Viewpoint: Target-Date Hearings—Of Skateboards and Hills

Guest Contribution

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The recent hearings on target date funds are similar to what one might expect from testimony on skateboards. Let’s say there were a lot of skateboard accidents in 2008, so regulators decided to fix the problems. The day would go something like this:

Skateboard manufacturers testify that they are merely manufacturing what they believe kids want. Specifically, they believe most kids don’t want to simply breeze down a hill. Rather they want to build sufficient momentum to reach the top of the next hill. Sure, safety is important, but this skateboard works for both the downhill and the uphill, and if the kids are expecting something different they should read the instructions. It’s not the manufacturer’s fault that there are accidents. Caveat emptor. No blame here.

Fund companies are merely providing what they believe participants want, and they are different because they compete with one another – some more aggressive and some more defensive. While there is no one right answer, all agree that investors want and need cradle-to-grave funds, not funds that end at retirement.

Participants should understand the risks they are taking. It’s not the fund company’s fault if participants don’t “get” it. Losses in 2008 are simply part of the investment game. If you can’t stand the heat get out of the kitchen. These comments ignore of course the fact that most participants in target date funds are defaulted into them, so participants have relied on their employers, and probably believe that their investments are safe. After all, the Pension Protection Act has the word “Protection” in it.

No surprise, fund companies are not seeking extra profits by keeping the investor beyond retirement, hiding fees, or using mutual funds of the fund company. These activities are all in the best interests of the participant, they say, because they are confirmed by extensive simulations.
Regulators should certainly not meddle with something so complex, say by mandating asset allocation ranges or open architecture.

Safety experts generally confirm that there are risks in the uphill battle, and that those risks are best addressed with momentum gathered during the downhill. Only one expert suggests that a different vehicle should be used for the uphill climb, like a motorized skateboard or simply walking.

Only one consultant believes that the distribution phase cannot be served by a one-size-fits-all glide path because the considerations in retirement are far too complex and individualized. For example, some retired investors may be best served by annuities and/or structured distribution programs. Importantly, there are considerable risks during the transition from accumulation to distribution because the most assets are at stake during this critical phase. The target date should not be simply a speed bump in the highway of life.

As happens far too often, consultants are disinclined to question the status quo. Some even believe that best practices that are not common practices are simply someone’s unpopular opinion.

Attorneys contribute the view that it’s the responsibility of parents to choose the right skateboard for their kids. After all, parents will pay the bills for any accidents and are much more knowledgeable. Attorneys also state that the skateboard manufacturers are not responsible for accidents.

This is a scary fact. Plan sponsors have a fiduciary responsibility to select and monitor the “right” target date funds, but they have no standards to guide their choice. They alone are responsible because mutual funds are not fiduciaries. The buck stops with plan fiduciaries. No one else wants it, and it appears they won’t have to take it.

Parents submit that they have acted like most other parents, choosing from among the top three skateboards, but they complain that since there are no standards these decisions have not been informed.

Plan sponsors should take very little comfort in choosing from among the big three, and should be finding ways to free themselves from the lock these firms have by virtue of their recordkeeping services. Such alternatives include collective funds and so-called “custom glide paths.”

Procedural prudence— hiring consultants and the like—may help, but sponsors should be prepared to stand behind their selections. Without a standard it’s awfully difficult to substantiate the wisdom of our choices. Perhaps this is a desirable situation, but it’s certainly not in the best interests of the participants. “Ignorance is bliss” does not work as a fiduciary defense.

Bottom line, no one wants to own this hot potato, but everyone is keen to profit from it. Who wouldn’t want a profit without a responsibility? There is no doubt that the only entities clearly on the hook are the plan sponsors, and it may well be that some form of additional regulation will help them avoid their mistakes by preventing the funds themselves from doing what they
legitimately believe is right. It would be much better if plan sponsors woke up to their duty and 
took the time and energy to become educated to make informed decisions. Most consultants 
don’t understand, so reliance on them is shaky at best. If plan sponsors get serious the cream will 
rise to the top, and it might not be the currently prominent players.

These hearings would have gone far better if there were accepted standards, forming a basis for 
differentiating between good and bad target date funds. More important, plan sponsors and their 
advisors should be seeking the very best standards they can find. I believe that the best standards 
are designed to achieve the best objectives. Throughout the hearing a recurring theme emerged:
Someone needs to decide how important safety is, relative to growth in assets. Growth cannot 
occur without risk.

Here are objectives for target-date funds that I consider universal, which set priorities for safety 
and growth:
1. Deliver to the participant at the target date his accumulated contributions plus inflation. This 
is the safety objective, and we want to deliver this with high likelihood.
2. Grow the assets as much as possible without jeopardizing the paramount safety objective. 
One might consider other objectives, but most would agree that these make fundamental sense, 
especially from a fiduciary perspective. Safety first.

Target Date Solutions has developed the Safe Landing Glide Path to meet these objectives, using 
the following framework:
• A two-asset structure is employed – a risky portfolio and a safe inflation-protected reserve 
portfolio. The risky portfolio is broadly diversified around the world and includes stocks, bonds, 
real estate and commodities. The safe assets are Treasury bills and Treasury Inflation Protected 
Securities (TIPS). The risky asset is for growth and the reserve asset is for protection.
• The mix between these 2 assets is governed by liability-driven investing (LDI). The liability 
in this case is the accumulated value of contributions plus inflation. This structure leads to a 
glide path that is entirely in risky assets until 20 years from the target date, and moves gradually 
at first toward the reserve asset. Then, about 5 years from the target date, the glide path moves 
very quickly into reserves and is entirely in reserves at the target date. This is the only way to 
deliver on the safety objective.

Note that this standard takes the view that the transition period between accumulation and 
distribution, namely the 5 years before and after target date, represents the most critical years in 
everyone’s investment lifetime. This is in stark contrast to current industry beliefs and practices. 
The standard gets you safely to the bottom of the hill, and recommends that the investor select 
from among other vehicles designed for the uphill climb, like annuities or guaranteed funds. No 
equities at target date.

Fund companies compared to the Safe Landing Glide Path will think twice about a 70% equity 
allocation at target. Plan sponsors will explicitly convey their desire for safety and growth, with a 
strong preference for safety. This communication from the plan sponsor community is critical.