Testimony Concerning Target Date Funds

by

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Before the United States Senate Special Committee on Aging

October 28, 2009

Chairman Kohl, Ranking Member Corker, and Members of the Committee:

Thank you for the opportunity to testify before you today. My name is Andrew Donohue, and I am the Director of the Division of Investment Management at the Securities and Exchange Commission. I am pleased to testify on behalf of the Commission about target date funds.

I. Introduction

Today's hearing occurs against the backdrop of the recent significant turmoil in the financial markets and its effect on the ability of Americans to meet their financial goals at retirement. This issue is particularly acute for those individuals who are retired or close to retirement.

Over the past couple of decades, there has been a sizable shift in how Americans provide for their retirement needs. Previously, many Americans were able to rely on a combination of Social Security and company-sponsored defined benefit pension plans. Today, however, defined benefit pension plans are less common and workers are increasingly dependent on participant-directed vehicles, such as 401(k) plans, that place the responsibility for accumulating sufficient assets for retirement squarely on the shoulders of participants.

As a result, Americans are increasingly responsible for constructing and managing their own retirement portfolios. Given the complexities inherent in concepts such as diversification, asset allocation, rebalancing, and volatility, such responsibilities can pose a challenge for many and also require a significant commitment of time, knowledge, and interest by plan participants to effectively manage their retirement portfolios.

Target date funds are designed to make it easier and less-time consuming for investors to hold a diversified portfolio of assets that are rebalanced automatically among asset classes over time without the need for each investor to rebalance his or her own portfolio. A target date fund is typically intended for investors whose retirement date is at or about the fund's stated target date. Target date funds generally invest in other funds representing a diverse mix of asset classes, including stocks, bonds, and cash. As the target date approaches and sometimes continues for a period thereafter, a target date fund shifts its asset allocation to investments that are intended to be more conservative – usually by decreasing the percentage allocated to stock.

Since the inception of target date funds in the mid-1990s, assets held by these funds have grown considerably. Today, assets of target date funds registered with the Commission total approximately $227 billion.[1] Target date mutual funds received $42 billion in net new cash flow during 2008 and $56 billion during 2007, compared to $22 billion in 2005 and $4 billion in 2002.[2]

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1 Based on Commission staff analysis of data as of October 14, 2009, obtained from Morningstar Direct.

2 Public Hearing on Target Date Funds and Other Similar Investments before the U.S. Securities and Exchange Commission and the U.S. Department of Labor (June 18, 2009) (statement of Investment Company Institute).

Recently, target date funds have become more prevalent in 401(k) plans as a result of the designation of these funds as a qualified default investment alternative ("QDIA") by the Department of Labor pursuant to the Pension Protection Act of 2006. The QDIA designation provides liability protection for an employer who sponsors a defined contribution plan and places contributions of those plan participants who have not made an investment choice into a target date fund or other QDIA.[3] Since their designation as a QDIA in late 2007, target date funds have become an increasingly common addition to 401(k) plans. According to one recent study, 70 percent of U.S. employers now use target date funds as their default investment.[4]

II. Concerns

On June 18, 2009, the Commission and the Department of Labor held a joint hearing to explore issues relating to target date funds. Representatives of a wide range of constituencies participated at the hearing, including investor advocates, employers who sponsor 401(k) plans, representatives of the financial services industry, and academics. While some at the hearing spoke of the benefits of target date funds (for example, as a means to permit investors to diversify their holdings and prepare for retirement), a number also raised concerns, particularly regarding investor understanding of the risks

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3 See Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 FR 60452, 60452-53 (Oct. 24, 2007). As an alternative to a target date fund as a QDIA, Department of Labor regulations permit a plan sponsor to select a "balanced fund" that is consistent with a target level of risk appropriate for participants of the plan as a whole or a "managed account" that operates similarly to a target date fund.

4 Margaret Collins, Target-Date Retirement Funds May Miss Mark for Unsavvy Savers, Bloomberg (Oct. 15, 2009) (citing a Mercer, Inc. study of more than 1,500 companies).

associated with, and the differences among, target date funds and the manner in which target date funds are marketed, including the use of target dates in fund names.

A. Investor Understanding

One concern that has been raised is the degree to which communications to 401(k) plan participants and other investors in target date funds have – or have not – resulted in a thorough understanding by investors of those funds and their associated risks and designs. As discussed below, target date fund losses incurred in 2008, particularly losses in funds with near-term target dates, raised questions about the effectiveness of the communications about those funds and the extent to which investors understand the risks of target date funds.

In the market turmoil of 2008, investment losses for funds with a target date of 2010 were as high as 41 percent, with an average loss of almost 25 percent.[5] These losses raised the question of whether information provided to participants in 401(k) plans who were approaching retirement successfully communicated that losses of this magnitude could occur so close to the target retirement date. During the same period, pure equity indices such as the S&P, NASDAQ Composite and Wilshire 5000 were down 37, 41 and 45 percent respectively. Current year-to-date returns for 2010 target date funds have been as high as 30 percent, with an average return of approximately 20 percent.[6] During the same time frame, the above equity indices rose 22, 38 and 27 percent respectively. While 2009 has been a much better year than 2008 in the markets and for target date fund investors, the volatility demonstrated by the contrast between

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5 Based on Commission staff analysis of data obtained from Morningstar Direct.

6 Based on Commission staff analysis of data obtained from Morningstar Direct (performance information calculated through October 19, 2009).

2008 and 2009 returns reflects a level of risk that may have been unexpected by many investors as they approached retirement in or around the year 2010.

Recent variations in returns among target date funds with the same target date have also raised questions about the extent to which differences among target date funds have been effectively communicated to investors. In 2008, the losses for 2010 target date funds ranged from approximately 4 percent to 41 percent.[7] While these differences can be explained by a number of factors, one key factor is the use of different asset allocation models by different funds, with the result that target date funds sharing the same target date have significantly different degrees of exposure to riskier asset classes, such as stocks.

The schedule by which a target date fund's asset allocation is adjusted is commonly referred to as the fund's "glide path." Glide paths of different target date funds diverge widely both in length and in asset allocations along the way. For example, some glide paths end at the target retirement date; other glide paths continue for as long as 30 years past the target retirement date. As another example, stock exposures of target date funds have ranged from as low as 15 percent to as high as 65 percent at the target date.

B. Marketing

Marketing materials for target date funds typically portray the funds as offering a simple solution for investor retirement needs. While marketing materials for target date funds often include some information about associated risks, they typically encourage investors to choose a fund that most closely matches their anticipated retirement date and then "set it and forget it," hit "cruise control," or the like.

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[7] Based on Commission staff analysis of data obtained from Morningstar Direct.

While these marketing messages are generally consistent with the intended design of target date funds to make it easier for investors to hold a diversified portfolio of assets that are rebalanced automatically over time, the simplicity of the messages at times belies the fact that target date fund managers have adopted very different asset allocation strategies and that investments that are appropriate for an investor depend not only on his or her retirement date, but on other factors, including other investments, expected longevity, and appetite for risk. The marketing materials frequently are less nuanced than the disclosures found in target date fund prospectuses, which tend to provide more thorough discussions of a particular target date fund's strategies and associated risks. To the extent that an investor relies primarily on a fund's marketing materials, the investor may develop unreasonable expectations regarding target date funds and their ability to provide for retirement.

C. Target Date Fund Names

Often target date funds contain a year, such as 2010, in their name. The year is intended as the approximate year of an investor's retirement. Like the "set it and forget it" and "cruise control" advertising message, these names provide a convenient mechanism by which an investor may identify a fund that appears to meet his or her retirement needs.

This naming convention, however, is believed by many as contributing to investor misunderstanding of target date funds. Investors may not understand, from the name, the significance of the target date in the fund's management or the nature of the glide path up to *and after* that date. For example, investors may expect that at the target date, most, if not all, of their fund's assets will be invested conservatively to provide a pool of assets for retirement needs. They also may mistakenly assume that funds that all have the same date in their name are managed according to a uniform asset allocation strategy – when in fact one such fund might hold 15 percent of its portfolio at the target date in stocks while another fund might hold as much as 65 percent.

III. Commission Activities

At Chairman Schapiro's request, the Division of Investment Management has undertaken a review of target date funds, with a view to recommending steps that the Commission may take to address concerns that have been raised with respect to these funds. We are concentrating particularly on the expectations of the millions of Americans who increasingly rely on target date funds to invest for retirement needs.

Our focus is on target date funds that are organized as mutual funds. With respect to those funds, the Commission has jurisdiction under the Securities Act of 1933 and the Investment Company Act of 1940. The Commission does not, however, regulate 401(k) plans and other defined contribution plans or the QDIA designation, nor does the Commission prescribe the disclosures that are required to be provided to participants in 401(k) plans. In addition, some plan investment options that may operate as target date funds, such as bank-sponsored collective investment trusts, are not subject to Commission jurisdiction.[8]

Cooperation with Department of Labor

Because many individuals invest in target date funds through 401(k) plans and other defined contribution plans that are not regulated by the Commission, we have been

[8] Collective investment trusts are a type of pooled investment vehicle qualifying for the exclusion from the Investment Company Act pursuant to Section 3(c)(11) thereof [15 U.S.C. 80a-3(c)(11)], and whose securities are excepted from the registration requirements of the Securities Act pursuant to Section 3(a)(2) thereof [15 U.S.C. 77c(a)(2)].

cooperating closely with our counterparts at the Department of Labor. We believe this collaborative approach will better enable the concerns that have been raised to be addressed in a comprehensive manner that does not create regulatory gaps.

As discussed above, the Commission and the Department of Labor held a joint hearing this past June to explore issues relating to target date funds. The testimony at the hearing and comments submitted in connection with it contained numerous suggestions and observations as to how the concerns with respect to target date funds can be addressed. We are continuing to work with our counterparts at the Department of Labor as we move forward with our efforts.

Prospectus Disclosure

The federal securities laws require every mutual fund, including target date funds, to disclose material information in the fund's prospectus regarding its investment objectives, strategies, and risks, and to include a table containing comprehensive information about the costs of investing. In meeting their prospectus disclosure requirements, target date funds typically include a glide path illustration, information on what happens after a fund reaches the target date and whether the glide path continues, a description of how the asset allocation becomes increasingly conservative, and the specific risks associated with an investment in a target date fund such as asset allocation risk. Target date fund prospectuses are required to disclose both the costs imposed by the target date fund itself and the costs associated with any underlying funds in which the target date fund invests. We are considering whether any changes to existing requirements could enhance the disclosures that are provided in fund prospectuses and provide better information to target date fund investors.

Earlier this year, the Commission adopted amendments to the disclosure requirements for all mutual funds that permit the use of a new Summary Prospectus that is intended to result in a presentation of key fund information that is concise and easy to read.[9] We believe that the Summary Prospectus will be helpful to investors in target date funds. Last month, the Department of Labor provided guidance on the use of Summary Prospectuses by retirement plans, which should facilitate the use of Summary Prospectuses by retirement plans to the benefit of participants who invest in target date and other funds.[10]

Options to Address Target Date Fund Concerns

The Division of Investment Management is focusing on two areas where enhanced regulation of target date funds may be appropriate, with a view to making recommendations to the Commission: fund names and fund sales materials. In addition, we are developing investor education initiatives to assist target date fund investors.

Section 35(d) of the Investment Company Act makes it unlawful for any mutual fund to adopt, as part of its name, any word or words that the Commission finds are materially deceptive or misleading. As noted above, some believe that the naming conventions of target date funds may contribute to investor misunderstanding of those funds. As a result, one approach that we are examining closely is whether the use of a particular target date in a fund's name may be materially misleading and whether there are circumstances where the use of a date in a fund's name should be restricted in any way or prohibited.

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9 See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 FR 4546, 4564 (Jan. 26, 2009).

10 U.S. Department of Labor, EBSA Field Assistance Bulletin No. 2009-3 (Sept. 8, 2009) available at http://www.dol.gov/ebsa/regs/fab2009-3.html.

The Division also is considering whether we should recommend that the Commission amend its rules governing mutual fund sales materials to address issues raised by target date funds. Marketing materials that portray target date funds as offering a simple solution for investor retirement needs may create unreasonable investor expectations regarding the ability of such funds to provide for retirement. As we consider target date fund sales materials, we have consulted with the Financial Industry Regulatory Authority (FINRA), which reviews mutual fund sales materials, and we expect to work closely with FINRA to address any concerns in this area. In scrutinizing fund sales materials, the Division is concerned that target date marketing messages be balanced, that they contribute to investor understanding, and that they not suggest a uniformity or simplicity of target date funds where these are not present.

The Commission's Office of Investor Education and Advocacy is committed to furthering the Commission's mission of investor protection through the complementary missions of financial literacy and educating those seeking to invest. Together with that Office, the Division of Investment Management is developing outreach efforts to investors that could help to address potential misconceptions about target date funds. We are considering outreach through materials and media that would effectively reach 401(k) plan participants at all points in the investment cycle, from newly hired workers in their first jobs to those nearing retirement and seniors who may be in, or entering, the distribution phase. This is an area where we are hopeful that we can leverage our partnership with the Department of Labor to enhance the effectiveness of our outreach efforts.

IV. Conclusion

In recent years, target date funds have assumed a position of increasing importance in the financial security of Americans throughout their retirement years by providing a means for investors to diversify their holdings. At the same time, significant concerns have been raised about the varied performance of target date funds, their marketing, and investor understanding of these funds and their associated risks. We are committed to taking steps to address those concerns and to working with the Special Committee on these important issues.

Thank you for this opportunity to appear before the Special Committee. I would be pleased to answer any questions you may have.