Does Your Approach to Monitoring and Communicating Your Target-Date Funds Need Rethinking?

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Author
Richard D. Glass, PhD, CEBS
Investment Horizons, Inc.
412-261-5510
rglass@investmenthorizons.com
www.investmenthorizons.com

January 2014

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> *"The problem with government is that we tend to be more reactive than visionary, and Congress is 18 times more like that than anybody."*
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> — Phyllis Borzi, Assistant Secretary for EBSA at DOL, in "A Long History of Reaction", *Pensions & Investments*, October 14, 2013, p. 22.

> "*Investors who are prepared to save aggressively, spend cautiously, and work a few years longer (because we're living longer), will be fine. Those who do not follow this course are likely to suffer perhaps grievous disappointment.*"
>
> — Rob Arnott, *The Glide Path Illusion*, Research Affiliates, September 2012, p. 5.

> *"The truth is that most of us decide what lies we want to believe."*
>
> — Noah benShea

The Pension Protection Act of 2006 sanctioned the use of target-date funds (TDFs) to help the average, financially and mathematically unsophisticated 401(k) participant achieve a lifelong, comfortable retirement. Congress, and presumably the DOL, believed that professional investment management, incorporating generally accepted investment principles and modern portfolio theory (MPT), could deliver the sought-after results.

Although the use of TDFs has been blessed, the regulations require 401(k) fiduciaries to prudently select and then monitor the ones they choose. What should go into the selection and monitoring processes, however, is not spelled out in detail.

Congress's assumption that "generally accepted investment principles" and MPT were indeed widely accepted and understood, along with the DOL's ambiguity surrounding the selection and monitoring of TDFs, have unfortunately made it easy for 401(k) fiduciaries and their advisors to conclude that the fiduciary duties of prudence and disclosure do not include:

- monitoring whether or not their selection of TDFs is actually helping participants to achieve a financially secure retirement;
- delving into the "nuts and bolts" of TDF glide path construction;
- providing the participants with the assumptions underlying the TDF's glide path even though without this information, they can't calculate what their contribution rates should be.

The balance of this paper will discuss these issues and provide suggestions for addressing them. After all, unless these misconceptions are addressed, two unintended and definitely unwanted consequences will result:

- The fiduciaries will be setting their participants up for what will likely be a dire lack of retirement security.

- The fiduciaries will become low-hanging fruit for time consuming and expensive litigation by class-action lawyers on behalf of financially strapped retirees and current 401(k) participants who fear that they will not be able to afford retiring.

In 2007, the DOL commissioned Deloitte Financial Advisory Services to outline what are considered "generally accepted investment principles" and to determine whether or not they are widely accepted. The report, presented in July 2007, concluded:

> *"[i]n the absence of objective criteria, precisely what is and what is not generally accepted is therefore subject to interpretation and may evolve over time".*

Then, the blow-up of 2010 TDFs during the 2008 economic crisis focused attention on the tremendous variation in the asset allocations (and returns) of TDFs with the same target date. Although this revealed variation came as a surprise to many, perhaps it should not have, as earlier in 2008 Morningstar had pointed out that:

> *"Little rigorous work has been done to answer how and why the equity-bond glide path should evolve throughout an investor's lifetime, and even less work has been done to answer how and why intra-stock and intra-bond splits should evolve over time."*
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> – Tom Idzorek, *Lifetime Asset Allocations: Methodologies for Target Maturity Funds,* Ibbotson Associates Research Paper, February 11, 2008 p. 48.

In 2011, a GAO study noted that there were no basic guidelines for the design of TDF glide paths or the creation of the asset allocations that implement them:

> *"Target date funds vary considerably… largely as a result of the different objectives and investment philosophies of fund managers. In the years approaching the retirement date, for example, some TDFs have a relatively low equity allocation—35 percent or less…Other TDFs have an equity allocation of 60 percent or more…TDFs also vary considerably in other respects, such as in the use of alternative assets and complex investment techniques…[and] on assumptions about plan participant actions—such as contribution rates and how plan participants will manage 401(k) assets upon retirement…"*
>
> – GAO-11-118, *Key Information on Target Date Funds as Default Investments Should be Provided to Plan Sponsors and Participants*, January 2011

Thus, it appears that there are no generally accepted investment principles that are being used universally to create TDFs. Further, the foundations of MPT appear to be based on data mining rather than rigorous science.

This reality was recently highlighted when the 2013 Nobel Prize in economics was awarded to both Eugene Fama and Robert Shiller.

> *"People with knowledge of financial economics may be further surprised this year Eugene Fama and Robert Shiller are both recipients. Prof Fama made his name by developing the efficient market hypothesis, long the cornerstone of finance theory. Prof Shiller is the most prominent critic of that hypothesis. It is like awarding the physics prize jointly to Ptolemy for his theory that the Earth is the centre of the universe, and to Copernicus for showing it is not."*
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> ─ John Kay, "The Nobel committee is muddled on the nature of economics", *Financial Times*, October 15, 2013

Professor Fama also admitted that probably all the models used in financial economics lack a conceptual basis:

> *"I've spent a good part of the last 40 years testing those models. And a result of a lot of hat is the so-called Fama-French three-factor model. It's widely used both by academics and in industry. [He chuckles.] I'm laughing because the theoretical basis for the model is quite shaky. Basically, we saw these patterns in returns and our motivation was to try to explain them…"*
>
> ─ Interview with 2013 Nobel Laureate in economics, Eugene Fama: Jeff Sommer, "The Not-So-Predictable King of Predictable Markets", *New York Times*, October 27, 2013

In that same conversation, Professor Fama went on to say:

> *"And, of course, people don't entirely understand how risky investing is. That's very important to get across. We don't really know if the stock market will produce the returns in the future that people expect. Statistically, you can't show that it will. There's real risk there."*

Earlier in 2013, the DOL released *Target-Date Retirement Funds ─ Tips for ERISA Fiduciaries*. The wording of this "*general guidance*" implied that the common fiduciary practice of treating TDFs as "black boxes" that do not need to be opened and examined (and monitored) is not prudent.

> *"[T]here are considerable differences among TDFs offered by different providers, even among TDFs with the same target date. For example, TDFs may have different investment strategies, glide paths, and investment-related fees. Because these differences can significantly affect*

> *the way a TDF performs, it is important that fiduciaries understand these differences when selecting a TDF as an investment option for their plan."*

The DOL tip sheet goes on to state:

> *"Plan fiduciaries are required to periodically review the plan's investment options…At a minimum, the review process should include examining whether there have been any significant changes in the information fiduciaries considered when the option was selected or last reviewed… or if the fund's manager is not effectively carrying out the fund's stated investment strategy."*

Reviewing the plan's TDFs must go beyond delving into their "black box" nature. Fiduciaries must monitor whether or not their TDFS are actually enhancing or perhaps even reducing their users' chances of achieving a financially secure retirement. After all, it's one thing to know that:

> *"[In] 2008, the returns of 2010 target date funds ranged from negative 9% to negative 41%. While the returns turned positive in 2009, the variability continued, with 2010 target date fund returns ranging from 7% to 31%."*
>
> ─ Former SEC Chairman Mary L. Schapiro's Opening Statement at Commission Open Meeting, June 16, 2010.

It's something else to understand the effect two years of intense market volatility has on your participants' retirement readiness. Such critical knowledge can only be obtained only by assessing the participants' retirement readiness.

A well-designed retirement readiness assessment will analyze the progress, or lack thereof, participants ─ grouped into age bands and by other relevant criteria ─ are making towards achieving retirement security. While defining retirement security is no easy task, perhaps for the fiduciaries' purposes it can be defined as an income stream that will approximate 80% of the participant's projected salary at his normal retirement age on an inflation-adjusted basis to age 90.

The calculations used in the analysis should factor in Social Security and the sponsor's other retirement programs for which various employee groups may be eligible. The assumptions used, such as pre- and post-retirement investment growth rates and annual salary increases, should be determined by the fiduciaries and their investment consultants.

The retirement readiness assessment should show the fiduciaries the number of years, on average, each participant age band is projected to receive an inflation-adjusted income equal to 80% of their projected final salary. The study should also show an averaged suggested contribution rate for each age band that will get the participants on track, if they aren't already, to have the targeted income stream to age 90.

If the annual retirement readiness assessments suggest that the TDFs aren't significantly increasing the participants' chances of achieving a secure lifetime retirement, the fiduciaries should assess why not. Are the participants making inadequate contributions? Can they afford to increase their contributions? Have the participant communications been ineffective at getting the participants engaged in retirement planning? Is the glide path not capturing what's happening in the capital markets? Have there been so-called Black Swan events? Did the assumptions used in constructing the glide path differ from those used for the retirement readiness assessment? Or is it a combination of all of the above?

If any fiduciary doubts his or her duty to know and use this actionable information to help their participants help themselves in achieving a comfortable retirement, a rereading of *Tips for ERISA Fiduciaries* should dispose of any of their doubts:

> *"You should consider how well the TDF's characteristics align with eligible employees' ages and likely retirement dates. It also may be helpful for plan fiduciaries to discuss with their prospective TDF providers the possible significance of other characteristics of the participant population, such as participation in a traditional defined benefit pension plan offered by the employer, salary levels, turnover rates, contribution rates and withdrawal patterns."*

The DOL's "guidance" also makes it clear that 401(k) fiduciaries should tell their participants the assumptions underlying the glide path:

> *"If the employees don't understand the fund's glide path assumptions when they invest, they may be surprised later if it turns out not to be a good fit for them."*

Prudence also dictates that the fiduciaries tell the participants that the assumptions will most likely have to be revised. The fiduciaries should also periodically remind the participants, as well as themselves, of the Wall Street witticism:

> *"What do you call an economist with a forecast?" Answer: "Wrong."*

The DOL, then, has recognized that participants can't achieve a financially secure retirement unless they make adequate contributions and that it is impossible for participants to know what contribution is likely to be adequate without understanding the assumptions. Perhaps the best way of getting this message across to participants is to provide them annually with a personalized gap (shortfall) analysis that clearly shows them, based on a clearly spelled out set of assumptions, where they are on the road to retirement security, including the number of years that they are projected to receive their targeted inflation-adjusted retirement income.

The analysis should also provide participants with a personalized suggested contribution rate based upon the assumptions used in the report and the participants own salary, current balance, age, etc. Such analyses should also be given to new participants when

they are auto-enrolled into the 401(k) plan since the default contribution rate is likely to be too low for many of them. In fact, the *SSgA DC Investor Survey January 2013* found that participants want to be given this information in an easily understood form. Blackrock's 2013 Annual Retirement Survey found that 45% of employees who don't contribute to their company's 401(k) plan say it is because they don't know how much they will need.

Alternatively, the fiduciaries could provide the participants with the assumptions and encourage them to use a calculator on their plan's (or recordkeeper's) website. Unfortunately, there is little, if any, evidence, to suggest that web-based approaches lead to significant increases in participant contribution rates (Wei-Yin Hu, Olivia S. Mitchell, Cynthia Pagliaro, Stephen P. Utkus, *Evaluating Web-based Savings Interventions: A Preliminary Assessment*, October 2013, www.mrrc.isr.umich.edu).

In conclusion, 401(k) fiduciaries must accept the fact that selecting and retaining (or not) TDFs are anything but no-brainers. These tasks require the fiduciaries to understand whether or not their choice of TDFs is contributing to the participants' retirement security as well as what needs to be communicated to enable the participants to help themselves. Retirement readiness assessments provide much of the actionable information that is needed to obtain this required understanding.

In addition, if the 401(k) plan is to function as a viable retirement tool for employees, the employees must understand the role they play in achieving their own retirement security. Well-designed gap analyses are perhaps the most effective communication tool for changing participant behavior. After all, these personalize reports not only provide participants with the information they need, but it's provided in a manner they want and in a format that the benefits of increased contributions are readily apparent.