Recommendations to the 2024 ERISA Advisory Council
Study of Qualified Default Investment Alternatives (QDIAs)
Specifically, Target Date Funds

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ERISA Advisory Council

Thank you for the opportunity to share my experience and beliefs about the most popular QDIA – target date funds (TDFs). I have patented my Safe Landing Glide Path design that has been incorporated in target date funds since 2008, coincident with the Department's QDIA regulations. The QDIA is an essential component of participant-directed 401k plans where the participant has failed to make an affirmative investment election, thereby defaulting their investment decision to their employer.

The primary challenge in creating a "good" QDIA is making investment decisions for people who do not want to engage, so we don't know what each individual wants. As account balances increase and as individuals approach retirement, their needs, goals, marital and familial status, health, longevity, and accumulated assets vary substantially, yet a QDIA can only do what is best for most because it is one-size-fits-all.

Academics have addressed this challenge in their lifetime investment theory that is the cornerstone of TDF glidepaths. This theory is very safe for those near retirement at 80% in risk-free assets. TDF providers say they follow this theory, but they don't – they're much riskier at their target date than the theory, with 90% in risky assets.

In addition to academic literature, surveys reveal what participants want in general. They want to be protected as they approach retirement, and most defaulted participants think their investments in QDIAs are endorsed by their employer and protected against losses near the target date. We all suffer from loss aversion cognitive bias where the pain of investment losses is psychologically twice as powerful as the pleasure from an equivalent dollar amount of investment gain.

Also, retirement researchers have identified Sequence of Return Risk where investment losses near retirement can ruin the rest of life. That's why the 5 years before and after retirement are called the Retirement Risk Zone. Investment losses near retirement "hurt more" than losses sustained early on in life because account balances are higher, and life horizons are shorter.

TDFs are not providing the level of protection near retirement that academics, retirement researchers and surveys all say defaulted participants want and need. The Department should address this departure of common TDF practice away from the best interests of participants. I consider the risk in most TDFs to be excessive near their target date. It has benefitted performance for the past 16 years because this has been the longest bull market on record.

But that will change. The odds and magnitude of the next stock market crash increase with every market advance. And this time most of our 78 million baby boomers are in the Retirement Risk Zone. Recall that the crash of 2008 prompted the joint SEC-DOL hearing on TDFs in June 2009. In many cases, TDF risk actually increased after this hearing, primarily because risk has won the performance horserace so far.

Before the Pension Protection Act (PPA) of 2006, the common practice was to invest assets of all defaulted participants (regardless of age) very conservatively, in Stable Value and Treasury Bills, but the Act changed that. Instead, the most popular QDIA – TDFs – are risky for all ages with 90% in risky assets throughout their glidepaths, where I consider equities and long term bonds to be risky.

With the passage of the PPA and the resulting popularity of TDFs, the pendulum has swung too far to high risk for those near their target date, which is intended to be a retirement date.

Managed Accounts (MAs) are the second most popular QDIA. These are TDFs masquerading as "managed." In order to truly manage an account, you need to know your investor, but defaulted participants do not want to be known – they do not want to engage. Since MAs don't know what the investor wants, they rely on the glidepath structure in TDFs. MAs can work well for non-defaulted participants, but these are not QDIAs. People who engage with an MA, especially one-on-one consultation, have not defaulted their investment decision.

Blending MAs with TDFs has merit. Personalized Target Date Accounts (PTDAs) give non-defaulted participants – who want to engage -- the ability to manage their own unique glidepaths, and they provide fiduciaries with much more flexibility in structuring their unique QDIA. DOL Tips on TDFs recommend choosing a TDF that serves the demographics of the plan population; this is a hard order if you're limited to off-the-shelf products.

PTDAs offer risk and target date choices that can change over time. Current TDFs are High risk. PTDAs provide several glidepaths with varying risk levels. A Low risk glidepath can be blended with High as appropriate; for example, 33% High risk and 67% Low risk. Also, the target date is the actual date that employment is expected to end, rather than a 10-year cohort.

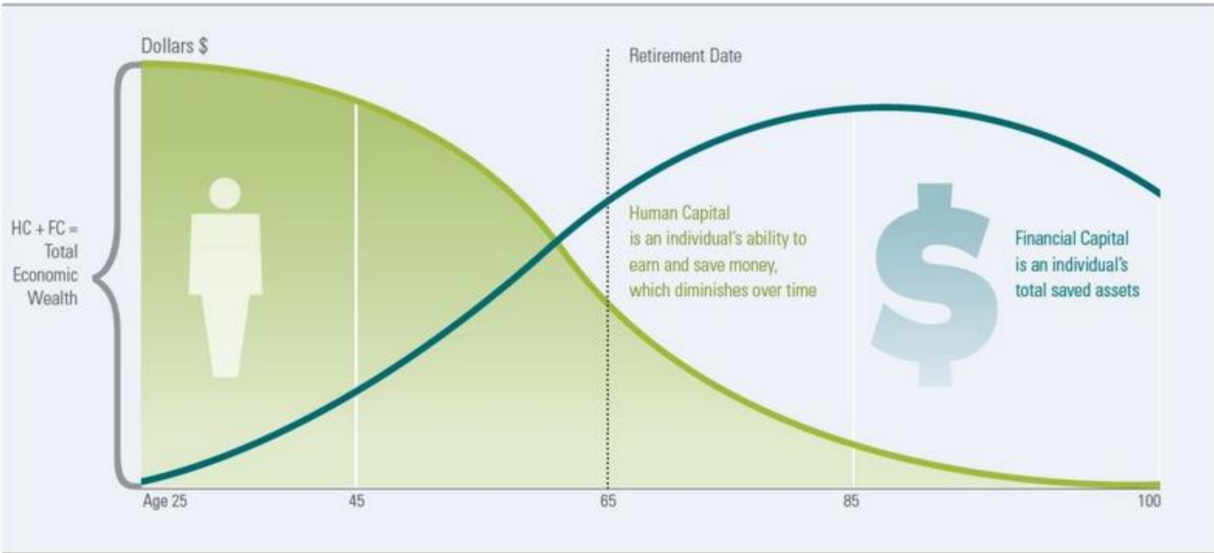
In the following, I recommend (1) a revolutionary U-shaped glidepath that is very safe at the target date and then re-risks in retirement, (2) two risk-customized benchmarks for evaluating the performance of TDFs based on the fiduciary's risk choice, and (3) personalization that might be supported by artificial intelligence.

Recommendations

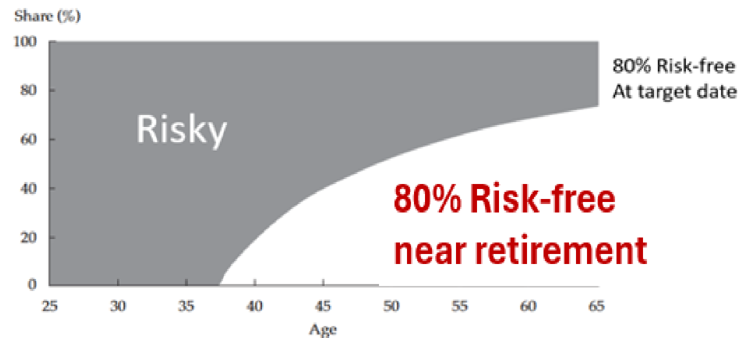
Very Safe Near Retirement (near the target date)

TDF glidepaths are the same for young people; they are aggressive and growth oriented. There is disagreement near retirement. What is the "right" level of risk for those near retirement? Academics have extensively studied this question, and their answer is "Very Safe."

TDF providers say they follow academic theory that integrates human and financial capital , but they don't. Regardless of using a "to" or "through" glidepath, TDFs are invested 90% in risky assets at the target date (55% equities plus 35% risky long-term bonds)[i], while academics recommend 80% in risk-free assets[ii]. The Federal Thrift Savings Plan (TSP) – the largest savings plan in the world – does follow academic theory in its TDF L Funds that are invested 70% in the government guaranteed G Fund at retirement.



TDF companies say they use this theory, but they don't follow the guidance in the academic literature, because it clearly recommends high safety, as shown on the right.



Although fund companies don't admit that they're not following the theory, they acknowledge that they are not protecting against Sequence of Return Risk -- taking substantial risk near the target date -- and justify it by pointing out that most participants are not saving enough so they need to earn more by taking more investment risk. There's also the fact that they get paid more for taking more risk.

Common TDF practice ignores both academic theory and Sequence of Return Risk. It is very risky near retirement. Academic theory also addresses the decumulation glidepath, as discussed in the next section. My glidepath is the only path that follows this guidance, although the press reports that some fund companies have considered it[iii].

Most plan sponsors only offer a single series of TDFs. So, most TDFs serve a dual purpose of:

- Acting as a QDIA for those who fail to make an investment election, and
- Serving as a specific choice for those who make affirmative investment elections.

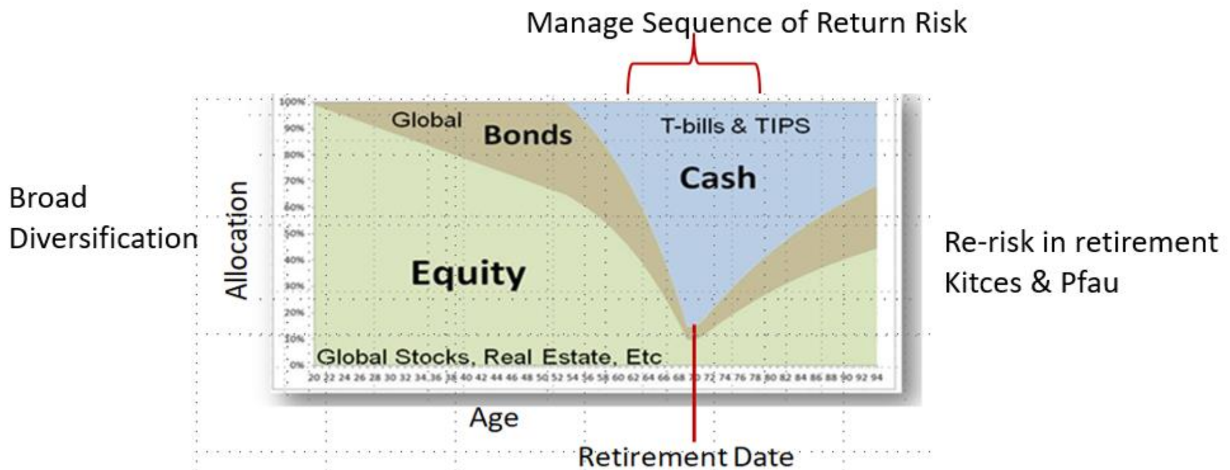
Where individuals select a TDF, they need not select the series that would be the default (closest to age 65), and they need not apply the TDF to all assets (potentially introducing investment conflicts, often called "mixed-use"). See the discussion below on "Pesonalization."

Decumulation: Re-risk in Retirement

Early on I got push-back for advocating safety near retirement because retirees can't live on low risk assets that pay nothing. Academics have addressed optimal post-retirement glidepaths and recommend a glidepath that starts very conservatively and re-risks in retirement[iv]. This dovetails very well with research that recommends high safety at payout commencement. For many, the end of working life is the beginning of retired life. For others, payout commencement is timed to occur with a significant change – perhaps the end of "career" employment.

The end of working life is the beginning of retirement life.

The optimal lifetime glidepath is U-shaped, so it is both "To" (lowest equity allocation at the target date) and "Through" (serving entire lifetime). While the TSP follows academic theory up to the target date, it is a "To" fund with low risk in retirement. TSP should consider re-risking in retirement.



Annuities might also play a role in decumulation, sort of converting a DC plan to a DB type plan with a known guaranteed payout. This option has not played out in TDFs because most participants want to take out their savings when they leave. Annuities could be offered as an option to lump sum, but then employers need to be protected from choosing a "bad" annuity.

Such a decision could be a participant election as part of a hybrid QDIA – a combination of target date investments and managed accounts. And, similar to TSP, such a decision to annuitize would require an affirmative election by the participant.

Note that the typical TDF can't re-risk because it enters retirement at high risk.

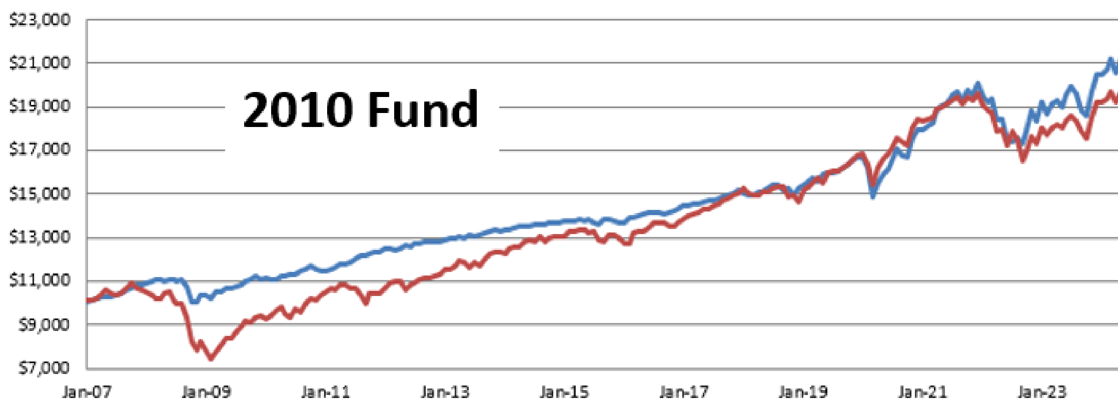
Evaluating TDF performance

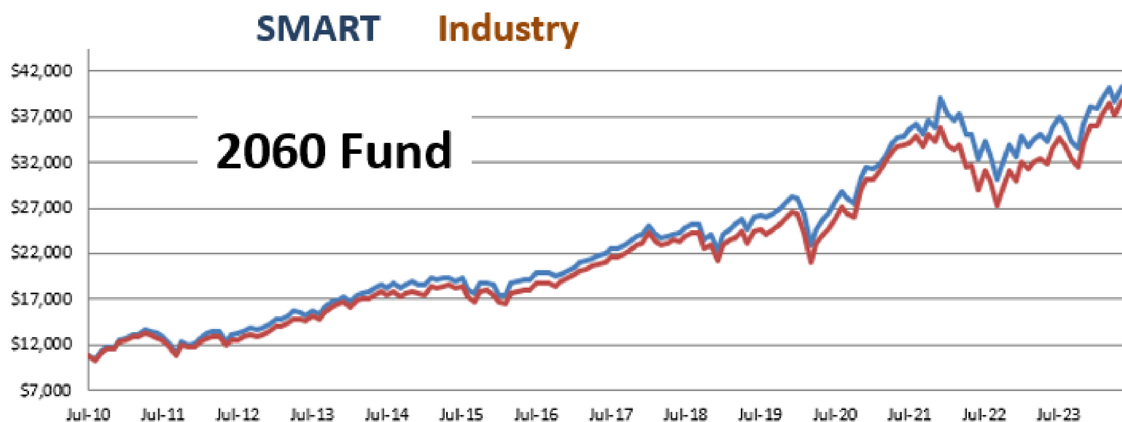
The Department should incorporate a low-risk benchmark and a risk metric in QDIA guidance, like the SMART TDF Index[v] that is available on Morningstar Direct and Target Date Solutions.

Vanguard has become the *de facto* TDF benchmark, but this is a high risk standard. Lawsuits have been brought against safer TDFs for underperformance because high risk has won the performance game over the past 15 years[vi]. These lawsuits are just plain wrong because the benchmark is wrong. Fortunately, these lawsuits have failed.

The current Vanguard benchmark could continue to be used for high risk TDFs, which is the majority. It is shown as the "Industry" in the following. "SMART" is the low risk alternative.

Growth of $10,000 from 1/2007-6/2024





Personalization

A disappointing 2022 generated interest in managed accounts that purport to protect, but this is hype. The big challenge is making decisions for those who do not want to engage. Saying you “manage” does not make it so.

TDFs are currently evolving toward personalized target date accounts (PTDAs)[vii] that combine TDFs with MAs. PTDAs are straightforward for self-directed participants because they want to engage. Self-directed participants choose their risk and retirement date, and they can change their decisions at any time. They manage their own unique glidepath. A third of the $4.5 trillion in TDFs is from self-directed participants

Some PTDA providers try to use recordkeeper data for defaulted participants, but the median tenure of participants is less than 5 years, and even less for those most likely to

be defaulted into participation – workers under age 35. Artificial intelligence (AI) might ultimately solve this problem by acquiring participant wealth information, but in the meantime it's best that the plan investment fiduciary selects the QDIA and applies it in accordance with Department guidance.

One advantage of PTDAs is that they can accommodate any one of several glidepaths. Importantly, the target date can be personalized, and even if age 65 is selected, it would be the month and year the individual reaches age 65 - rather than a 5-year or 10-year cohort.

The Department should acknowledge that QDIAs could incorporate features that are part of target date investments and managed accounts.

Conclusion

Despite a mostly "status-quo" strategy across the TDF industry, and a product that lacks significant innovation, assets under management have grown substantially as a result of the Department's "endorsement" in the QDIA regulations. The TDF industry has not evolved in the past 16 years, largely because it is an oligopoly[viii] dominated by just a few firms. Oligopolies are never good for innovation.

The Government Accountability Office (GAO) report on target date funds[ix] highlights significant challenges and issues but fails to make substantial recommendations that would increase transparency and reduce risk.

TDF participants need better protection, especially our 78 million baby boomers. A stock market crash will happen. A crash in this decade will be in the Risk Zone for most baby boomers. Another crash like 2008 would decimate baby boomers[x] in TDFs.

[i] R. Surz. Most TDFs are about 90% risky at all dates. Target Date Funds Do NOT Reduce Risk Through Time, Except a Few TDFs. 7/10/23 https://401kspecialistmag.com/target-date-funds-do-not-reduce-risk-through-time-except-a-few-tdfs/

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Also see T. Idzorek and P. Kaplan, Lifetime Financial Advice 2/15/24 https://rpc.cfainstitute.org/en/research/foundation/2024/lifetime-financial-advice-a-personalized-optimal-multilevel-approach

[iii] G. Iacurci. Investment News, 6/17/19 Target-date fund design may be wrong for retirees https://www.investmentnews.com/retirement-planning/target-date-fund-design-may-be-wrong-for-retirees/80007

[iviv] M. Kitces and W. Pfau Reducing Retirement Risk with a Rising Equity Glide Path, 1/2014 https://www.financialplanningassociation.org/article/journal/JAN14-reducing-retirement-risk-rising-equity-glide-path

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[vi] R. Surz. Why the Best Performing Target Date Funds are the Riskiest 6/2/21 https://401kspecialistmag.com/why-the-best-performing-401k-target-date-funds-are-riskiest/

[vii] R. Surz. Managed Accounts Can't Work for Defaulted 401(k) Participants, 10/2/23 https://401kspecialistmag.com/managed-accounts-cant-work-for-defaulted-401k-participants/

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[x] R. Surz Why a Crash Like 2008 Would Decimate Boomers in TDFs, 9/18/23 https://401kspecialistmag.com/why-a-crash-like-2008-would-decimate-boomers-in-tdfs/