

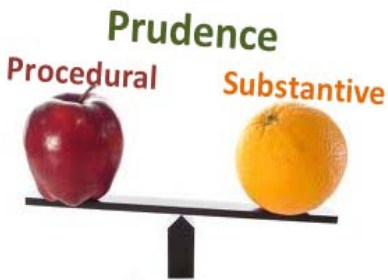


It's All About the Beneficiaries



Benchmarking Target Date Funds: 2 Simple Choices for Fiduciaries

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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, there are really 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 act in a similar capacity: follow the herd. The S&P Target Date Index is a good benchmark for Procedural Prudence because it is a composite of all TDF mutual funds – it's a consensus index. 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're mere hopes, and even worse they're 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. 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 "Safe Landing Glide Path" described here. This glide path is the other choice for benchmarking TDFs.

Contrary to popular participant belief, TDFs do not protect the vulnerable from equity loss. They sure didn't in 2008, and nothing has happened to change that. Most participants in TDFs are defaulted into this product, which means that most participants rely upon their

employers to do the right thing by protecting participant assets, especially near retirement (even though they are not). Substantive Prudence argues for protection.

Fiduciaries are duty bound to seek solutions rather than settling for high-risk products that are oblivious to history. Ignoring the past and hoping it's different the next time is not an option, and it's certainly not an enlightened view of risk management. Fiduciaries are obligated to actually vet their TDF selections and to establish objectives that are truly in the best interests of employees.

For the most part, TDFs are too risky at the target date because they aspire to serve participants beyond retirement. Even "to" funds hope to keep assets in retirement. So risk is the medicine these "doctors" serve up to folks who are expected to live long lives, and the occasional losses are the side effects that should be expected from time to time. The problems with this view are: (1) most participants withdraw their accounts at retirement, and (2) there is no one-size-fits-all-set-it-and-forget-it asset allocation that can possibly serve to manage longevity risk; insurance companies exist for just this purpose.

Fortunately, there is an alternative view that the sole mission of a TDF is to get the beneficiary safely to the target date. Attempts to do more lead to excessive risk.

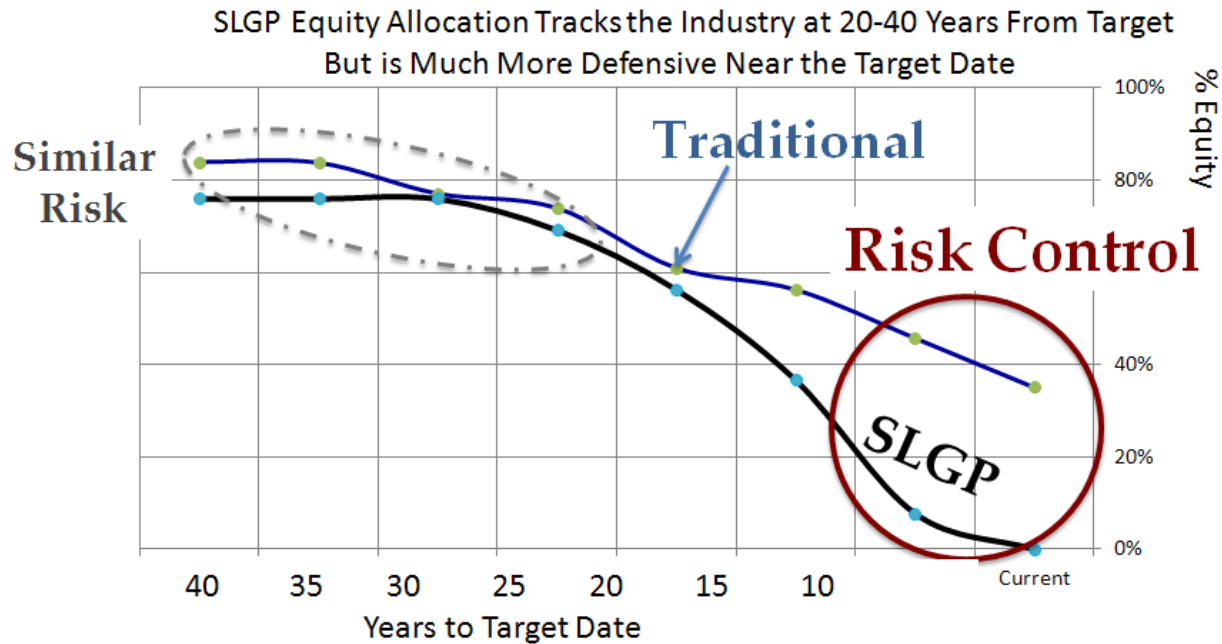
Specifically, meaningful objectives for TDFs are:

- (1) Don't lose participant savings, and
- (2) Make as much as you can but don't lose participant savings

These create real reform to protect the vulnerable.

Taking a lesson from 2008, the course of action for achieving these objectives is the patent-pending Safe Landing Glide Path® (SLGP) that integrates the tenets of Modern Portfolio Theory (MPT) with the disciplines of Liability Driven Investing (LDI). Yes, this one-size-fits-all-set-it-and-forget-it glide path is the plan for achieving these straightforward objectives. The SLGP is a concept, a blueprint, for target date funds. It's like an "ideal gas" in physics. It is not a product per se – you can't buy the SLGP target date fund. But you can design a TDF to follow the SLGP. For example, the SMART Funds® are collective investment trusts that follow the SLGP, offered by Hand Benefit & Trust, Houston.

Importantly, the emphasis is placed on safety, as it should be, so asset allocation at target date is mostly TIPS and T-bills, as shown in the following graph.



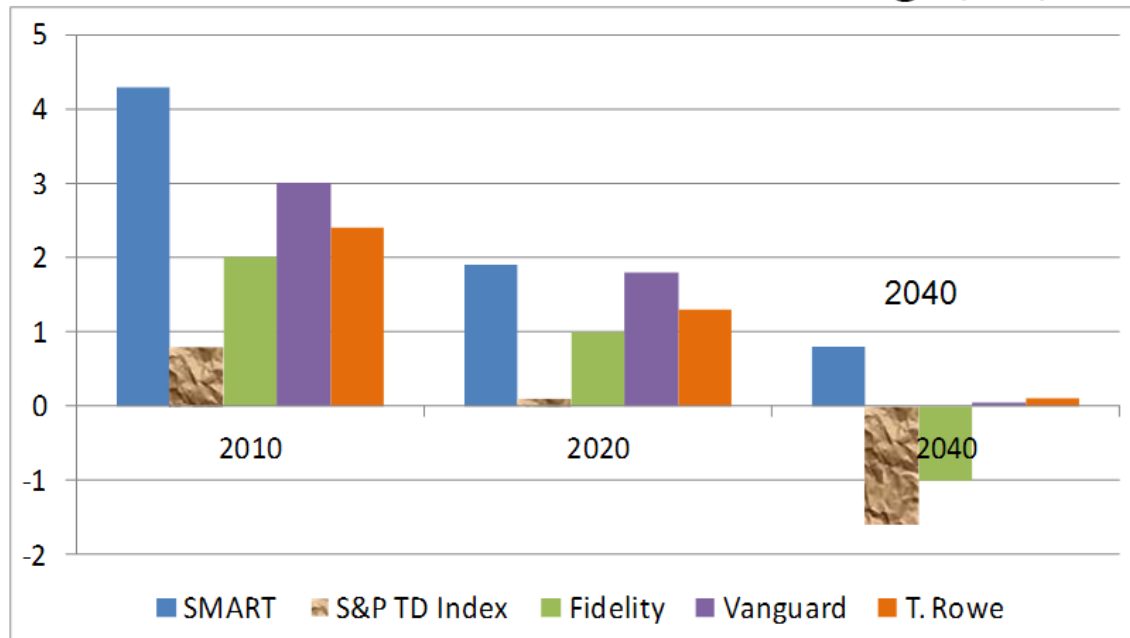
So the fiduciary choices for benchmarking TDFs are:

1. S&P Target Date Indexes representing Procedural Prudence
2. Safe Landing Glide Path representing Substantive Prudence

The two have performed quite differently over the relatively short history of TDFs, as shown in the following exhibits. We use the SMART Funds as the benchmark in the following because they are investable, a desirable characteristic of a benchmark. As you can see, SMART has outperformed S&P and it has lower risk. It is also worth noting that the Big 3 have performed in between these two benchmarks, outperforming S&P while underperforming SMART. Substantive Prudence has dominated Procedural Prudence. This outperformance is likely to continue, especially on a risk-adjusted basis. Also note that the Big 3 have higher standard deviations than both benchmarks.

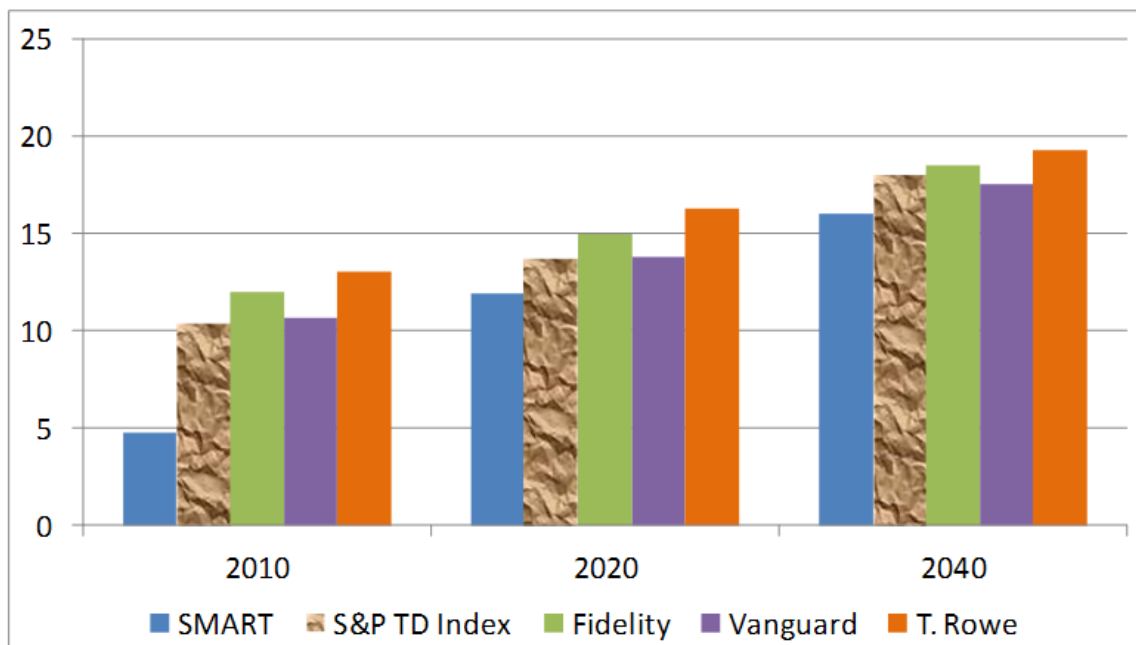
Fiduciaries choose your standard.

Annualized Returns for the 5 Years Ending 9/30/2011



SMART track record is Brightscope On-Target Index, developed by Ron Surz, for 10/2006-10/2008
 And live SMART collective investment funds for 11/2008-forward

Standard Deviation for the 5 Years Ending 9/30/2011



For a humorous look at the problems please see our short movie at [Target Date Movie](#).