

## **Recommendation of the Investor Advisory Committee Target Date Mutual Funds (Adopted April 11, 2013)**

### **Findings:**

- Target date mutual funds have come to play an increasingly important role in the retirement savings of American investors. Assets of target date funds totaled approximately \$485 billion at the end of 2012, up 29 percent over the previous year.<sup>1</sup> Roughly 70 percent of U.S. employers report offering target date funds as their default investment option for company sponsored defined contribution plans, according to one recent survey.<sup>2</sup>
- Well-designed target date funds can provide a cost-effective long-term investing solution for the many individual investors who find it difficult to construct and maintain a diversified portfolio with risk levels changing to match their evolving needs.
- The dramatic drop in value in 2008 of some target date funds that were close to reaching their advertised target date brought new attention to the significant differences in risk levels that exist among funds with identical target dates.
- Evidence suggests that individual investors are ill-equipped to identify those risk disparities among similar seeming funds.<sup>3</sup> For example, on a survey commissioned by the SEC, only 36 percent of respondents (including 48 percent of target date fund owners and 26 percent of non-owners) correctly answered a true-false question regarding whether target date funds provide guaranteed income after retirement. Thirty percent (including 25 percent of owners and 34 percent of non-owners) answered incorrectly that target date funds do provide guaranteed income.<sup>4</sup> Fifteen percent of respondents said whether there is a guarantee depends on the fund and 20 percent said they didn't know.

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<sup>1</sup> Rob Kozlowski, "Target-date fund assets rise 29% in 2012 to record \$485 billion," *Pensions & Investments*, February 7, 2013, citing a report by Ibbotson Associates, available here: <http://www.pionline.com/article/20130207/dailyreg/130209884>.

<sup>2</sup> *Investment Company Advertising: Target Date Retirement Fund Names and Marketing*, Securities and Exchange Commission, File No. S7-12-10, June 23, 2010. (Available [here](#).) (See footnote 21, citing a Mercer, Inc. study of more than 1,500 companies).

<sup>3</sup> See, for example, Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors*, study by the SEC staff as required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (August 2012), which shows high levels of financial illiteracy.

<sup>4</sup> *Investor Testing of Target Date Retirement Fund (TDF) Comprehension and Communications*, Submitted to the Securities and Exchange Committee by Siegel and Gale, February 15, 2012. (See slides 26-28.)

- Even many professional pension fund consultants who help select retirement plan fund options offered through defined contribution plans under-estimate the degree of risk in many target date funds. For example, one unpublished study<sup>5</sup> found that, although target date funds on average exposed investors nearing retirement to a significantly higher maximum potential loss than most pension consultants surveyed deemed appropriate for those nearing retirement, only about 35 percent of those pension consultants viewed current glide paths as somewhat to highly inappropriate (i.e., too aggressive). In other words, almost two-thirds of these pension consultants assumed that funds were invested more conservatively than was in fact the case.
- There is a high degree of saver concentration among just a few target date funds. According to Morningstar, the top three fund families had 75 percent of the market share in 2011, and the top ten fund families had 90 percent of the 2011 market share.<sup>6</sup> As a result, large numbers of investors, including large numbers of individuals approaching retirement at the same time, will be affected by the approaches these companies adopt.

## Recommendations

The Committee applauds the Commission and its staff for turning its attention to this important issue and for seeking to develop an approach to target date fund marketing and advertising practices that will improve investor understanding of target date fund operations and risks. However, we believe the current proposal<sup>7</sup> needs to be revised and expanded if it is to achieve this goal. In addition to improving the marketing material provided to investors, the Commission should seek to ensure that retirement plan consultants also receive the information they need to make sound decisions about which target date funds are included on the menu of retirement plan options and offered as default investments in those plans. The goal should be to ensure that the information provides an accurate and easily comparable depiction of fund risk, does so in a manner that is objective, is not easily gamed, and is sufficiently flexible to apply to different methods of managing risk and to allow for continuing innovation among target date funds.

### Recommendation 1

The Commission should develop a glide path illustration for target date funds that is based on a standardized measure of fund risk (see Recommendation 2) as either a replacement for or supplement to its proposed asset allocation glide path illustration.

**Supporting Rationale:** As the Commission notes in its proposing release, the performance of target date funds with the same target date has varied widely, reflecting very different risk characteristics among these funds. For example, among funds with a 2010 target date, losses in 2008 ranged from 9 percent to 41 percent while returns in 2009 ranged from

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<sup>5</sup> The study was conducted for PIMCO in 2010.

<sup>6</sup> Morningstar 2012 Target-Date Fund survey (Charlson and Lutton), page

<sup>7</sup> Securities and Exchange Commission, Investment Company Advertising: Target Date Retirement Fund Names and Marketing, File No. S7-12-10, June 23, 2010, available [here](#).

approximately 7 percent to 31 percent. Much of those differences in risk can be explained by differences in the asset allocation models and glide paths used by different funds, as different target-date funds with the same target dates may pursue vastly divergent investment strategies. A 2011 Morningstar study of 36 funds with a target date of 2020 found, for example, that their equity weightings ranged from 35 percent to 80 percent, with an average of 61 percent.<sup>8</sup> But choices of assets within the various asset classes, inclusion of assets from outside the traditional asset classes, and other risk management practices can also have a significant impact on fund risk levels. A glide-path illustration based solely on asset allocation is therefore unlikely to reliably capture potentially significant differences in fund risk levels.

Asset allocation is a particularly unreliable proxy for risk where the asset classes are defined quite broadly, as they are in the Commission proposal. Because assets within those broad classes may have markedly different risk characteristics, such an approach may serve to mask significant differences in the risk levels of funds with apparently similar or even identical asset allocation glide paths. Indeed, basing the glide path illustration on broadly defined asset classes could create an incentive for some funds to attempt to increase returns by selecting riskier options within the various broad asset classes, since those added risks would likely be overlooked by anyone relying on the glide path illustration to compare fund risk levels. Moreover, a glide path illustration that focuses solely on asset allocation could inadvertently act to limit the flexibility of fund managers to adapt to changing market conditions that may warrant a change in asset allocation, potentially exposing target date fund investors to greater risks.

We therefore encourage the Commission to develop an alternative glide path illustration based on the target risk level over the life of the fund. A glide path illustration based on an appropriate, standardized measure of fund risk would be both more accurate and more flexible than a glide path illustration based on asset allocation alone. It is possible that the two approaches could be designed to work together. If the fund is designed around a target risk level, illustrated through an appropriate risk glide path, the fund could also be required to disclose what the expected asset allocation would be to produce the desired risk level and explain that the asset allocation may vary, and other risk management practices may be employed, to maintain that target risk level. Where a fund bases its approach on a target asset allocation, the fund could be required to show the expected risk level associated with that asset allocation over the life of the investment. In each case, the illustrations would need to be periodically updated to reflect actual market experience and any changes in management strategy.

## **Recommendation 2**

The Commission should adopt a standard methodology or methodologies to be used in both the risk-based and asset allocation glide path illustrations.

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<sup>8</sup> Daisy Maxey, "Evolving Target-Date Funds May Require More Guidance," *The Wall Street Journal*, February 19, 2013. (Available here: [http://professional.wsj.com/article/SB10001424127887323495104578314203197157768.html?mod=googlenews\\_wsj&mg=reno64-wsj](http://professional.wsj.com/article/SB10001424127887323495104578314203197157768.html?mod=googlenews_wsj&mg=reno64-wsj))

**Supporting Rationale:** A primary purpose of the glide path illustration is to allow side-by-side comparisons of target date fund risks. As noted above, we believe this is better achieved through a risk-based glide path illustration than an asset allocation glide path illustration, though we recognize that both may have their place. To promote comparability, risk-based illustrations should be based on a standardized measure of risk. Currently, no such standard exists, though a variety of accepted risk measures exist and are in use today. In determining the appropriate risk measure to use in a risk-based glide path illustration, the Commission should focus on factors such as maximum exposure to loss or volatility of returns that are directly relevant to the primary concerns of those approaching retirement. (Funds would remain free to supplement this disclosure with additional information about fund risk and methods they use to manage those risks, as they deem appropriate.) By the same token, we believe the proposed asset allocation glide path illustration would better serve its intended purpose if the Commission were to prescribe both the asset classes to be used in disclosing a target date fund's asset allocation and the methodology for calculating the percentage allocations. Failure to do so increases the likelihood that the asset allocation glide path illustrations will create a misleading impression of similarity among funds with significant differences in risk exposure.

### **Recommendation 3**

The Commission should require target date fund prospectuses to disclose and clearly explain the policies and assumptions used to design and manage the target date offerings to attain the target risk level over the life of the fund.

**Supporting Rationale:** The policies and assumptions that fund managers use in constructing their target date funds play a critical role in determining a fund's risk level at various points over the expected lifetime of the investment. Relevant factors may include whether the fund employs an active or passive investment strategy, whether or how the fund addresses protection against inflation in its asset selection, whether or how the fund may adjust its asset selection or other factors in response to changing market conditions, and what assumptions about "average" investor behavior are used in constructing the fund. While many if not most target date fund investors may be poorly equipped to evaluate qualitative disclosures with regard to these policies and assumptions, retirement plan consultants should be able to make good use of the information. Because these plan consultants play a gatekeeper role in selecting defined contribution retirement plan offerings and default options, the enhanced disclosures could provide significant indirect benefits to workplace investors in target date funds. Moreover, evidence noted above that retirement plan consultants tend to under-estimate the risk exposure in target date funds suggests that they would benefit greatly from a clear explanation of those risks and the strategies used to manage risk over the life of the fund. While the Commission proposal focuses on changes to the marketing materials and advertising of target date funds, this information, because of its complex and technical nature, would better be provided in the fund prospectus as a supplement to the risk illustrations proposed for inclusion in marketing materials.

### **Recommendation 4**

The Committee strongly supports the Commission proposal to require target date fund marketing materials to include a warning that the fund is not guaranteed and that losses are possible, including at or after the target date. The Commission should consider testing various approaches to providing this disclosure to determine the most effective approach and then mandate that approach in the final rule.

**Supporting Rationale:** The survey report commissioned by the SEC found that significant numbers of investors falsely believe that target date funds provide guaranteed income in retirement. The survey found that the sample marketing materials developed based on the Commission proposal significantly reduced, but did not eliminate, this confusion. For each of the four model documents tested, a majority of survey respondents correctly answered a true-false question about the possibility of losing money in a target date fund, with correct responses ranging from a low of 56 percent to a high of 61 percent. Given the importance of this information, however, we encourage the Commission to explore through investor testing whether alternative approaches to providing this warning might not improve the response rate. Based on the results of that testing, the Commission should consider mandating a disclosure approach that maximizes the effectiveness of the disclosure.

### **Recommendation 5**

The Commission should amend the fee disclosure requirements for target date funds to provide better information about the likely impact of fund fees on total accumulations over the expected holding period of the investment.

**Supporting Rationale:** The Committee believes that promoting improved investor understanding of fees and costs is a priority that deserves attention across all categories of investment products and services. However, because target date funds are specifically designed as long-term investments, often held over a period of several decades, fund fees can have a particularly significant impact on total accumulations over the life of the investment. In our view, the fee table currently provided in the fund summary and fund prospectus does not adequately illustrate the significant impact that seemingly small differences in fees can have on long-term accumulations. We therefore urge the Commission to explore ways to improve this disclosure. Where a fund is designed for a retirement date many years in the future, for example, the impact of fees could be measured based on that expected retirement date. Similarly, the calculation could be based on average or “typical” annual investment amounts in the fund. Ideally, the information would be provided in a way that allows investors (and retirement plan consultants) to easily determine how these accumulated costs compare with those of other target date funds. Finally, the Commission should require that this information be included in target date fund marketing materials. This exploration of how to more effectively convey the impact of fund fees has implications beyond target date funds, but it is particularly relevant in the context of an investment that is specifically designed to be held for several decades and as an appropriate option for less sophisticated, middle income investors.