Statement of John Rekenthaler

Vice President, Research, Morningstar, Inc.

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My name is John Rekenthaler. I am Vice President of Research for Morningstar. Thank you for inviting me to speak today before the Senate Committee on Aging.

Morningstar is a leading provider of independent investment research and the largest provider of mutual-fund research in the United States. Recently, Morningstar published a detailed report on target-date mutual funds, creatively titled *Target-Date Series Research Paper: 2009 Industry Survey*. My presentation today contains key findings from that report.

I would like to state upfront that Morningstar is generally supportive of target-date funds. Throughout its history, Morningstar has frequently criticized entire categories of funds for being gimmicky and/or overpriced. We are considerably more positive about target-date funds. We regard target-date funds as being a sound invention that meets a true investor need. By offering broadly diversified portfolios that change over time, target-date funds are a suitable choice for those who wish to delegate their investment decisions. They also are well suited for inactive owners who will not be making trades as they grow older and their situations change.

That said, there are certain concerns, given the extraordinary position that target-date funds now occupy as the default investment of choice for America's New Retirement Model. These concerns include:

1) Variation in fees
2) The use of proprietary (in-house) funds
3) Lack of manager ownership
4) Variation in glide paths among the shorter-dated funds
5) Lack of transparency

The first concern lies with fees. Overall, annual expense ratios for target-date mutual funds compare favorably with the expense ratios charged by other types of mutual funds. For example, on an asset-weighted basis, that is with the larger funds counting proportionately more in the calculation than the smaller funds, target-date funds have an average annual expense ratio of 0.69%. This is lower than the 0.82% figure for so-called "allocation" funds, which also invest in a broad mix of stocks and bonds.

However, the average conceals a very wide range among the 48 target-date fund families that we track. On the low end, one target-date family has an expense ratio of only 0.19%. On the high end, another has an expense ratio of 1.82% -- more than 9 times higher than the first family. The issue of expenses is particularly important with target-date funds because of their very long time horizons. Several fund families today offer funds with a 2055 date – 46 years into the future! As the Committee well knows, the power of compounding greatly magnifies small differences over such a long time period.

For example, let's assume two target-date funds that invest in identical underlying assets, returning 7% annually. One fund boasts the industry's low expense ratio of 0.19% and the other has the industry's high expense ratio of 1.82%. Over the 46-year time period mentioned above, an intial investment made in the low-expense fund would become worth more than twice as much as the investment that was made in the high-expense fund. (A lump-sum investment of $1,000 in the two funds would grow to $20,708 and $10,208, respectively.) Few employees who are defaulted into target-date funds through their 401(k) plans will be aware of the expense differences that exist among funds, and fewer still will understand their very powerful effects.

The second concern is the tendency of target-date funds to invest solely in their own company's underlying funds. No reputable institutional investor would hand over his or her entire portfolio to a single asset-management firm. Instead, the institutional investor sifts among the many investment managers that make up the industry, seeking to purchase the best and lowest-cost options for various slices of the portfolio. One firm gets a portion of the portfolio's large-company stocks, another manages its short-term Treasuries, a third takes control of its emerging-market investments, and so forth. The institutional investor would not expect a single firm to excel at all types of investing. Yet that is implicitly the position taken by most fund families in running their target-date funds. It is difficult to square such a practice as being the best outcome for an investor – although of course from a business perspective, it is understandable that a target-date fund family would like to keep all of the assets collected in-house.

Third, we are worried by the low level of conviction placed by the industry's target-date investment managers in the funds that they run. Morningstar tracks how much money a target-date manager invests in his or her own funds, as this is an item listed in each fund's Statement of Additional Information. After all, target-date funds would seem to be the ideal way for a fund manager to "eat his own cooking" (as the saying goes), given that target-date funds are openly marketed as being suitable for every possible type of investor. Yet only two out of 58 target-date managers whom we track list $500,000 or more invested in their own funds. Even more strikingly, 33 of the managers, or 57%, show nothing at all.

It is true that there are mitigating circumstances. In some cases, target-date managers can only invest in their funds through 401(k) plans, as those funds are not available in a retail account. In other cases, the managers hold a different version of their fund, one that is not a registered mutual fund but is instead an institutionally priced separate account that is available only for larger 401(k) plans. (However, this does beg another question, as the typical investor will not necessarily be able to avail himself of this lower-cost option.) But the point remains: Manager ownership is light. Overall in the fund industry, managers who invest heavily in their own funds tend to outperform those who invest less. We would like to see fund managers more enthusiastically embrace target-date funds.

Fourth, there is a great disparity in the “glide paths” – the ratio of stocks to bonds that is held by a target-date series, as it changes over time – among the shorter-dated funds. The longer-dated funds tend to look quite similar. For example, the allocation to stocks for the 2040 funds in Morningstar’s database runs from 80% as a minimum to 95% as a maximum. Absent any mistakes from implementing the asset allocation, those funds will tend to perform fairly similarly. As the target-date series age, however, the funds drift apart. Some fund families focus on longevity risk, that is the risk that the retiree may outlive his or her assets. Therefore, they hold more equities. Other fund families are more concerned about market risk, and wish to minimize volatility by greatly reducing their funds’ stock positions.

As a result, the glide paths for the 2010 funds diverge sharply. At the upper end, two fund families have more than 70% of their 2010 funds’ assets placed in equities. Conversely, three families have fewer than 30% of their 2010 investments in stocks. This divergence in asset allocation resulted in a wide difference in performance during the dramatic 2008 market, when losses in the 2040 category ranged from a modest 9% to a breathtaking 41%. Morningstar’s point is not to praise those families that were positioned most conservatively, nor to condemn those that were hurt by their high equity exposure, but rather to consider the investor’s perspective. An employee defaulted into the first fund would have lost 9% on year, while one defaulted into second fund would lose 41%. Yet each employee would consider herself invested in an identical fund –as both funds carryied the same “2010” label and were aimed at employees of exactly the same age. Who knew?

Fifth, transparency about target-date funds’ strategies can and must improve. In gathering the data for its *Industry Survey*, Morningstar struggled to collect even the basic stock/bond/cash information for some of the target-date funds. Details such as the allocations between domestic and international stocks, or corporate and government bonds, were even harder to obtain. If Morningstar with its market presence and staff of data experts scrambled to learn the characteristics of the industry's target-date funds, then surely the everyday employee who seeks to learn more about his default investment, faces real difficulties.

Finally, we should note the tendency of the fund industry's secondary providers to "swing for the fences" in the attempt to distinguish themselves from the pack. This is a pattern that exists in all segments of the mutual-fund marketplace. The companies that offer a category's biggest funds are quite naturally interested in protecting their market share, and thus are relatively risk-averse when it comes to making investment innovations. The smaller providers, however, have little to lose and much to gain by trying something bold. Over the fund industry's history, such an attitude has led to many fund-industry innovations – but also to the industry's biggest flops.

The tendency of the smaller players to take big chances has been implicitly accepted by the industry, by regulators, and even by fund shareholders. The question is, whether such experimentation is appropriate for a default investment in a company-sponsored retirement plan. Morningstar worries when target-date funds purchase heavily leveraged bond funds that conducted over-the-counter derivative swaps, or when they buy new, opaque, and high-cost funds that use complex investment strategies. It is one thing to experiment in a defined-benefit plan, when the company rather than the employee is on the hook for any failures. It is a second thing to experiment as a retail mutual fund, when the investor actively chooses to buy the fund. But it is a a third and altogether different thing t experiment on behalf of a default investor, and it is the default investor who directly bears the risk.

For the most part, Morningstar recommends improved disclosure as the prescription for addressing its five concerns. The principles for improved disclosure include:

1) Creating three new, selected data tables that would be used only for target-date funds (thereby acknowledging both the unusual investment

characteristics of target-date funds, and also their position of privilege within employee-sponsored retirement plans)

a. A fee table comparing the fund's fees against the industry median fee, and the industry's cheapest fees. The table would illustrate the effect of compounding by showing how similar gross returns diverge on an after-cost basis over long time periods.
b. A table showing the fund's use of proprietary mutual funds, again comparing to the industry median and the industry's lowest use. This would be accompanied by standardized language discussing the pros and cons of target-date funds using proprietary funds.
c. A glide-path table that compares the fund's glide path against the industry median. In the discussion section, the fund company would be required to mention areas where it differs significantly from the median, and (briefly) the reasons for those differences. (It is fine for target-date families to differ from the consensus – but the investor should know when that is occurring, and understand why.)

2) Moving the manager ownership information that is currently contained within the obscure Statement of Additional Information to a position of greater prominence by being placed in the prospectus.

These changes would address all five of the concerns noted at the beginning of my testimony. They would not, however, address the final item of potential risk-taking by the smaller target-date families. That issue must await either a market solution – whereby fund families that disappoint are ruthlessly chased out of the business by a well-informed community of plan sponsors – or a tightened notion of the fiduciary responsibility engendered by target-date providers. But the latter is a subject for another discussion.

In summary, target-date funds are a useful and productive addition to the fund industry, and a clear benefit to employees who have 401(k) plans. They must improve further, however, if they are to fully earn their position of being at the heart of America's retirement future.