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Employee Benefit
Research Institute

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Office of Regulations and Interpretations
EBSA
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RE: Joint Target-Date Fund Hearing, June 18, 2009, Rm. 5655

This is EBRI's request to testify at the upcoming joint hearing on target-date funds. The nonpartisan Employee Benefit Research Institute has conducted extensive and unique analyses of both 401(k) plans and target-date funds (online at www.ebri.org), and its testimony would cover these topics:

- **Target-Date Funds Use and Allocation within Fund Families and Participants' Accounts (2 minutes)**
    - This portion of the presentation will use the unique richness of the data in the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project, which has almost 22 million participants from more than 56,000 plans, to examine the choices and characteristics of participants whose plans offer target-date funds.[1]
    - Topics covered in this portion include:
        - Extent of Their Use
            - Of the 401(k) plan participants in plans that *offered* target-date funds, 37 percent had at least some fraction of their account in target-date funds in 2007.
            - Target-date funds held about 7 percent of total assets in 401(k) plans as of end of year 2007.
            - The Pension Protection Act of 2006 (PPA) has resulted in target-date funds being the funds of choice as the default investment in 401(k) plans, leading to greater offerings by plans going forward.
        - Demographics of Their Use. On average, target-date fund investors are:
            - About 2.5 years younger than those who do not invest in target-date funds,
            - Have about 3.5 years less tenure,
            - Make about $11,000 less in salary,
            - Have $25,000 less in their account,
            - And are in smaller plans.
        - Equity Allocations Within Fund Families: The equity allocations of various target-date fund families have significantly different shapes and starting/ending equity allocations. As of 2007, the equity allocation ranges from about 80–90 percent for 2040 funds, and from 26–66 percent for 2010 funds. Moreover, the fund families change their relative rank in equity allocation within the different fund years.

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        - The relative rank of the equity allocation within a target-date fund year does not appear to affect the percentage of participants investing all their account in that fund.
        - Investors in specific fund families are more likely to invest all their assets in a single target-date fund from that family, regardless of the relative equity allocation rank.
    - Resulting Allocations within Accounts:
        - Participants' use of target-date funds alone or in combination with other investment options varies widely.
        - Yet, the use of target-date funds—regardless of the fund's characteristics— tends to move participants' overall asset allocations in 401(k) plans away from all-or-nothing allocations in equities and provides for greater rebalancing of assets toward more conservative investments as the participant ages, when compared with 401(k) participants' voluntary investment decision-making.
        - This results in participants having a theoretically superior long-term asset allocation based on taking larger risks when they are young and lower risks as they get closer to retirement.

- **How would 401(k) participants have fared had they been in target-date funds recently? (4 minutes)**
    - Using the "consistent sample" of 401(k) participants in the EBRI/ICI database who have been with the same plan sponsor since year-end 1999, we will project the ratio of account balances under several alternative scenarios to the account balances they actually have at the end of the most recent time period available.
    - It is well known that a significant portion of 401(k) participants have their balances invested in a manner that does not conform with asset allocations that would be recommended by most financial advisers:
        - A sizeable percentage of 401(k) participants have no equities (broadly defined).[2] Overall, 13.2 percent of the 401(k) participants in the year-end 2007 EBRI/ICI data base fell into this category.[3] While there may be reasons for some 401(k) participants on the verge of retirement to have little or no asset allocation to equities, it may be problematic that 19.2 percent of 401(k) participant in their twenties have no equity allocation.
        - A sizeable percentage of 401(k) participants still have a significant percentage of their balances invested largely in company stock. Overall, 14.5 percent of the 401(k) participants in the year-end 2007 EBRI/ICI database who were in plans with company stock had more than 50 percent of their account balances invested in company stock.[4]
            - However, in the aftermath of Enron,[5] this number has decreased. This is particularly true for recently hired employees with respect to both frequency and severity.
                - Overall, 8.6 percent of the account balances for the recently hired[6] 401(k) participants in the year-end 1998 EBRI/ICI data base were invested in company stock. This number fell to 5.1 percent for year-end 2007.[7]
                - In 1998, 60.5 percent of all recently hired 401(k) participants who were in plans with company stock held company stock. This number decreased to 38.7 percent in 2007.[8]
                - In 1998, 21.3 percent of all recently hired 401(k) participants who were in plans with company stock had at least 50 percent of

their account balance in company stock. This number decreased to 7.9 percent in 2007.[9]

        - A significant percentage of 401(k) participants between 55 and 64 in the year-end 2007 EBRI/ICI database had equity positions that may be considered extreme when considered in isolation:
            - More than 1 out of 5 participants have more than 90 percent of their balances in equities (broadly defined), and more than 2 out of 5 have more than 70 percent in equities.[10]
            - Note that if the average target-date fund equity exposure for this age group in 2007 had been 51 percent, then AT LEAST 40 percent of this age cohort would have had at least a 20 percentage point reduction in equity concentration had they been in target date funds.
    - We will provide a series of counterfactual experiments on the relative financial performance by age cohort over this time period for actual participant directed investments relative to:
        - The average target-date fund (in terms of equity concentration)
        - The most conservative target-date fund
        - The most aggressive target-date fund
        - A proxy for returns from stable value funds during this period.
- **How would target date funds likely impact FUTURE 401(k) accumulations? (4 minutes)**
    - As part of EBRI's analysis of the likely impact of the PPA's safe harbor automatic enrollment and automatic escalation provisions,[11] we developed a stochastic simulation model to project future 401(k) balances (as well as IRA rollover balances assumed to originate in 401(k) plans) as a function of various plan design variables as well as assumptions with respect to various employee behavioral responses.
    - Although the counterfactual experiments in the previous section will provide useful information in assessing how target-date funds may have changed various outcomes during this decade, we realize that this is a very short period of time to assess the efficiency of any investment strategy. Therefore, we will use the EBRI simulation model to determine how the four alternative investment scenarios mentioned above would likely impact 401(k) participants assumed to be automatically enrolled.[12]

Sincerely,

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Endnotes

[1] See Craig Copeland, "Use of Target-Date Funds in 401(k) Plans, 2007," *EBRI Issue Brief,* March 2009.

[2] The broad definition of equities includes equity funds, company stock, and the equity portion of balanced funds (including target date funds).

[3] See Figure 27 in Jack VanDerhei, Sarah Holden, Luis Alonso and Craig Copeland, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007," *EBRI Issue Brief* and ICI Perspective, December 2008.

[4] See Figure 30 in Jack VanDerhei, Sarah Holden, Luis Alonso and Craig Copeland, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007," *EBRI Issue Brief* and *ICI Perspective,* December 2008.

[5] See Testimony by Jack VanDerhei for the Senate Finance Committee Hearing on Retirement Security: Picking Up the Enron Pieces, February 27, 2002; Testimony by Jack VanDerhei for the House Ways and Means Committee Hearing on Retirement Security and Defined Contribution Pension Plans, February 26, 2002; and Statement of Jack VanDerhei for the House Education and Workforce Subcommittee on Employer-Employee Relations Hearing on Enron and Beyond: Enhancing Worker Retirement Security, February 13, 2002.

[6] We define "recently hired" employees as those with two or fewer years of tenure.

[7] See Figure 36 in Jack VanDerhei, Sarah Holden, Luis Alonso and Craig Copeland, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007," *EBRI Issue Brief* and *ICI Perspective*, December 2008.

[8] See figure 37 in Jack VanDerhei, Sarah Holden, Luis Alonso and Craig Copeland, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007," *EBRI Issue Brief* and *ICI Perspective,* December 2008.

[9] See Figure 38 in Jack VanDerhei, Sarah Holden, Luis Alonso and Craig Copeland, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007," *EBRI Issue Brief* and *ICI Perspective*, December 2008.

[10] See Figure 10 in Jack VanDerhei, "The Impact of the Recent Financial Crisis on 401(k) Account Balances," *EBRI Issue Brief*, February 2009.

[11] See Jack VanDerhei and Craig Copeland, "The Impact of PPA on Retirement Savings for 401(k) Participants" *EBRI Issue Brief,* June 2008.

[12] We realize that the fourth alternative would not technically qualify for the fiduciary protection offered for QDIAs; however, we will provide simulations assuming they are included as a fourth alternative to the current final regulations.