MY WORD

Target-Date Fix

New legislation currently being proposed in Washington won't fix the problem with target-date funds. Here's what will. By Ron Surz

Target date funds (TDFs) are broken, and legislation isn't likely to fix them. It comes as no surprise, TDFs have been manufactured more for profit than for the benefit of plan participants. Closed architecture, using proprietary funds, and high equity allocations (read high fees) near the target date are the culprits—and 2008 losses are the smoking gun.

As a result, the SEC and DOL held hearings last June and are promising regulation, probably in the form of greater disclosures. More recently, Sen. Herb Kohl, D-Wis., announced intentions to introduce a measure that would make mutual fund companies fiduciaries to the pensions that invest with them. This is somewhat confusing in that mutual fund managers are already fiduciaries subject to the 1940 Investment Advisors Act, so it would seem that Sen. Kohl's intent is to put fear into the hearts of those who would profit from shoddy TDF management.

Better-educated fiduciaries will know the difference between good and bad TDFs, and what they need to do to get the better choices.

CARROTS AND STICKS

Incentives modify behavior and come in carrots and sticks. Sen. Kohl is suggesting a stick. I think a carrot will work better on fund companies, and we should use the stick on current fiduciaries, namely employers and their consultants.

The stick of fiduciary responsibility should compel fiduciaries to select and monitor the best TDFs, creating a carrot for fund companies to become the best. TDFs have been sold, not bought, primarily by plan record keepers. Fiduciaries have come to believe that any TDF will suffice, since all are qualified default investment alternatives (QDIAs). But there are huge differences among TDFs, especially near the target date.

Convenience and familiarity are foolish reasons for entrusting employee savings to the plan's record keeper. But the additional costs of going off platform can be prohibitive. To deal with these complexities fiduciaries must be better educated, and therein lies the opportunity for effective regulation.

Better-educated fiduciaries will know the difference between good and bad TDFs, and will know what they need to do to get the better choices. Smaller plans, for example, might find themselves developing "custom" glidepaths using funds on their current platform because it is the glidepath that matters most—much more than the underlying funds.

Education, coupled with a threat of adjudication (the stick), could fix TDFs. Regulators should consider issuing a checklist for fulfilling fiduciary responsibilities in the selection of TDFs, and ERISA attorneys should view this list as gospel.

THE CRITERIA FOR FUND SELECTION

At the highest level, this list should include three key decisions that all involve fiduciaries affirmed by signature:

1. Type of target-date fund: "To" or "Through."
2. Amount of equities, especially near the target date.
3. Glidepath rationale.

I think the best choice is a "To" fund that ends at the target date with no equities, and uses a financially engineered glidepath. Most TDFs, though, are "Through" funds, designed to serve beyond the target date to death. The typical TDF ends with a 35% exposure to equities, an allocation that cost 2010 fund investors an average loss of 25% in 2008. They should be relabeled "Target Death Funds." The issue is the trade-off between safety and growth. Before TDFs gained QDIA status, stable value was the preferred default. Now the pendulum has swung far in the opposite direction.

"To" funds, by contrast, are designed to end at the target date, and they should do so entirely in safe non-equities. Also, there is financial engineering that can strive to obtain two critical objectives: delivering at least total savings plus inflation at the target date, and growing assets as much as possible without jeopardizing the first objective.

Some fiduciaries will disagree with me. The important thing is to diligently document your decisions. TDFs could be fixed by heightened due diligence on the part of plan fiduciaries. This would create a carrot for fund companies to align their interests with those of the beneficiaries. FP

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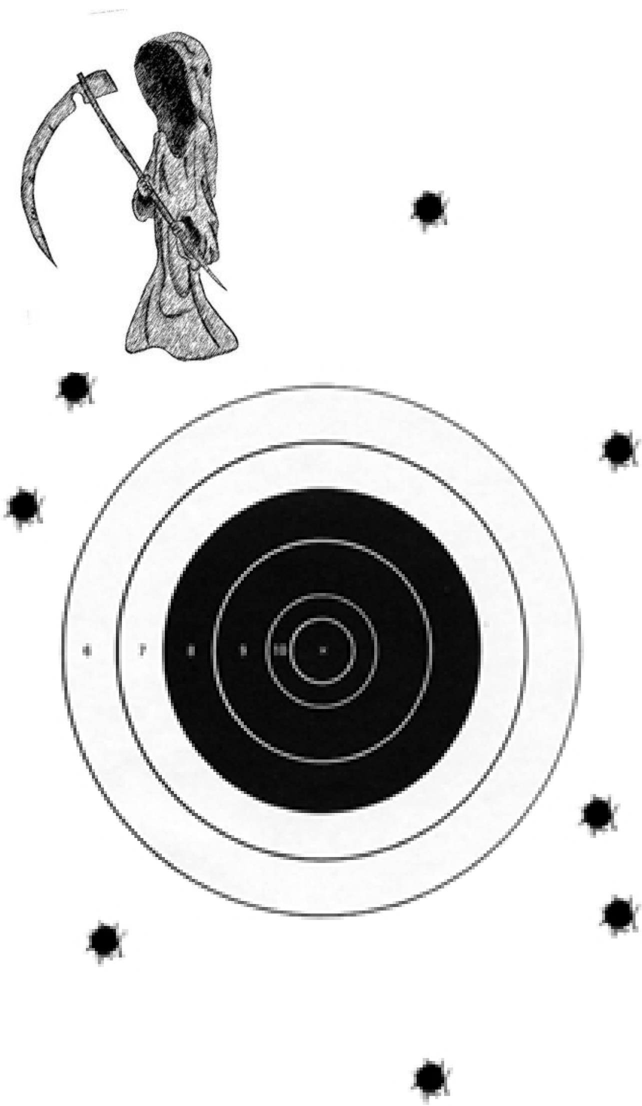
Most TDFs are "Through" Funds, and this is a big mistake

Designed to Miss Their Target Date on Purpose Because They **Target Death**



The Purpose Cannot Be Served Because:

(1)Retirees Exit the Fund at Target Date

AND

(2) Longevity risk **cannot** be managed with a Glidepath