Senate Aging Committee Hearing on target date funds
October 28, 2009
Testimony by Ralph Derbyshire

Chairman Kohl, Ranking Member Corker and members of the Committee, thank you for the opportunity to testify before you today. My name is Ralph Derbyshire and I am Senior Vice President and Deputy General Counsel for Fidelity Investments.

My testimony today will focus on three areas:

- How target date funds help investors address improper asset allocation
- How automatic enrollment plans with target date funds as the default investment have helped increase retirement savings, and
- Suggested improvements to help both plan sponsors and plan participants better understand target date funds.

Since the advent of the 401(k) plan in the early 1980s, Fidelity has been a leading provider of investment solutions and administrative services to plan sponsors and participants. Today, the 19,000 workplace retirement plans recordkept by Fidelity cover over 14 million plan participants. We are also the industry's leading provider of target date funds with 47 funds and more than $93 billion in assets under management.

Target date funds were created in the mid 1990s to help solve one of the biggest problems with defined contribution plan investors – improper asset allocation. Across all age groups, the majority of participants hold equity allocations that do not align with the amounts that most investment professionals recommend. Figure 1 demonstrates that as participants approach retirement age, there is an almost even split among those who are too aggressive and too conservative.

Target date funds are an important tool to help participants achieve better asset allocation. These funds offer investors the power of a diversified set of mutual funds in a single fund, with the added benefit of professional asset allocation. Through target date funds, investors avoid the risks of excessive caution early in life and excessive risk-taking as retirement approaches. It is a powerful offering for investors who lack the time, knowledge or interest needed to manage their retirement savings.

Fidelity was one of the first mutual fund firms to offer target date funds specifically designed to meet the needs of retirement investors. Known as the "Freedom Funds", Fidelity's target date funds have helped investors save for retirement since their debut in October of 1996 and have been tested during two market cycles over the last 13 years.

Our commitment to investors through these funds is to provide a disciplined and well-diversified approach to saving and investing for retirement. Freedom Funds have an asset allocation mix among stocks, bonds and short-term instruments that is more aggressive when an investor is younger and becomes more conservative as the investor nears retirement. The funds' managers set the target asset allocation mix for all of the Freedom Funds.

Each Freedom Fund invests in as many as 24 underlying Fidelity mutual funds. We employ a thorough, rigorous process of selecting the underlying funds, based on an analysis of performance, risk, style consistency, and how the funds complement each other. Although the Freedom Fund portfolio managers take a long-term approach to asset allocation decisions, they also review the portfolio on a daily basis and adjust or rebalance as needed.

Three elements are required for a retirement investor to meet his or her objectives: (1) adequate and consistent contributions, (2) a disciplined investment strategy that meets performance expectations, and (3) time. While no asset allocation approach will be successful if individuals do not contribute enough towards retirement savings, we believe the best-suited strategy for reaching a retirement goal is one that balances the trade-offs among required contributions, investment volatility, and time. Target date funds provide this balance and offer sophisticated long-term asset allocation strategies in a simplified, straightforward investment vehicle.

It is important to note that for the Freedom Funds, the "target date" is the date when the individual plans to retire and not when they plan to liquidate their holdings in the fund. Target date funds are designed to last well into an investor's distribution phase. For the typical investor, this will extend for 20 years beyond retirement, and could reach 30 years or longer for some retirees. The asset allocation for the Freedom Funds at the target date and in the retirement years takes into account several risks that can be grouped into four broad categories: longevity risk, market risk, withdrawal rate risk, and inflation. The Fidelity Freedom Funds currently have an allocation of about 50% to equities at the target date and this gradually declines until reaching 20% equities about 15 years after the target date. Figure 2 shows the asset allocation of Freedom Funds over the entire lifecycle.

The target date fund fee – like other mutual funds – is typically expressed in an expense ratio. The Freedom Fund expense ratio is derived from the proportional summation of the fees of the underlying funds in which the target date fund is invested. Fidelity does not charge an additional "wrap fee" on top of the Freedom Fund expense ratio.

Target date funds have increased in popularity in recent years due in large part to the changes made to automatic retirement plan features in the Pension Protection Act. While automatic enrollment of participants into 401(k) plans was available before 2006, the passage of PPA provided fiduciary plan relief to plan sponsors who select a "qualified default investment alternative" or "QDIA" for automatically-enrolled employees. In regulations issued in December of 2007, the Department of Labor included target date funds when it designated investments that were eligible to be QDIAs.

Since then, the growth of target date funds in plans has been significant. The percentage of plans at Fidelity that use a target date fund as its default investment option has increased from 38% in December of 2007 to 64% in September of 2009. Among plans at Fidelity that offer automatic enrollment, 96% use a target date fund as the default.

Our data shows that automatic enrollment has had a dramatic affect on employee participation in retirement plans, particularly among younger and lower paid workers. Figure 3 demonstrates how automatic enrollment impacts employee behavior. Overall, 76% of eligible employees are automatically enrolled into the plan. An additional 19% enroll by making a pro-active choice to contribute a different amount to the plan. Only 5% opt-out of the plan entirely before enrollment, and an additional 6% opt-out during the 12 months following enrollment, for an overall participation rate of 89%.

The combination of automatic enrollment and target date investing has had a powerful impact on participant asset allocation. The chart on the left of Figure 4 shows participant asset allocation in March 2000 vs. March 2009. The green bars on either end of the spectrum show the number of participants invested in either all equities or all fixed income. The bars in the middle show the number of participants at different asset allocations in 1% increments. The blue line represents the Freedom Funds' glide path and the yellow area is where we feel participants should be allocated with a glide path that becomes more conservative as the employee nears retirement age. Clearly, more participants in 2009 have a more balanced allocation between equity and fixed income than in 2000. Investment professionals can perhaps disagree over the precise mix of equity and fixed income that is appropriate, but I think most would agree that it is better to be somewhere in the middle rather than at the ends of this spectrum.

There has been much discussion around how funds have performed during the market downturn last year. After the worst year for the stock market since the Great Depression, it is understandable that investors are concerned about significant losses in their retirement accounts. In this type of environment, many individuals take dramatic action with their investment portfolios, often selling at depressed price levels only to buy back later at higher price levels. To avoid these pitfalls, we believe that it is important for investors to stay committed to their plan for retirement savings. Target date funds are designed to help participants maintain this discipline.

For example while the Fidelity Freedom 2010 fund was down 25.32% for the 2008 calendar year it is back up 22.40% YTD (as of10/23) in 2009. That means that $1 invested in 2008 is worth $.90 today. If we go back even further, we find that the 2010 fund has produced a greater than 6% average annual return since it was launched in 1996 – and this includes a lost decade for stocks. I think it's reasonable to assume that most investors will need at least 13 years to save for retirement.

While we feel target date funds are an important investment tool and we have actively engaged in educating investors about the many benefits of target dates funds, we agree that improvements can be made to help enhance investor understanding. The Investment Company Institute has been actively working with regulators on this issue over the past nine months and earlier this year released a set of principles aimed at improving the disclosure, communications and education of target date funds. We support these efforts.

Among the suggested recommendations include the clear and concise disclosure of the relevance of the target date used in a fund name, the funds' assumptions about the investor's withdrawal intentions, the targeted age group and an explanation of the funds' glide path. Such disclosures should be used to enhance understanding by investors and would not be meant to replace disclosures required by law.

Fidelity appreciates your concerns regarding the appropriate use of target date funds and the role they play in helping Americans achieve their retirement goals. As America's retirement leader, Fidelity is committed to helping solve the retirement savings challenge. We believe that the investment principles used by target date funds provide a critical foundation for individuals saving for retirement, and are an effective solution for participants who lack the time and inclination to apply lifecycle investing principles to their own retirement portfolios.

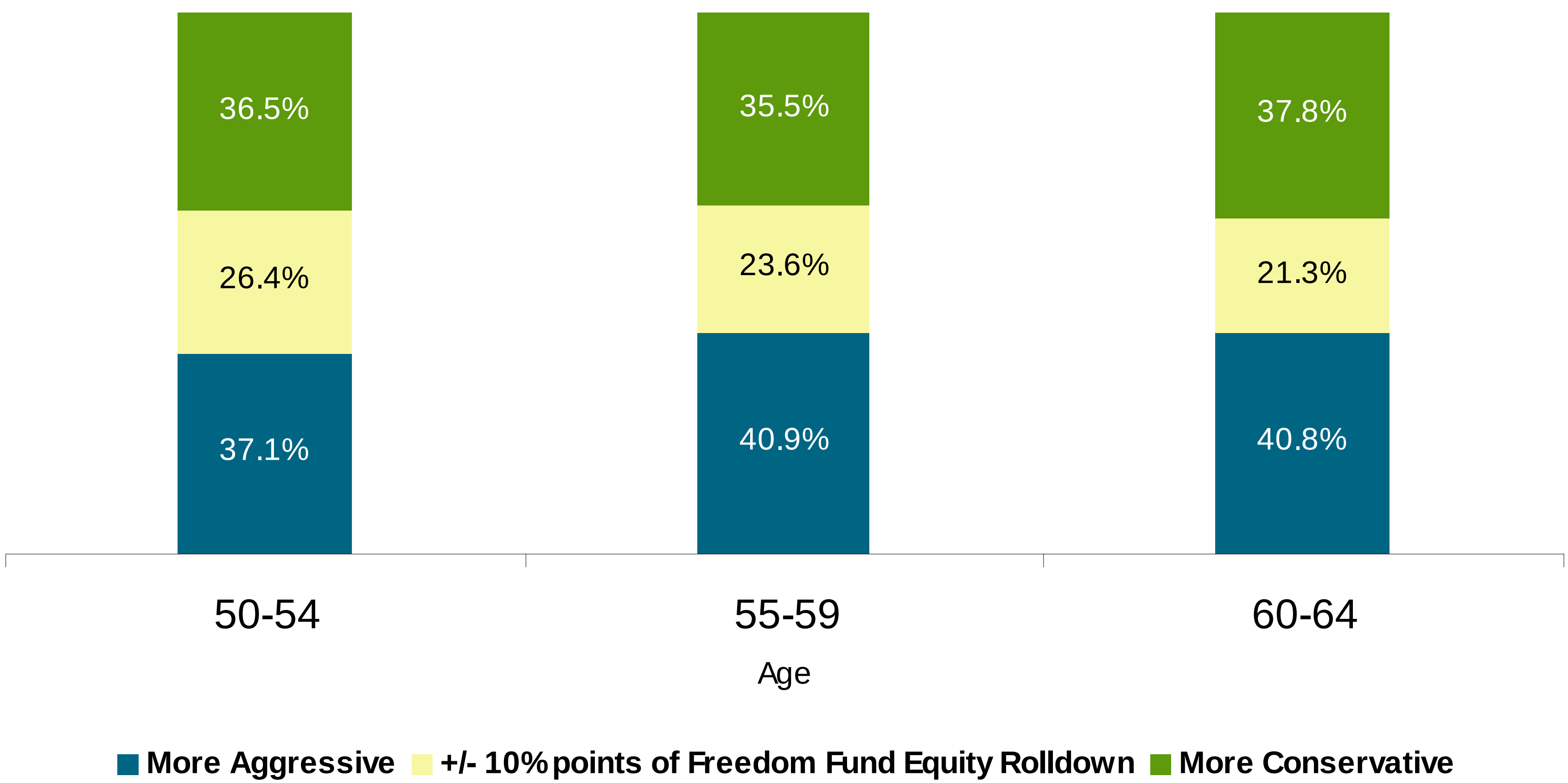
Thank you for the opportunity to address this important topic. I'd be pleased to take your questions.

Ralph Derbyshire
Senior Vice President, Deputy General Counsel
Fidelity Investments

Appendix

Equity Allocation +/- 10% Fidelity Freedom Fund Equity Rolldown

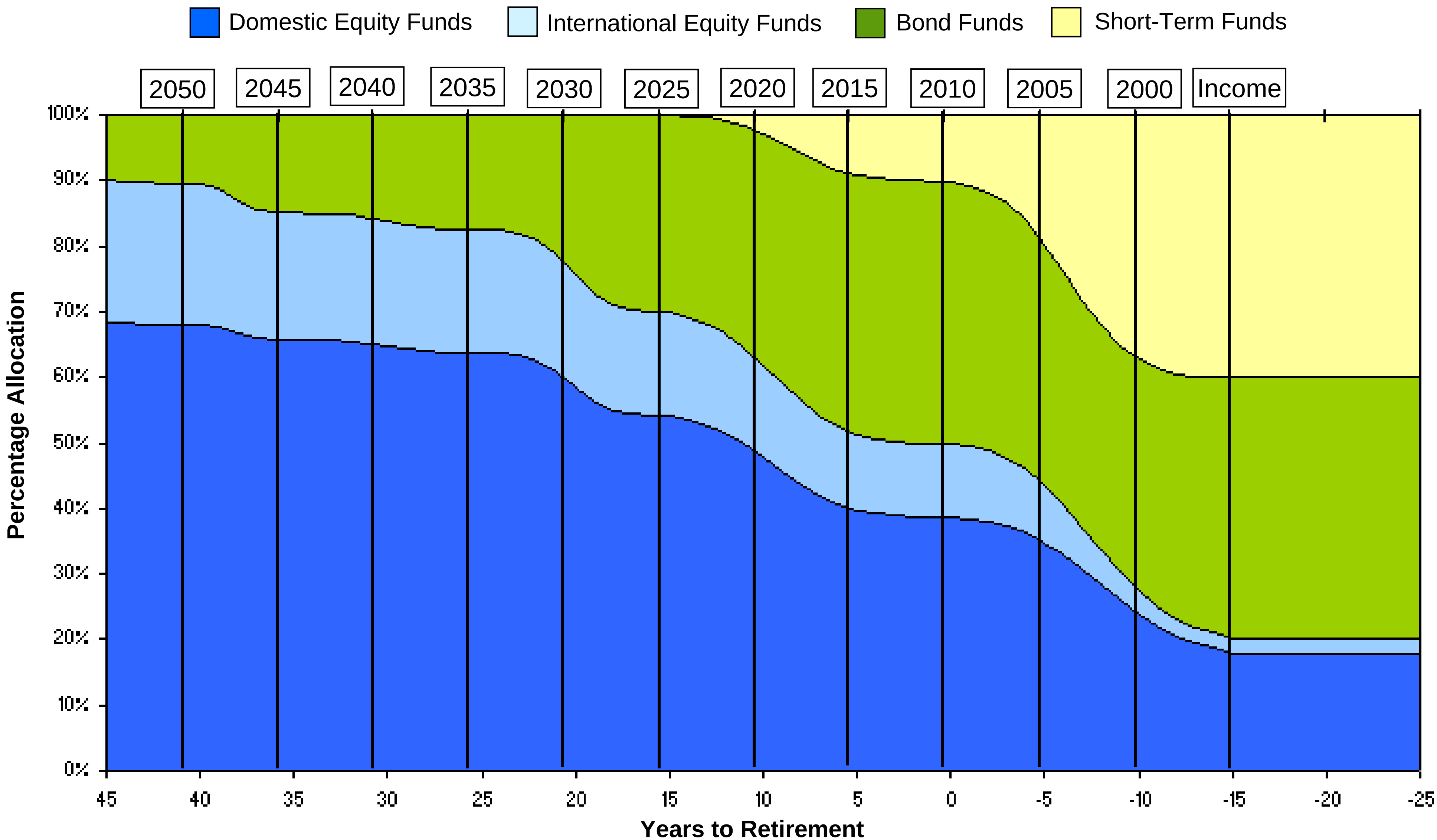
There is roughly an even split of participants near retirement with equity allocations more aggressive or more conservative than the +/- 10% Fidelity Freedom Fund equity allocation



Fidelity Investments recordkept data of corporate DC Plans (over 17, 500 plans and 11.3M participants) as of 3/31/2009.

Figure 1

Asset Allocation: Fidelity Freedom Fund Rolldown



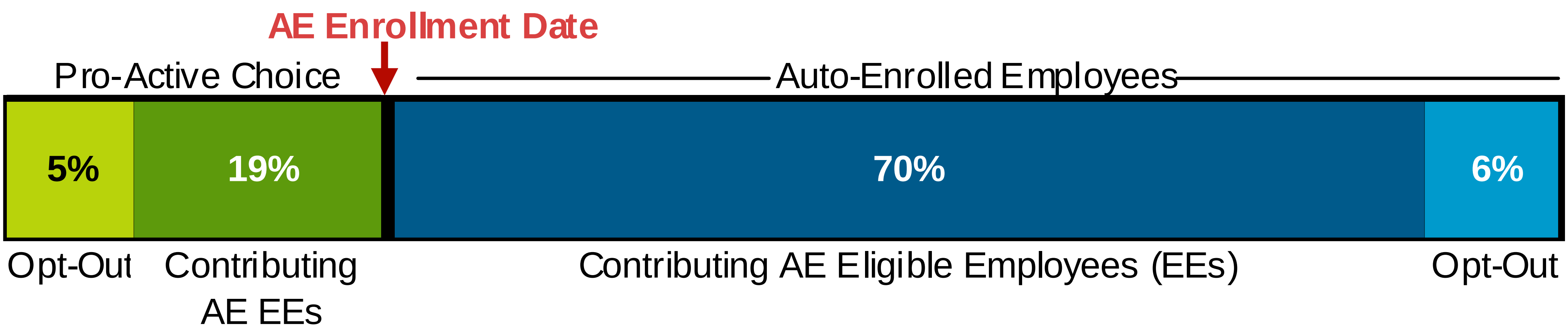
This chart illustrates the Freedom Funds' target asset allocations among Domestic Equity, International Equity, Bond, and Short Term funds. This chart also illustrates how these allocations may change over time. The Freedom Funds future target asset allocations may differ from this approximate illustration. Changes authorized by the Board, but not yet fully implemented. Rolldown as of 10/1/2009

Source: FMRCo.

Figure 2

Auto Enrollment Behavior

76% Overall, seventy-six percent of AE eligible employees are auto enrolled – only 6% opt out after being auto enrolled



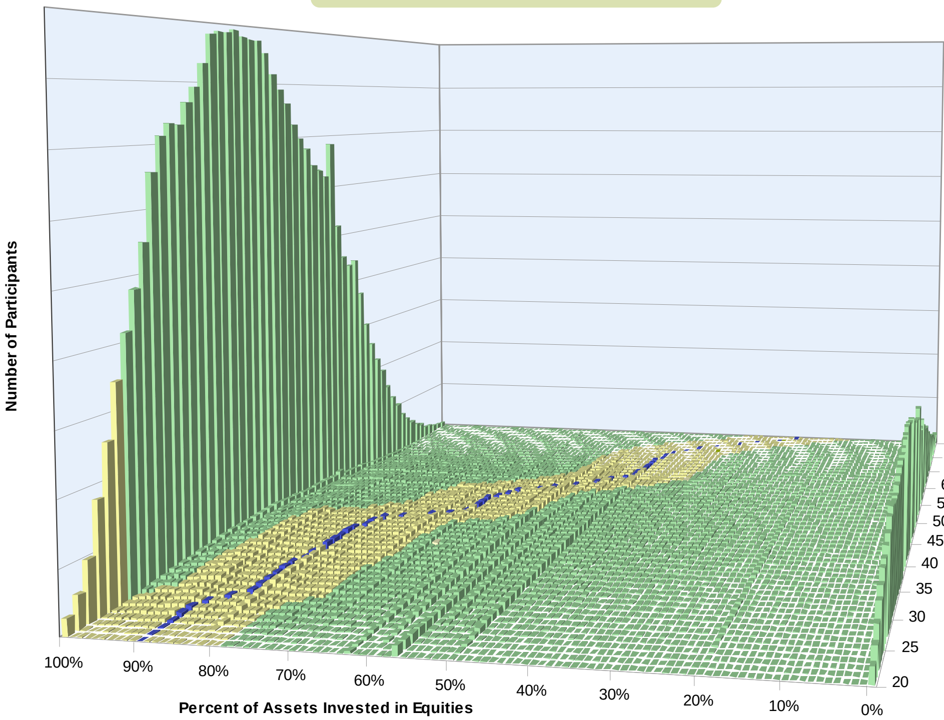
Fidelity Investments recordkept data of corporate DC qualified AE plans (over 2,690 plans and 5.2M participants) as of 3/31/09. Depicts the four categories of AE eligible employees as of 3/31/09 (percentages add to 100%). "Contributing" refers to making an employee pre-tax contribution in the 12 months period ending 3/31/09. % and represent portion of AE employees in each category who were still actively employed by plan sponsor as of 3/31/09.

Figure 3

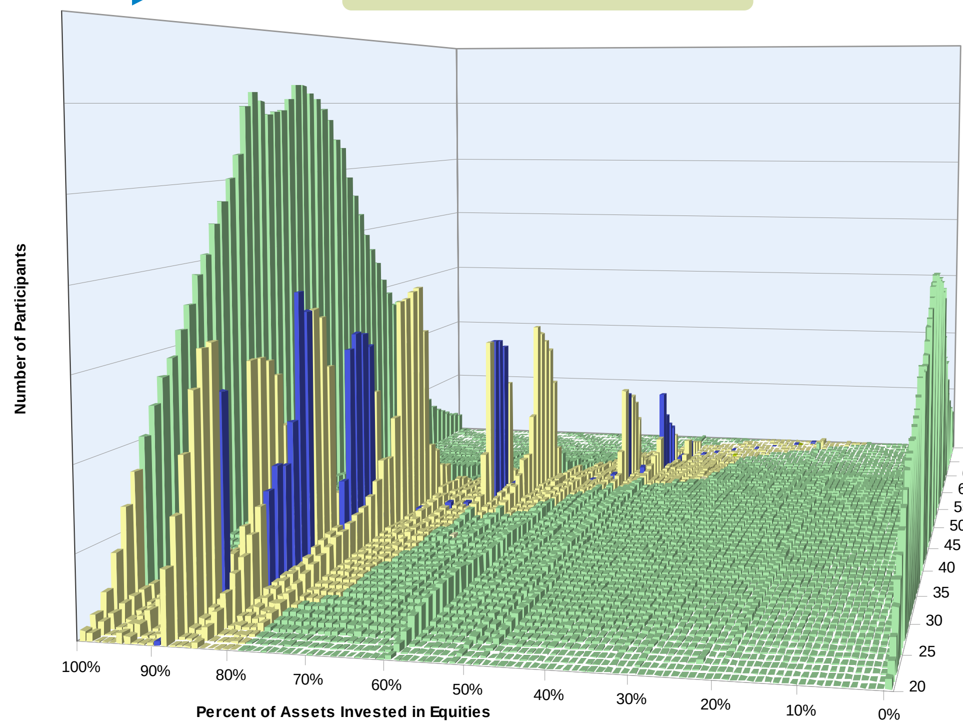
Participant Plan Accounts Are More Diversified

1) Plans offering lifecycle, 2) Utilizing as the Plan Default, and 3) Participant Adoption of Lifecycle have created many more diversified participant plan accounts.

3/31/2000



3/31/2009



Freedom Funds Equity Rolldown

+/- 10% points of the Equity Rolldown

Outside the Freedom Fund Equity Rolldown Band

The Fidelity Freedom Funds® are target-date lifecycle funds designed to become more conservative and to hold a smaller percentage of equities as investors approach their retirement date. This chart assumes that participants will retire in the year they turn age 65. The equity rolldown schedule line is as of May 30, 2006, and it would continue down to 20% at age 80. Investors should allocate assets based on individual risk tolerance, investment time horizon, and personal financial situation. A particular asset allocation may be achieved by using different allocations in different accounts or by using the same one across multiple accounts. The equity rolldown shown is not intended as a benchmark for individual investors; rather, it is a range of equity allocations that may be appropriate for many investors saving for retirement and retiring at age 65. See the Exhibit Methodology section at the end of this deck for the definition of equities and an explanation of participant data included.

Figure 4

Additional Important Information

Additional Information About Charts Showing Participant Equity Holding versus Freedom Funds' Equity Rolldown

For the equity rolldown chart, "Equities" are defined as domestic equity, international equity, company stock, and the equity portion of blended investment options. A random sample of 5,000 participant data points are plotted on this chart. Percentage of assets invested in equities is based on data for participants in the defined contribution plans recordkept by Fidelity with a balance as of quarter end. These plans included both qualified and assetized nonqualified plans (i.e., nonqualified plans informally funded with mutual funds and other securities), as well as single-fund plans, which include Employee Stock Ownership Plans (ESOPs). Plans sponsored by Fidelity Investments for the benefit of its own employees are excluded. The Fidelity Freedom Funds® rolldown schedule on both Exhibits illustrate the Freedom Funds' target asset allocations among equities and was created by Strategic Advisers, Inc. This rolldown schedule also illustrates how these allocations may change over time. The Freedom fund future target asset allocations may differ from this approximate illustration.

Other Information:

The investment risks of each Fidelity Freedom Fund changes over time as its asset allocation changes. They are subject to the volatility of the financial markets, including equity and fixed income investments in the U.S. and abroad and may be subject to risks associated with investing in high yield, small cap and foreign securities. Principal invested is not guaranteed at any time, including at or after their target dates.

Fidelity Freedom Funds are designed for investors expecting to retire around the year indicated in each fund's name. It is important to keep in mind that the Freedom Funds are designed to become more conservative as they near their target retirement date.

Before investing in any mutual fund, please carefully consider the investment objectives, risks, charges and expenses. For this and other information, call or write Fidelity for a free prospectus. Read it carefully before you invest.