benchmarks; therefore, we necessarily must decide based on the principles.

A fiduciary must exercise loyalty, prudence and due care in choosing a TDF as well as the appropriate benchmark. In making these choices, the following three questions might be helpful:

1) Am I choosing this fund in the sole interest of my participants?

2) Have I prudently sought the best available choice for my participants?

3) Have I exercised due care by ensuring this choice will provide my participants with the greatest opportunity to achieve retirement income security?