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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

UNITED STATES DEPARTMENT OF LABOR

PUBLIC HEARING ON
TARGET DATE FUNDS
AND OTHER SIMILAR INVESTMENT OPTIONS

Thursday, June 18, 2009

9:00 a.m.

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P R O C E E D I N G S

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MR. DOYLE: Welcome to our joint hearing on Target Date Funds and Similar Investments. It is a joint undertaking by the Department of Labor and the Securities and Exchange Commission, a first, and I would also note it's a first in terms of at least the Department of Labor's webcasting of one of its hearings, so in terms of at least the Department of Labor's webcasting one of its hearings, so an exciting day I think all around for us certainly, and a day to learn a lot about target date funds and some of the issues that have been surrounding those types of investments of late.

14

Prior to opening remarks from Seth Harris, Deputy Secretary of Labor, and Mary Schapiro, Chairman of the Securities and Exchange Commission, I just want to thank both the SEC staff and the Department of Labor staff for all the work that went into organizing this morning's hearing.

19

I think what we will begin with is opening remarks, and then I'll cover, following those remarks, some of the technical aspects, the administrative aspects of this morning's hearing, but we will be going on a panel-by-panel basis. There are subjects that have been associated with the various panels. We tried to do the best in doing some

24

1 informal categorization, but the panelists will not
2 necessarily be limited to those particular topics.

3 So with that, we will officially begin our hearing
4 today, and I will introduce Seth Harris.

5 MR. HARRIS: Thank you very much.

6 Good morning, everyone, and welcome to the Labor
7 Department on behalf of Secretary Solis and the Employee
8 Benefits Security Agency and all of us here at the Labor
9 Department. We're delighted to have you here and to be
10 embarking on this unique and hopefully not unique for long
11 partnership with our friends and partners at the Securities
12 and Exchange Commission.

13 We are delighted to welcome Chairman Mary Schapiro
14 and Commissioners Walter and Paredes here today to review the
15 issues related to the use and the offering of target date
16 funds by participants in 401(k) plans and by individual
17 investors.

18 And of course I'd like to thank Senator Kohl, who
19 chairs the Senate Special Committee on Aging, for his
20 interest and the work of his committee and his committee
21 staff on some of the challenges that are faced by today's
22 investors as they save for retirement.

23 I'm especially delighted to be able to participate
24 today because I am myself an investor in a couple of target

1 date funds, so I'm looking forward to learning what I've
2 gotten myself into.

3 As most of the people in this room know already,
4 target date and lifecycle funds are designed to be simple,
5 long-term investment vehicles for individuals with particular
6 target retirement dates in mind. They operate by investing
7 in a diversified mix of investments and automatically
8 shifting that mix away from riskier investments to more
9 conservative investments, perhaps lower yield but more
10 reliable investments, as the target date approaches. That
11 shift is referred to as a fund's glide path.

12 These investments funds have become increasingly
13 popular with investors including participants in 401(k) plans
14 because of those built-in features. An investor can choose
15 an appropriate target retirement date and let the fund
16 managers do the rest because investments will automatically,
17 or at least by the design of the manager, become more
18 conservative as the retirement date approaches.

19 Their increasing popularity, I think it's fair to
20 say, is also due in part to the Department's identification
21 of target date type funds as appropriate investments for plan
22 sponsors when they're investing 401(k) plan contributions on
23 behalf of participants who don't give specific investment
24 instructions. They're appropriate, we have said that they

1 are appropriate default investments for employees in their
2 401(k) plans.

3 Recent concerns have been raised about variation in
4 the glide paths of target date funds offered by different
5 providers and how that variation may result in plan
6 participants and investors unknowingly placing their
7 retirement assets at risk, or at least not knowing exactly
8 what risks they are bearing with respect to their particular
9 investment, making choices without the full information that
10 we would like them perhaps to have. We are here today to
11 explore precisely those concerns.

12 We're going to hear about how target date fund
13 managers make decisions about their funds' glide paths and
14 underlying fund investments, what information is disclosed to
15 plan sponsors, plan participants and individual investors and
16 how investors such as 401(k) plan participants are using
17 these funds.

18 The public record established as part of today's
19 hearing will help us determine whether regulatory or other
20 guidance will be helpful to alleviate those concerns, and
21 we're hoping to learn more about all of that from those of
22 you in the room today and others.

23 Let me thank the members of our panel including
24 representatives from both the Labor Department's EBSA and the

1 SEC, and I want to thank all of the witnesses who are going
2 to be testifying throughout the day about these important
3 topics. We are delighted that you are willing to come here,
4 share information, help us to figure out this emerging and
5 growing field of retirement planning and retirement investing
6 in our society. Of course our goal is safeguard investors'
7 funds and to assure a secure retirement for every American.

8 Now, it's my great pleasure, let me just say, the
9 reason I say that, while this meeting is unique, we hope it's
10 not going to be unique in a few years is we hope that this is
11 a beginning of a longstanding, soon-to-be-longstanding
12 partnership or a long-lasting perhaps I should say
13 partnership with our colleagues at the SEC.

14 It's, frankly, unclear to me why this hasn't been a
15 partnership that's been in existence for years and years and
16 years since we have responsibilities that don't just overlap
17 but that should be closely integrated and I think common
18 interests between the two organizations.

19 So we're delighted to be able to welcome three
20 members of the SEC today, and particularly it's my great
21 pleasure to be able to both welcome and introduce the Chair
22 of the SEC.

23 Prior to becoming the SEC Chairwoman, Mary L.
24 Schapiro was the CEO of the Financial Industry Regulatory

1 Authority, or, to the cognoscenti in this field, FINRA.
2 That's the largest nongovernmental regulator for all
3 securities firms doing business with U.S. public, and she had
4 previously served as a Commissioner of the SEC as well as the
5 chair of the Commodities Futures Trading Commission.

6 On January 20, 2009, she was appointed the 29th
7 chair of the Securities and Exchange Commission by President
8 Barrack Obama, and it's my great pleasure, and I hope you'll
9 join me, in welcoming Mary Schapiro.

10 (Applause.)

11 CHAIRMAN SCHAPIRO: Thank you very much, Seth.
12 It's really a thrill for me to be here and for us to begin
13 what I also hope will be a very long and successful
14 partnership with the Department of Labor. Our interests are
15 very much aligned as we all work to protect investors and
16 retirees in our country.

17 I also want to thank Secretary Hilda Solis and the
18 very dedicated staff of the Department of Labor for hosting
19 this event and working with the staff at the SEC to get it
20 organized.

21 I'd also like to echo Deputy Secretary Harris'
22 thanks to Senator Kohl for his focus on target date funds. I
23 think that was an important impetus for all of us to really
24 pay attention to this space.

1 As you've heard, target date funds have become an
2 increasingly popular investment option for Americans
3 investing for retirement and educational needs. These funds
4 and other similar investment options are financial products
5 that allocate their investments among various asset classes.
6 These funds automatically shift that allocation to more
7 conservative investments as a target date approaches, and
8 this shifting allocation is frequently referred to as the
9 funds' glide path.

10 The set-it-and-forget-it approach of target date
11 funds can be very appealing to investors. Target date funds
12 were expected to make investing easier for the typical
13 American and avoid the need for investors to constantly
14 monitor market movements and realign their personal
15 investment allocations.

16 But the reality of target date funds was quite
17 surprising to many investors last year. It has been reported
18 that the average loss in 2008 among 31 funds with a 2010
19 target date was almost 25 percent, but perhaps even more
20 surprising were their widely varying performance results.
21 Returns of 2010 target date funds in 2008 range from minus
22 3.6 percent to minus 41 percent.

23 These varying results should cause all of us to
24 pause and consider whether regulatory changes, industry

1 reforms or other revisions are needed with respect to target
2 date funds, and this is what I hope today's joint hearing
3 will help us assess.

4 I'm really looking forward to an in-depth
5 discussion of target date funds, their construction, their
6 role in retirement investing, their allocation to various
7 investment classes and the understanding or perhaps
8 misunderstanding of target date funds by some retail
9 investors.

10 I'm of course particularly interested in how SEC
11 regulations, including our disclosure requirements, impact
12 target date funds. For example, do our regulations foster
13 investor understanding of target date funds, their risk
14 characteristics, their fees and the meaning of a particular
15 target date that's actually used in the fund's name.

16 And of course I'm interested in whether it's
17 necessary to improve SEC regulations to address any
18 deficiencies with respect to target date funds. Of all of
19 the issues that the SEC is examining at the moment, our
20 review of target date funds is one that may most directly
21 affect everyday Americans seeking access to our securities
22 markets to help build a better life and a greater sense of
23 financial security for themselves and for their families.

24 We owe these workers and other investors our

1 commitment to addressing target date funds' issues for their
2 benefit. I believe that today's hearing, which features a
3 number of respected experts and impassioned thought leaders,
4 will help advance the understanding of these funds and help
5 crystalize our thoughts on the role of target date funds in a
6 retail investor's retirement portfolio.

7 As you know, the administration is in the midst of
8 overhauling the entire regulatory landscape with the goal of
9 better protecting investors and restoring confidence in the
10 markets, and we are doing our share within each of our own
11 agencies to achieve these goals as well, and I think today's
12 hearing is an example of just that.

13 So I also want to thank all of today's joint
14 hearing participants for volunteering to share their views
15 and insights with us. I look forward to hearing from you and
16 to engaging in a meaningful dialogue on target date funds.
17 And finally I'd also like to thank the staff members of the
18 SEC who worked with the Department of Labor to bring this
19 event about, primarily Buddy Donohue and Tara Buckley. Thank
20 you all very much for being here.

21 (Applause.)

22 MR. DOYLE: The panels will be called in the order
23 in which they are listed in the agenda. We ask that each
24 panel member in advance of their testimony identify

1 themselves, who they are affiliated with, who they're
2 testifying on behalf of, and perhaps a short indication of
3 the nature of the organization they're representing, unless
4 it's otherwise obvious from the description.

5 It's important that, again, we try to stay within
6 the allocated time limits. There will be an opportunity to
7 supplement the record. We will keep the official record open
8 for 30 days so those testifying that want to supplement their
9 remarks will certainly have an adequate opportunity to do so.

10 We would also invite those who have not had an
11 opportunity to testify today that may have views on the
12 issues or some of the comments or testimony they hear today
13 to submit their views.

14 As I indicated, this proceeding is being webcast,
15 and the webcast will be archived and available on both our
16 website and through the SEC website. We will also have a
17 transcript of the proceeding as the official record, and
18 those will be available in both agencies' public disclosure
19 rooms.

20 I suppose I should introduce the panel. Going from
21 my right to left, we have Commissioner Troy A. Paredes;
22 Elissa B. Walter, Commissioner, SEC; of course Chairman
23 Schapiro; Alan D. Lebowitz, Deputy Assistant Secretary for
24 the Employee Benefits Security Administration; Joe

1 Piacentini, to my immediate right, who is EBSA's Chief
2 Economist and Director of Policy and Research.

3 With that, I think we'll call the first panel.

4 MS. McMILLAN: Good morning, Chairman Schapiro and
5 distinguished members of the panel. I'm Karrie McMillan, the
6 general counsel of the Investment Company Institute. We're
7 the National Association of Registered Investment Company
8 Industry, and I'm very pleased to testify here today on
9 behalf of ICI and its members on the subject of target date
10 funds.

11 This hearing was inspired in large part by the
12 market turmoil of the last two years, a bear market that is
13 wider, deeper and more unsettling than any in generations,
14 and that turmoil has taken a significant toll on retirement
15 plans of all types.

16 We're very mindful of the declining balances that
17 workers have seen and that those declines are particularly
18 hard on workers that are nearing retirement. Because this
19 downturn has hit a wide range of asset classes, diversified
20 investments such as Target Date Funds have not been immune,
21 so we welcome this examination of how Target Date Funds are
22 constructed, used and understood.

23 Target Date Funds are one of the most important
24 recent innovations in retirement savings. They provide a

1 convenient way for an investor to purchase a mix of asset
2 classes within a single fund that will re-balance the asset
3 allocation and become more conservative as the investor ages.

4 Research shows that asset allocation is one of the
5 most important factors in portfolio performance, and just as
6 important, Target Date Fund investors avoid extreme asset
7 allocations that we often observe in retirement savings, a
8 25-year-old that holds only cash or a 60-year-old that is
9 fully invested in equities alone.

10 Just like growth funds or value funds, Target Date
11 Funds are not all the same. Some providers design their
12 Target Date Funds to reach the most conservative asset mix at
13 or shortly after the target date. These funds place a higher
14 priority on producing immediate income and preserving assets
15 at retirement age.

16 Many other providers design their Target Date Funds
17 to reach their most conservative asset allocation ten or
18 twenty years or even longer after the target date, and these
19 funds emphasize the need to earn higher returns at and after
20 the retirement age in order to increase assets and generate
21 income later into retirement.

22 Clearly it is vital that employers, 401(k) plan
23 participants and IRA investors understand these and other key
24 features of any Target Date Funds that they're considering.

1 While Target Date Mutual Funds currently do a good
2 job of describing their objectives, risks and glide paths, we
3 do see gaps in the public understanding of Target Date Funds
4 generally, so ICI formed a working group of members to
5 propose ways to enhance understanding.

6 After several months of work, the group identified
7 five key pieces of information that employers and investors
8 should consider about any Target Date Fund and drafted
9 principles to insure that this information is prominently and
10 clearly displayed.

11 So what are those five key pieces of information?
12 First, the relevance of the target date used in the fund's
13 name including what happens at the target date. A fund
14 should explain that the target date represents the assumed
15 retirement date and when the investors expect it to stop
16 making further investments.

17 Second, the fund's assumptions about the investor's
18 withdrawal intentions. A fund should explain whether it is
19 designed for an investor who expects to spend all or most of
20 his or her money at retirement or is designed for an investor
21 that plans to withdraw money over a longer period of time.

22 Third, the age group for which the fund is
23 intended, and, fourth, an illustration of the glide path that
24 the Target Date Fund follows to become more conservative over

1 time. The illustration should highlight the asset allocation
2 both at the target date and at the date that the fund reaches
3 its most conservative allocation.

4 We also think there should be a simple narrative
5 describing the same information, and, if an asset manager has
6 the discretion to deviate from the glide path, the parameters
7 of that should also be described.

8 And finally, a statement that the risks associated
9 with a Target Date Fund include the risk of loss near, at or
10 after the target date, and that there is no guarantee that
11 the fund will provide adequate income at or through the
12 investor's retirement.

13 We believe that these principles can be applied to
14 any Target Date Fund product used for retirement savings no
15 matter who offers it. The principles are not meant to
16 replace the disclosures already in place by the federal
17 securities laws, ERISA or other statutes, but, rather to
18 highlight how disclosures can be made effectively within
19 these standards. My written statement includes a copy of the
20 disclosure principles, sample language and an illustrative
21 fund information sheet showing how the disclosures can be
22 implemented.

23 Our working group also considered whether we could
24 enhance investor understanding of Target Date Funds by

1 changing the names of these funds. As detailed in my written
2 statement, the group considered changing the current
3 convention of linking the name of the fund to the target
4 date's assumed retirement date, it considered dropping any
5 mention of target dates from fund names, and it considered
6 adding descriptors to fund's names. In each case, the
7 working group concluded the changes could increase investor
8 confusion, still without providing all of the information
9 that an investor needs to know about these particular funds.

10 In the end, we are firmly convinced that investor
11 understanding of Target Date Funds should be enhanced through
12 disclosure and education, and we stand ready to work with
13 regulators and others in the retirement industry to improve
14 understanding of the Target Date Funds.

15 Thank you.

16 MR. WHITNEY: Good morning. My name is Richard
17 Whitney, and I'm the Director of Asset Allocation of T. Rowe
18 Price and lead the team responsible for the T. Rowe Price
19 retirement funds. Thank you for this opportunity to present
20 our views regarding the important topic of Target Date Funds
21 and your efforts to determine if additional guidance is
22 needed.

23 The T. Rowe Price retirement funds are designed to
24 make investing easier and more successful for participants,

1 both during the accumulation stage when they're saving for
2 retirement and during the post-retirement stage when they're
3 managing their savings to last through their lifetimes.

4 Our design is based on the concept of a single fund
5 focused on the expected retirement date of an individual can
6 be a suitable investment for life for a broad population of
7 investors who choose to delegate their investment decisions
8 to professionals. It is not intended to require an investor
9 to switch to an alternative strategy at retirement.

10 We'd like to make several points this morning from
11 our written testimony. First, investing for retirement
12 involves facing a variety of risks including market,
13 inflation and longevity and managing the tradeoffs between
14 them.

15 Focusing solely on short-term market volatility
16 will leave investors vulnerable to other risks. There's no
17 single strategy that's optimal for all these risks at the
18 same time, but Target Date Funds attempt to strike a balance
19 between them.

20 The second point is satisfactory outcomes will only
21 come through sound financial advice provided through
22 investment vehicles that simplify actions required by
23 participants. Target Date Funds were designed to be easy to
24 use and require little maintenance.

1 And our third point is that plan participants
2 should understand their investments, and we support industry
3 efforts to adopt model disclosure principles.

4 We're of course now focused on market risks, and,
5 while the recent experience has understandably led many of us
6 to overemphasize the short-term volatility of equity markets
7 versus their long-term benefits, it also tempts us to
8 underemphasize the longer-term challenges participants face
9 in funding their retirement years. However, those risks
10 remain substantial.

11 The erosion of purchasing power by inflation
12 continues to be a serious long-term threat. Assuming a
13 relatively conservative 3 percent inflation rate, the real
14 value of retirement assets will be cut in half in just over
15 20 years. An income stream of \$40,000 a year must grow to
16 \$80,000 a year to maintain the same level of purchasing
17 power.

18 Rising life expectancy means the duration of income
19 needed from retirement savings is increasing. Average life
20 expectancy at age 65 is approaching 20 years. Today the
21 chance that one member of a couple in their sixties will live
22 beyond 90 is more than 50 percent, and there is almost a 25
23 percent chance that one spouse will live to 95.

24 In short, many should expect to spend 30 or more

1 years in retirement, and because the elderly are most -- the
2 most elderly are most likely to need expensive custodial care
3 or other support services, retirees generally are likely to
4 need greater financial resources in the later years of their
5 retirement, not less.

6 After considering all these factors in conjunction
7 with extensive simulation and financial modeling tested
8 against historical data, it's clear to us that an appropriate
9 asset allocation strategy must balance short-term volatility
10 against long-term earnings potential.

11 When considering the typical rates of savings and
12 withdrawals, the need for equity becomes even stronger. At
13 the same time, we understand that investors' tolerance and
14 capacity to bear risks varies as they age, and so we manage
15 the degree of market risks through the use of a glide path.
16 This glide path tends to match portfolio volatility to the
17 declining risk tolerances typically exhibited by investors as
18 they age.

19 Our second point is that participant behavior can
20 significantly influence their financial success. Our funds
21 were developed in response to the fact that many individuals
22 have neither the time nor expertise to construct an
23 investment strategy to see them through retirement.

24 Target Date Funds were designed to address these

1 difficulties through a comprehensive, diversified asset
2 allocation portfolio that minimizes the decisions needed from
3 an investor, and while 2008, was a test of strategies, it's
4 also a test of the behaviorally friendly design that Target
5 Date Funds are intended to offer.

6 The results so far show that participants appear to
7 have stayed the course and have stuck with their investments
8 to a much greater extent than would have been expected by
9 many observers.

10 To be sure, it's likely this outcome is driven by
11 inertia working in investors' favor here, but there are also
12 indications that target date investors have been so far even
13 less likely to make changes to their strategy than investors
14 with more of a do-it-themselves approach.

15 The last point is that target date investors should
16 understand their investments and how they fit into an overall
17 plan for retirement. In most cases, consultants or advisors
18 assist plan sponsors in selecting Target Date Funds that are
19 appropriate to the needs of their plan.

20 From our experience, consultants and sponsors are
21 very engaged in reviewing our products' glide path,
22 underlying investments, related risks and compare such
23 factors against those of other products in evaluating Target
24 Date Funds for their plans.

1 While we believe sponsors fully understand the
2 theory and practice of Target Date Funds, we also know that a
3 key to success for individuals is a suitable level of
4 confidence and knowledge to stay with their strategy during
5 challenging times.

6 Thank you.

7 MR. AMERIKS: Good morning. My name is John
8 Ameriks. I'm an economist and a principal at the Vanguard
9 Group. Thank you all very much for this opportunity this
10 morning to testify on behalf of the Vanguard Group on the
11 subject of Target Date Funds and their effectiveness as a
12 retirement savings vehicle.

13 Given the short amount of time that I have today, I
14 want to focus my remarks on three major points about Target
15 Date Funds. First, the diversification that Target Date
16 Funds offer is critical in helping investors manage the array
17 of financial and economic risks that they face throughout
18 their lives.

19 Second, while the financial markets have been
20 historically poor in the last year, Target Date Funds have,
21 in general, weathered this storm and have achieved the
22 objective of improving diversification and mitigating risks
23 for their investors.

24 And third, going forward, we see opportunities to

1 further simplify and improve disclosure and communications
2 with respect to Target Date Funds which could make these
3 funds even more effective for investors and plan
4 participants. So I'll address each of these points in turn.

5 First, diversification. At their most basic,
6 Target Date Funds are a diversified investment portfolio
7 designed to be appropriate for individuals accumulating
8 assets for retirement.

9 Target Date Funds are not designed to be riskless
10 or to provide a guaranteed amount of retirement income which
11 continues to be the crucial role of social security as well
12 as defined benefit pensions.

13 In contrast, the fundamental purpose of Target Date
14 Funds is to provide investors a diversified,
15 prudently-managed, appropriate exposure to investment risks.

16 Both financial theory and hundreds of years of financial
17 markets' experience suggest that broadly-diversified
18 investment risk is a compensated risk. By bearing these
19 risks, one can expect, on average, to earn a return well
20 above that of less-volatile investments.

21 The need to remain diversified and continue to bear
22 investment risks is not limited to younger investors.
23 Investors approaching or in retirement still have long
24 horizons. They need diversification and significant growth

1 potential to protect against inflation, longevity risk,
2 rising health care and other costs that are uniquely
3 important to this age group.

4 Second, on the current environment, when evaluating
5 the performance of Target Date Funds, it's important to
6 acknowledge the extreme severity of the financial meltdown we
7 have just experienced. Virtually all types of investment
8 portfolios, defined benefit plans, endowments, even the
9 general accounts of commercial insurers have suffered
10 significant losses.

11 Target Date Funds were no exception, but in our
12 view they performed as designed. In particular, in the vast
13 majority of cases, older investors were exposed to far less
14 risks than younger investors and consequently suffered less
15 dramatic losses. In addition, even in the worse cases, the
16 broad diversification of these funds helped to diminish the
17 impact of specific financial failures on investors.

18 It's also critical to note that in cases where
19 there was poor performance, it was not necessarily a result
20 of exposure to the stock market. In fact, underperformance
21 in certain sectors of the bond market was a major cause of
22 negative results in some funds.

23 We agree it's valuable to note and understand the
24 reasons why Target Date Funds perform well or poorly in

1 crisis, but it's just as critical to assess the value of
2 these funds over longer periods of time, and there the news
3 is not as dire.

4 In particular, at the end of May, all the Vanguard
5 target retirement funds with at least a five-year track
6 record generated positive returns over that five-year period
7 and over a far longer horizon, which is appropriate for even
8 retired investors, we expect our funds to provide a
9 significant positive return on average.

10 While general principles of diversification and
11 declining risk exposure with age are a part of all Target
12 Date Funds, a vigorous debate continues over the ideal design
13 of these funds. There are several design principles that
14 Vanguard adheres to which we believe are key factors in the
15 optimal design of TDFs.

16 Our Target Date Funds are comprised of different
17 combinations of seven underlying mutual funds. They include
18 our total stock market fund, total bond market index fund,
19 three international stock index funds representing the global
20 equity market, our TIPS fund and our prime money market fund.

21 Our glide path features a clearly specified,
22 passive allocation of these funds with equity allocations for
23 those under 40 at 90 percent declining to 50 percent at age
24 65 and falling to 30 percent by age 72, assuming retirement

1 at 65. Our funds have expense ratios of under 19 basis
2 points, less than one-fifth of 1 percent.

3 We believe that transparency, simplicity, broad
4 diversification and the low cost of this structure represent
5 an ideal approach to TDFs with many advantages for plan
6 sponsors and investors, but we recognize that investment
7 professionals, investors and plan sponsors may see
8 significant value in alternative approaches.

9 While we're convinced of the merits of our design,
10 we strongly believe that innovation and further improvement
11 of these funds can only occur if sponsors and investors have
12 the freedom to choose a specific design that best meets their
13 specific needs. The Target Date Fund market is and should
14 remain highly competitive. For all of these reasons, we
15 strongly oppose any efforts to regulate the glide paths or
16 other aspects of the investment design or construction of
17 Target Date Funds.

18 On disclosure, Target Date Funds are built on a
19 strong foundation; however, we recognize the challenges that
20 exist with regard to full and clear communication and
21 disclosure about various aspects of these funds.

22 The industry and the regulatory community can do
23 more to simplify and standardize information for plan
24 sponsors, participants and other investors. In general, we

1 favor proposals such as the ones outlined by the Investment
2 Company Institute which attempt to present information on
3 Target Date Funds in a simple, straightforward manner.

4 That said, we do want to emphasize the challenges
5 that exist in getting disengaged participants to read and
6 fully digest any information provided to them. In fact,
7 Target Date Funds were specifically designed to provide an
8 appropriate, broadly diversified, professionally managed
9 investment portfolio for exactly those participants who are
10 unlikely to pay sufficient attention to required disclosures
11 or communications.

12 Target Date Fund investing is one of the most
13 significant and promising innovations in the retirement
14 savings marketplace in years. These funds offer diversified,
15 low-cost, professional investment management to a wide
16 variety of plan participants and other retirement investors.

17 We strongly support both private and public efforts to
18 foster innovation growth and further adoption of these funds.

19 Thank you.

20 MR. YOUNG: Thank you for the opportunity to
21 present today. My name is Derrick Young, and I am the Chief
22 Investment Officer of the Fidelity Global Asset Allocation
23 Group. This is the investment team responsible for
24 Fidelity's Target Date Funds known as Freedom Funds.

1 Now since the advent of defined contribution plans
2 in the 1980s, Fidelity has been a leader in providing
3 comprehensive investment solutions, analytical tools and
4 administrative services to plan sponsors and participants.
5 The Freedom Funds were launched in 1996, and Fidelity was one
6 of the first mutual fund firms to offer Target Date Funds
7 specifically designed to meet investors' retirement needs.

8 The Freedom Funds are constructed to provide
9 individuals with a well-diversified investment portfolio that
10 is professionally managed and automatically re-balanced over
11 time, gradually shifting from asset types with greater risks
12 to those with lower risks. We take a long-term, strategic
13 approach to asset allocation decisions and employ a rigorous
14 process for selecting the underlying funds in the portfolios.

15 For a lifecycle fund to meet its objectives, three
16 elements are required: First, adequate and consistent
17 contributions; second, a disciplined investment strategy that
18 meets performance expectations; and, third, time.

19 While no asset allocation approach will be
20 successful if individuals do not contribute enough toward
21 retirement savings, we believe the best-suited strategy for
22 reaching a retirement goal is one that balances the tradeoffs
23 among required contributions, investment volatility and time.
24 Target Date Funds provide this balance and offer powerful,

1 sophisticated, long-term asset allocation strategies in a
2 simple, straightforward investment vehicle.

3 The Fidelity Freedom Funds are constructed with the
4 assumption that an individual's defined contribution
5 investments in combination with social security will
6 represent the bulk of his or her retirement income resources.

7 Based on this assumption, the savings objective for an
8 individual's defined contribution plan can be expressed in
9 the form of a salary multiple such as a retirement account
10 balance of ten times ending salary at target date.

11 While future investment returns are unknown, we can
12 evaluate strategies using historical risks and returns of
13 various market indices for stocks, bonds and cash
14 equivalents. Using these assumptions, we can solve for the
15 required contribution rates among different investment
16 strategies.

17 To illustrate the benefits of the target date
18 approach, it is useful to consider two extreme cases. If we
19 consider an all-cash portfolio over the last 30 years, 29
20 percent of a participant's salary must be contributed each
21 year to reach the savings objective. While this approach
22 poses no market risk of losing money, the contribution rate
23 would be prohibitively high for the majority of investors.

24 If we assume an all-stock portfolio over the same

1 period, the contribution rate is reduced to approximately 14
2 percent of annual salary, a more obtainable level. However,
3 an all-stock portfolio exposes investors to substantial
4 volatility as the experience of 2008 demonstrates. A remedy
5 for excessive volatility is to reduce stock exposures as the
6 target date approaches.

7 Now when we evaluate a general lifecycle strategy
8 over the prior 30 years, our analysis showed the required
9 contribution rate to reach the objective is just over 12
10 percent of annual salary, lower than either the all-cash or
11 the all-stock strategy. While the next 30 years may not
12 resemble the last, these relationships are maintained over
13 most time horizons of similar length; therefore, an
14 investment in a Target Date Fund has the potential to reduce
15 volatility compared to an all-stock portfolio but provide a
16 more realistic chance for achieving the retirement goal than
17 an all-cash portfolio.

18 The target date is the point at which the
19 accumulation phase and the distribution phase meet. For the
20 typical investor, the distribution of income phase will
21 extend for 20 years beyond retirement and could reach 30
22 years or longer for some retirees.

23 The asset allocation for the Freedom Funds at the
24 target date and in the retirement years recognizes several

1 risks that can be grouped into four broad categories:
2 Longevity risk, market risk, withdrawal-rate risk and
3 inflation.

4 The Fidelity Freedom Funds currently have an
5 allocation of about 50 percent to equities at the target
6 date, and this gradually declines until reaching 20 percent
7 equities about 15 years after the target date.

8 We believe that the Freedom Funds glide path
9 prudently balances the risk of retirees outliving their
10 savings, exposure to capital market declines,
11 higher-than-expected spending rates in retirement and the
12 damaging effects of inflation.

13 The challenging market environment in 2008 has
14 raised concerns about the viability of long-term investment
15 strategies such as those used by Target Date Funds. After
16 the worst year for the stock market since 1931, it is
17 understandable that investors have strong emotions in
18 reaction to short-term market events. In this type of
19 environment, many individuals take dramatic action with their
20 investment portfolios, often selling at depressed levels only
21 to buy back at higher priced levels.

22 To avoid these pitfalls, we believe that it is
23 important for investors to stay committed to a retirement
24 savings plan. Target Date Funds are designed to help

1 participants maintain this discipline.

2 Fidelity appreciates your concerns regarding the
3 portfolio construction and performance of Target Date Funds.

4 As America's retirement leader, Fidelity is committed to
5 helping solve the retirement savings challenge. We believe
6 that the investment principles used by Target Date Funds
7 provide a critical foundation for individuals' savings for
8 retirement and are an effective solution for participants who
9 lack the time and inclination to apply lifecycle principles
10 to their own retirement portfolios.

11 Thank you for the opportunity to discuss this
12 important topic today.

13 MR. KNIGHT: Good morning. My name is Jeff Knight.
14 I am managing director and head of global asset allocation
15 at Putnam Investments in Boston, Massachusetts. In this
16 role, I helped to design our lifecycle offerings in 2003 and
17 am presently lead manager on both our retirement-ready and
18 retirement-advantage lifecycle strategies.

19 I first want to commend the Department of Labor and
20 the Securities Exchange Commission for convening today's
21 hearing on Target Date Funds, arguably the single, most
22 useful investment innovation of the past generation with
23 particular value in workplace savings such as 401(k) plans,
24 403(b)s and 457s.

1 Congress, in our view, took a major step forward
2 with the Pension Protection Act of 2006 to recognizing the
3 emerging role of workplace savings as the primary source of
4 future retirees' lifelong incomes.

5 The PPA's explicit recognition of lifecycle or
6 Target Date Funds as qualified default alternatives
7 appropriately called attention to an investment strategy that
8 helps investors solve a complex, lifelong challenge with a
9 single strategy that provides diversification, risk
10 adjustment and re-balancing over a lifetime. Since many
11 participants in a workplace savings program rarely, if ever,
12 change their investment elections, mutual funds that adjust
13 over time are especially valuable.

14 Within the overall lifecycle pattern, there are
15 many different approaches or glide paths for managing the
16 shift from higher to lower risk allocations. All lifecycle
17 fund managers must balance the objectives of growing
18 investors' wealth and protecting investors' wealth in the
19 face of market risk and longevity risk.

20 At Putnam, we have prioritized wealth conservation
21 in our glide path design as evidenced by our low allocation
22 of 25 percent to equities at our funds' designated target
23 date. Our research concludes that such conservatism
24 minimizes the risk of asset depletion or severe financial

1 stress in late old age.

2 Last year the stress across financial markets was
3 unusual and severe. Stocks, as measured by the S&P 500 Index
4 fell by 37 percent, its third worst year since 1900. In
5 addition, many categories of fixed income securities
6 including corporate bonds and mortgage-backed bonds fell in
7 price almost as dramatically as equities did as forced
8 selling into frozen credit markets drove unprecedented
9 pricing volatility in those areas. Diversification therefore
10 across asset classes or across geographies provided only weak
11 defense against these market losses.

12 Not every investor in lifecycle funds, though, was
13 hurt by these events. Younger investors in lifecycle funds
14 still have plenty of time before retirement. They may well
15 recoup all of last year's losses long before they have to
16 draw down their savings, and for them the stock market drop
17 represents a chance perhaps to buy low, accumulating
18 long-term equity in bonds at reduced prices.

19 But for investors in or very close to retirement,
20 the timing was awful. Many 2010 lifecycle funds, including
21 ours, fell by 25 to 30 percent or even more. For those who
22 needed to draw current income from these shrinking
23 portfolios, the impact was severe. Under stress, existing
24 risk-dampening strategies fell short last year.

1 In fairness, this episode is not over, and
2 securities prices have recovered substantially in 2009. Our
3 own 2010 fund, for example, has gained over 10 percent at NAV
4 through June 15th.

5 A calm reckoning, though, of last year's events
6 suggest that we indeed have work to do to improve the
7 resilience of lifecycle strategies, but to dismiss the
8 lifecycle concept now in the wake of a market trauma or to
9 return to stable-value funds, for example, as qualified
10 default options in our retirement policy planning would be a
11 gross mistake. A more sensible course is for providers to
12 identify and repair the vulnerabilities that were exposed by
13 the market stress of 2008.

14 The good news is that we can and should evolve and
15 improve these funds. Among the steps that we are taking at
16 Putnam to improve the resiliency of our lifecycle funds is
17 evaluating the role that absolute return strategies can play
18 in the glide path as well as evaluating methods to
19 incorporate customized insurance against longevity risk into
20 our product offerings.

21 And make no mistake: Target Date Funds face strong
22 market discipline and competitive pressures. There may at
23 times be a disconnect between the lifelong investment
24 horizons that lifecycle managers aim for, 30 years or more,

1 and the far shorter windows that some rating agencies use to
2 judge lifecycle funds' investment performance, often three
3 years or less; therefore, we would not oppose regulatory
4 guidelines to limit these pressures while fostering strong
5 competition.

6 On behalf of Putnam Investments, thank you very
7 much for this opportunity to share our views.

8 MR. DOYLE: Thank you very much.

9 Now we'll begin with the questioning. We'll start
10 with Chairman Schapiro.

11 CHAIRMAN SCHAPIRO: Thank you very much, and thank
12 you all so much. Thank you all so much for your
13 presentations. They're enormously helpful.

14 One of the things I'm trying to understand is the
15 extent to which, if it is at all a problem, that investors
16 have one set of expectations about the date in the Target
17 Date Fund, and you all have a different set of expectations
18 about what that date means, so for the fund groups, I guess
19 particularly, sorry, Karrie, I'd love to know if there's
20 consistency even among all of you about what the date means
21 in the name of the fund.

22 MR. WHITNEY: Well, I can start. I think there is
23 at least one degree of consistency. I think that all of us
24 would agree that the date in the fund name means the date at

1 which we expect investors to stop contributing to the fund,
2 so I think that's pretty standard across the industry.

3 And I think it's also relatively standard, although
4 there will be some more variation around this in terms of the
5 duration of time in which the fund is expected to generate an
6 income stream, there are some that have a much longer
7 duration than others.

8 MR. YOUNG: But I think there's a -- we have to make
9 a value judgment at that date as to what the priorities are,
10 and I think there is some difference of opinion in good faith
11 across that decision, whether or not we should treat equally
12 the risks of shortfall versus the value of happy surprises,
13 and I think that does allow for some fairly substantial
14 differences in the strategies that we champion at that point.

15 MR. AMERIKS: Yeah, I think that's right. For all
16 of us, the target date is used as the anchor for the design
17 of the asset allocations that we do. It's the point of
18 retirement around which we build the rest of the portfolio
19 allocation.

20 The reality is is that retirees do a lot of
21 different things with the money in these plans at the point
22 of retirement, and so there is some debate around exactly how
23 the money is going to be used. Many folks don't draw on this
24 money until the required minimum distributions kick in at 70

1 and a half, which may be well after when they've retired.
2 Others may want to roll that money out and choose an annuity
3 or other payout mechanism, so it's very difficult to come up
4 with a sort of specific answer that solves the problem for
5 everybody.

6 What we're trying to do is come up with, I think, a
7 prudent approach that tries to balance all of these needs,
8 and, you know, part of that is a judgment about how much risk
9 needs to be there. There's not a wrong answer there. It
10 really is a preference of where on an efficient frontier, if
11 you will, you want to be, and that's a fiduciary call.

12 MR. YOUNG: We tried -- I was going to say when we
13 launched the Freedom Funds back in 1996, and this is before
14 this industry had taken off like it has now, we were going
15 through and trying to determine what is the appropriate name
16 to have on a fund, and we went through a lot of debate about,
17 you know, should you use a birth date, should you use a
18 projected death date?

19 You know, if you go through and you look at those
20 alternatives, I mean you can see very quickly that all of a
21 sudden you're forced into thinking, now what is the most
22 logical date to use?

23 So as far as how it actually happened for us, we
24 did go through and we'd say, you know, the retirement date is

1 a very important date for people to think about their
2 investment savings. We want it to be a threshold. We want
3 that date to be important.

4 I mean, at Fidelity, we have retirement income
5 planning, and we encourage all of our participants to go
6 through that retirement income planning process as part of
7 that target date, so that target date really highlights that
8 whole need of at that point in time it's a critical juncture,
9 you are going, you're from the accumulation phase to the
10 withdrawal phase, and you need to make sure that you're
11 planning for that.

12 MR. WHITNEY: If I could just add one last point.
13 I think, at least in the 401(k) space, most Target Date Funds
14 are selected through the use of a consultant or an advisor,
15 and the plan sponsor obviously has a very big role. They
16 know their employees, they know the demographics across their
17 employee base, and in conjunction with that consultant,
18 they'll examine a wide variety of different strategies and
19 pick the one that they think best matches what their
20 employees need.

21 COMMISSIONER PAREDES: Is this on? Can you hear
22 me? All right.

23 Jeff, you mentioned the need to evolve and improve
24 the fund, and so I'm just curious to hear a little more from

1 you and from the others. What lessons have been learned in
2 terms of asset allocation and diversification based on the
3 recent events and performance of the funds to improve and
4 evolve on a going-forward basis?

5 MR. KNIGHT: Well, I mean, I think it would have
6 been difficult to foresee just how widespread and dramatic
7 the declines would be across everything last year. It was
8 surprising I think to even professional investors how weak
9 diversification turned out to be, and so I think the two
10 directions where we need to evolve the strategies, number
11 one, is to redouble our efforts to think about ways to
12 diversify.

13 And typically the historical play book has involved
14 diversifying by asset class, by geography, by style, by
15 market cap, all of the things that are generally fully
16 invested in market tracking, and I think other mechanisms to
17 diversify exist but haven't been explored, incorporating
18 investments that respond to a different philosophy, not buy
19 and hold track the index but rather something that's built
20 more for stability and an all-weather pattern of returns.
21 Now, that's a challenge in and of itself, but I think one
22 aspect is just the investment engineering of expanding the
23 playing field for diversification.

24 The second, though, is, because, as unusual as last

1 year is and hopefully it will never happen again, I think
2 it's nevertheless unacceptable, particularly for the close to
3 retirement years and for somebody whose savings themselves
4 are kind of borderline, aren't quite -- they're cutting it
5 close. And I think for those investors we need to do a
6 careful job of thinking about insurance-driven solutions that
7 offer some kind of minimum income guarantee throughout a
8 lifetime, however long that lifetime is. And those are
9 really the two engineering directions that we're taking.

10 COMMISSIONER WALTER: I'd like to follow up a
11 little bit on Chairman Schapiro's original question. You
12 said that different allocations among different classes of
13 holdings and different glide paths may be appropriate for
14 different retirees, but, unless I'm wrong, generally
15 speaking, people will offer a series of Target Date Funds
16 just from one sponsor or one investment company complex, and
17 that doesn't really take into account, I mean it's one thing
18 to say a sponsor knows the demographics of his employee
19 population, but that population is going to differ and have
20 different needs.

21 Does that suggest to you that actually there ought
22 to be a series of 2010 funds offered that have different
23 balances between the upside and the downside post-retirement,
24 because I think the way it's been done to date sort of

1 assures that there's going to be a mismatch with a
2 substantial number of people.

3 MR. AMERIKS: If could take that, I'll respond to
4 that one, and then I want to go back to the other question
5 quickly if I could.

6 I think -- I've seen that proposal before. It's
7 one of the favorites out of the academic community in terms
8 of the different -- the conservative version of the target
9 date, the moderate, the aggressive. I think the challenge
10 there is what I alluded to in my testimony is that you've got
11 to get people to engage. A plan sponsor can't look at a
12 participant and put them in a fund that, you know, they don't
13 have "risk tolerance" stamped on their foreheads, so we don't
14 know whether someone's conservative or aggressive or
15 moderate.

16 And so I think what you have to do, I mean, the
17 power of these funds is their ability to be suitable for a
18 broad spectrum of investors. And it's not perfect, but it is
19 suitable, and it's based on one piece of information, you
20 know, at the point at which they want to retire and an
21 assumption on the part of the plan sponsor about when that
22 retirement date's going to occur. That's really the
23 innovation here.

24 There are other types of funds. In Vanguard's case,

1 the life strategy funds, that have exactly that structure:
2 Moderate, aggressive, conservative. And if someone is
3 willing to take the five minutes to fill out a risk-tolerance
4 questionnaire, you could target a better portfolio, but the
5 strength of these is that you can help people who aren't
6 going to engage and make that kind of decision and provide
7 that type of information.

8 On the other issue in terms of what have we learned
9 from the markets last year, I'm not so much that we learn --
10 I don't think we've learned a lot new. We relearned some old
11 lessons, I think, about the power of diversification and what
12 true diversification means.

13 You had to have exposure to all parts of the
14 investment markets last year. Government bonds performed
15 incredibly well last year in general and did provide the
16 diversification benefits that people talk about, but you had
17 to have exposure to those, and now that's why, you know, I
18 think we emphasize broad-based exposure at market
19 capitalizations through index funds to try to make the most
20 of the diversification that does exist.

21 It's never going to be perfect. Diversification is
22 not insurance. But it did help us to do much better than the
23 average last year in our funds.

24 MS. McMILLAN: If I can jump in on the question

1 that you asked, Commissioner Walter, you know, I think the
2 average number of plans -- funds that are offered in a plan
3 are 19, so if you start doubling that to add on a whole
4 another array of Target Date Funds, you really risk, I think,
5 confusing investors.

6 And what investors do have the ability to do if
7 they engage is to take a look and say, you know, the 2020
8 fund is too conservative for me based on when I think I'm
9 going to retire, my risk-type preference, I'm going to adjust
10 by five years, I'm going to invest in a different target
11 date. You're not required to invest in the one that matches
12 up with your presumed retirement date.

13 So again, and this is the question, how do you get
14 them engaged? And so that's what we were trying to focus on
15 is how can you give them the fact sheet that they get, you
16 know, as they're looking at this and make it something that's
17 graphically available to them to understand what this really
18 means, so we think you're going to retire at 65, maybe you're
19 going to retire at 60 or 70, and you have to look at that in
20 your own circumstance and then decide what that means for
21 you, both for your retirement date and the level of
22 conservativeness or not that you're going to hit at that
23 date.

24 And we think that's probably a less confusing way

1 of getting to the same question than throwing a lot more
2 choices at them that are just going to vary a little bit
3 amongst their glide paths. I mean, there are some
4 significant deviations, but not more that could be adjusted
5 for than by switching your date of retirement.

6 COMMISSIONER WALTER: Now, Karrie, if I can stick
7 with that for a second. I guess what brings the question to
8 mind, and I'm certainly no academic and not knowledgeable
9 enough to really suggest a solution, but if you look at the
10 2010 funds where people were hit very hard, and I know people
11 myself who kind of looked around and said once they were hit
12 that hard, gee, my Target Date Fund has an allocation of, you
13 know, X in equity; if I had a Y's Target Date Fund, it would
14 have been less.

15 I don't think there's a real appreciation, I mean
16 there's a decision being made, and maybe it's a question of
17 disclosure, although we all know lots of people don't read
18 disclosures, so I hesitate to have that be the only answer.

19 But there were wide variations for people in terms
20 of what, you know, what their allocations were, so obviously
21 you guys are making somewhat significantly divergent expert
22 decisions, and I don't think people understand that.

23 MS. McMILLAN: I think it's fair that they don't
24 understand it. I guess the hope is that this is a wakeup

1 call for everybody and people will pay more attention. And
2 it's also a wakeup call for the industry to do a better job
3 of educating investors about what it means.

4 I mean, there are ways that plan sponsors provide
5 education to their employees. There are ways that fund
6 groups get better information out there. And I think we all,
7 this is a challenge and sort of a call for all of us to step
8 up our jobs and do a better job at that.

9 I don't -- I would hesitate for it to be a
10 government rule of mandating a particular asset allocation,
11 though. First of all, it's not something that the government
12 has typically done as to go in and put parameters on
13 investment. I'm sitting here with some really smart people,
14 and they don't agree, so, you know, I think it'll be a
15 challenge for anybody to come up with one one size fits all
16 answer.

17 And I think, very importantly, if you were to have
18 been looking at this and coming up with a mandated asset
19 allocation ten years ago based upon the market at that time
20 in your experience, it probably would be a very different
21 answer than it would if you're regulating right now with
22 these experiences.

23 And ten years from now, you may look back and go,
24 wow, that was really conservative, our investor just missed

1 this huge bull market, so I think that, you know, being able
2 to have the flexibility of the professional management is
3 very important.

4 MR. AMERIKS: I think that set of circumstances
5 that you described probably applies in most cases to a plan
6 participant who maybe was defaulted and really wasn't engaged
7 and saw the performance and noticed for the first time that
8 they were in these funds and started asking questions.

9 So I think it's also an opportunity for the plan
10 sponsor to talk about the process that they went through to
11 select the Target Date Fund, to explain why they chose the
12 particular fund that they did.

13 And in my experience in dealing with plan sponsors,
14 they are very diligent about the process of selecting funds,
15 and they have good arguments for either increasing the risk
16 exposure or decreasing the risk exposure relative to what we
17 offer, and they try to make that decision with the best
18 interests of the plan participant in mind. And it's
19 certainly fair to ask questions, I think, about that process,
20 but in most cases I think the plan sponsors have very good
21 answers.

22 MR. WHITNEY: It's also, I think, a lesson from
23 behavior finance that we've learned, is that you can't
24 underestimate how much more difficult you make a decision for

1 an uninformed participant when you ask them to think about
2 different dimensions.

3 MR. LEBOWITZ: And maybe I could interrupt there,
4 and just ask, how do you intend to inform them? You've all
5 said in one degree or another that your investors, in large
6 part plan participants, were uninformed about the
7 consequences -- about what was behind these funds and why
8 they performed the way they did during the market last year,
9 and you seem to have -- there seems to be a consensus among
10 you that you all need to do a better job of explaining these
11 things, I guess, the dynamics of these funds, to
12 participants, but there doesn't -- am I right?

13 Mr. Knight, you seem to -- you seem to be
14 suggesting maybe there's a role for government in defining
15 the parameters of the asset allocation, but I gather the ICI
16 doesn't see that as being a productive way to go, and I don't
17 know how the other organizations feel.

18 MR. KNIGHT: I mean, first of all, honestly, I
19 think the biggest surprise last year had to do with the
20 markets and not the funds, particularly at the trustee level.
21 I think there is a great deal of due diligence, and they
22 would, given the set of facts that the markets delivered last
23 year, would probably conclude that they would have seen
24 losses on the order of magnitude that they did, so I don't --

1 I don't think the emphasis necessarily is that we
2 under-disclosed or that there was confusion about what to
3 expect under those circumstances. I think the surprise was
4 the circumstances themselves.

5 And to the other point, I think there just -- part
6 of what would make a lifecycle offering effective is that it
7 reinforces the correct behaviors. A number of my colleagues
8 pointed out how important it is to the overall retirement
9 equation when it's self-directed for participants to start
10 early, to invest adequately and to stay the course.

11 And our view is that if there is a confusion based
12 around the sort of proliferation of solutions that undermines
13 that behavior, then it's worth having a dialogue as to how we
14 can address that. And that's about as far as I care to go on
15 that, on that subject. I'm not arguing for any specific
16 legislation, just that we want to have the best solution for
17 the national retirement problem.

18 MR. AMERIKS: I want to jump in on this, too. I
19 mean, I think we're all highlighting and very concerned about
20 those investors that are not informed, but I don't want to --
21 we certainly don't want to leave the impression that we think
22 our investors are uninformed. There are an awful lot of them
23 that are very well-informed, and in our case, we're very
24 proud of the materials that we provide and give to them to

1 help them understand their investments.

2 There are lots of people that use Target Date Funds
3 as just a part of their portfolio, that actually pick a
4 Target Date Fund for say half of their assets and then make
5 other elections around that, and, in our experience, they do
6 that in an informed way, but definitely our concern is with
7 those people who don't feel like they had enough information
8 and how can we do things even better to help them.

9 And so I think the types of things that we have in
10 mind are simple, clear descriptions that emphasize graphics.

11 People like pictures rather than words. These pictures of a
12 glide path I think are incredibly useful for people and make
13 it easy for them to see what these funds do and what they
14 are.

15 And the second thing just on this is, you know, I
16 think, if this is the problem, the lack of information, the
17 lack of understanding, I'm not so sure that a government
18 regulation would address that. I think you're still going to
19 end up with that problem. Even if Target Date Funds all have
20 the same glide path, they're going to be a class of investors
21 who didn't understand that, didn't expect what happens, and
22 how do we help them.

23 And I think what we're all saying is we can get
24 better at that, we can continue to improve the way that we do

1 that, but, you know, let's remember it's a small set of the
2 investors that are having these issues around
3 misunderstanding them. There's even a larger set that like
4 these funds an awful lot and use them very effectively.

5 MR. YOUNG: I would also just point out that, when
6 you look at the market that we had in 2008, I mean, as we
7 know, we haven't had an equity market that far down since
8 1931, so it truly is, it is a test, and it's a valid test, a
9 real, live stress test to go through and see what happens
10 with certain allocations, so it's important for investors to
11 understand this is the impact of that risk profile, but also,
12 as you look forward and think about what happens over the
13 long term, you have to go through it and think about the
14 impact, not only of the down markets, but also the up markets
15 that could potentially be there.

16 If I go through and look more specifically at a
17 fund like our 2010 fund, because I know there's been a lot of
18 discussion about the 2010 funds, our 2010 fund was down 25
19 percent 2008; however, remember we launched the Fidelity
20 Freedom Funds back in 1996.

21 So for an investor who put \$100,000 into the
22 Fidelity 2010 Fund back in 1996 when we launched would in
23 essence, after having declined 25 percent in 2008, would now
24 have \$197,000 in the Fidelity 2010 Fund, because what

1 happened is, if you go back the past ten years, for example,
2 only three of those years were down years.

3 You had a couple of years in there where you had
4 high-teens type returns, 19 percent back in '99. You had 17
5 percent for the fund in 2003. So in essence, what happened
6 is, as you go through, and I'll tell you, when 2008 happened,
7 I felt the pain personally, right. I mean losing money is
8 never fun. I mean we know that. I mean that's the normal
9 reaction. I had the same reaction.

10 But you have to go through and think about it: If
11 the market takes something from you, what has the market
12 given you in the past? Do you feel like, net net, you're
13 whole, or do you feel like looking forward, net net, you're
14 going to be whole?

15 And so for us, we keep trying to reinforce that
16 message with our shareholders about what happens over the
17 long term. It's one of the most important parts of this whole
18 exercise because what we know is that investors are very
19 emotional.

20 What they do, and I mentioned it in my testimony,
21 what they do, and we see it over and over again and it just
22 pains us to no end, right, because what happens is the market
23 falls, everybody sells because of the panic, and then what do
24 they do? They wait until they're confident that the market's

1 back again, and they buy back in high. And that's the part
2 of the strategy that we're really trying to think about with
3 Target Date Funds. Can we somehow avoid that emotional
4 reaction? That's what we're trying to accomplish.

5 MR. PIACENTINI: I guess let me jump in. I heard
6 several of you talk about the fact that there are multiple
7 risks to keep in mind, right. It's not just short-term
8 volatility. You also have to think about, for example,
9 longevity risk, and that in choosing how to design a Target
10 Date Fund, the way you would manage each of those risks is
11 not identical, so you have to reach some kind of a balance.

12 I guess my question is, how large is that tradeoff
13 and, as a result, how much -- what is the magnitude of this
14 risk that's tolerated?

15 Mr. Young said at one point that you could
16 contribute 12 percent rather than much more if you had a good
17 glide path, and then you'd hit your goal, but I'd presume
18 that means with some small chance of failing to hit your
19 goal, so what is that chance and how much is acceptable?

20 MR. YOUNG: Yeah, if you go through and look, and
21 let's just talk more about the glide paths, one of the
22 important things to think about is these are all based on
23 models, and, as you know, the models are only as good as the
24 assumptions that go into the models.

1 So what happens is, there's a couple of different
2 stages here, so we can think about wealth accumulation and we
3 can think about, in essence, the distribution phase, so
4 there's two different pieces to the model. In essence, it's
5 the same thing. It's like whether you're putting cashflows
6 into the process or are you taking cashflows out.

7 So when you're looking up front and you're trying
8 to think about what is the goal that one should set, you're
9 trying to think about the behavior of those contributions, so
10 you have to give yourself a range of expectations.

11 While you have an optimal point you'd like to see,
12 you have to think about that range of possible contributions
13 that could be there. You also have to go through and think
14 about the assumptions associated with investments, so a
15 couple of different inputs there. So you're going to have
16 the inputs of how much are you contributing and you're going
17 to have the input of what are the market assumptions that
18 you're putting into your model.

19 Then for us we build actually a target of ten times
20 the ending salary. Now, once you get to the stage of
21 distribution, there are other assumptions that go into our
22 model, so we're looking at the withdrawals, so withdrawal
23 rates matter as we know. You'd prefer to see a withdrawal
24 rate around 4 percent. The history will tell you, in terms

1 of the research, that a 4 percent withdrawal rate will
2 actually give you 30 years of protection off of your
3 investments.

4 If you look at it, we have to consider the
5 withdrawal rates. We consider longevity, so life expectancy
6 risk. We consider inflation. And we also consider the
7 market risk again at that stage.

8 So there are all these different inputs that are
9 going into models, and I think that's the reason why you see
10 a lot of difference between the providers is because any one
11 of these assumptions, dramatic changes in any of these
12 assumptions can dramatically change what the allocations are.

13 MR. PIACENTINI: So in the end for any particular
14 investor, they are facing some risk. They are facing a risk
15 that they will outlive their assets. They're facing a risk
16 that, because of a market downturn close to their target
17 date, that they will undershoot their goal from the start.
18 You all have estimates of what you think those risks are,
19 but, in fact, the size of those risks is unknown.

20 MR. YOUNG: Yeah.

21 MR. PIACENTINI: Is that all accurate?

22 So but, going back to the 12 percent to hit the
23 goal, how big is the risk there that you won't, what is the
24 risk that's tolerated?

1 MR. YOUNG: Yeah, it's interesting, because what we
2 see is that most plan sponsors -- or, excuse me -- plan
3 participants actually contribute around 7 percent, and then,
4 if you assume there's a matching component on top of that of
5 three to 5 percent, it gets you close to that 12 percent
6 range, so the history, in terms of our data, is indicating
7 that fairly close to that, to that type of a number, but,
8 again, that assumption matters just like all the other
9 assumptions, but our individual data indicates a 7 percent
10 contribution rate is what we've seen historically from our
11 participants and then a matching on top of that.

12 MR. WHITNEY: I could be maybe a little bit more
13 specific. In terms of when we look the duration of an income
14 stream generated in distribution from a retiree's assets, our
15 glide path is designed to provide a 90 percent chance of
16 success, so our estimate is that nine times out of ten, given
17 market environments that are recently typical, that nine
18 times out of ten we will see assets last for at least 30
19 years as retirees draw income from that asset base.

20 MR. PIACENTINI: Okay.

21 MR. YOUNG: And then I would say we do the same
22 kind of thing, but to go back to your further point, I mean,
23 these are all estimates of risk.

24 MR. PIACENTINI: I understand.

1 MR. YOUNG: It's not as if this risk is knowable
2 and we can quantify it, so we do the same kinds of estimates,
3 and we use a number more on the order of 85 percent at a
4 30-year horizon, but then you've got 85 percent of the money
5 lasting that long a period, but you -- for an individual,
6 you've got a five or 10 percent of the individual lasting
7 that long of a period, so it's a much higher standard than it
8 sounds from 85 or 90 percent.

9 MR. PIACENTINI: So just the last little bit of the
10 question, when you have numbers like that, there's a 10
11 percent chance that you'll fail to achieve something. Is
12 that part of what is communicated, and, if not, is that
13 something it should be?

14 MR. AMERIKS: I mean, just in the discussion that
15 we're having here, you can see how hard it is to talk about
16 these structures, and, you know, we all have the backgrounds
17 to do this kind of a thing.

18 I think what we need to disclose is that there is a
19 risk. This is not a guaranteed, insured product. We are
20 trying to balance longevity risk and market risk and
21 inflation risk in designing the portfolios, so the risk
22 exist. It's not zero. And I think we've tried to be prudent
23 about managing that, but I just don't know, other than taking
24 everyone to graduate school and giving them an economics

1 degree, how we're going to get more precise information into
2 their hands.

3 MR. WHITNEY: And we do -- we do certainly
4 communicate that information in great detail with plan
5 sponsors and consultants and through white papers and
6 research, so the design of our glide paths are well-known and
7 well-communicated, but, as John said, you know, distilling
8 that down to, you know, a few sound bullets that make sense
9 is very difficult to do.

10 COMMISSIONER WALTER: But it seems to me it might
11 be helpful to be more specific with respect to the variables
12 that are under the particular person's control, how much I
13 take out a year, how much I put in. You could more generally
14 describe the kinds of things that went into the balance about
15 the structure, but, if I know that I should be taking out 4
16 percent if I want it last 30 years and if I take out 8
17 percent that's not going to happen that's something that
18 would be quite useful.

19 MR. WHITNEY: Right. We agree completely, and, in
20 fact, we have a retirement calculator that's available on our
21 website to anybody where they can go through those
22 simulations and model their exact experience and their own
23 patterns to really get a good handle on what those numbers
24 would be.

1 MS. McMILLAN: It's also important to remember,
2 though, that this probably isn't the only asset that's going
3 to support an investor's retirement, and so, when you do
4 these calculators, you need to really tailor it for your own
5 circumstances.

6 You probably have social security which is going to
7 provide a good foundation point for you, and then you may
8 have your own, outside of your 401(k) or outside of your
9 target date plan, so these assumptions of taking out 4
10 percent or 8 percent are based really just on the fund, not
11 so much what else is going on, and so I think we'd have to
12 make sure that investors understand that caveat as well.

13 MR. DOYLE: Do we have any further questions?

14 Well, thank you very much.

15 MR. YOUNG: Thank you.

16 MS. McMILLAN: Thank you.

17 (Applause.)

18 MR. DOYLE: So if we could have Panel Two. And I'm
19 hoping you know who you are. I don't know whether you have a
20 preferred order, but I'll defer to the panel.

21 MS. CAPELLI-DIMITROFF: I'll go first if you'd
22 like.

23 MR. DOYLE: Ladies first.

24 MS. CAPELLI-DIMITROFF: Good morning. I'm Marilyn

1 Capelli-Dimitroff, and I'm chair of the Certified Financial
2 Planner Board of Standards and president of a financial
3 planning firm in the Detroit, Michigan, area. I appreciate
4 the opportunity to testify today at this hearing.

5 CFP Board's mission is to benefit the public by
6 granting CFP certification and upholding it as the recognized
7 standard of excellence in personal financial planning. CFP
8 Board currently regulates nearly 60,000 CFP professionals who
9 voluntarily agree to comply with our standards of ethics,
10 which includes a fiduciary standard, and with our competency
11 standards.

12 Financial planning professionals help their clients
13 meet their goals through proper management of financial
14 resources and cover a broad range of subject areas including
15 investments, employee benefits and retirement planning.

16 CFP Board appreciates the opportunity to address
17 the use of Target Date Funds in participant-directed
18 retirement plans.

19 Target Date Funds, appropriately managed, can be
20 beneficial to investors. However, we have serious concerns
21 that these funds are fundamentally misleading to investors
22 because they're allowed to be managed in ways that are
23 inconsistent with reasonable expectations that are created by
24 the titles and the use of the names.

1 The use of a date in a fund's name carries with it
2 a generally understood message to investors. For example,
3 the name, "Target Date 2010," says to the investor this fund
4 will invest in an appropriate mix of investments for someone
5 retiring around 2010.

6 However, you heard SEC Chairman Mary Schapiro
7 recognize the widely varying strategies used among fund
8 managers as evidenced by the 2008 performance of the Target
9 Date 2010 funds ranging from minus 3.6 percent to minus 41
10 percent.

11 Now, put yourself in the place of a person who's
12 retiring in seven months who is invested in a 2010 fund
13 expecting low volatility and then experiencing a 41 percent
14 loss in 2008. It's devastating.

15 Let me underscore an important point. It can be
16 perfectly appropriate for investors approaching retirement to
17 employ an aggressive strategy with their 401(k) funds,
18 particularly when they have other resources, but Target Date
19 Funds, which are marketed as being on autopilot, investments
20 for those who do not have the time, desire or expertise to
21 monitor their investments, are not the appropriate vehicles
22 for implementing aggressive retirement investment strategies
23 for those nearing retirement.

24 It is not an answer to say that misleading fund

1 names can be cured by effective disclosures. Appropriate
2 disclosures are required and must be provided, but, in
3 reality, disclosures are seldom read or understood fully
4 despite our ongoing education of our clients. For example,
5 many of our clients continue to ask us how they can shut off
6 receiving prospectuses, and, if they get them by mail, they
7 say to me, I just throw them away and it's waste of trees.
8 If they get them electronically, they say it's a nuisance
9 because they have to hit delete, delete, delete.

10 For these reasons, we recommend that the SEC amend
11 its misleading names rule to provide that a Target Date
12 Funds' name is materially deceptive and misleading unless the
13 fund's investments fall within an acceptable range of asset
14 allocations consistent with its name.

15 Appropriate ranges of asset allocations for target
16 dates based on reasonably accepted industry practices can and
17 should be established. Such ranges can be developed by a
18 panel of experts from the financial service industry that
19 could include experts in ERISA, investment advisors, CFP
20 professionals. The establishment of acceptable ranges will
21 allow for continued competition among funds while at the same
22 time aligning risks with investors' expectations.

23 Establishing asset allocation standards for Target
24 Date Funds is especially important given that Target Date

1 Funds are designated as qualified default investment
2 alternatives under the Pension Protection Act of 2006.

3 The designation as a QDIA sends two important
4 messages. First it conveys to employers that the government
5 believes that the allocations in Target Date Funds are
6 appropriate for individuals based on their expected date of
7 retirement. Second, it conveys to employees that the
8 government is making an appropriate investment decision on
9 their behalf.

10 That's why it's particularly important for the
11 Department of Labor to work with the SEC to encourage the
12 development of accepted industry standards. Should the SEC
13 fail to move toward needed investor protections in the
14 management of Target Date Funds, we believe that the
15 Department should proceed on its own to regulate these funds,
16 or, alternatively, should rescind such funds' eligibility as
17 qualified default investment alternatives.

18 Let me close by saying CFP Board stands ready and
19 willing to facilitate the participation of CFP professionals
20 who are experts in retirement planning to assist in the
21 development of needed industry standards for Target Date
22 Funds.

23 Thank you.

24 MR. BARE: Good morning, ladies and gentlemen.

1 Thank you for this opportunity to present our views on how to
2 improve the investor experience relative to Target Date
3 Funds. My name is Rod Bare and I'm the Director of Asset
4 Allocation Strategies at Morningstar in Chicago.

5 Now, to set the context, we believe there are five
6 major risks investors face. We've heard a bit about them
7 this morning as investors face these over their lifetime as
8 they work on funding a retirement.

9 The first and most important risk in our minds is
10 the savings risk, the risk a person doesn't contribute enough
11 money to give the strategy a reasonable chance of success.
12 The second is mortality risk, the risk the investor dies
13 before the financial security of loved ones is secure. The
14 third is market risk via suboptimal asset allocation or poor
15 security selection. The fourth is inflation risk which has
16 been a longstanding concern for retirees facing fixed income
17 streams, and finally, longevity risk, the risk the investor
18 outlives their retirement income.

19 Now the first two risks, savings and mortality, are
20 very important early in an investor's life. Savings is
21 always important but especially early on. Auto enrollment,
22 financial education and life insurance helps control these
23 risks.

24 As an investor matures, market risk, inflation risk

1 and longevity risk rise in importance. A properly
2 constructed target date portfolio can do much to tame these
3 three risks. Like most new products, today's first
4 generation Target Date Funds have helped highlight what to
5 improve in the next generation.

6 Morningstar and our subsidiary, Ibbotson
7 Associates, has spent the past year and a half packing a
8 combined 60 years of asset allocation and security selection
9 research into a set of retirement portfolio indexes. These
10 benchmarks are helping us analyze the current target date
11 marketplace to understand what could be improved.

12 In our opinion, there are three enhancements to
13 consider adding to a default target date series: Risk
14 profile choice; expanded asset class diversity; and low-cost
15 passive security selection.

16 First is risk profile choice. Everyone agrees that
17 investors have a diverse set of financial situations,
18 retirement objectives, risk appetites and lifetime income
19 possibilities. Because this investor diversity is
20 unavoidable we say glide path choice is essential so
21 investors can better synchronize their risk profiles with
22 their retirement portfolios.

23 We have three glide paths in our target date
24 benchmark family to address three common risk profiles,

1 conservative, moderate and aggressive to help fiduciaries and
2 asset managers select benchmark and construct Target Date
3 Funds. Offering risk profile choice in a target date solution
4 also creates a natural opportunity for an advisor or online
5 tool to engage the investor in valuable reviews of retirement
6 resources, long-term objectives and outcome expectations.

7 The second enhancement is expanded asset class
8 diversity. There are Target Date Funds on the market today
9 that aren't taking advantage of the benefits of meaningful
10 diversification into asset classes such as emerging markets
11 equities, international bonds, TIPS and commodities.

12 Fifty years of research starting with Harry
13 Markowitz' modern portfolio theory have established that
14 portfolios with a broad set of asset classes can deliver
15 better risk return experiences for investors than portfolios
16 with narrower ranges of asset class exposures. Adding
17 guaranteed income as an asset class will also be beneficial
18 for investors for reasons that will most likely be discussed
19 in later panels.

20 There is a relationship here that should be
21 considered. Increasing a Target Date Funds' asset class
22 diversity can, in some cases, strengthen the case for passive
23 security selection. This third enhancement is the trickiest
24 to discuss with this audience, but one that should really be

1 the most intuitive to understand given the performance
2 history of thousands of funds across several countries over
3 many years.

4 In general, we know actively managed funds have a
5 difficult time beating their benchmarks and can be more
6 expensive. Of course there are exemplary portfolio managers
7 who add value to the security selection process, but they are
8 rare, especially in clusters.

9 The difficulty then is that a Target Date Fund with
10 adequate asset class diversity typically doesn't have access
11 to the leading portfolio managers for every asset class.
12 There are ways to construct custom Target Date Funds using
13 hand-picked managers. That additional effort in manager
14 selection and monitoring has a cost which is sometimes offset
15 by the cost of the underlying investment, but the odds of
16 outperformance still remain uncertain.

17 Today's Target Date Funds therefore may have the
18 cart before the horse. Instead of starting with Target Date
19 Funds filled with active portfolio managers who can't all be
20 above average, let's be honest, it should make sense for
21 Target Date Funds to start with a foundation of passive index
22 funds and perhaps substitute in value-adding managers over
23 time. The benefits of lower costs in terms of extra
24 retirement income after 30 years of accumulation are another

1 big plus for this approach.

2 In conclusion, investors deserve the best target
3 date investment experience we can give them. Industry
4 research suggests risk profile choice, expanded asset class
5 diversity including guarantee income and low-cost,
6 transparent security selection are three enhancements that
7 can improve target date investor outcomes going forward.

8 The uniqueness of today's format and the joint
9 effort involved in understanding the issues highlight the
10 depth and complexity of this topic. Morningstar has a number
11 of free resources and research devoted to target date
12 investing at indexes.morningstar.com, and the performance
13 data, summary allocations and research papers there are tools
14 that we hope folks will utilize as they work through the
15 issues presented today.

16 Thank you.

17 MR. NAGENGAST: Good morning, Joe Nagengast, Target
18 Date Analytics, an independent RIA dedicated to the analysis
19 and indexing of Target Date Funds. Thank you for receiving
20 our comments, and let me tell you a story, the origin of
21 Target Date Funds and where some of them went wrong.

22 TDFs were designed in response to a persistent
23 problem plaguing the 401(k) industry; that is, with the
24 investment responsibility now in the hands of each

1 participant, it was clear that the challenge was greater than
2 the average skill or inclination.

3 In response, Wells Fargo and BGI introduced the
4 first TDFs in March 1994, 15 years ago. It was a stroke of
5 genius. Aggregate all participants by years to retirement
6 and use a glide path to attenuate risks over the accumulation
7 period. Objective: Do it for them. Invest their retirement
8 savings. Get them safely to the target date, then fold the
9 assets into the income or preservation fund.

10 When plan sponsors and participants started
11 adopting TDFs in big meaningful numbers starting in 2002, the
12 race was on for performance numbers, and this is where the
13 train went off the track.

14 The way to win the short-term performance horse
15 race and resulting market share was through higher equity
16 allocations. Each of the major fund families found
17 justifications for, one, increasing the equity allocations
18 across the glide path, and, two, extending the glide path
19 beyond the target date, beyond the period that can be managed
20 with a glide path.

21 These two changes correspond to the two biggest
22 contributors to risk in TDFs, one, the amount of equity in
23 the fund, and, two, the design of the glide path. There is
24 some theoretical rationale for employing a glide path through

1 the accumulation phase. No credible rationale has ever been
2 proffered for using a glide path in the distribution phase.

3 This is what caused the unacceptably large losses
4 in 2010 funds in 2008. Both of these flaws stem from
5 misunderstanding or misappropriating the purpose of Target
6 Date Funds, and these excessive losses weren't necessary.
7 Our 2010 index lost less than 5 percent in 2008 because it
8 stuck to its core objective while the average 2010 fund lost
9 23 percent.

10 Recommendations: We favor target date investing,
11 and there are legitimate areas for improvement that may not
12 be affected by market forces alone. You can help.

13 The name of each fund must bear some relationship
14 to the way the fund is managed; that is, its glide path. If a
15 fund labeled 2010 is really targeted to land at 2040, it
16 should be relabeled as a 2040 fund. Disclosing that the 2010
17 fund isn't actually designed for safety at 2010 will not
18 work. It must be properly named.

19 In turn, glide path -- the glide path should be
20 designed to provide for a predominance of asset preservation
21 as the target date nears and arrives. This is, after all,
22 nothing more than implied by the date in the name of the fund
23 and is what participants expect.

24 For benchmarking purposes, the Commission and the

1 Department should encourage the adoption by plan sponsors and
2 their consultants of indexes based on the core objectives of
3 target date investing; that is, indexes which end their glide
4 paths at the target date. Indexes which are derived from
5 current flawed practices will only reflect the performance of
6 those flawed practices and will not hold the funds to any
7 standard.

8 Prospectuses, especially for the SEC, prospectuses
9 should be clear about the objectives of the funds. Language
10 describing the objective of a fund as dependent on its
11 allocation should not be permitted. We support NAIIPA's
12 proposal to eliminate the mutual fund exemption of fiduciary
13 responsibility borne by any QDIA manager.

14 And I add some cautions about regulating. I urge
15 you to keep your eye on the ball. Required disclosure about
16 a fund's glide path will not be read. The solution is to
17 require proper naming of a Target Date Fund. Again, there is
18 no credible rationale for doing otherwise. And then you
19 won't have to mandate allocation percentages.

20 Beware of red herrings. Issues that cannot be
21 addressed by glide-path-based allocation models, longevity
22 risk, inadequate savings, inflation risk, those are not the
23 domain of glide path-based investing. That is properly the
24 accumulation phase.

1 Addressing the inherent conflict of interests in
2 fund managers using their own funds as the underlying assets
3 is sensible, but, if you address the underlying assets and
4 not the allocation, you've addressed only 10 percent of the
5 variability of returns leaving 90 percent on the table. I'd
6 be happy to discuss how you can effectively regulate TDFs
7 without getting into the messy business of mandating
8 allocation percentages.

9 Thank you.

10 MR. CERTNER: Members of the panel, my name is
11 David Certner. I'm Legislative Counselor and Legislative
12 Policy Director at AARP. We appreciate the opportunity to
13 discuss the important issues surrounding Target Date Funds.

14 Over the past 20 years, America has seen a shift
15 from DB plans and DC plans, and TDFs have become an
16 increasingly an important investment vehicle for participants
17 in DC plans. It is estimated that roughly 200 billion was
18 invested in TDFs in 2008, and the percentage and the amount
19 of funds in TDFs are expected to continue to grow
20 dramatically.

21 TDFs are designed particularly for a simpler
22 mechanism to address the needs of the very large numbers of
23 people who really don't want to manage their funds. These
24 funds allow participants to simply choose their retirement

1 date and have a TDF allocate funds accordingly. So TDFs hold
2 out the promise of professional asset management in an
3 individual account context.

4 TDFs, however, are not a perfect solution.
5 Numerous questions have been raised about TDFs ranging from
6 fund make-up to fee structure to asset allocation and
7 underlying glide path assumptions, and the answers to these
8 questions can have a profound affect on an individual's
9 retirement savings.

10 Because plan fiduciaries must determine whether to
11 select TDFs and what kind of TDFs as investment options for
12 their 401(k) plans, it presents an opportunity to better
13 manage expectations and improve disclosure around TDFs. Plan
14 fiduciaries must assess whether TDFs are prudent for their
15 plans, and there's an important opportunity to improve the
16 role of the fiduciary. This is particularly important
17 because almost by definition participants who choose TDFs do
18 not want to exercise ongoing management and oversight of
19 their investment choices.

20 So AARP suggests that the DOL develop a selection
21 and monitoring target date tool similar to other compliance
22 assistance the Department has issued in order to assist
23 fiduciaries to better meet their duties in selecting Target
24 Date Funds.

1 The tool should provide suggested areas of inquiry
2 for evaluation including, but not limited to, asset classes
3 allocation, numbering quality of underlying funds, glide
4 paths and fees and expense ratios for both the fund itself
5 and any of the other mutual funds in which the Target Date
6 Fund invests. We have prepared a more detailed list of
7 potential areas of inquiry, which we will submit for the
8 record.

9 The DOL may also wish to issue compliance
10 assistance for fiduciaries on best practices and eventually
11 more specific regulatory guidance on fiduciary
12 responsibilities.

13 We also agree with the DOL's ERISA Advisory Counsel
14 that participant education and materials are a good start to
15 better inform participant investors of how their TDFs work,
16 the underlying assumptions and the risks involved.

17 More explicit and better disclosures concerning
18 risk, glide paths and fund allocations would be helpful, and
19 AARP suggests that DOL and SEC work together to determine the
20 specific types of disclosure necessary including fund names
21 and issue guidance or regulations.

22 However, because the underlying principle behind
23 TDFs is to simplify investment choices, especially for those
24 investments who are less financially literate, participant

1 education and disclosure will not be enough. The real issue
2 surrounding TDFs is how to make them work better to meet the
3 objectives of providing an adequate and secure retirement, so
4 we believe that more specific regulations on disclosure and
5 consistency in terminology will be needed.

6 Terminology is important. For example, Morningstar
7 reported that the percentage of equities in private 2010
8 funds range from less than 30 percent to 65 percent. The
9 Federal Thrift Savings Plan holds 30 percent in its 2010
10 fund.

11 This difference results, in part, from the meaning
12 and purpose of the Target Date Fund. Is it a fund with the
13 assumption that money will be drawn immediately or is it one
14 where funds will be drawn until death? Both purposes are
15 legitimate, but the expectation of the investor may not at
16 all coincide with the either the title or purpose of the
17 fund.

18 AARP also recommends additional research on the
19 issue of appropriate benchmarks on TDFs. Benchmarks have
20 only recently been established and are inconsistent.
21 Consistency on the underlying purpose of the TDF may yield
22 the appropriate benchmark which would provide welcome
23 guidance.

24 Some commentators have suggested there should be

1 limitations on the amount of equities held in Target Date
2 Funds especially for funds within a five- to ten-year window
3 of a participant's retirement date.

4 AARP is aware that there is a dearth of research
5 and inconsistencies, as we've heard, concerning the
6 methodology currently used to determine the amount of
7 equities held in a Target Date Fund. As noted earlier, this
8 has led to wide variation in the amount of equities held in
9 TDFs.

10 This is particularly critical as an individual
11 approaches retirement. We suggest that DOL and SEC collect
12 further information and work with interested parties to
13 determine best practices and whether the parameters are
14 needed.

15 In addition, added disclosure to participants may
16 be necessary to help them better understand the level of
17 risk. Although, again, we note that these plans are designed
18 for those who desire to avoid such decisions. However, in
19 our view, it is likely that many close to age 65 would be
20 surprised to learn the level of risks they are assuming under
21 some TDF allocations.

22 Of additional concern to AARP is the lack of
23 transparency for individual funds that make up Target Date
24 Funds, the fees for those funds, the overall fee level for

1 TDF and their affect on overall returns.

2 While asset allocation is critical, plan fees
3 compound over time, and the larger the fees, the bigger the
4 reduction. Comprehensive information on plan fees and
5 expenses will enable both fiduciaries and participants and
6 other investors to insure that fees and expenses are
7 reasonable. Consequently, TDFs should disclose, not only the
8 fees they are charging, but also the underlying fees --
9 underlying funds or other investments that comprise the TDF.

10 In conclusion, we thank you for this hearing and we
11 look forward to continuing to work to help both the
12 fiduciaries and investors to make proper decisions.

13 MR. DOYLE: Thank you very much.

14 CHAIRMAN SCHAPIRO: Thank you. Thank you all very
15 much.

16 I have a question that perhaps I should have asked
17 the last panel, but maybe Morningstar can help with it. I'd
18 be curious about whether the same target -- the same funds
19 underlie Target Date Funds as underlie 529 plans where
20 there's an expectation of a, you know, 2015 retirement date
21 and 2015 a child's going off to college, and, if so, is that
22 appropriate?

23 MR. BARE: I wish I could answer that. I don't
24 have that info. I can get that to you, though, but I don't

1 work in that particular --

2 MS. SCHAPIRO: Okay.

3 MR. BARE: -- group that analyzes the 529 plans.

4 MS. SCHAPIRO: Does anyone else have any idea about
5 whether there's a one size fits all approach in between 529s
6 and Target Date Funds?

7 MR. CERTNER: I don't know the answer to that
8 question, but you would think that the distribution phase and
9 for the 529 plans would be over a shorter amount of time, so
10 it may be different because of that.

11 MS. SCHAPIRO: Okay. I'll probably get --

12 MS. CAPELLI-DIMITROFF: Yeah, I believe that it is
13 shorter but the allocation is different because of the time
14 frame.

15 MS. SCHAPIRO: Okay.

16 MR. BARE: Yeah, the allocation is different, but
17 the underlying funds, are they the same? I'll get you that
18 information.

19 MS. SCHAPIRO: That would be great. Thank you.

20 MR. DOYLE: Joe, any questions?

21 MR. LEBOWITZ: David, you talked about fees and the
22 need for more transparency, I guess, more disclosure or
23 better disclosure with respect to fees. How are the fees --
24 in the typical Target Date Fund, which is made up of a number

1 of funds, a fund of funds, they're fees at the individual
2 fund level and then presumably at the Target Date Fund level.
3 Are they all aggregated and disclosed to investors or how
4 does that work?

5 MR. CERTNER: I think here what's probably more
6 important is how they're disclosed to their fiduciaries,
7 because I think, by definition, in these kinds of funds we're
8 not going to have individuals paying as close attention.
9 That's not to say we shouldn't be providing some of this
10 information to individuals who want to go and look at it, but
11 I'm not sure that giving them tons of information is going to
12 be completely helpful as is giving them the broadest number
13 that's available in funds but then allowing them to go
14 someplace else for those who want to have more information
15 because, as we've discussed, people in these funds tend not
16 to be the ones who want to oversee and manage these funds in
17 the first place.

18 So the issue is really for the fiduciary. Are they
19 going to have access to all the fee information they need,
20 not just in the aggregate, but in the underlying funds?

21 And part of the concern here is when you have a
22 fund of funds, it may become a lot easier to, for example,
23 hide under-performing funds in Target Date Funds, hide higher
24 fee funds in a Target Date Fund that may not be completely

1 appropriate, and so having the investigation not of just the
2 total cost but of the cost and the adequacy of each of the
3 underlying funds, I think, is going to be a very important
4 for the fiduciary as a first line of defense.

5 MR. PAREDES: In terms of the possibility of
6 enhanced disclosure, it's still important, ultimately, for
7 the investors to actually be engaged with whatever
8 information is disclosed, so in terms of strategies to
9 actually prompt investors to be more engaged with respect to,
10 again, whatever the disclosures happen to be, what are your
11 thoughts on that aspect of the challenge?

12 MS. CAPELLI-DIMITROFF: When I hear the word
13 "engaged," it says to me financial planning. And again, when
14 we look at the whole issue that we're talking about today,
15 with the funds, and we talk about investments in general,
16 it's always something that's in order to. Investing is in
17 order to meet the goals that you have.

18 And engaging folks is often a matter of getting
19 them to look at a bigger picture to see where this fits into
20 the whole analysis of their financial well-being, and so we
21 find that working from that point often is a prod to get
22 people to take a look at that.

23 Most people are afraid of looking at these issues
24 and just are quick to turn them off, so it is important to

1 find a reason to lure them into exploring all of these
2 issues.

3 MR. BARE: I think from our perspective, you know,
4 we've designed three glide paths that, you know, we think can
5 be used with advisors and other tools, at key points in an
6 investor's, you know, lifetime so that they can take the time
7 to assess where they are financially and what their
8 objectives are and then select something that's appropriate
9 for them.

10 We went with three glide paths. I understand you
11 could, as an alternative, move up and down on the glide path.
12 You know, we felt that, you know, the date that you, you
13 know, stop receiving a salary is an important date. And it's
14 easier to kind of understand the retirement time frame and
15 then what's my relative risk appetite, you know, in that time
16 frame rather than should I, instead of the 2010 fund, move
17 into the 2005 or 2015 fund?

18 Our algorithms, you know, produce glide paths that
19 are distinct, and there is a difference in equity exposure
20 moving from moderate to conservative. For example, our 2010
21 moderate has 45 percent equity exposure; our 2010
22 conservative has 29 percent equity exposure. That same 2010,
23 if we just went to -- if we moved to 2005 to try to get more
24 aggressive, you know, our moderate has 39 percent equity

1 exposure. So it's still higher than what we think is
2 conservative. Again, this is just according to our math and
3 research.

4 MR. CERTNER: This is -- you're sort of dealing
5 with the basic conundrum here, which is that these Target
6 Date Funds are designed for people who really don't want to
7 pay attention, don't want to manage, don't want to read the
8 information. And so how do you get information to people who
9 really aren't that interested in information?

10 Well, and then, really, you're talking about
11 information at a very basic simplified level, which is, I
12 think, why, as some have expressed here, you know, the names
13 of these funds and how they're labeled is going to be very
14 important.

15 We have not done specific research among our
16 membership on this issue, but my guess is that people who are
17 looking at 2010 Target Date Funds are thinking something much
18 more conservative than maybe the theoretical notions of what
19 the payouts are going to be over a longer lifetime period.

20 That may have some theoretical basis, but I don't
21 think a lot of people are actually thinking about it that
22 way. Trying to get them to think about it that way would be
23 useful. I'm not sure how successful we can be at that for a
24 large number of people. So trying to at least originally

1 name something correctly is going to be helpful.

2 I mean, we do know, for example, from previous
3 issues in debates we've dealt with that, you know, the older
4 population tends to be more risk adverse. We saw that, for
5 example, in the social security debate where it was very
6 clear that individuals preferred security over risk-related
7 gains that they could potentially have by overwhelming
8 numbers.

9 So when you're talking about a 2010 fund where
10 people certainly who are in retirement, I think they value
11 security much more than they do potential upside returns that
12 they could get, and so I think it's going to be important to
13 think about that in this context particularly for those who
14 are at or near retirement.

15 You know, glide paths may have some theoretical
16 basis, but I'm not sure if, you know, the theoretical glide
17 path basis is really matching the way real people really
18 think.

19 MR. NAGENGAST: If I could address that issue, I
20 think we -- you look at what made Target Date Funds work at
21 all, and that's the aggregation glue, the stroke of genius if
22 you will, that allowed us to say everybody with the same
23 length of time to the liquidity date can more or less be
24 lumped into one allocation, and we'll adjust that, fund

1 managers will adjust that over time.

2 As you -- so a 20-year-old with a \$2,000 account
3 balance suffering a 50 percent market loss isn't really hurt
4 too much if you consider all the possibilities for making it
5 up by contributions, market returns. A 55-year-old maybe
6 with a \$500,000 account balance suffering a 50 percent loss
7 is devastated.

8 And so I think for -- to get back to your question,
9 I think you need to segment the group. Don't try to train
10 every 20-year-old to become their own CIO. That's why we
11 have Target Date Funds. But focus the efforts on people in
12 this transition phase. As you move from the accumulation
13 phase to the Target Date Fund where that aggregation glue, if
14 you will, is melting, we're no longer able to put everybody
15 in the same bucket. Then you have some options.

16 Now a participant with a \$500,000 account balance
17 can afford some financial planning, some personal assistance.

18 Or they may be better served by an annuity product. Or
19 maybe the fund company themselves can manage a portfolio --
20 the income portfolio. It's no longer a single path at this
21 point. It's a transition area, and that's where I think your
22 targeting communication could be most effective.

23 MR. BARE: And can I add, if I may, there aren't
24 many safety nets left for the individual retirement --

1 retiree. This is a huge responsibility for an individual to
2 take on, and we don't want to cut too many corners here. One
3 solution is elegant, I agree, but having two or three options
4 that can work with a financial planning session to help, you
5 know, better fit an investor to a solution should be, you
6 know, better than having 15 options on the menu, which is
7 what we currently have today in a number of 401(k)s.

8 MS. SCHAPIRO: Could I -- just a small question.
9 To what extent are target funds marketed as the solution for
10 somebody's retirement security or marketed as just a
11 component of other investments or obviously social security
12 or other options? Are they really pushed as the be-all-and-
13 the-end-all in your experience?

14 MR. NAGENGAST: In my experience, if you read the
15 material -- if you read the brochures, you'll see one
16 message, which is, relax, pick the date, we'll take care of
17 the rest of it for you.

18 If you read the disclosure, the prospectus, it
19 disclaims everything that the brochures say. We have no
20 responsibility. This is on you. Make sure you're picking
21 the right thing. These can lose money. Be careful.

22 MS. CAPELLI-DIMITROFF: Mary, also I believe it
23 depends often on a workplace by workplace environment. A lot
24 of things take place where there are meetings for employees

1 and things are explained. And I don't know how to answer how
2 that occurs on an individual workplace situation. We think
3 that's where a lot of the communication does take place.

4 MR. CERTNER: I think particularly in the workplace
5 in the context of a retirement plan, I think it is
6 essentially -- I mean market is probably not the right term,
7 but the education you're getting from your employer from the
8 context of the plan is that, you know, for those who do not
9 want to take responsibility for allocating their money, here
10 we have these Target Date Funds that allow you to put your
11 money directly into something that's appropriate for your
12 retirement date.

13 And of course, now, with automatic enrollment, you
14 may not even have anything. It's just automatically
15 happening and people are automatically being put into these
16 Target Date Funds, which may be very appropriate, but,
17 particularly as people get close to retirement, I think it
18 gets a lot more complicated as we've all been discussing
19 about what your time lines are for taking the money and what
20 may make the most sense there.

21 But I think the way it is, when you're taking about
22 in a plan design, it is interestingly talked about: Well, if
23 you don't want to have to take control of investing your
24 money, pick a Target Date Fund.

1 But interestingly I think the experience in a lot
2 of plans is that these are not necessarily seen that way by
3 participants. Participants, I think, very often look at
4 these as just another fund choice, and so they are allocating
5 their monies among funds including, you know, potentially
6 their appropriate Target Date Fund, so even in the plan
7 context, I'm not sure it's working the way it's even being
8 talked about in the plan context.

9 MR. BARE: We would certainly agree these should be
10 marketed as the primary fund, you know, for retirement
11 investing if you're going to participate in the target date
12 structure. It doesn't make any sense to split your money
13 across three other Target Date Funds or use it as a core and
14 then dabble in tech funds and, you know, other things like
15 that.

16 The message should be clear that these are
17 carefully designed, that there are a lot of smart folks here
18 have put a lot of work into designing these to be efficient,
19 and the power of that efficiency is pretty easily destroyed
20 if you -- if you don't put 100 percent in.

21 MR. PIACENTINI: I have a question for -- I'm sorry
22 if I pronounce this -- Mr. Nagengast. I'm pretty sure I
23 heard you say that glide paths don't belong after a target
24 date.

1 MR. NAGENGAST: Yes.

2 MR. PIACENTINI: And that glide paths are not a
3 good tool for managing longevity risk. And I think I heard
4 some people on the last panel say the opposite, that
5 longevity risk is one of the things that they try to balance
6 when they design a Target Date Fund, and I think the
7 implication was that continuing the glide path after the
8 target date is a piece of that.

9 So could you elaborate a little bit on why you hold
10 this strong view?

11 MR. NAGENGAST: Certainly. As I pointed out at the
12 beginning, target date investing was developed to answer a
13 specific need, and that is participants in
14 participant-directed defined contribution plans are now being
15 charged with their own asset allocation responsibility, which
16 they never had before. And we tried for years to educate
17 them and that didn't work.

18 And it's not that participants are ignorant or
19 stupid or anything like that, it's just that they have other
20 things to do. I don't know how to tune my car up anymore,
21 and I shouldn't be expected to. Nor should a participant
22 know everything about how their fund mechanics work. They
23 should have somebody to whom they can say, please do it for
24 me, that's what I'm turning to you for.

1 So the glide path was developed to manage
2 time-based asset allocation over the accumulation phase only.
3 The first funds were immediately rolled into the receiver
4 fund, the income or asset preservation fund. Wells Fargo's
5 Lifepath 2000 was folded into their Today fund in 2000. And
6 that's how it worked fine until the assets started to get so
7 attractive that a performance horse race ensued.

8 And the way to win that, as I said, was through
9 higher equity allocations. I would say that the solution to
10 a number of problems, longevity risk, inflation risk, under
11 savings for goodness sake, guaranteed income, the solution to
12 all those is going to turn out to be more equity. So the
13 answer is there before the problem is presented. The
14 problems are mere justifications for the higher equity
15 allocation, and that's why I say what I say.

16 If -- a glide path -- if you are an investor at age
17 65 now with a pool of money starting your distribution phase,
18 your point of highest risk is at that first day, so why would
19 you have a glide path that starts out with high risk and
20 tends to lower risk at your actuarial projected death date
21 for some example. Your highest risk is at the beginning.
22 You could turn a glide path on its head.

23 But we really think that people need individual,
24 more individual opportunities as they enter that transition

1 phase, maybe different aggregations, not turning that
2 completely back on every individual.

3 MR. PIACENTINI: Thank you.

4 MR. CERTNER: If I could add to that. I mean, I
5 think what we've heard is that these funds are really based
6 on a moderate risk, long-term investor. And certainly, while
7 choosing moderate risk may, you know, make sense, as on
8 average, it's -- you know, we're talking about one size fits
9 all plans, this is where it becomes problematic, particularly
10 for longer-term investors.

11 I mean, you may have -- with high turnover among
12 workers, long-term investors may or may not make sense,
13 particularly when you're getting to closer to retirement.
14 Many people may be planning on leaving the money in the plan
15 and not taking it out until minimum distribution is
16 necessary. Others may need money more immediately for health
17 or long-term care needs. So the long-term horizon doesn't
18 necessarily fit very well, particularly as one's getting
19 close to retirement.

20 MR. NAGENGAST: If I could just add one key thing
21 that I forgot, and that is the glide path serves its core
22 function, investing through the accumulation phase. If you
23 put it into service for other purposes, ameliorating
24 longevity risk, making up for inadequate savings, you disable

1 its ability to perform its core function, and that's what
2 happened in 2008.

3 MR. BARE: If I could just add another counterpoint
4 quickly. My philosophy is at the other end of the range than
5 Joe's, and we agree to disagree, but actually it's really
6 relative to the objective. Our glide paths continue well
7 past the target date and into retirement because there's
8 still a lot of life to live. You still need to keep the
9 money working as hard as it can. If you're in a -- and
10 that's for a self-annuitization model where folks have talked
11 about, you know, withdrawal rates of four to 5 percent and
12 how that can last.

13 Now, if you're in a situation where you're going to
14 buy an annuity product on retirement date, then it does make
15 sense to force yourself into a more conservative stance at
16 that date. If I was looking at the U.K. in designing a glide
17 path for that where there's mandatory annuitization, then I
18 would adjust the allocation. This is tuned for a U.S.
19 investor that's presumed to be self-annuitizing.

20 MS. CAPELLI-DIMITROFF: And I think this discussion
21 points out very clearly that the issues that are here and
22 understanding, first of all, what it means to have a 2020
23 fund. It is defined a little differently if we're looking at
24 that's the point of retirement and then withdrawals start,

1 and we have a set of circumstances in place. It may be
2 defined differently if we're looking at this is something
3 that's going to be designed to last 30 years.

4 So I think there are -- it's clear that there are
5 best practices that need to be developed so that the consumer
6 is not confused. When the consumer hears that this is a
7 Target Date Fund with a given year, the consumer has a clear
8 idea of what that means and then can use that to design the
9 rest of their actions around financial decisions.

10 MR. PIACENTINI: Thank you.

11 MR. DOYLE: Thank you. Thank you very much.

12 (Applause.)

13 MR. DOYLE: And I think with the conclusion of that
14 panel, we're going to take a short 15-minute break. We will
15 be reconvening exactly at 11:20, so if the next panel could
16 be up and ready to go at that time, that would be terrific.

17 (A brief recess was taken.)

18 MR. DOYLE: Thank you very much. Just to call your
19 attention, we've had some substitutions representing the
20 Agency, Andrew Donohue, Director of the Division of
21 Investment Management at the SEC, has joined us, and Fred
22 Wong of the Office of Regulations and Interpretations with
23 EBSA has joined us. So with that I will turn it over to the
24 panel.

1 MR. MOSLANDER: Good morning. I'm Ed Moslander,
2 SVP for Institutional Business Development at TIAA-CREF, and
3 I'd like to thank you for giving us the opportunity to share
4 our views on Target Date Funds.

5 TIAA-CREF is a not-for-profit provider of defined
6 contribution pension plans and one of the world's largest
7 retirement systems with \$363 billion in assets under
8 management almost all dedicated to retirement. We also pay
9 out more than \$10 billion a year in lifetime retirement
10 and -- lifetime retirement income to over 300,000 annuitants.

11 As a provider of defined contribution retirement
12 plans for over 90 years, TIAA-CREF has a unique perspective
13 on both Target Date Funds and pension plan design. We've
14 invested a substantial amount of time and attention in
15 determining the appropriate asset allocation to provide our
16 clients with lifetime financial security.

17 Today I will discuss disclosure, the glide path and
18 retirement income management. TIAA-CREF supports clear,
19 concise and meaningful disclosure of investment information
20 to retirement plan sponsors and their plan participants.
21 Plan sponsors and investors need to understand that the
22 primary goal of Target Date Funds is to maintain a
23 diversified portfolio over time that offsets risks from
24 overexposure to one particular asset class.

1 To insure the plan sponsors and their participants
2 have complete information, TIAA-CREF believes that Target
3 Date Funds must provide a detailed description of how the
4 portfolio will change over time, perhaps graphically, to make
5 it really clear what the glide path is, clearly state the
6 asset allocation for each asset class in the fund, provide a
7 listing of the investments that comprise each asset class and
8 provide a brief description of the risks associated with
9 each. The prospectus should also include a clear description
10 of the parts and the sum of all the fees participants pay.

11 Target Date Funds are designed to be a one-stop
12 solution that enable plan participants to set a specific
13 course for their retirement through automatic asset
14 re-balancing and continuous diversification over time. The
15 glide path is an essential element of the funds.

16 Our research has shown that a balanced portfolio of
17 multiple asset classes, diversification, is essential to
18 creating retirement savings and preserving financial
19 security. We promote the prudent use of traditional assets,
20 such as stocks and bonds, provide diversification and enhance
21 risk adjusted returns, but we also believe that other asset
22 classes, such as real estate, guaranteed interest products
23 and stable-value funds also provide diversification benefits.

24 While equity prices fluctuate, we agree with

1 research that demonstrates equity investors earn a premium
2 over time for taking on additional risks. This has led us to
3 conclude that equities are an essential part of an investment
4 portfolio in both the accumulation stage and the retirement
5 income phase.

6 Recent poor returns of the publicly traded equity
7 markets has sparked a debate about this point, especially
8 concerning how these returns have affected individuals at or
9 near retirement, but it's important to focus on the long-term
10 nature of investing, not only to retirement, but through
11 retirement.

12 Many participants are going to live 20, 25,
13 30 years or more in retirement. As a result we believe it's
14 important not to limit or constrain a retiree's opportunity
15 to benefit from this asset class, from the equity asset class
16 with its potential for growth.

17 Risk-mitigated growth is as important in the income
18 phase as during the accumulation phase because there are
19 multiple risks to retirement security that the potential for
20 growth helps to mitigate such as, for example, the potential
21 for outliving savings and health care expenses.

22 TIAA-CREF has 10 lifecycle funds starting with an
23 initial allocation of 90 percent equity, 10 percent fixed
24 income. At 25 years before the funds' maturity date, the

1 equity allocation decreases at a rate of approximately 1.6
2 percent per year until the fund ultimately reaches an
3 allocation of 40 percent equity, 60 percent fixed income
4 10 years beyond the target date. This deliberate approach
5 helps our lifecycle funds maintain an appropriate level of
6 risk while still providing the growth potential necessary for
7 building assets.

8 There is no right or perfect glide path. There are
9 multiple appropriate paths to achieve a desired portfolio
10 composition and, as experience with new asset classes grows,
11 improvement to glide path design will emerge.

12 We urge the DOL and the SEC to issue guidelines
13 that insure full and clear disclosures regarding the
14 composition of Target Date Funds so plan sponsors can make
15 fully informed decisions. However, fund managers do need to
16 be able to determine, based on their own research and
17 experience, both the glide paths and the underlying
18 investments that comprise the Target Date Funds.

19 TIAA-CREF supports the same asset allocation tenets
20 in the retirement income management phase as in the
21 accumulation phase, which means maintaining a well-
22 diversified portfolio that uses equity, fixed income and
23 other asset classes to attain lifetime financial security.

24 The ongoing allocation of equities during

1 retirement is designed to strike a balance between the need
2 for both current income and continued portfolio growth
3 through retirement. We also strongly believe that guaranteed
4 lifetime income is essential to insure a financially secure
5 retirement for most people.

6 But Target Date Funds as mutual funds cannot
7 guarantee lifetime income. As a result we feel that it's
8 important for retirees to be encouraged or incented or
9 perhaps even required to place a portion of their tax-favored
10 retirement savings into an annuity that guarantees lifetime
11 income and perhaps even into an annuity that guarantees a
12 minimum level of lifetime income.

13 We support the use of Target Date Funds within
14 retirement plans. Properly constructed Target Date Funds
15 with clearly defined and clearly disclosed investment goals
16 and characteristics provide investors ready access to a
17 professionally managed, broadly diversified portfolio that's
18 an important component of a successful defined contribution
19 retirement plan.

20 We look forward to working with the DOL and the SEC
21 on this issue, and thank you very much for the opportunity to
22 express our views.

23 MR. MASTERS: Good morning. I'm Seth Masters, the
24 Chief Investment Officer for Blend Strategies and Defined

1 Contribution at AllianceBernstein. And thank you very much
2 to the DOL and the SEC for the opportunity to testify at this
3 hearing.

4 We at AllianceBernstein agree that Target Date
5 Funds should help DC participants achieve good outcomes and
6 must be properly designed, managed, monitored and
7 communicated. We also agree that most Target Date Funds,
8 including our own, delivered very disappointing results in
9 2008. But we do not agree that the purpose of Target Date
10 Funds should be, as Senator Kohl recently stated, to minimize
11 the risk and volatility for those nearing retirement.

12 The express objective of our Target Date Funds in
13 the U.S. is and was to minimize the risk that participants
14 will run out of money in retirement, and, to achieve this
15 objective, we designed our Target Date Funds to maximize
16 savings in the working years and prolonged spending in
17 retirement. Our research and 40 years of experience in
18 investment planning suggests that even after retirement, most
19 participants need the growth that equities can provide.

20 When saving for retirement, over-reliance on cash
21 and bonds will likely be a smooth road to ruin whereas
22 sufficient exposure to well diversified equities can provide
23 a bumpy path to adequate retirement income. So let me
24 explain.

1 As a few other speakers have mentioned, there are
2 several risks in retirement income. One key risk is market
3 volatility which hurt so much last year. And stocks are
4 certainly more volatile than cash or bonds. But the risks to
5 retirees from inflation, which erodes purchasing power and
6 longevity, which is the need for income that's longer than on
7 average, are equally serious. And over time we believe cash
8 and bonds expose investors to far greater inflation risk and
9 longevity risk than do stocks.

10 The challenge to appropriate glide path design is
11 to strike the right balance for each phase in participants'
12 lives, and we took that approach when we designed our
13 standard glide path with a 60/40 stock bond mix at
14 retirement, I've explained in a research report we published
15 in 2005 and I've submitted for the record.

16 Now, after last year's financial crisis, we took
17 another look at retiree asset allocation by modeling
18 investment results for people who retired in every year since
19 1926. Using index data for U.S. stocks, bonds and cash, we
20 compared the results of a 60/40 stock bond strategy with
21 holding cash and bonds.

22 Assuming that retirees withdrew 5 percent of their
23 initial savings every year, we then looked at how often each
24 strategy funded 30 years of retirement spending, and we

1 focused on 30 years because some 25 percent of today's
2 65-year-olds will live at least that long. So if this hits
3 home, I'd like everyone here to think about the fact that
4 some material number of people here today will live to at
5 least age 100.

6 Well, the results of our study were pretty stunning
7 to me, too. A portfolio with 60 percent in stocks never ran
8 out of money, not once in all the 30-year periods that we
9 studied and not even in those periods that included the Great
10 Depression.

11 The cash strategy, by contrast, ran out of money in
12 half of the 30-year periods. And when we adjusted
13 withdrawals for inflation, the cash strategy ran out of money
14 in every single 30-year period, and the bond strategy ran out
15 of money in 85 percent of the 30-year periods.

16 By contrast, after inflation, the 60/40 strategy
17 only ran out of money in a quarter of the periods. So this
18 study, which we have also submitted for the record, confirms
19 our earlier research that in most cases a 60/40 stock bond
20 mix is appropriate for participants at retirement.

21 Now, today you're hearing many points of view.
22 Perhaps the only common ground is that there's absolutely no
23 consensus on the best glide path design. And that means
24 there's no such thing as a passive Target Date Fund because

1 the key decision, the glide path design, is always an active
2 choice. And under ERISA, fiduciaries must evaluate whether
3 the glide path is prudent and likely to help plan
4 participants to meet their retirement goals. So why pass
5 rules which could weaken this layer of fiduciary oversight?

6 In fact, we do not think that a 60/40 strategy at
7 retirement is suitable for all plans. For example, when DC
8 plan participants are also enrolled in a DB plan, an even
9 higher level of equity allocation might be prudent. By
10 contrast, where a plan sponsor makes large contributions of
11 company stock into a DC plan, then a lower equity allocation
12 would probably be prudent.

13 Such factors influence how we customize target date
14 glide paths for large DC plans. And there is a differential
15 of over 20 percentage points in the equity exposures of the
16 2010 target date portfolios that we manage. So why consider
17 rules that could preclude plan sponsors from adopting the
18 glide path best suited for their particular circumstances?

19 In addition, we're close to launching a target date
20 platform with embedded income guarantees backed by multiple
21 insurers. This could reduce the impact of market risk on
22 participants and could therefore warrant increasing the
23 equity exposure in target date glide paths especially after
24 retirement. So why implement rules that could stifle such

1 innovation?

2 Now, let's turn to the underlying investments in
3 Target Date Funds. We also think the fiduciary should
4 evaluate whether the underlying investments are appropriate,
5 well-run and cost-effective. But because most target date
6 assets are currently in proprietary mutual funds, such
7 fiduciary reviews can be very challenging.

8 In proprietary mutual funds, a mutual fund firm
9 designs the glide path and manages all the underlying
10 components. Frequently, and not coincidentally, the fund
11 company also happens to provide the recordkeeping.

12 Now, if a plan sponsor is unhappy with the
13 management of one or more of the underlying investments,
14 there is really nothing it can do short of moving to a
15 different target date provider and perhaps another
16 recordkeeper. The logistical challenge of changing target
17 date providers tends to keep plans therefore locked in to
18 proprietary offerings.

19 Now, recently an increasing number of large DC
20 plans have begun to adopt custom Target Date Funds which
21 liberate them from proprietary offerings. In a custom target
22 date structure, the plan sponsor selects a glide path manager
23 and best-in-class managers for each underlying investment and
24 its preferred recordkeeper. The plan sponsor then

1 continually monitors the performance and costs of each of
2 those underlying providers and is free to replace any of
3 them.

4 In short, DC plan sponsors and their consultants
5 can oversee custom Target Date Funds exactly as they would a
6 DB plan. We believe the custom target date structure provides
7 much better governance and it can also significantly lower
8 costs for larger DC plans.

9 Now, recent advancements have made it easier for
10 larger plans to implement custom target date portfolios. I
11 should also mention that at this point proprietary target
12 date mutual funds do remain the most cost-effective option
13 for smaller DC plans.

14 So we believe that any rules covering Target Date
15 Funds need to be broad enough to encompass both the legacy
16 proprietary mutual funds and the emerging custom target date
17 programs.

18 So I just have a couple key points just to
19 summarize. The first, glide paths require flexible and
20 substantial equity at retirement in most cases, so any
21 guidance that the SEC or DOL provide has to keep that in
22 mind. And secondly, custom Target Date Funds are growing and
23 they will permit better governance and lower costs for quite
24 a few larger plans in years ahead.

1 So thank you very much for your consideration, and
2 I look forward to your questions and comments.

3 MS. LESTER: Thank you. My name is Anne Lester,
4 and I am Senior Portfolio Manager at J.P. Morgan Asset
5 Management and responsible for J.P. Morgan's target date
6 strategies. I want to thank the panel for the opportunity to
7 present our views on Target Date Funds today.

8 The testimony that I'm giving draws upon the very
9 extensive work that my colleagues have done in developing and
10 managing our Target Date Funds, and we will be submitting for
11 the record written testimony that will cover what I am going
12 to summarize here in much greater detail as well as a number
13 of white papers that we've written.

14 But what I'd like to really focus on are what we
15 believe is the key considerations for fiduciaries are in
16 developing, managing and monitoring target date strategies.
17 In building our target date strategy, we really took a
18 defined benefit approach to the problem. That means three
19 things.

20 First, it means defining a desired outcome for
21 investors in the funds, a definition of success. Second, it
22 means defining a time horizon for the investment. And third,
23 it means understanding what cashflows will be coming into and
24 going out of the funds.

1 All three steps are extremely important, but in
2 hundreds of conversations with plan sponsors over the past
3 five years on target date investing, we think that the first
4 step, defining an outcome and a definition of success, is the
5 most critical.

6 What do we mean by this? Simply stated, we mean
7 articulating what you want the target date strategy to
8 achieve. At the extreme we think there are two different
9 outcomes that a manager or a sponsor can pursue, and I
10 suspect you're seeing those extremes at this table right now,
11 maximizing the upside or minimizing the downside. Another
12 way of looking at it, are you building a strategy that will
13 earn more when the markets are strong or are you building a
14 strategy that will lose less when markets are weak?

15 The outcome that we are aiming for at J.P. Morgan
16 is the following: Maximizing the number of participants who
17 reach a minimum level of income replacement at the point of
18 retirement. That's how we are defining success for Target
19 Date Funds from the view of the plan sponsor.

20 We aren't trying to generate the highest expected
21 balance at the point of retirement or even trying to
22 articulate what it means not to run out of money before death
23 because we know that in seeking higher returns, we're also
24 adding volatility and the chance of greater failure if the

1 markets don't cooperate.

2 Now, not all plan sponsors will, in fact, want that
3 same outcome that we have articulated, and the broad range of
4 Target Date Funds allows plan sponsors to match the outcome
5 that they were seeking to that of the provider they have
6 selected.

7 But if neither the plan sponsor nor the fund
8 manager understands what that desired outcome is, finding
9 that best match is pretty tough, and that's why we think this
10 is, in fact, the most part of the process regarding Target
11 Date Fund evaluation.

12 Second, time horizon. There has been a lot of
13 discussion around to-retirement or through-retirement. Our
14 bottom line is as a fiduciary, I know that I can understand
15 with some degree of certainty how participants will behave as
16 savers up to the point of retirement. But I have very little
17 ability to predict what happens to participants' cash at that
18 point of retirement.

19 Some people leave all of their money in the plan
20 and don't touch it till their 70 and a half. Some people
21 take all of their money out before they retire after the age
22 of 59 and a half and everything in between. So again, as the
23 fiduciary responsible for saying what the right answer is, we
24 feel it's very hard to do.

1 And that brings me to this third point, cashflows.
2 We are very, very focused on defining and articulating what
3 we know and what we don't. And so we have developed our
4 target date philosophy around observed cashflows, how
5 participants put money into and take it out of 401(k) plans
6 instead of making assumptions about how people behave or,
7 worse, managing money based on what we think they should be
8 doing.

9 It turns out the participants save a lot less than
10 most people assume, and they take a whole lot more out in
11 loans and distributions than we think they should.

12 I'd like to conclude my remarks by commenting on
13 something that we don't spend enough time discussing, and
14 that is the rate of savings. How much people save is by far
15 the most important factor in determining success in
16 accumulating assets for retirement, and there isn't enough
17 discussion on the relationship between how much people are
18 willing to save, on the one hand, and the certainty of
19 outcomes on the other.

20 Put another way, the safest retirement strategy, we
21 believe, is the one that has the highest probability of
22 getting over the finish line safely, not the strategy that is
23 going to lose money in a bear market. If people want a more
24 certain outcome, they have to save more to get to that same

1 finish line.

2 We will be submitting for the written record an
3 analysis that we did comparing hypothetical results of
4 someone in our 2010 glide path over the past 25 years whose
5 portfolio would have lost approximately 20 percent in 2008
6 with someone invested in the safe alternative, a money market
7 fund. The hypothetical glide path generated almost double
8 the assets, even after a 20 percent loss in 2008, in ten
9 years of essentially no returns in the U.S. equity market.
10 The person in the money market fund would have had to save
11 more than twice as much to end up in the same place.

12 Unmet expectations are always a risk when there is
13 a default option no matter what the market environment, which
14 is why understanding a target date strategy's desired outcome
15 is so critical. As Yogi Berra said, "You've got to be very
16 careful if you don't know where you're going because you
17 might not get there."

18 I look forward to answering any questions that you
19 might have. Thank you.

20 MR. SMITH: Good morning. My name is Michael Case
21 Smith, and I am a Target Date Manager in Avatar Associates.
22 Avatar is tactical asset allocator founded in 1970. We run a
23 series of collective trusts that rotate balances above and
24 below the set glide path based on indicative data and risk

1 return tradeoffs identified by analysis in over 150 economic
2 and behavioral, factors. As an example, our 2010 fund has a
3 20 percent allocation of equities.

4 In March of this year, we tactically overweighed it
5 to 25 percent to capture some of the rebound in the market.
6 In the fall of last year, we under-weighted it to 13 percent,
7 rotated away from credit and treasuries in the spring and
8 avoided a lot of financial stocks internationally, and the
9 result for our 2010 fund was a loss of 2.6 percent.

10 You're going to hear a lot today about insurance
11 and modern portfolio theory and absolute return and different
12 things and different tools in the market. Here's the dirty
13 little secret about our business. One's standard of living
14 and retirement is about the glide path. You get that right
15 and all the other things are mathematically pretty
16 irrelevant. I want to talk about how we compose ours and how
17 we got to that 20 percent.

18 The consensus methodology is based on modern
19 portfolio theory, and this assumes that if you have the
20 dollar today, you can minimize the variability of its future
21 value given the mean of its future value. For an investor
22 with a financial investment or commitment to fund at
23 retirement, the challenge is the exact opposite.

24 Future values, the retirement commitment, is known,

1 and the challenge is to determine how much to invest and
2 allocate at the present. Our glide path begins with a risk
3 aversion sequence. This is the path of probabilities of
4 meeting the retirement funding goal or falling short.

5 To solve for the glide path mathematically, the one
6 that serves the investor's best interest, defined as
7 providing the highest level of income, replacement ratio,
8 that can be achieved for a given level of contribution and
9 risk aversion path, we use Nash equilibrium calculations. If
10 you remember the movie "A Beautiful Mind," you recall that
11 equilibrium is met when every asset allocation along the
12 glide path is the best response to all other asset allocation
13 decisions.

14 So here's how it works. Imagine yourself as a
15 clone of yourself over 40 years. You at 25 versus you at 65.
16 Nash equilibrium theory is going to go through a series of
17 trade-offs to fund that commitment. Modern portfolio theory
18 begins at the portfolio and has a series of unrelated
19 portfolios going forward. We begin backwards and go to the
20 current day.

21 So at 65 -- or at 64 you know you need to fund the
22 commitment in a year, and you have less tolerance to the kind
23 of risk we saw in 2008 because three things happen. You stop
24 contributing, your employer stops matching and you drawing

1 down. So it's not just another day as far as the commitment
2 and the human aspect.

3 So your risk aversion is going to be higher.
4 That's something that's sort of unique in glide path design.

5 And when the Nash equilibrium trade-off, the 64-year-old
6 then turns and hands the portfolio to you at 63, who in the
7 trade-off selects the portfolio that minimizes the mean and
8 standard deviation for the year. And we have white papers
9 available on this to go into more detail.

10 This equilibrium game is repeated again to deliver
11 the glide path that mathematically serves the employer's best
12 interest and the employee's best interest, again, defined as
13 the highest income replacement ratio given the contribution
14 and given the probability of success and shortfall.

15 Now, in 2009 with a year to go, as I said, this
16 Nash equilibrium based glide path resulted in a solution --
17 mathematical solution, not a theory, of a 20 percent of
18 allocation of equities. Now, I would note that our 2040 and
19 2050 in 2008, we're closer to the 90 percent, and we were
20 good at tactically avoiding some risk, but, again, it's about
21 the glide path. So those funds got crushed.

22 But our clients -- our clients know and understand
23 the process, and they take solace in knowing there's a
24 mathematical optimization solution that's prudent, unbiased

1 and effective.

2 I'd like to use my remaining time to address the
3 selection of the funds that populate the glide path.
4 Principles of our firm were involved in the creation of the
5 TCW exemption and the Sun America Advisory business methods
6 that allowed parties and interests to create portfolios, give
7 advice, take discretion so long as the conflicts of interests
8 were removed.

9 So fiduciary interests are very serious to us. A
10 number of our clients ask us to be fiduciaries to the plan.
11 We have 338 ERISA managers. We put it in writing. And as
12 such, it's imprudent for us to expose them to prohibitive
13 transactions and construct our glide paths with funds from
14 which we receive an economic interest.

15 So the first criterion we have when we construct
16 the glide path is to make sure there's no economic interest
17 in the underlying funds. We construct the Nash equilibrium
18 glide path that I've described with exchange traded funds,
19 typically 20 to 35 ETFs.

20 The ETFs are much more close to the tracking of the
21 asset classes we're trying to track. We're a beta manager.
22 They're very transparent, very low fee. And again, since
23 there's no economic interest, it removes the ability for us
24 as a party of interest, an ERISA fiduciary to self-deal.

1 Thank you.

2 MR. DOYLE: Thank you.

3 COMMISSIONER WALTER: I'd like to come back to the
4 "to or through" point. And I think we've heard a fair amount
5 of support this morning for a "through" point of view. I'm
6 wondering -- and don't take this as a point of view because
7 I'm learning a lot here so I really don't have a position --
8 whether we would be wiser to accommodate both by encouraging
9 or perhaps forcing a "to" decision with plan sponsors then
10 being required to offer a set of options at the -- at the
11 "through" point of view, at the retirement point of view.

12 And I wondered what your reaction to that would be,
13 which essentially would allow more flexibility if people
14 didn't necessarily feel that the same mix of assets or, you
15 know, an evolving mix of assets, same sorts of decisions, are
16 appropriate during the accumulation phase and following that.

17 MR. MASTERS: Okay. Let me perhaps take a stab at
18 that. I think the question really revolves around what
19 people do with the money. And let me echo something that was
20 mentioned on an earlier panel. In the U.K. in DC plans,
21 there is mandatory annuitization by age 75 in their case, and
22 our glide path in the U.K. is, therefore, a "to" retirement
23 glide path and would look like some of the ones that have
24 been described earlier with a far, far lower equity

1 allocation at the retirement phase, because if you know for
2 sure that you're going to be taking the money and spending
3 it, in this case on an annuity, you want to be essentially
4 minimizing the variance of the risk of making that purchase
5 decision at retirement.

6 The problem is, though, that quite a lot of plan
7 participants, especially the ones who are likely to end up in
8 a target date default option, may very well stay there for
9 the rest of their lives and at that point to have managed
10 their glide path as if they were going to spend the money at
11 age 65 when, in fact, they're going to be drawing that money
12 down over the next 25, 35 years perhaps would actually
13 produce a very, very unfavorable outcome for them.

14 So our belief is that, given the way that things
15 work today in the U.S., we should be designing a glide path
16 that goes through retirement because that is what the default
17 would indicate. And to the extent that there is a plan
18 sponsor that has a different point of view and wants to
19 actually get participants annuitized, we would, in fact, work
20 with them to design the appropriate glide path for that plan
21 sponsor.

22 MS. LESTER: I think it all goes back to
23 assumptions. And as someone on one of the earlier panel
24 says, the differences in all of our glide paths really go

1 back to those assumptions. And one of the things that I find
2 most difficult as a fiduciary for the assets that we manage
3 is to make a best determination about what we think is going
4 to happen.

5 And I think the level of uncertainty around what
6 participants actually do at that point of retirement is so
7 large that we have taken, I think, a different view, that
8 given that level of uncertainty that we observe and given
9 very, very lumpy cash distributions that we typically see, we
10 did a very detailed analysis and saw that starting at the age
11 59 and a half, one quarter of the population that we're a
12 recordkeeper for takes out about 20 percent of their assets
13 in a lump sum every year.

14 So very large sums of money leave. But of course,
15 not everybody does. Not everybody -- you know, and so given
16 that level of uncertainty, we decided as fiduciaries the most
17 prudent thing to do would be to minimize the risk of down --
18 shortfall, if you will, at the point of retirement and
19 negative returns, but at the same time being cognizant that
20 most people leave some money in.

21 You don't actually want to go, we don't believe, to
22 a hundred percent cash portfolio, which, again, if there were
23 certainty around, for instance, annuitizing, right, you would
24 really want to minimize volatility at that point. But

1 there's no certainty at all, so a portfolio manager is left
2 to the set of assumptions they're going to make about what
3 happens to the money.

4 We're assuming that most of it's going to leave.
5 Others assume most of its going to stay. There's very little
6 data right now that's terribly clear because, of course,
7 there are very few people, historically speaking, who have
8 entered retirement with a defined contribution program as one
9 of their main sources as retirement income. So that that
10 uncertainty makes it very, very tricky to know how to behave.

11 But that goes back to my point about disclosure in
12 dialogue with the plan sponsor or the advisor as they are
13 helping someone pick the Target Date Fund, and trying to
14 articulate that precise point is, I think, one of the biggest
15 elements of getting this right.

16 MR. MOSLANDER: We are one of the places, we've had
17 a defined contribution plan for 90 years for the institutions
18 of higher education, so we do actually have a lot of
19 experience with people approaching retirement. And for the
20 -- people don't -- they may be defaulted into any sort of
21 fund, whatever it might be. They don't default out of it.

22 People generally, in our experience, always have
23 extensive consultation either with us or with an independent
24 financial advisor who's working with them when it coming to

1 constructing a retirement income management stream.

2 I think to your point, a lot of people do take
3 money out in lump sums, probably not always wisely, but there
4 is that option. But people don't default out. They default
5 in. So there is a little bit of that -- there is a "to" and
6 then there is a "through," and they are two differently
7 managed experiences from the individual's perspective.

8 MR. MASTERS: Could I also make maybe one further
9 point, which is I believe that the -- Anne Lester's point
10 about we don't really have great data yet on the way DC plans
11 will behave. It's a very important one because literally no
12 one yet has really, since 401(k) plans were created in 1981,
13 no one yet has retired whose retirement plan was based on a
14 401(k).

15 And in fact, the evolving regulatory environment
16 has drastically changed the way the plan sponsors think about
17 their 401(k)s. PPA really does change everything. Auto
18 enrollment and auto-escalation has transformed the landscape.

19 And especially in the default option I think what we're
20 going to find is there is a new population of Americans who
21 are growing up now with, in general, Target Date Funds as
22 their primary savings pool of money. And my guess is because
23 they were defaulted into it and because they were
24 auto-enrolled and auto-escalated, they're going to

1 increasingly think that that automation is a good thing.

2 And I do believe that the Target Date Funds, as
3 currently designed, have the potential to serve them very,
4 very well, and as we continue to innovate around this
5 vehicle, I think we will enable retirement success even
6 greater.

7 But think about what that means. When they retire,
8 they will probably have grown quite comfortable with the fact
9 that they're in that Target Date Fund. Their behavior may be
10 very different in the future than in the past, and we do have
11 to envision the probability that many of them will want to
12 stay there especially because it's not obvious to me that
13 individuals buying at retail will ever be able to replicate
14 the quality of investments that they can get from a plan
15 sponsor who spent a lot of time and effort choosing the best
16 thing he can find for them.

17 MR. DONOHUE: When you've gone through a lot of
18 your research in order to determine an appropriate glide path
19 for a -- either a plan or a fund that's being put together, I
20 suspect that the information that you use is historical index
21 information as opposed to actual actively managed fund
22 information, and, yet, then when it's implemented there's the
23 additional risk I would think, where I've only heard of one
24 that uses -- and, Michael, you'd indicated that, I think,

1 when you do it that you try and avoid tracking error, but
2 that, you know, in terms of using ETF set that would track
3 the indices.

4 How do you -- you know, to the extent that you've
5 come up with a really good mousetrap for a glide path that's
6 based on indices, then go to actively managed?

7 MS. LESTER: I'll start. I think what we viewed,
8 and, again, I didn't touch on this in my summary, is that
9 it's incumbent upon the fund manager to articulate a process
10 by which they select underlying managers.

11 And if they choose to believe, as we do, that
12 active management will add value over time, one of the jobs
13 that's absolutely incumbent upon that manager is articulating
14 on a prospective basis why they believe the managers that
15 they've selected will, in fact, add value, and then as you
16 move through time, basically make those hiring and firing
17 decisions to make sure that that continues to be true.

18 I will point out that there are a number of asset
19 classes that we use that are not easily indexable so that,
20 while you use a historical analysis to understand how an
21 index might have, you know, behaved over time, when we, in
22 fact, build our glide paths, we're using a forward-looking
23 return in risk expectations, and we test them to understand
24 what might have happened using historical data, but we don't,

1 in fact, use history to sort of rear-view mirror drive where
2 we're going in the future. So we don't, in fact, use those
3 historical returns to build a glide path.

4 But it is very important to have a process by which
5 you select funds. And I guess in response to some comments
6 that have been made, if the fund manager can't articulate and
7 demonstrate that process as fiduciaries by which they hire
8 underlying managers and remove them when necessary, I think
9 that that's a very key part of the hiring process the plan
10 sponsor and individual has to go through, and we need to be
11 transparent about that process.

12 But there are a number of asset classes that you
13 cannot cheaply or effectively index. And in some instances
14 the active management fee is lower than it would be in ETF.
15 And so I don't necessarily think you can just say that that's
16 always the best way to implement it.

17 MR. DONOHUE: And I didn't mean to imply --

18 MS. LESTER: No, I didn't --

19 MR. MASTERS: If I could further those comments by
20 saying I think this is one of the reasons why custom Target
21 Date Funds are so interesting and are really beginning to
22 take off, because this is an element of the success or
23 failure of any target date program. And although the glide
24 path is going to drive the vast bulk of the return, any

1 active management can either contribute or detract from that
2 success.

3 And so what we are finding, in fact, is that many
4 plan sponsors are increasingly viewing this decision exactly
5 the same way they would view active versus passive inside a
6 DB program. And by having a custom target date structure
7 where essentially all of the underlying components can be
8 either active or passive and can change from time to time as
9 perhaps asset classes that used to not be available in
10 passive form suddenly do become available or perhaps an asset
11 class that used to be managed passively, now you've found a
12 great active manager that you like, you can put them in, that
13 to us makes an awful lot of sense.

14 And I should just mention that some of the target
15 date clients of ours who are doing this are all passive.
16 Some of them are all active, and most, increasingly, are
17 somewhere in between, which reminds me an awful lot of what
18 they're doing in DB.

19 MR. SMITH: I used to work for Harry Markowitz, and
20 he tells the story of he was getting his graduate degree at
21 the University of Chicago, waited to meet with his advisor.
22 And in the waiting room was the guy's stockbroker. He said,
23 what are you doing here? He said, well, I got to go figure
24 out what I'm going to do my thesis on. And the guy says,

1 well, why don't you do it on the stock market. And Harry
2 said, okay. And it was that serendipitous.

3 And a number of times today people have said
4 there's a lot of smart people in the room, but it all goes
5 back to that chance meeting in that room in Hyde Park,
6 Chicago.

7 The point is that linear math that he had applied
8 became modern portfolio theory, the two values of risk and
9 reward, was based on natural occurrences, you know, how
10 neutrons pop off each other, cloud vectors, things like that.

11 The limited data we have thrown in with the human behavior,
12 I think makes that modern portfolio theory what it is, just a
13 theory. Okay?

14 For what it's worth, you asked a question. I'll
15 give you an answer. We forecast nothing. Okay? We infer
16 value from the actions of different market participants.
17 Insiders are usually right. Mutual fund buyers are usually
18 wrong.

19 But based on that, we have just a different sort of
20 approach that, again, optimizes for an answer rather than
21 theorizes what could happen and creates a bell curve and you
22 have events that happen like 2008, which are six standard
23 deviation events. That's nine with 21 nines after it, but it
24 happened. So we got to focus on that. So we avoid

1 forecasting.

2 MR. PIACENTINI: I have just two questions. I'll
3 try to keep them both narrow and short if I can.

4 The first, a couple of the panelists talked about
5 the merit of building a Target Date Fund out of underlying
6 funds in which the builder has no financial interest. I
7 guess the implication there is that the opposite is true
8 where the underlying funds are proprietary funds are signs
9 that there's a problem. Was that meant to be implied and can
10 you elaborate just a little?

11 MR. MASTERS: Well, since we do both, maybe I
12 should comment. We do not think that there is necessarily
13 any problem and there's not a necessary conflict between the
14 target date manager also managing some or all of the sleeves.
15 That is a fiduciary decision, a choice, that the plan
16 sponsor should be making.

17 But our view is, it is a choice. And the problem
18 perhaps in a lot of target date mutual funds is that because
19 mutual funds by definition are pre-baked, many of the plan
20 sponsors may not realize that they're implicitly making a
21 choice to have the same investor manage the glide path and
22 all the pieces.

23 MR. PIACENTINI: So if there is a financial
24 interest of the person building the Target Date Fund, what's

1 the nature of the financial incentives they face when they
2 choose the underlying funds?

3 MR. SMITH: One might argue that taking discretion
4 over participant assets, which is a highly, a highly
5 regulated act under ERISA, allows them to skew allocations to
6 underlying funds of variable fees, so now I've taken
7 participant -- taken discretion and I can skew the glide path
8 or that point-in-time allocation to the funds that deliver
9 more fees. One could make that argument.

10 To eliminate that happening, you know, we choose to
11 construct portfolios with ETFs. The argument one might make
12 is, well, in 1974 the framers of ERISA said mutual fund share
13 is a plan asset but the underlying stuff isn't, so we apply
14 that today to these tiered-funded funds to say we're not
15 part -- we're not fiduciaries; therefore, this isn't a
16 prohibited transaction; therefore, we're free to do that.

17 I think it's a question that should be asked. And
18 in fact, we've submitted a question in exactly that tone to
19 the Department of Labor on March 3rd asking to clarify that.

20 MS. LESTER: Yeah. And I think as a manager who
21 typically manages assets in either commingled trust funds or
22 in mutual funds as well as some separately managed accounts
23 for clients, I think that the very clear way to avoid any
24 potential conflict of interests, which I'm not entirely sure

1 I agree with to begin with, but theoretically speaking, is to
2 just state what your fee is irrespective of what the
3 underlying asset or fund choices will be so that there's no
4 incentive to move those underlying funds around. And I think
5 that's very straightforward.

6 So I do not, in fact, think there is any conflict
7 there at all. But the key to that is, again, articulating
8 clearly what you're doing and articulating clearly what the
9 fee is for that.

10 MR. MASTERS: Let me just agree that we, again, we
11 do not believe either that there is a conflict. We do think,
12 though, that it can be attractive for plan sponsors to have
13 the choice.

14 MR. PIACENTINI: But is the fee of the underlying
15 fund the only possible source of a financial interest?

16 MR. SMITH: In increasing the glide path, the Wall
17 Street Journal two years ago did a story called what was once
18 a safe investment has become exotic. It wasn't exactly. And
19 it notes that the glide paths have increased their equity
20 allocation as the Pension Protection Act of 624 --
21 Section 624 came on. And it just sort of questioned why.

22 You know, again, where everybody's looking at the
23 same math, but the solution before the Pension Protection Act
24 was to end the glide path at I think it was 30 percent

1 equity, and all of a sudden the industry average is 45. So
2 there are two ways that one could question its increase in
3 the glide path exposure to equities, which generate higher
4 fees, and then within that point in time skewing the
5 allocation to higher fee equities.

6 COMMISSIONER WALTER: One brief question about
7 sponsor options in terms of customizing for your particular
8 plan. Do you think it calls for some governmental
9 intervention to require that that be permitted, because there
10 are some people who are kind of tied in, as I understand it,
11 to a series of choices depending on who's administering their
12 plan?

13 MS. LESTER: We actually did an in-depth study of
14 about 45 different plan sponsors looking at different
15 participant behaviors, different demographic bases and
16 different benefit structures. And depending on the
17 definition of success that a plan sponsor chooses to apply,
18 we don't believe that in most cases a different glide path
19 gives a better outcome; that is, getting more individual
20 participants to a level of a minimum income replacement at
21 the point of retirement.

22 There are circumstances that are typically --
23 devolve around plan design like minimum -- excuse me, a
24 required age of retirement at the age of 60 and you must take

1 your balance out in cash, right. If your 401(k) happens to
2 be structured that way, that's a very unique plan design.

3 So our view is that it is not terribly frequently
4 that we do see plan sponsors who would benefit from a
5 different asset allocation in their glide path. But I think,
6 again, that helping a plan sponsor understand how to think
7 about aligning their goals in the glide path that they choose
8 would be constructive.

9 MR. MASTERS: May I make sure I understood the
10 question? Were you asking is there a need to facilitate or
11 pass regulations or facilitate moving away from proprietary
12 target date mutual funds to custom Target Date Funds because
13 of some problem that the plan sponsors have getting from A to
14 B?

15 COMMISSIONER WALTER: Uh-hmm.

16 MR. MASTERS: Because if that's the case, I believe
17 that a speaker on the forthcoming panel has done a survey,
18 and somewhere between 25 to 35 percent of large plan sponsors
19 have already customized their Target Date Funds, and quite a
20 few more are planning to do it.

21 The main impediment in our experience to
22 customizing is plan size. The economics of building a custom
23 Target Date Fund are simply not attractive if you have too
24 little in assets in the Target Date Fund.

1 COMMISSIONER WALTER: Does that problem go away as
2 you create numbers of customized plans, which, in fact, may
3 match those smaller companies as well so that they, in
4 effect, become another commodity option?

5 MR. MASTERS: No, I don't think so, because the
6 whole point of a customized plan is it actually belongs to
7 the plan sponsor, not to the fund company.

8 COMMISSIONER WALTER: I see.

9 MR. MASTERS: And therefore -- well, I can tell you
10 that we're doing everything we can to bring that threshold
11 level down as far as we can go. But there will always be a
12 threshold because there are some significant fixed costs at
13 the plan level to setting up a customized structure.

14 MS. LESTER: I would also add that there are a
15 number of issues and risks that arise as you start creating
16 daily valued funds with daily liquidity that are operational
17 in nature. And again, the costs, the fixed costs, associated
18 with having a robust solution are quite high. And again, I
19 would state that I do believe that it's very easy to
20 underestimate the risks in running typically ten daily valued
21 funds with liquidity moving that money around between
22 managers. And creating a very robust solution to that is not
23 inexpensive in terms of money or time.

24 MR. MASTERS: Well, actually, since we as a firm

1 happen to run over \$5 billion in such asset structures for
2 quite a variety of plans, and have been doing so for a number
3 of years, I would invite, by the way, anyone who's interested
4 to approach us, we actually can document that the risks are
5 quite manageable. They are exactly the same risks
6 incidentally as exist inside a target date mutual fund, which
7 has to do exactly the same thing every night.

8 And furthermore, as far as we can tell -- in fact,
9 on the operational side there are some advantages from a risk
10 standpoint and there are definitely, if you're large enough,
11 very, very significant cost savings.

12 MR. SMITH: If I can answer, your question
13 specifically said, do we need to think about a statutory
14 relief to talk about customized QDIAs. Section 624 of the
15 Pension Protection Act 2006 as promulgated by the Department
16 of Labor and the Qualified Default Investment Alternatives
17 said, you can construct a customized glide path so long as
18 there's a fiduciary somewhere that signs off on it.

19 You can have your consultant do it, and you as the
20 plan sponsor signs off on it, that you're on the hook for the
21 glide path, and you've monitored what they're doing. Or you
22 can bring in an ERISA 338 manager and have them do it. So
23 there's clarity in the statute to facilitate that.

24 What we do see is plan sponsors saying, hey, I want

1 a fiduciary to do this because with the QDIA I've taken
2 someone's terminal wealth at retirement and previously here's
3 a fund roster, kind of go off in the woods and shoot
4 yourself. As long as they're diversified in 404(C), I'm off
5 the hook.

6 When you buy a Target Date Fund, someone's wealth
7 at retirement, standard of living at retirement, is 100
8 percent dependent on picking the Bernstein fund versus the
9 J.P. Morgan. It's a significantly high fiduciary hurdle. So
10 to do a customized approach, bring in a 338 manager. A lot
11 of plan sponsors say, hey, that's my job to pick the high
12 yield fund, not the fund company's job, I need to switch them
13 out, so we like that business model a lot.

14 COMMISSIONER WALTER: Thank you.

15 MR. DOYLE: No further questions. I'll thank the
16 panel.

17 (Applause.)

18 MR. DOYLE: So if we could have Panel Four.

19 MR. KOPELMAN: Well, good afternoon. Thank you for
20 the opportunity to speak. My name is Ian Kopelman, and I am
21 a partner with the law firm of DLA Piper where I chaired the
22 firm's Employee Benefits and Executive Compensation Practice
23 Group.

24 I am here representing the views of the Profit

1 Sharing/401(k) Counsel of America, which is a 60-year-old
2 association representing companies that sponsor profit
3 sharing and 401(k) plans. I've been PSCA's legal counsel for
4 seven years, and I've been actively involved with PSCA since
5 1978.

6 Target Date Funds have rapidly become the
7 investment option of choice for defined contribution plans.
8 Where virtually no defined contribution plans offered a
9 Target Date Fund in 2000, PSCA research indicates that 25
10 percent of such plans offered a Target Date Fund in 2005 and
11 over 58 percent of such plans offered Target Date Funds in
12 2008. In addition, half of such plans with automatic
13 enrollment have a Target Date Fund as their default
14 investment.

15 It's also of the utmost importance to keep in mind
16 that mutual fund products continue to be the product of
17 choice for most qualified plans. Our research indicates that
18 78 percent of target date investments are, in fact, mutual
19 fund products.

20 There are three widely accepted principles for
21 long-term capital appreciation. First, diversification among
22 asset classes provides the maximum balance between risk and
23 return. Second, periodic re-balancing is necessary to
24 preserve the allocation ratio; and, finally, the asset

1 allocation ratio should be altered as an investment horizon
2 shortens in favor of risk aversion over returns.

3 Target Date Funds embrace these principles and
4 apply them automatically to individual plan participants, and
5 we hope that this hearing results in a reaffirmation of these
6 principles and a recognition of the efficacy of Target Date
7 Funds in achieving these investment goals.

8 The selection and monitoring of an investment fund
9 offered within a plan is subject to the fiduciary
10 requirements of ERISA and a prudent process is required.
11 However, what is absolutely not required is to insure that a
12 plan investment always results in positive returns over all
13 possible time horizons. Even prudent investors can suffer an
14 investment loss over a particular period of time, and it must
15 be understood that the plan investments are for the long --
16 are for long-term investing and questioning their propriety
17 based on short-term performance will create havoc for the
18 retirement system.

19 A plan fiduciary must determine that the glide path
20 offered by a particular Target Date Fund is prudent. How is
21 this achieved? Some plans will hire an expert to assist them
22 while others will conduct a survey of the glide paths of
23 several Target Date Funds under consideration. Benchmarks
24 may be utilized to assist in this process.

1 And we believe that a plan fiduciary should be able
2 to consider that a particular fund's glide path being within
3 the general range of similar funds is an indication of the
4 glide path being reasonable.

5 It must be remembered that 95 percent of the almost
6 700,000 plans reporting under the 2006 Form 5500 Abstract
7 have assets of \$10 million or less. These plans are
8 maintained by small and mid-sized businesses, and the
9 application of particular fiduciary requirements to them must
10 be effective in insuring a sufficiently high standard of
11 performance, but there must also be a recognition that it
12 must be reasonable for plan fiduciaries of small and
13 medium-sized plans to comply with the requirements.

14 There is little debate whether a 65-year-old
15 retiree should hold equities in his or her retirement
16 account. The question is how much. The consensus among
17 investment managers is in the general area of 40 to 50
18 percent, based on the 20- to 25-year investment horizon for a
19 recent retiree.

20 We believe that it is imperative that the glide
21 path should extend throughout the life of the participant or
22 beneficiary following retirement if the plan permits these
23 parties to remain in the plan beyond the normal retirement
24 age.

1 We disagree with those who claim that there's no
2 regulation of Target Date Funds. For example, the QDIA rule
3 specifically states that, quote, "It does not provide any
4 relief from the general fiduciary rules applicable to the
5 selection and monitoring of a particular qualified default
6 investment or from any liability that results in a failure to
7 satisfy these rules," close quote.

8 The rule describes a Target Date Fund default
9 investment as one that, quote, "applies generally accepted
10 accounting investment theories, is diversified so as to
11 minimize the risk of large losses and that is designed to
12 provide varying degrees of long-term appreciation and capital
13 preservation through a mix of equity and fixed income
14 exposure based on a participant's age, target retirement date
15 such as the normal retirement date under the plan or life
16 expectancy," close quote. These are firm requirements, and
17 we have described the process used to meet them.

18 Some advocate that regulations set glide path
19 parameters. Should this approach be pursued, plan
20 fiduciaries must be relieved of any fiduciary responsibility
21 regarding selection and monitoring of a glide path in a
22 Target Date Fund; however, we do not recommend that this
23 course of action be taken.

24 It will substitute government agency preferences,

1 which are inherently political and oftentimes static for
2 generally accepted investment theories that may be dynamic
3 based on changing market conditions and new and more
4 efficient investment products. It will also result in a one
5 size fit all product that precludes the flexibility to select
6 a Target Date Fund that recognizes the unique situations of a
7 particular plan.

8 Thank you for this opportunity to share the views
9 of the PSCA, and I look forward to your questions.

10 MS. FLORES: Hi. My name is Jessica Flores, and I
11 am the Managing Partner of Fiduciary Compliance Center or
12 FCC. FCC is a boutique consulting firm that collaborates the
13 efforts of other industry leading subject matter experts to
14 address the needs of both plan sponsors and the legal
15 communities.

16 My testimony today was formed in response to the
17 issues I've identified while performing complex product
18 reviews for large-plan fiduciaries and as a result of my
19 experience as a litigation consulting expert.

20 While I believe the asset allocation should be more
21 consistent from product to product to make it possible for
22 investors to properly compare performance and other
23 attributes when deciphering which 2030 or 2050 fund to use, I
24 also think there are other issues that the regulatory

1 agencies need to be watching.

2 Fiduciaries are responsible for selecting and
3 monitoring the fund of funds product. Yet, in most cases
4 they have no control over the selection of the underlying
5 fund options. Financial experts craft and manage these
6 investments, making decisions with regards to what underlying
7 investment vehicles will be represented; yet, they're still a
8 question as to the extent of their liability for the
9 suitability of the underlying participants invested in these
10 products.

11 One of the concerns that I see as a key issue, and
12 I know it's been brought up in previous panels, is feeding
13 the family. While offering a turnkey allocated portfolio
14 makes sense for most participants who have better things to
15 do than to become investment experts, the manufacturing of
16 these products also creates enormous opportunities for the
17 investment complexes.

18 The PPA ignited an explosion in the development and
19 the adoption of these products. Most investment complexes
20 have taken advantage of this market opportunity to feed their
21 family of fund managers. According to the financial research
22 corporation 2008 study of lifecycle funds, as of 2007, 71
23 percent of firms offering target date products only invested
24 in their own underlying funds.

1 I've yet to find an investment complex that is
2 stellar in every asset category. In fact, most became
3 significant market players because over the years they
4 offered a few management strategies that were notably better
5 than most competitors. This has not and is not likely to
6 change because you just can't be great at everything.

7 Each complex offers a suite of investment products
8 that represent the varying asset classes, some of which they
9 are really competitive at managing and some of which they are
10 terrible at managing and then there's everything in between.

11 These products represent an asset allocation into the
12 investment complex's varying investment options, the asset
13 classes they are good at managing and the asset classes they
14 are not.

15 Many times the underlying investments can rarely be
16 sold on the street because they possess insufficient assets
17 under management and/or their performance isn't competitive.

18 Holding these funds in a fund of funds approach enables the
19 complex to beef up the assets under management regardless of
20 the performance and whether or not it's quality.

21 There are inconsistencies with the oversight
22 process imposed on fiduciaries. Feeding the family creates
23 serious issues for decision-making fiduciaries responsible
24 for monitoring these investment selections. It is not

1 uncommon that funds that will not pass the criteria set forth
2 in the investment policy statement and therefore would not be
3 permitted for direct investment through the plan would be the
4 very funds that these prepackaged products will invest.

5 If the funds do not qualify for direct investment,
6 they should not be hidden beneath the layers of other fund of
7 funds approaches; yet, few fiduciaries, if any, have peeled
8 back the onion and examined the funds held in these products
9 imposing significant liability for inconsistently applying
10 their own investment policies.

11 Looking at the product performance on the surface
12 is irrelevant. As we have already established in this
13 debate, none of these products are equal. How can you
14 determine you are achieving sound performance if you don't
15 examine the underlying investments, and even if you do, in
16 most instances, what can you do about it if the fiduciaries
17 cannot control what these funds invest in?

18 The sales pitch for these products is all about
19 the efficient frontier, not management selection. Most
20 vendors discredit the need for quality managers with strong,
21 consistent performance histories by quoting modern portfolio
22 theory. If that's the case, then why aren't we all just
23 going passive versus active? I've asked this question to the
24 best managers in the past. They make arguments as to why

1 active is better; yet, at the same time they deny that
2 manager selection is a key driver.

3 You pay a great deal more in costs in managing
4 active portfolios, much more than any investor realizes, as
5 currently only a small percentage of true underlying costs
6 are required to be disclosed. For example, in active
7 strategies annual transaction costs for the trading of
8 securities held in the underlying funds are commonly as high
9 as 3 percent roundtrip costs. This figure is not disclosed
10 anywhere to fiduciaries unless they are very, very large
11 fiduciaries and have a way of getting that information.

12 We do not enforce the usage of only top quality active
13 managers. We will accept mediocrity; yet, we will also pay
14 for the premium managers.

15 When sitting back and watching this great debate
16 over appropriate asset allocation and listening to all of the
17 strategic economic arguments as to why each complex has the
18 best capture of the appropriate allocation, I kind of have to
19 laugh. One must understand why so many complexes want to be
20 aggressive in their mix. The answer is very simple:
21 Performance.

22 Fiduciaries are only comparing products on their
23 surface and complexes are bearing poor performing funds
24 inside these products. They have to be aggressive in the

1 allocation to make certain their product performs well in
2 comparison to the other products labeled with the same
3 targeted retirement date. This debate in many ways is
4 nothing more than a distraction from reality. You should be
5 responsible for the underlying funds that you invest in these
6 products.

7 There's been a great deterrence over the years with
8 benchmarking, a lot of questions over whether or not you can
9 effectively benchmark these. I know a lot of those solutions
10 have been created now. The tools have improved. We were
11 told this was not easy, that you couldn't do it, which never
12 made any sense to me because you could blend the benchmarks
13 just as easy as you can blend the portfolios.

14 Looking into the investments this way, if you were
15 to offer a tool that both benchmarked the underlying
16 investment, the allocation itself, and then went a step
17 further and rank the underlying funds by peer group, it would
18 expose the usage of these poor performing fund managers that
19 are buried in most of these products. So as an industry,
20 we've made this very simple solution overly complicated,
21 denied that it was really that easy all along.

22 Another area where I've seen abuse of practices
23 that just make me cringe is when the asset allocation funds
24 are combined with online investment advice systems. Most

1 investment advice providers with the help of the sales
2 efforts of the investment complex and recordkeepers managing
3 the plan encourage automatic enrollment to their products for
4 participants and forcing them to take action to get out of
5 these investment advice products. This causes participants
6 paying extra layers of fees to be enrolled in these products.

7 Then the investment advice system they are paying
8 additional fees to use will recommend that they invest in
9 2030 or 2050 fund, which also imposes a layer of fees over
10 top of the underlying investments.

11 This is a ridiculous solution for participants and
12 a gravy train for providers and a trend is growing, given all
13 the pressure to better disclose fees, which will in turn
14 empower fiduciaries to negotiate fee reductions. They have
15 to make it up some way, and this crafty strategy is a good
16 place to start; yet, this is overkill and unnecessary for the
17 participants. It only increases cost and not performance,
18 and it should not be permitted to go on.

19 The asset allocation theories used to develop these
20 products as well as the processes applied or not applied when
21 selecting the underlying investment options can be very
22 self-serving for many investment complexes. There's no
23 requirement for fiduciary status with the suitability of the
24 products for the participants and no requirement of

1 independence.

2 As in most aspects of the industry, the failure to
3 demand, regulate and enforce independence will continue to
4 prove costly for all participants as well as fiduciaries,
5 because they're going to pay the price in litigation.

6 MR. DOYLE: Thank you.

7 MS. KLAUSNER: My name is Allison Klausner, and I'm
8 the Assistant General Counsel of Benefits for Honeywell
9 International, Inc. I appreciate having the opportunity to
10 testify at this hearing.

11 I'm here today on behalf of the American Benefits
12 Council, a public policy organization representing
13 principally Fortune 500 companies and other organizations
14 that assist employers of all sizes in providing benefits to
15 employees.

16 Honeywell's primary defined contribution plan
17 permits participants to make contributions and to direct the
18 investment of their contributions among numerous asset
19 classes, including relatively low funds, such as bond funds,
20 fixed income funds and stable value funds, four equity based
21 funds, three special funds, the company's stock fund and, of
22 course, the Target Date Funds.

23 Currently the Target Date Funds are a series of ten
24 funds which invest in several asset classes, are targeted to

1 specific retirement dates and automatically reduce the
2 exposure to equities and risks as the targeted retirement
3 date approaches. Honeywell 401(k) plan participants can
4 choose to invest in one or more Target Date Funds. And for
5 those participants who do not make an investment direction,
6 their plan assets are defaulted to the eight appropriate
7 Target Date Funds.

8 After Honeywell made the decision to include Target
9 Date Funds as an asset class available for investment of the
10 plan's assets, the Honeywell Savings Plan Investment
11 Committee, a fiduciary committee, made numerous decisions
12 consistent with its investment policy including whether to
13 offer Target Date Funds that are custom designed or off the
14 shelf, actively or passively managed in five- or ten-year
15 increments. The committee analyzed glide paths, asset
16 allocations and retirement and, of course, fees and expenses
17 relating to the potential funds.

18 With my counsel, the committee understood that
19 satisfaction of their fiduciary duties depended on the
20 process itself. I note this today as it is critical that any
21 guidance issued with regard to the selection and monitoring
22 of Target Date Funds should be on the decision-makers'
23 prudent process.

24 The focus should be on whether the process employed

1 by the fiduciaries is designed to identify Target Date Funds
2 that are appropriate as an investment within a menu of
3 investment funds and as a default for those who do not
4 affirmatively choose the investment funds to which their plan
5 assets will be allocated.

6 I urge the Agencies to draft regulations which do
7 not mandate the features and characteristics of Target Date
8 Funds. Any regulations promulgated should permit plan
9 fiduciaries to make prudent decisions appropriate for its
10 body of plan participants. We ask the Agencies to respect
11 that one size and one style will not be best for all plans.

12 After Honeywell decided to include Target Date
13 Funds in their 401(k) plan, the focus turned on disclosure
14 and communication. I counseled our Honeywell team and worked
15 with our communications, investments and administration teams
16 to develop and implement communications describing the pros
17 and cons of Target Date Funds including the value these funds
18 offer to investors who are interested in a more hands-off
19 approach to investing.

20 We described the differences between Target Date
21 Funds with glide paths on the one hand and prepackaged funds
22 which were static and non-dynamic on the other hand.
23 Participant education was deemed critical as the
24 implementation of the Target Date Funds was followed shortly

1 thereafter with the closing of the prepackaged funds.

2 Thus, in addition to providing the SMM, pop-up
3 messaging was added to our website, meaningful brochures were
4 distributed and a fund fact sheet was created. This document
5 noted the Target Date Funds' objectives, investment
6 strategies, expense ratio, historical performance and, very
7 importantly, the asset allocation in each of the Target Date
8 Funds.

9 Although Honeywell made great efforts to disclose
10 and communicate the Target Date Funds to Honeywell's 401(k)
11 participants, I urge the Agencies to recognize the special
12 disclosure rules for Target Date Funds are not necessary.
13 Rather, plan sponsors should be encouraged to comply with the
14 current disclosure rules that are applicable to all DC plan
15 contribution investment choices.

16 With regard to glide paths and the underlying
17 investments in Target Date Funds, plan fiduciaries, again,
18 generally do not support government mandates. Plan
19 fiduciaries will support regulations that respect the
20 well-established rule that fiduciary decisions will be
21 satisfied by fiduciaries, who, in fact, engage in thoughtful,
22 developed processes which are documented and provide evidence
23 of diligence, prudence and care. It is not apparent to me
24 why this standard would need to be modified or lose its

1 flexibility in the context of Target Date Funds.

2 If Target Date Funds must comply with mandated
3 glide paths and rules regarding the underlying investments,
4 the Agencies must provide protections for plan fiduciaries
5 that use appropriate processes in adding and maintaining
6 Target Date Funds. Plan fiduciaries that have a reasonable
7 process in place to gather and analyze information should
8 have their decisions regarding the Target Date Fund glide
9 paths respected in the absence of a showing that their
10 judgment was adversely impacted by bad faith, gross
11 negligence, or willful misconduct.

12 If regulations mandate the glide path for Target
13 Date Funds, it is critical that any such regulations insulate
14 plan fiduciaries from liability with regard to any negative
15 outcome which is based in whole or in part on the mandated
16 glide path.

17 Finally, like with glide paths, any regulations
18 regarding whether Target Date Funds are custom or off the
19 shelf should be flexible so fiduciaries can determine the
20 appropriate offering to its plan participants based on the
21 information it gathers from its due diligence. As such, we
22 specifically request that the Agencies not draft regulations
23 which include an inflexible rule or to include a presumption
24 for or against any one type of Target Date Fund.

1 Thank you for holding this hearing and providing
2 the American Benefits Council to testify today. I anticipate
3 that our comments and the comments you will receive from
4 others at the hearing will be helpful in guiding you to your
5 next steps. I am happy to answer any questions you have.

6 MR. WAYNE: Good afternoon. My name is Mark Wayne.
7 I am the President of Freedom One Investment Advisors. For
8 over 20 years, Freedom One has been an investment consultant
9 and a plan fiduciary to hundreds of 401(k) plan sponsors, and
10 our firm has been evaluating and recommending various target
11 date alternatives for over ten years.

12 I am here on behalf of the National Association of
13 Independent Retirement Plan Advisors. NAIRPA is a national
14 organization of firms which provide independent investment
15 advice to retirement plans and their participants.

16 I'd like to share my experiences on how TDF asset
17 allocation strategies and the associated risks communicated
18 to plan sponsors and their participants and ways that this
19 process could be improved, and I'll close with the proposal
20 to improve the use of TDFs as a qualified domestic investment
21 alternative.

22 My written testimony also gives you a detailed
23 description of a review Freedom One conducted on a particular
24 plan's target date offerings and the sponsors lack of

1 understanding of their TDFs.

2 In my work, I meet with plan sponsors on a daily
3 basis, and TDFs, although relatively new, are very popular
4 and gaining in popularity. NAIRPA strongly agrees with the
5 concept and theory behind offering TDFs as 401(k) plan
6 investment option. For most participants it's the most
7 easily accessed mechanism to insure that a participant has an
8 appropriate mix of investments and that their portfolio is
9 re-balanced on an ongoing basis.

10 However, my experience has shown that there are
11 significant problems with how TDFs are presently marketed.
12 In particular, what is lacking is clear and understandable
13 information on the investment strategy and potential risks
14 associated with that strategy.

15 The experience of our members is that TDF
16 prospectuses for major mutual fund families generally
17 describe the funds' investment objectives to simply be,
18 quote, "provide capital appreciation and current income
19 consistent with its current asset allocation," end quote.

20 This wording comes from a Vanguard prospectus and
21 is used to describe the investment objective for Vanguard's
22 entire family of TDFs. However, these -- similar language
23 can be found in prospectuses from ING, Schwab,
24 AllianceBernstein and others.

1 Plan fiduciaries and unsophisticated plan
2 participants need a clear and more understandable way to
3 understand how the fund invests and the investment risk that
4 are associated with that strategy, and only then would it be
5 possible for participants to clearly understand the different
6 asset allocations and be able to compare different TDFs
7 providers.

8 We suggest the communications could be greatly
9 improved with kind of a truth-in-lending approach. Merely
10 providing the prospectus information required under current
11 securities laws is not enough as I demonstrated already, and
12 there's a widespread confusion as to what the word "target
13 date" really means. And we believe there must be a
14 consistent standard although we don't believe there should be
15 a mandated mix of a particular investment or types of
16 investments; however, plan managers should disclose in plain
17 English what the landing point will be for their TDF's glide
18 path.

19 In other words what will the point be that the fund
20 no longer needs to be re-balanced because it's reached the
21 appropriate mix of stocks, bonds and cash? Now, with this
22 information plan sponsors will be in a better position to
23 make an apples-to-apples comparison between providers.

24 I'd like to close with a recommendation on how to

1 improve the use of TDFs in the context of a 401(k) plans
2 default investment menu. Under the QDIA regulation, an
3 investment fund can qualify as a QDIA only if it's managed by
4 ERISA 338 investment manager or a named fiduciary of the
5 plan. However, mutual funds are exempted from this
6 requirement.

7 As a result, a mutual fund is not required to
8 assume any fiduciary responsibility for the investment
9 decisions made regarding the funds' asset allocation or the
10 underlying investments used in its allocation or glide path.

11 We believe that the TDF regulations must be
12 changed; that, in the absence of an ERISA 338 investment
13 manager, the manager of a mutual fund TDF must also agree to
14 assume fiduciary responsibility with respect to the plan's
15 investments in the TDF and the asset allocations made with
16 respect to the TDF so that the entity making the decisions is
17 actually on the hook for those decisions.

18 This is consistent with the sentiment expressed in
19 the preamble to the QDIA regulation that those responsible
20 for investment allocation decisions must be fiduciaries who
21 acknowledge the responsibility, and, although the preamble is
22 in reference to the required fiduciary status of a non-mutual
23 fund TDF, treating a mutual fund TDF and a non-mutual fund
24 TDF differently in this context, we -- was not the case of

1 the preamble.

2 We believe this fiduciary requirement will greatly
3 assist plan sponsors and participants by providing that all
4 Target Date Fund managers stand behind the investment
5 decisions they make.

6 Interestingly, applying this fiduciary standard is
7 also consistent with President Obama's proposal just
8 yesterday to establish a fiduciary duty and to kind of, you
9 know, harmonize regulations between different types of
10 organizations that offer the same types of services.

11 Thank you, and we appreciate the opportunity to
12 express our views.

13 MR. DOYLE: Thank you.

14 COMMISSIONER WALTER: I'd like to actually go back
15 to a fairly basic point, and there's been a lot of talk so
16 far today about one size doesn't fit all, and I'd like to
17 talk about that in a slightly different context.

18 Obviously the approval of Target Date Funds as a
19 default show that we do believe, to a certain extent at
20 least, in one size fits most, and in reaching a default
21 decision, you're really actually balancing the needs of your
22 collective employee population as opposed to the needs of
23 your individual employee population.

24 And I wondered if you have any thoughts about

1 whether that decision, that decision really needs to be
2 re-balanced? Do we need to encourage -- and I want to stay
3 away from what the government should do or not do and really
4 talk more about the policy in terms of what direction we
5 should head in in terms of whether there are things that we
6 can do either from the private sector or the government
7 encouraging or perhaps mandating a little bit more weight on
8 the individual side of the spectrum; for example, if a plan
9 sponsor were required to take into account certain
10 demographics of individual employees in deciding what Target
11 Date Fund to default someone into, not necessarily the one
12 that has the particular date that one would otherwise assume
13 or any other variation on that theme?

14 MS. KLAUSNER: Well, I'll try and take a stab at
15 answering that answer -- that question. In terms of having a
16 plan sponsor or more likely the plan fiduciaries consider
17 other elements of their broad-base population in determining
18 how to present Target Date Funds to their plan and to their
19 participants, we do believe that it should be a very broad
20 discussion.

21 So for example, at Honeywell and many of the plan
22 sponsors who have defined benefit plans, we do consider that
23 some of our participants will be having the opportunity to
24 draw down on retirement funds from our employer-sponsored

1 defined benefit plan, recognizing, of course, that, as
2 there's been a great shift from defined benefit plans and
3 defined contribution plans, number one, not all companies
4 have defined benefit plans; and, two, not all companies who
5 have defined benefit plans have them continuing to accrue
6 benefits; and, number three, not all employees within that
7 company have actually opportunity for a DB plan.

8 But recognizing that there are other elements in
9 the organization that need to be considered to understand
10 your population is important, not just recognizing the
11 individual's age and populating them into a Target Date Fund
12 that way.

13 MR. KOPELMAN: Yeah, if I could add, I'm worried
14 that two very different concepts are being thrown into this
15 mix, and we're getting into an apples-and-oranges discussion.
16 I mean, the concept of whether a Target Date Fund as a class
17 does or should fit the concept of what a default option
18 should be is very different than which of the various
19 offerings of Target Date Funds are appropriate for a
20 particular plan at a particular time.

21 For the former, you know, under those regulations,
22 I personally agree with them. I think the Target Date Funds
23 clearly satisfy and should continue to satisfy the rules of a
24 qualified default investment option, if that's what you were

1 asking.

2 But whether a particular fiduciary, you know, how a
3 particular fiduciary chooses what a -- which Target Date Fund
4 he will or she will select as an option in a fund or even as
5 a default option in a fund. That is, you know, that's very
6 different. That's going to depend on the particular fund.
7 It's going to depend, quite bluntly, on the resources. You
8 know, the process will determine the resource -- on the
9 resources that the fiduciary has available to them.

10 And with all respect, the fiduciaries of a very
11 large plan are a lot greater than the resources of one of
12 the -- you know, the 90 percent of the 700,000 plans that we
13 talked about that have assets of \$10 million or less. You do
14 the best you can with what you've got.

15 COMMISSIONER WALTER: My question certainly goes
16 more to the latter than to the former. And I guess my
17 question was really, as a matter of policy, whether you
18 believe that tailoring -- I mean, let's assume you have
19 Target Date Funds as your default option, whether it is a
20 good idea to encourage plan sponsors to try to tailor the
21 choice of fund to the individual employee as opposed to
22 making an across-the-board decision. And that was sort of
23 irrespective -- I recognize resources are going to determine,
24 in part, whether that's practical, but is that a good idea?

1 MR. WAYNE: I think it would definitely be a
2 difficult option to try and make that kind of customization
3 at the employee level individually. Employers have trouble
4 figuring out what those demographic issues are, although we
5 firmly believe that offering, you know, Target Date Funds as
6 a default alternative makes a lot of sense to the question of
7 resources.

8 That's why we believe if the exemption was taken
9 off of the mutual funds and more treated similarly between
10 independent advisors in the mutual fund industry to be able
11 to have the same fiduciary standing, then you'd have many
12 more people who would be watching over that mix, and, as a
13 result would be helping that employer to better prepare those
14 employees for their retirement.

15 MS. KLAUSNER: I'd just like to add that I think
16 your issue can be better addressed by the Department of Labor
17 looking at financial advice and, you know, how we frame what
18 financial advice should be provided or can be provided to our
19 plan participants and how that can be provided in a
20 framework; whereby, if a process is followed by the plan
21 sponsor or the plan fiduciary or outside consultants that are
22 brought in that there is, you know, a minimization of the
23 liability that could flow with providing that financial
24 education.

1 So that if you look at Target Date Funds and try
2 and customize them on an employee level or even have, as
3 someone had suggested earlier, multiple different types of
4 Target Date Funds within a specific plan, I don't mean 2010,
5 2020, 2030, I mean one that has a landing point at different
6 places or a glide path that does or doesn't continue to or
7 through retirement, I think you start to get to the point
8 where there's too much complexity, too many opportunities,
9 disclosures we've described that may or may not be read or
10 useful, but instead start to change our focus.

11 We want to get to the employee level, on, again,
12 financial education and how that financial education can be
13 best provided through the employer or the sponsor or its
14 consultants with the safety that, if they do it through an
15 appropriate process, they don't have liability.

16 MR. KOPELMAN: Although, for example, were I a
17 fiduciary of a plan that required people to take distribution
18 at normal retirement age, I might choose a Target Date Fund
19 with a different glide path than if I were a fiduciary of a
20 plan where employees typically permitted -- typically
21 continue to keep their money in the plan past normal
22 retirement date for five or ten years, and I knew -- and I
23 had the information to know that that situation is occurring.

24 MS. FLORES: I think also another answer to that is

1 we have indeed created a system to do custom retirement
2 planning already with the investment advice regulations.

3 You could easily answer that solution if someone
4 decided that they wanted to be custom for each employee and
5 they didn't think a 2050 was a one size fit all for everyone
6 retiring in 2050, you could default everyone into an
7 investment advice model that took the funds that were
8 selected as the options within the plan and would create
9 those models and monitor them ongoing.

10 So I think we've already got a solution to that.
11 You either have the pre-packaged or you have an investment
12 advice model that customizes by employee, and every employer
13 can choose how they combine those two options.

14 But I think we have the two solutions that answer
15 that question. Now, which one we enforce or if we don't
16 enforce either one of them is, you know, obviously a debate,
17 but I think that there's already something created for that.

18 MR. DOYLE: So I mean, what I'm hearing from this
19 particular panel and we've heard it from other panels that
20 you don't see a real benefit to some standardization, some
21 pre-defined regulatory criteria for what constitutes a
22 lifecycle fund, Target Date Fund type investment option
23 whether, independent of whether it's a default option or not,
24 or does it make any difference if it is a default.

1 MS. KLAUSNER: I think that's correct. You know,
2 all of our other funds, there really aren't government-
3 mandated parameters, so, if we decide to offer a small cap
4 fund, you know, we can include some mid cap as long as in our
5 disclosure we say it's a small cap fund with mid cap
6 companies, you know, up to a certain percentage or, if we
7 have an international fund, it's called an international
8 fund, but we could choose with our investment managers to
9 have domestic companies within that international fund so
10 long as there are appropriate disclosures and we recognize
11 it.

12 So with the Target Date Fund, as long as there's a
13 certain minimum disclosure that describes that it goes from,
14 you know, an equity-based, a primarily equity-based
15 investment fund down to something with a lower exposure to
16 bond funds or, you know, some form of a fixed income fund, I
17 think the general description of it starting with one level
18 of risk down to another is the parameter in and of itself.

19 MR. WAYNE: And I would suggest that certain
20 standardizations, certain standardization is necessary,
21 because today you have funds that hold to or through
22 scenarios. Just think about that. That's a 30-year
23 difference between those two numbers.

24 And if a fund is labeled 2020 and one is a

1 to-retirement and one is a through-retirement, unless that's
2 really, really clear somehow, the participant won't know it,
3 and really the plan sponsor won't know either.

4 MR. DOYLE: Well, that's my, kind of my other
5 question, is there a distinction between what plan sponsors
6 understand about the investments they're choosing and what
7 participants understand about the nature of these
8 investments?

9 MR. WAYNE: Surprisingly, usually the plan sponsor
10 is the participant, you know, they invest in their own plans.
11 And unfortunately, and disappointingly, there is not a lot
12 of difference in the understanding.

13 And the larger plans that have been represented
14 here, they have incredible resources to figure those things
15 out, and they do very, very well. I mean, 80 percent of the
16 plans that have, you know, a million and two million or
17 ten million dollars in them, you know, there's quite a
18 statistic there in their percentage, you know, they have a
19 very difficult time figuring out what's in a Target Date
20 Fund, how do they evaluate it, what is a glide path and
21 whether or not to even ask the question whether it's a to or
22 a through. That is something that, in our experience, nine
23 out of ten plan sponsors would not ask and do not know how to
24 ask.

1 MR. KOPELMAN: But I would suggest that the
2 resolution would be in the area of disclosure rather than in
3 required parameters for the funds. That's within the
4 province of the fiduciary to determine.

5 MR. DOYLE: Any other questions? Thank you very
6 much.

7 And with this panel, we will adjourn for a short
8 lunch. We will try to convene at 1:30 or shortly thereafter.

9 (Whereupon, a luncheon recess was taken.)

10 A F T E R N O O N S E S S I O N

11 MR. DOYLE: We will reconvene our hearing. Thank
12 you again for all being here. Thank you, Panel Four, for
13 being so timely.

14 We have some new members of the panel, Douglas
15 Scheidt, Associate Director and Chief Counsel, Division of
16 Investment Management, Securities and Exchange Commission;
17 Gene Gohlke, Associate Director, Office of Compliance
18 Inspection and Examinations with the Securities and Exchange
19 Commission.

20 And with that we'll turn it over to our next panel.

21 MR. VanDERHEI: Members of the panel, thank you for
22 your invitation to testify today on this important topic.
23 I'm Jack VanDerhei, Research Director of the Employee Benefit
24 Research Institute. EBRI is a nonpartisan research institute

1 that has been focusing on retirement and health benefits for
2 the past 30 years. EBRI does not take policy positions and
3 does not lobby.

4 Last year, as part of EBRI's analysis on the likely
5 impact of the PPA's safe harbor automatic enrollment and
6 automatic escalation provisions, we developed a stochastic
7 simulation model to project future 401(k) balances as a
8 function of various plan design variables as well as
9 assumptions with respect to various employee behavior
10 responses.

11 Today I will report results I obtained using the
12 EBRI simulation model to determine how TDFs would likely
13 impact 401(k) participants assumed to be automatically
14 enrolled. I realize that TDF use in 401(k) plans is not
15 limited to those automatically enrolled, and our March 2009
16 "Issue Brief" by Craig Copeland provides significant details
17 on the differences.

18 However, based on our simulation results, it
19 appears that this will represent the majority of TDF use in
20 the future, and, hence, I will concentrate my comments today
21 on those results.

22 I have passed out copies of my figures to each of
23 you, and I apologize for those of you in the audience, but we
24 will have those posted on EBRI.org by the end of tomorrow.

1 The simulation model starts with all workers,
2 whether or not they are currently enrolled in a 401(k) plan,
3 and tracks them through age 65 by stochastically assigning
4 job change, whether the new employer sponsors a 401(k) plan,
5 cashout behavior, and financial market performance. In
6 addition, we use the EBRI/ICI 401(k) database to
7 statistically impute asset allocation under participant
8 directed baseline scenarios.

9 And again, this is a database that has more than
10 21 million individual participants from more than 56,000
11 401(k) plans dating back to 1996. It represents more than 50
12 percent of the 401(k) assets in the universe as of year end
13 2007.

14 Now, although this model produces several output
15 metrics, the one of most interest for today's discussion is
16 the ratio of what we refer to as "401(k) accumulations"
17 divided by wage at the time of retirement, or, for purposes
18 of cashout behavior discussed later, the time of job change.

19 Most of the analysis presented today will focus on the
20 percentage increase or decrease of those balances moving from
21 participant-directed investments to TDFs.

22 Given my time constraints, I will limit my comments
23 today to the comparison of the so-called "average" TDFs in
24 terms of equity allocation, but I have included sensitivity

1 analysis in the appendix for both the most aggressive and the
2 most conservative TDFs as well.

3 Now, as you can see from the table of contents on
4 page 2 of the handout, I am bifurcating all my results today
5 into those dealing with account balances at retirement and
6 those dealing with account balances at job change for those
7 who cash out. Although the results for these seven figures
8 all assume a baseline rate of return assumptions, which are
9 detailed on the last page of the handout, results for
10 alternative return assumptions are also provided in the
11 appendix for your consideration.

12 Moving to Figure 1, I show the interquartile range
13 for the percentage increase in balances moving from
14 participant direction to Target Date Funds. As you can see
15 from the medians in the middle column for each cohort, the
16 average impact appears to be truly de minimis, less than 1
17 percent. However, this can be very deceiving.

18 The 25th and 75th percentiles show that this can
19 make a huge difference, especially those exposed to TDFs at a
20 relatively young age. For those 25 to 29, the top 25 percent
21 will have at least an 8 percent gain in account balances by
22 moving to TDFs, but the bottom 25 percent would have at least
23 a 5.9 percent loss.

24 But given the incredible heterogeneity of asset

1 allocations under participant direction, it should not be
2 surprising that the adoption of TDFs has a large range of
3 different outcomes.

4 If you turn to Figure 2, it shows the same type of
5 analysis as the previous figure, although this time the
6 relative gains are displayed as a function of the
7 participant's initial equity allocation. Obviously, the
8 primary advantage of TDFs when viewed in this context is the
9 expected gains for those with an initial equity allocation of
10 less than 40 percent.

11 Although the median gains are still relatively
12 small, less than 5 percent for all groups other than those
13 with zero equity exposure, the 75th percentile is in the
14 range of a 14 to 25 percent gain for those under a 30 percent
15 equity allocation while the 25th percentile is only about a 2
16 to 6 percent loss.

17 While some financial advisors may argue that less
18 than a 30 percent equity allocation may be optimal for those
19 very close to retirement age, it is likely that that will not
20 be the case for younger participants. In fact, much of the
21 EBRI/ICI analysis we've done since 1996 has shown that about
22 a third of the individuals in the 20s and 30s have absolutely
23 no equity allocation whatsoever in their 401(k) plans.

24 To show the potential value of TDFs for these young

1 employees, I bifurcate the analysis in Figure 2; for those
2 under age 45, in Figure 3; in those 45 or over, in Figure 4.

3 As you can see in Figure 3, the positive results of
4 TDFs in the lower equity allocation ranges are much more
5 pronounced with the 75th percentile for those with a less
6 than 30 percent allocation in the positive 25 to 37 percent
7 range while the losses associated with the 25th percentile is
8 always less than 6 percent. Moreover, even the median gains
9 in this range are in excess of 5 percent for all groups.

10 Figure 4 shows exactly the same analysis, only for
11 those over 45. Obviously, results were much more muted given
12 the compressed investment horizons.

13 Now, while the previous figures illustrate that the
14 TDFs can indeed make a substantial difference in balances at
15 retirement for some participants, another concern that has
16 often been expressed after the proposed QDIA regs were
17 released dealt with the potential impact on participants who
18 were likely to cash out instead.

19 So if you look at Figure 5, it shows the expected
20 impact on these individuals of moving from participant
21 directed investments to TDFs, as a function of how long the
22 employee had been with the employer before they cashed out.
23 The median impact is extremely small, 1 percent or less;
24 however, the interquartile range increases with duration, as

1 expected, and the 75th percentile for those with 11 or more
2 years with the employer exceeds 6 percent.

3 Now, another related issue during the discussion
4 period for the proposed QDIA regs dealt with the potential
5 utility of including a stable-value alternative. If you turn
6 to Figure 6, it shows the results of an average TDF versus a
7 stable-value fund on those who cash out. And there's two
8 interesting, but very conflicting, messages in here.

9 First, the median increase from TDFs is positive,
10 reaching a value just in excess of 5 percent for those in the
11 highest tenure category. However, the probability that a
12 participant who cashes out would have had a larger balance in
13 stable value as opposed to average TDF consistently remains
14 in the 40 percent range.

15 And then finally on Figure 7, I show exactly the
16 same analysis but instead of using a stable-value fund this
17 time, I used a money market fund. The medians in this case
18 are substantial, ranging from approximately 5 percent for the
19 lowest tenure range to approximately one-third for those with
20 11 or more years in the plan.

21 Moreover, the probability that the TDF balance
22 exceeds the money market account for this group is
23 monotonically increasing from 71 percent for the lowest
24 tenure group to 85 percent for those in the highest tenure

1 group.

2 I also have an appendix on page 10 for you of the
3 handout that shows some of the sensitivity analysis that we
4 run, and we're also doing additional work that we plan to do
5 within the 30-day period for written testimony looking at
6 counter-factual experiments that will track people who have
7 been with the same employer from 1999 through 2008, look at
8 what they actually ended up with for account balances on the
9 participant direction and go back and compute what they would
10 have ended up with had they been in the average Target Date
11 Fund, the most conservative Target Date Fund, the most
12 aggressive Target Date Fund and a stable-value alternative.

13 Thank you very much for this hearing, and we look
14 forward to working with you in the future on this important
15 topic.

16 MR. WARSHAWSKY: I appreciate the opportunity to
17 offer some comments on the risk characteristics of Target
18 Date Funds, both when used as an accumulation vehicle in
19 retirement accounts and when used for retirement
20 distributions.

21 My name is Mark Warshawsky. I'm Director of
22 Retirement Research at Watson Wyatt Worldwide. And I base
23 these comments on a conference of analysis we have conducted
24 recently in the Research and Innovation Center at Watson.

1 And I will attach, for the record, a copy of our working
2 paper containing this analysis. We would be glad to answer
3 any questions that the Department or Commission may have on
4 the data assumptions, methodologies and results in our paper.

5 It is difficult to say what is the optimal, overall
6 asset allocation in retirement accounts because individual
7 workers have different extensive pension and social security
8 coverage, career and employer risks, tax situations and
9 personal characteristics such as health and marital status
10 and family responsibilities.

11 Nonetheless, our empirical evidence suggests that
12 asset allocations by workers in their retirement accounts
13 seem to be less than optimal with many, regardless of age,
14 investing entirely in equities or entirely in fixed income
15 instruments. Indeed, one-fifth of workers approaching
16 retirement in 2007 had their entire balances invested in
17 equities.

18 Against this background, Target Date Funds offer a
19 better and easier approach to retirement investing for
20 individuals because the asset mix shifts automatically away
21 from equities towards fixed income instruments as the worker
22 ages.

23 Our empirical evidence also shows that there is a
24 wide range of initial allocations, glide paths and exit

1 positions among Target Date Funds of varying maturities and
2 the respective fund family's income distribution funds. This
3 range presents to us the need for deeper consideration and
4 analysis. Because Target Date Funds are so new, insight is
5 better gained through stochastic simulations rather than
6 actual performance.

7 Our particular stochastic model is quite
8 comprehensive in considering annuity pricing, fund expense
9 charges, mortality and cross correlations of returns, both
10 short and long run, among the three asset classes, equity
11 bonds and cash, bond yields and inflation. So what I'm going
12 to talk about now is based on the stochastic analysis which
13 we've conducted.

14 For typical workers of various ages contributing
15 consistently to a 401(k) across their career, they first
16 evaluate Target Date Funds in terms of the amount of terminal
17 wealth accrued upon retirement and the intendant levels of
18 risk.

19 For younger workers two findings are of note. The
20 differentials in final balances among the five Target Date
21 Funds that we have selected range from highest to lowest
22 initial equity allocations. They're actually relatively
23 small across stochastic outcomes, mainly because of multiple
24 crossovers of allocations over the life cycle in the fund

1 families. For example, they may start out higher and end up
2 with lower equity allocations.

3 And the second finding of note is the investment
4 risk remain substantial regardless of which Target Date Fund
5 family is used. Poor investment outcomes will be
6 disappointing to all 401(k) participants using any of these
7 families compared to, say, a lifelong participation in a
8 defined benefit plan.

9 For mid-career workers who start their Target Date
10 Fund investing at age 50, we begin to see more consistent
11 differentiation in outcomes among the fund families. Those
12 investing in funds with high equity allocations can see
13 significantly larger balances if equity markets perform well
14 whereas those investing in funds with higher bond and cash
15 allocations are better protected on the downside. Note,
16 however, again, that the initial allocations do not indicate
17 the whole picture because even at later ages some funds cross
18 over.

19 For workers approaching retirement, that is, first
20 investing their considerable balances at age 60, the return
21 differences among funds within the observed wide range of
22 equity allocations are quite large. A high equity fund may
23 outperform a low equity fund by about 27 percent in good
24 times, but may under perform the latter by 16 percent in a

1 down market. The sharp ratios, that is the risk adjusted
2 returns, are higher for low equity funds.

3 For some participants, plan sponsors and
4 policymakers, the analysis ends here, and it might be thought
5 that the need for regulation begins, but that would leave out
6 a significant, additional aspect of the problem: What is the
7 best asset allocation and distribution strategy to cover
8 comfortably a long retirement?

9 When that aspect is considered, playing it safe, in
10 other words lower equity, may not always be the best answer.

11 When a plan participant or an IRA holder holds a -- pursues
12 a fixed percentage or fixed dollar withdrawal strategy in
13 retirement, our simulations find that the fund families with
14 the highest allocations to equities at and during retirement
15 perform the best and represent the lower-risk alternatives
16 against the chance of falling below certain minimum income
17 amounts in inflation-adjusted terms or of outliving one's
18 retirement plan resources. Only if complete annuitization is
19 chosen do the lower equity allocations before and at
20 retirement represent lower risk.

21 Note also that a higher bond rather than cash
22 allocation before and at retirement makes more sense in this
23 latter strategy because the bond holdings in the funds
24 represent better hedges than cash against the interest rate

1 induced volatility in annuity pricing, and the annuitization
2 strategy, on average, produces a higher income stream at the
3 cost, however, of loss of liquidity and of bequest potential.

4 This concludes my summary of our research results,
5 and I'm glad to answer your questions.

6 MS. DiCENZO: Good afternoon. My name is Jodi
7 DiCenzo. I'm going to switch gears here a little bit. My
8 colleague, Michael Liersch, and I represent Behavioral
9 Research Associates. We're an applied behavioral research
10 firm, and we specialize in studying saving and investing
11 decisions. We are pleased to have the opportunity to speak
12 with you today, and we're primarily going to cover three
13 things.

14 First of all, worker misperceptions about Target
15 Date Funds. We'll offer some potential psychological
16 explanations for what might be causing those misperceptions.

17 And finally we'll discuss the importance of these
18 misperceptions, particularly in light of automatic enrollment
19 plans. And we suggest that behavioral research continue to
20 inform your regulatory efforts should there be any.

21 First of all, the misperceptions. In March of this
22 year, we conducted an online survey of 250 American workers.

23 Our respondent group is representative of the U.S.
24 population, and our methodology employed standard research

1 protocols.

2 Prior to asking respondents or survey subjects
3 particular questions about Target Date Funds, we showed them
4 a composite description of the funds that we compiled from
5 the actual marketing materials from the top three Target Date
6 Fund providers. You have a copy of what we provided to the
7 survey subjects.

8 Here are some of the results that we found. 61
9 percent of people say that Target Date Funds make some sort
10 of promise. At a 95 percent confidence level, that's a
11 statistical majority. Of these people we asked them to
12 describe the promise that Target Date Funds make. Nearly 70
13 percent of these people perceive a promise that does not, in
14 fact, exist.

15 Here are some of what respondents think that Target
16 Date Funds promise: Funds at the time of retirement; secure
17 investment with minimal risks; it's like a guaranteed return
18 on investment even when the market bottoms out; a comfortable
19 retirement.

20 Alarmingly, over 60 percent of employees say that
21 investing in a Target Date Fund means that they will be able
22 to retire on the target date. 38 percent believe that Target
23 Date Funds offer a guaranteed return, and 30 percent of
24 workers think that they can save less money and still meet

1 their retirement goals if they invest in a Target Date Fund.

2 Worse yet, when workers were asked to rank five
3 tasks in terms of their overall importance to their
4 retirement planning success, selecting a savings rate, which
5 arguably is the most critical determinant of retirement
6 planning success, was rated number one by the fewest number
7 of people. Only 8 percent of American workers selected it as
8 the most important factor in their overall retirement
9 planning success.

10 And what about the risk of Target Date Funds and
11 how workers perceive that? Over 23 percent of workers think
12 that there's little to no chance that they can lose money
13 either before or after the target date. 41 percent think
14 that there's little to no chance that they will lose money in
15 any one-year period. 70 percent think that they're equally
16 or less likely to lose money in a Target Date Fund as they
17 are in a money market fund.

18 What might explain these findings? Although more
19 research is necessary to really uncover what might be at work
20 here, we'll offer three potential psychological explanations.

21 And I encourage you to ask Michael more about each of them
22 during the Q&A.

23 First of all, excessive optimism probably explains
24 some of these responses. Humans tend to be tirelessly

1 optimistic. It explains why more than a majority of us think
2 that we will be better than typical.

3 Secondly, framing effects and how these funds are
4 framed may fit into a particular schema or mental framework
5 of investors. The framing may set expectations that the fund
6 will somehow solve general retirement planning issues rather
7 than just asset allocation issues. These frameworks may be
8 so powerful that people remember what they expect, not what
9 they are told.

10 Finally, attention salience and focusing illusions
11 may explain some of these results. The focus on the
12 investment simplicity of Target Date Funds and the target
13 date itself may cause people to misperceive them as a
14 superior retirement investment solution along many
15 dimensions, not just asset allocation.

16 What does the future hold if this problem is not
17 addressed? When do working Americans learn that Target Date
18 Funds do not promise retirement readiness; when they retire?
19 How can we drive the message home that how much you save is
20 of critical importance?

21 Until we can answer these questions, American
22 workers are investing in false hope. And absent change, we
23 are knowingly accepting that a significant percentage of
24 American workers believe in some sort of Target Date Fund

1 magic. They believe the funds offer retirement readiness on
2 the target date and a guaranteed return. These beliefs are
3 not just naive and harmless, they are detrimental to the
4 financial well-being of thousands of Americans.

5 How can it be addressed? Regulation offers at
6 least two alternatives, disclosure and product restrictions.

7 Let me be clear that we are not recommending one over the
8 other or even either for that matter. We are merely
9 suggesting that, as you move forward, continued behavioral
10 research will offer valuable insight on what may be
11 effective.

12 Understanding perceptions is just the first step of
13 this work. Empirical research must illuminate effective
14 methods to improve understanding and behavior. We can hear
15 smart people weigh in all day long on what might work, but
16 until we empirically test these ideas to evaluate the
17 behavioral impact, it's all just conjecture. Our actions
18 here must be based on rigorous empirical evidence.

19 As you consider ways to address this issue, and a
20 number of people have mentioned this already, but we need to
21 keep this in mind, that many Target Date Fund investors are
22 not actively engaged. They do not actively make the decision
23 to invest in them. They've been automatically enrolled in
24 them.

1 Many workers believe in Target Date Fund magic, and
2 we have a growing number of passive Target Date Fund
3 investors. As you move forward, consider the research
4 finding that people view default choices as implicit advice,
5 and in every decision context there's a default choice.

6 What implicit advice will you provide the American
7 worker and what behavioral evidence will it be based on?

8 Thank you.

9 MR. DOYLE: Thank you. I just have two quick
10 questions. One, when was this survey conducted?

11 MS. DiCENZO: March of this year.

12 MR. DOYLE: So these are presumably some workers
13 who actually had some firsthand experience with the current
14 market turmoil?

15 MS. DiCENZO: Only 9 percent of our respondents
16 actually self-reported that they invested in Target Date
17 Funds. The only other behavioral study that we're aware of
18 that looked at workers' perceptions of Target Date Funds was
19 one conducted by Janis, and in their work they only surveyed
20 people who self-reported that they invested in Target Date
21 Funds, and still, in their respondent group, 19 percent of
22 the people said that they thought that Target Date Funds
23 provided some sort of a guaranteed level of income at
24 retirement.

1 MR. DOYLE: So that actually was my other question
2 about the Target Date Fund magic. What was the basis for
3 this conclusion that there was magic? Was it the way these
4 funds were described? Was it the title? What aspect of the
5 material that was available or considered did the investors
6 or the surveyed individuals reach their conclusions?

7 MS. DiCENZO: So the retirement date or the Target
8 Date Fund magic, those are my words, and that's to make
9 salient the notion that workers think that investing in
10 Target Date Funds means that they'll be able to retire on the
11 target date and that a significant percentage believe that
12 they offer a guaranteed return when they, in fact, do not.

13 MR. DOYLE: But I guess what I'm asking is, did
14 they have particular material that defined what a Target Date
15 Fund was, and then, based on that material, they reached that
16 conclusion?

17 MS. DiCENZO: Right. And the description that we
18 provided to them, we dropped some copies off for each of you,
19 we compiled that description from the marketing materials of
20 the top three Target Date Fund providers.

21 MR. PIACENTINI: I have a couple of questions that
22 I think are probably mainly for Jack or Mark or both. We've
23 heard this morning and now this afternoon several conclusions
24 that are drawn from modeling that people do when they think

1 about Target Date Fund designs.

2 They run stochastic scenarios, different investment
3 returns that people might experience, and then you look at,
4 well, what are the probabilities of different outcomes,
5 right, so many researchers are doing similar things along
6 those lines.

7 So I guess the questions I want to ask, one is, is
8 it the case, I think it is, that the probabilities in fact
9 are not -- how do I want to explain this -- that there's
10 concentration in cohorts, so if there's a small chance of a
11 bad outcome or of a very nice surprise, that in fact, as it
12 plays out in reality, that those small probabilities, when
13 they do come to pass, come to pass for an entire group of
14 people who are about the same age, is that right, so that
15 when I look, for example, at Jack's diagrams, the people at
16 the different percentiles, that really a whole cohort will
17 find themselves being located in one of those places or
18 another most the time?

19 MR. VanDERHEI: Well, the way, there are several
20 different ways of conducting those stochastic simulations.
21 The way I conducted this one, what you said is correct.

22 MR. WARSHAWSKY: Yeah, I'm not quite sure that's
23 correct in terms of the way we've done the stochastic
24 simulations because, although it's based on historical

1 evidence, it is based on -- typically a stochastic analysis
2 is a projection, and it's not necessarily for any particular
3 cohort.

4 In other words, you -- certainly there are
5 outcomes. The simulation is done over a very long period of
6 time, and there are outcomes that are extremely positive, and
7 there are outcomes that are extremely negative, but I
8 wouldn't characterize it as an cohort analysis.

9 MR. PIACENTINI: But I guess what I mean is, if you
10 see an outcome that's predicted to occur with a 2 percent
11 probability, that doesn't mean that if you look at a
12 particular cohort, you'd find that 2 percent of them had that
13 experience. It's more the case that 2 percent of cohorts
14 will have an experience something like that.

15 MR. WARSHAWSKY: That's right, because, I mean,
16 we're talking about markets, and these are very broad trends,
17 and it would be extremely unlikely that, if they're investing
18 according to the glide paths of the Target Date Funds, that
19 different people find different outcomes.

20 In fact, you know, as I stated in the testimony,
21 one of the conclusions is the investment risk is very real,
22 and, you know, compared to other, for example, benefit plans,
23 there is risk here.

24 MR. PIACENTINI: My second question I guess goes to

1 the distribution of possible outcomes, so I know some people
2 use historical data, sometimes they mix up the historical
3 years, sometimes they just use historical years as they
4 actually consecutively happened. Sometimes they generate
5 hypothetical returns.

6 And Jack, looking at your material, it looks like
7 you chose an expected level of return and some amount of
8 deviation around that. Are you assuming the returns are
9 normally distributed according to those statistics?

10 MR. VanDERHEI: What we're generating, we've
11 generated three different scenarios. The baseline scenario
12 there's a log number distribution. And for the second
13 alternative scenario, which was in the appendix, it's nothing
14 I had time to talk about today, basically what we did was
15 radically reduce the expected equity premium going forwards.

16 The third one was truncated much more because we
17 wanted to have the stable-value alternative, and we were only
18 able to take our time series back 20 years for that, so the
19 equity, US or non-US equities are all logged normally,
20 distributed in that particular example, but there are
21 different time spans from which these data are being derived.

22 MR. PIACENTINI: So one of the areas of uncertainty
23 that I think these exercises have to deal with is, what is
24 the probability of the extremes? How likely is a very large

1 deviation from the average, either positive or negative, and
2 so if that -- I mean, we all expect those probabilities are
3 small, but then, you know, there's small and there's small,
4 and I'm assuming that some of the results, in terms of what
5 turns out better could be different?

6 MR. VanDERHEI: Without a doubt. This is not
7 contained in what I've done here under the Target Date Funds,
8 but in one of the first simulation models that was built
9 dealing with EBRI/ICI data, I did with Sarah Holden from ICI
10 back in 2002.

11 In those situations we basically went back to test
12 how bad bad could be. We would override stochastic
13 simulations both at the beginning and in the middle and at
14 the very end of a worker's career just to show the overall
15 impact.

16 That basically is the only way, at least the way we
17 have the simulation model constructed now, to basically focus
18 in on what that kind of a shock could be over an retirement
19 income. That would be extraordinarily easy to add into what
20 I've done for today if that's something you'd like to see.

21 MR. WARSHAWSKY: In responding to your question for
22 the model which we used, we used an vector auto-regression
23 model basically patterning it after a model that was first
24 introduced a few years ago by John Campbell at Harvard

1 University.

2 So it is based on historical data, but it is a
3 model so that it includes cross correlations both in the
4 short run and the long run among different asset classes,
5 equity, bond and cash, as well as the random inflation rates
6 and bond yields, so we feel as if it's a pretty sophisticated
7 model and comprehensive of the relevant risks for this type
8 of analysis.

9 And it doesn't -- in the paper which you will see,
10 we emphasize the outliers, so the 1 percentile outcomes as
11 well, which I think is -- will give you some indication of
12 how bad or good things could be.

13 MR. SCHEIDT: I have a question for all three or
14 all four panelists. It's based on your research and your
15 findings. What points would you -- do you believe that plan
16 sponsors and plan participants should take, what points arise
17 from your research, what points should they take into
18 consideration when considering, including Target Date Funds
19 and the options available, in either choosing a Target Date
20 Fund as a plan participants or in being defaulted into and
21 living with the consequences?

22 MR. WARSHAWSKY: Okay, I'll take it first. Maybe
23 we'll say five points. Number one is Target Date Funds are
24 an improvement over the status quo. For many participants

1 they're a good thing, and therefore for a plan sponsor
2 they've a good idea.

3 With that being said, they are risky, and I think
4 the findings, which indicate that there may be some
5 misunderstanding of that, is a significant finding because
6 the reality is that they do represent risk.

7 The third item is that the different strategies
8 that are out there are all possibly reasonable. Both the
9 initial equity allocations, the glide paths, the termination
10 allocations, they're all reasonable, but it very much depends
11 on, and this is the fourth point, on the strategy that the
12 participant is -- and I guess to some extent this is
13 determined by plan design, but I think more importantly the
14 participant plans to make of their investment.

15 Are they going to cash the plan out or are they
16 going to hold it till retirement or are they going to hold it
17 past retirement and actually use it for either a purchase of
18 an annuity or getting income from the retirement plan during
19 retirement? The answers for asset allocations, the optimal
20 strategy, really depends on how they're actually used.

21 And that may be not be understood, but I think
22 that's an important point, certainly from both the plan
23 sponsor and the participant.

24 MR. VanDERHEI: Let me add one other potential

1 stakeholder and that is the government in considering the
2 appropriate public policy route. As has been discussed many
3 times this morning, PPA basically changed the rules with
4 respect to employers considering the future adoption of
5 automatic enrollment and automatic escalation.

6 I think from the standpoint of what's likely to
7 happen in terms of more and more employees being brought into
8 these in a default basis going forward, whether or not the
9 overall distribution results tends to look better for Target
10 Date Funds or for participant direction, and that's what I
11 tried to focus on, but certainly it would appear that there
12 are a relatively large percentage of participants not
13 currently in Target Date Funds making choices that just do
14 not seem rational.

15 We don't have the whole household portfolio in
16 front of us, but in many cases, again a very large percentage
17 of people in their 20s and 30s have absolutely no equities
18 whatsoever. In testimony I did for Congress in October last
19 year showed that as many as 42 percent of people between 55
20 and 65 had over 70 percent on their portfolios in equities.
21 Over one in five had over 90 percent.

22 Getting people away from those extremes, again
23 given them the opportunity to opt out if they'd like, but, at
24 least in the default for those people who are not providing

1 serious consideration to this, I think is, from a public
2 policy standpoint, quite admirable.

3 With respect to the employer objective, I think the
4 presentation this morning from J.P. Morgan was excellent. I
5 think the type of thing you want to focus on is what is the
6 employer's objective in terms of making sure at least a
7 minimum percentage of your work force has a standard of
8 living, when combined with social security, that's going to
9 be acceptable.

10 What type of Target Date Fund or if indeed Target
11 Date Funds are going to help maximize that percentage, I
12 think is the thing to look at. From the standpoint of the
13 employees, I think what you really want to really to try and
14 focus on, and this is something I think Jodi was touching on,
15 is what type of research do we need to look at to see what
16 employees are doing when they're given the choice, not the
17 ones who are defaulted into this through automatic
18 enrollment, but when they're being provided those choices by
19 their employers, what are they doing with it and what's going
20 on with the rest of their portfolio?

21 MR. LIERSCH: I think from my perspective, coming
22 from a psychology background, is really that participant
23 behavior isn't rational, and I think we all need to
24 understand that, although we assume we give people proper

1 information, make the appropriate disclosures, that people
2 aren't rational actors and that there are behavioral biases
3 that will drive what people do.

4 And we need to consider that when informing or
5 making our future decisions about what to do with Target Date
6 Funds and what not to do with Target Date Funds. And as
7 people pointed out, Target Date Funds have made a vast
8 improvement upon what existed previously, but we also still
9 need to consider the behavioral aspect.

10 MS. DiCENZO: I'd like to just add my, and I
11 accepted the most difficult role by going last, but for
12 participants, two things: One, there is no magic in Target
13 Date Fund investing. You cannot invest your way to a secure
14 retirement. You must save.

15 The other thing is that there is risk associated
16 with Target Date Funds, and for plan sponsors, an awareness
17 of some of these misperceptions and then also to support what
18 Michael said: We really need to engage in behavioral
19 research as we try to identify effective ways to improve
20 retirement outcomes in America.

21 MR. DOYLE: Thank you very much.

22 MR. COHEN: Hi, I am Josh Cohen from Russell
23 Investments. Thank you for the opportunity to allow Russell
24 Investments to present today. Russell provides strategic

1 advice, performance benchmarks and a range of institutional
2 quality investment products to clients globally. I am a
3 Senior Consultant with a particular focus on defined
4 contribution plans.

5 Russell advises plan sponsors on the selection of
6 Target Date Funds. We also implement Target Date Funds
7 solutions through either customized approaches or commingled
8 to mutual funds.

9 Russell spent many years working with clients to
10 come up with better Target Date Fund solutions. We've done a
11 lot of research with respect to Target Date Funds, how they
12 are constructed, how they are used by participants, how their
13 performance can be measured and how to deal with some of
14 their challenges.

15 Many investors were surprised at the magnitude of
16 losses that many Target Date Funds, particularly those with a
17 near-term retirement date have suffered. Those losses are
18 primarily due to the high equity allocation exposure of some
19 funds near the retirement date.

20 Interestingly, we have found that there is a strong
21 correlation between the length of time that the glide path
22 continues to slope down after retirement and the level of
23 equity exposure at retirement.

24 Now, opinions will differ as to the right shape of

1 the Target Date Fund glide path. I would like to share with
2 you our opinion based on our work with clients, our research
3 and our analysis.

4 Two basic points: First, Russell believes that
5 investment risk should be more limited at retirement. In
6 fact, Russell's standard glide path has a 32 percent
7 allocation to equities at retirement. Second, in retirement,
8 the glide path should be flat rather than sloped.

9 We reached these conclusions because of a
10 fundamental understanding of what the objective of retirement
11 savings is and the nature of contribution patterns into
12 plans. We believe Target Date Funds should be created with a
13 certain objective in mind and rigorously engineered to meet
14 that objective. Further, we believe Target Date Funds should
15 be viewed as a component of an overall retirement savings
16 program.

17 The objective of retirement savings should be to
18 create greater certainty of meeting an income replacement
19 goal in retirement. Given this objective, risks should be
20 measured in terms of not meeting that goal. This is
21 different than some arbitrary point in time risk measure like
22 standard deviation returns or level of equities which really
23 doesn't tell you anything about the ultimate risk of falling
24 short of an income replacement goal.

1 So now let's discuss the nature of contributions.
2 The wealth of young participants with a long investment
3 horizon consists primarily of future payroll contributions,
4 and those participants can therefore afford more risk in
5 their asset portfolio.

6 At retirement, participants stop putting money into
7 their plan and start taking it out. As a result, large
8 losses, say a negative 40 percent return, have much more
9 impact just before retirement than any other time before
10 because account balances are at their highest and the ability
11 to respond to the setback and rebuild assets is small.

12 We would call this risk of experiencing poor
13 investment performance at the wrong time a sequential risk,
14 so if your objective is to reach your retirement income goal
15 while reducing as much as possible the risk that you will
16 fall significantly short of it and if your maximum exposure
17 to catastrophic loss is highest as you near retirement, we
18 believe fund risks should be more limited at that period.

19 Now to our second point, why a flat glide path in
20 retirement? We believe that a participant is financially
21 most at risk the day that he or she retires. That's because
22 he or she has, at that point, the longest time to live and
23 therefore the greatest amount of time for which he or she
24 needs to fund retirement income.

1 Therefore, it does not make sense to us to use a
2 sloping glide path that maximizes investment risk on the day
3 of retirement and reduces it thereafter regardless of what
4 that right allocation is.

5 I would like in closing to discuss two additional
6 issues. The first is target date performance measurement.
7 We believe a simple measurement of the effectiveness of a
8 glide path to generate wealth using actual fund performance
9 and contributions should be adopted.

10 I want to stress that there is not one good
11 performance number that will tell a plan sponsor whether a
12 Target Date Fund is good or not. Fiduciaries need to use
13 prudent investor standards to determine the appropriateness
14 of a solution.

15 That being said, Russell has developed a
16 performance measurement tool that attempts to answer the
17 question of how well a Target Date Fund family has done at
18 its task; specifically, how well did it do in building
19 retirement wealth over time versus other alternatives.

20 The key attributes to this approach are, one, it
21 evaluates the Target Date Fund family as a whole instead of
22 the individual funds in the series, and, two, it uses a
23 dollar weighted approach which gives considerably more weight
24 to the returns of those funds that are near their target date

1 than those that are farther away. More information about
2 this approach will be released soon.

3 Finally, in regards to manager selection, most
4 Target Date Funds tend to be manufactured entirely out of
5 proprietary funds from a single investment shop. While this
6 won't necessarily lead to inferior results, these approaches
7 do face head winds as it's hard to make the case that a
8 single investment management firm is best in class in all
9 asset classes.

10 A customized approach in which a plan sponsor
11 creates their own Target Date Funds is a possible solution;
12 yet, for many plan sponsors there are significant challenges
13 doing this correctly and cost-effectively. Russell's target
14 date commingled and mutual funds are put together using
15 multi-manager asset class funds based on extensive research
16 and the utilization of over 50 external investment managers.

17 Thanks for your time today, and I look forward to
18 further discussion.

19 MS. LUCAS: Good afternoon and thank you for the
20 opportunity to testify at this important hearing on Target
21 Date Funds. My name is Lori Lucas, and I am the defined
22 contribution practice leader at Callan Associates, one of the
23 largest independently-owned investment management consulting
24 firms in the country.

1 Our client services include strategic planning,
2 plan implementation, monitoring and evaluation and education
3 and research for institutional investors such as sponsors of
4 pension and DC plans. We do focus mainly on large plan
5 sponsors, those with 100 million in assets or above.

6 My comments are based on more than 20 years of
7 experience as a DC and investment consultant, and I would
8 like to address plan sponsors need to appropriately monitor
9 and evaluate Target Date Funds.

10 The introduction of Target Date Funds to DC plans
11 represents an important advancement for long-term retirement
12 income potential within these plans; however, during the
13 market collapse of 2008, Target Date Fund performance,
14 particularly the performance of 2010 funds, ranged widely due
15 to the highly varied approaches of Target Date Funds across
16 the industry.

17 First is the fact that there is no standard
18 approach to Target Date Fund investing, good or bad. We know
19 that this is consistent with the wide range of investment
20 approaches sponsors of DB pension plans take. Asset
21 allocations for DB plans can vary substantially depending on
22 the unique circumstances, investment goals and risk tolerance
23 of each DB plan sponsor, and to a large extent, the same
24 factors apply to DC plans. Demographic differences, the

1 presence of a DB plan, observed risk preferences all can
2 justifiably result in different target date asset
3 allocations.

4 However, a wide range of target date solutions
5 makes the evaluation process complex. Currently Target Date
6 Fund performance analysis is very basic, however. A Callan
7 survey found that 85 percent of Target Date Fund managers
8 used proprietary benchmarks in evaluating the performance of
9 their Target Date Funds.

10 Such benchmarking offers very limited insight into
11 the drivers of Target Date Fund performance since the focus
12 is on measuring excess return, the return relative to the
13 target asset allocation, and not the appropriateness of the
14 asset allocation itself. This is a significant drawback in
15 that it is asset allocation that ultimately is a key
16 determinant of long-term performance.

17 The first step in evaluating Target Date Funds
18 should be to select an appropriate objective index or
19 benchmark. Since as of today no standard third-party target
20 date index has emerged, Callan has developed its own target
21 date index, the Callan Target Date Index, in order to measure
22 the efficacy of various competing Target Date Fund glide
23 paths.

24 Callan's approach is straightforward. We base our

1 index on the glide paths of all of the available Target Date
2 Funds on the market. A consensus glide path index reflects
3 the range of Target Date Funds available to the plan sponsor.

4 By comparing the Target Date Fund to the consensus glide
5 path, the plan sponsor can make a knowledgeable determination
6 as to whether any differences away from the consensus are
7 acceptable or desirable.

8 This knowledge should help minimize surprises when
9 the performance of a sponsor's chosen Target Date Fund vary
10 significantly from competing target date offerings due to
11 differences in glide path.

12 Employing the right benchmark, however, is just the
13 first step. Other important factors to analyze include the
14 level of participants' pre-retirement income that the Target
15 Date Fund glide path is expected to replace with a reasonable
16 probability of success. After all, the true role of Target
17 Date Funds is to help participants maintain their standard of
18 living in retirement.

19 The interim risk is another risk that should be
20 examined. This is the risk to which participants are being
21 exposed on a near-term basis, and it is especially important
22 for individuals near retirement. Longevity risk or the risk
23 of investors in the Target Date Fund outliving their wealth
24 during retirement due to factors such as inflation, this is

1 also very important.

2 The quality of the implementation of the Target
3 Date Fund, this is where we get at the value of active over
4 passive management of the underlying funds in the Target Date
5 Fund.

6 And finally, Target Date Fund fees, and I would
7 submit that it is important that Target Date Fund fee
8 analysis take into account the potential value added of both
9 the asset classes included in the glide path and the
10 underlying managers.

11 The analysis described here is admittedly
12 multifaceted, but that reflects the complexity of Target Date
13 Fund products and their critical role in DC plans. Many in
14 the industry predict that Target Date Funds will ultimately
15 hold the majority of DC assets. These funds have a lot of
16 moving pieces and can offer surprises, as we saw last year,
17 if the plan sponsor does not understand how the pieces fit
18 together.

19 Finally in closing, I would like to offer that
20 Target Date Fund communication at the participant level has
21 been overly simplistic as well. Specifically, many Target
22 Date Funds are not targeted for retirement but for the
23 participant's lifetime, and that seems to have gone missing
24 in much of the existing target date communication.

1 Target Date Funds that continue to have equity
2 allocations that glide down during retirement with
3 substantial equity positions near or past age 65 should be
4 positioned as lifetime funds. This would clarify that
5 investment in these funds isn't intended to terminate at
6 retirement but to continue years after, thus necessitating
7 some continued risk-taking in order to combat the potential
8 damaging effect of inflation during retirement.

9 The same measures used by plan sponsors to evaluate
10 Target Date Funds should be simplified and adapted for
11 participants to explain risk return tradeoffs and
12 communication.

13 We have come far as an industry with Target Date
14 Funds, but it is time for such areas as benchmarking and
15 communication to catch up with the advancements we have made
16 on the investment side.

17 Thank you for the opportunity to share Callan's
18 views on this important topic.

19 MR. CASTILLE: Good afternoon. Barclays Global
20 Investors welcomes the opportunity to share our views and
21 experience regarding Target Date Funds with the Department of
22 Labor and the Securities and Exchange Commission.

23 BGI has been managing assets for defined
24 contribution investors for over 20 years. Today we're the

1 fourth largest manager of DC assets in the United States and
2 the largest investment-only DC provider. I'm the head of
3 product development for BGI's DC business and I'm closely
4 related in our Target Date Fund products.

5 Given the time available, I would like to focus our
6 testimony on three things: First, BGI's approach to asset
7 allocation with our Target Date Funds, i.e., the glide path;
8 the importance of providing flexibility around the
9 construction of the glide path; and, finally, the ways to
10 communicate with plan participants about Target Date Funds
11 that is simple for them to understand and allows them to make
12 informed decisions.

13 We have submitted testimony for the record that
14 contains numerous charts including an analysis of the
15 comparative performance of 2010 funds and their respective
16 allocations to equities. I am happy to answer questions on
17 any of the information in that submission.

18 Our focus on BGI's Target Date Fund strategy is
19 twofold. The first is to illustrate the discipline and
20 scientific rigor that underlie the construction of a
21 lifecycle fund, and second is to illustrate how the objective
22 of a fund series itself; for instance, are you trying to
23 replace income or are you trying to provide a stable
24 consumption stream, how that investment objective can impact

1 the desired equity allocation in retirement.

2 BGI's been incorporating asset class forecasts into
3 our investment products since the early 1970s, and we
4 invented the Target Date Fund category in 1993 and received a
5 patent on our methodology as a natural extension of our
6 multi-asset class research but with a very different and
7 specific objective in mind, and that was to design a fund
8 that would allow DC investors to achieve well-diversified
9 returns on par with those achieved in defined benefit plans.

10 We use historical data in our own proprietary
11 modeling capabilities to construct asset class, risk and
12 return forecasts, and importantly one of those reference
13 point we utilize is the average asset allocation of the top
14 corporate defined benefit plans in the United States, and
15 thereby we incorporate the consensus view of some of the
16 largest and most sophisticated investors in the world.

17 Once we develop risk and return forecasts for all
18 of the asset classes in our target date portfolios, we then
19 use a mean variance optimization to create a series of highly
20 efficient and investable portfolios. And we define
21 efficiency as maximizing expected return for a given level of
22 expected risk and we call the set of those efficient
23 portfolios the "Efficient Frontier."

24 Now, in order to construct a glide path, one needs

1 to know the appropriate risk level for each portfolio at a
2 given point in time and as well as to determine how that risk
3 could change throughout time as a participant nears
4 retirement, and so at BGI we start that process of creating
5 the glide path by focusing on the retirement portfolio.

6 And our retirement portfolio has a very specific
7 investment objective. That objective is to minimize the risk
8 to less than a one-in-ten chance that a retiree is forced to
9 significantly alter their consumption pattern in retirement,
10 and that alteration comes from either due to market
11 dislocation or because of a higher than average life span.

12 Now, we determine the asset allocation consistent
13 with this particular investment objective which we call the
14 stable consumption objective. We do that through extensive
15 Monte Carlo simulations, and that leads us to a current
16 allocation to equities and equity like instruments today of
17 38 and a half percent in our retirement portfolio, and that
18 equates to an annualized expected volatility of about six and
19 a half percent.

20 Now, once we've determined the risk level of the
21 retirement portfolio and located data on the Efficient
22 Frontier, we place the rest of the target date series on that
23 same frontier along that risk return continuum so that the
24 relationship between time until retirement and the level of

1 risk remains constant throughout the entire glide path.

2 Now, this stable consumption approach anchors the
3 glide path in the retirement portfolio itself, and the
4 retirement portfolio is that stock/bond mix that best
5 balances two risks, longevity risk, the risk of outliving
6 one's savings; and market risk, the risk of needing to alter
7 consumption because of a loss in account value similar to
8 what we experienced in 2008.

9 Now, there are other providers I'm sure you've
10 heard today that have a much higher allocation to equities at
11 retirement, and those providers are most likely focusing more
12 heavily on what is termed "income replacement" itself. So
13 the goal in these funds is to determine the retirement
14 portfolio most likely to yield the highest amount of expected
15 annual income for the participant.

16 And I think a simplistic way to understand the
17 differences in these two approaches is that the stable
18 consumption approach, the BGI approach, focuses on minimizing
19 the effect of the extreme event whereas the income
20 replacement approach focuses on increasing the mean or
21 maximizing the income in normal market conditions. So I
22 think it recognizes the cohort effect that you were talking
23 about earlier.

24 BGI strongly believes that it is important to

1 continue to permit managers and plan sponsors some
2 flexibility concerning the construction of the glide path,
3 and a good example of that is the creation of customized
4 Target Date Funds. Now, when we created the first Target
5 Date Fund, we understood at that time that we'd only know the
6 participant's expected retirement date, but today, working
7 with a particular plan sponsor, we can capture much more
8 information.

9 So for instance, about a particular plan population
10 we may be able to learn the expected defined benefit payment,
11 the average retirement age, the average allocation in the
12 company stock. And taking this information, we will in
13 certain cases create a customized glide path which can differ
14 materially from our standard product.

15 Although we use the same asset class forecast and
16 we use the same basic process, the solution differs when we
17 take this additional information into consideration. And an
18 example of that would be, all else being equal, a lower
19 retirement age would prudently suggest a more aggressive
20 asset allocation at retirement because there's more longevity
21 risk.

22 Because of our history in offering Target Date
23 Funds, BGI is well versed on the challenges that plan
24 sponsors face in communicating with participants, and our

1 experience indicates that communications about Target Date
2 Funds need to be simple and focus on the benefits rather than
3 diving immediately into the investment details.

4 We believe that it is important that the agencies
5 consider the potentially negative effects of complicating the
6 Target Date Fund message. The simplicity of Target Date
7 Funds is what makes them such effective investment vehicles.

8 Forcing sponsors to add risk-traunched target date
9 series would not only add significantly to plan costs, but
10 would also confuse participants, and, when confused, our
11 experience tell us that participants will either make an
12 election not to participate at all in the plan or to utilize
13 common and suboptimal heuristics.

14 BGI has been managing Target Date Funds since the
15 strategy's debut over 15 years ago, and we believe that
16 incorporating them into DC plans in a more meaningful way is
17 a very important step towards advancing these plans into
18 becoming credible self-funded pensions.

19 We do believe, however, that the current focus on
20 the returns of these funds needs to be considered in context
21 because Target Date Funds are very long-term investment
22 strategies designed for participants with an investment
23 horizon that often exceeds 40 years, and it is important
24 therefore to evaluate their efficacy over multiple years

1 rather than focusing on one extraordinarily negative quarter.

2 In closing, we would like to underscore the fact
3 that plan sponsors themselves are very knowledgeable on glide
4 path construction and take great care when selecting a target
5 date provider. BGI alone has had hundreds of discussions
6 with sponsors and the investment consultants who often advise
7 them on Target Date Fund construction, and in each of these
8 discussions, plan sponsors acting as fiduciaries have
9 endeavored to make the decision most appropriate for their
10 participants.

11 Again, I appreciate the opportunity to be here
12 today and would be pleased to answer any questions.

13 MR. RICHARD MICHAUD: Hello. My name is Richard
14 Michaud, and I'm from New Frontier Advisors in Boston. And
15 Robert Michaud is with me, my associate, and he will be
16 answering some questions.

17 The Swedish social security system found that
18 roughly 70 percent of participants either do not know or do
19 not want to know -- make investment decisions about their
20 long-term investments. Many individuals do not understand
21 portfolio risk or have access to reliable investment advice.

22 Qualified default investment alternatives are regulated to
23 provide safe, diversified investments for such individuals.

24 Target Date Funds claim to fulfill this QDIA role.

1 These age-based rules define risk as a stock/bond ratio that
2 declines in value as retirement approaches. TDFs are
3 extremely simple solutions to a very complex problem of
4 choosing an appropriate investment; however, TDFs have
5 critical limitations as QDIAs that include the
6 inappropriateness of age-based rules for defining risk and
7 have unregulated management and risk control policies.

8 Some background in risk is useful. Risk level or
9 the stock/bond ratio asset allocation is widely acknowledged
10 as the single most important investment decision for
11 long-term investment, but effectively choosing the
12 appropriate risk level is a highly complex and often very
13 costly kind of process.

14 Age-based risk is a myth that is unreliable,
15 ineffective, misleading and often very perverse. An
16 unemployed 25-year-old may be rightly far more conservative
17 than a wealthy octogenarian. No formal, credible financial
18 theory exists or can exist that rationalizes age-based risk
19 for long-term investing. Such rules ignore wealth level,
20 income volatility, risk aversion, the health of an individual
21 at a point in time, marital status that changes over time,
22 and legacies for the future.

23 Financial economists have devoted much of their
24 careers to the study of defining investment risk. Serious

1 studies for defining long-term risk are very intensive. Even
2 empirically, age is on average unrelated to risk. That's a
3 new result. Age-based rules are basically artifacts that
4 facilitate fund sales. Age-based choice simplifies sales
5 while encouraging investors to stay in the same fund until
6 retirement.

7 TDFs are largely unregulated through a wide
8 variation of stock/bond ratios with the same target date it
9 highlights as fact. Many managers engage in stock market and
10 market timing of the stock/bond ratio, increasing the risk of
11 meeting long-term objectives.

12 Target risk funds are a more appropriate
13 alternative. Target risk funds are well-defined, diversified
14 asset allocations indexed by the stock/bond ratio. Usually a
15 spectrum of TRFs are made available to investors from 20
16 percent to 100 percent in stocks. Many sophisticated
17 investment platforms for wealthier individuals have this kind
18 of platform.

19 Now, a 60/40 or balanced TRF may usefully represent
20 a market-neutral investment. In aggregate, investors hold
21 claims to the economic productivity of the economy.

22 Mathematically, the average portfolio is roughly equal to a
23 60/40 risk target portfolio of capitalization-weighted ETFs
24 or index funds. Deviating from this portfolio represents

1 under-weighting of one segment of the economy over another.

2 The market portfolio is a good candidate for a
3 default-qualified QDIA. A TRF framework is transparent and
4 does not encourage either recklessness for the young or
5 excessive conservatism for the elderly and does not lock
6 investors into a fund over time when things change. Marital
7 status changes, wealth changes and many other things changes.

8 TRFs can be mandated not to engage in market timing
9 and more explicitly follow their long-term objectives. TRFs
10 that require professional advice are no simpler and much less
11 transparent than TRFs. Asset allocations are often optimized
12 with a 50-year-old procedure that has proven performance
13 limitations. In other cases managers often ignore risk
14 management principles. Fund fees are a very important
15 additional consideration. New technology can be improved in
16 risk management and is often being ignored.

17 To summarize, no formal credible financial theory
18 exists or can exist that rationalizes an age-based reduction
19 in stock/bond risk for retirement investing. TDF age-based
20 decision rules are unreliable and very often perverse for
21 defining risk suitable for QDIA investing.

22 TRF QDIAs are an alternative that is more
23 transparent and may more properly meet retirement objectives,
24 a wide range of them. A balanced TRF can be used as a

1 default QDIA.

2 So our recommendations carefully limit the use of
3 TDFs as QDIAs. Use TRFs as an alternative to QDIA investing.

4 I have no idea why nobody here has mentioned TRFs before,
5 but they are being used widely in many other contexts.

6 Propose a balanced TRF as a qualified QDIA perhaps with ETFs
7 to reduce costs. Limit active management in QDIAs. Limit
8 ineffective risk management technologies and encourage more
9 effective risk management.

10 MR. DOYLE: Thank you very much.

11 MR. MICHAUD: Did you want to say anything, Bobby?

12 MR. ROBERT MICHAUD: If I could have about 90
13 seconds. So just to make some comments about today, most
14 people here are representing management companies that are
15 all claiming to have investment value, but what we really
16 want to do is gather the most assets and get paid for it.
17 Managers are either boasting about their 2008 performance or
18 excusing it, but this misses the point here.

19 We're talking about investment for the people, and
20 this should not be subjective. A person's financial future
21 shouldn't depend on a lucky and insufficiently-informed
22 decision about which fund to pick. Being informed isn't easy
23 and, for you, neither is regulation. Even with specific
24 stock/bond constraints, competing managers seeking

1 performance and the assets that will come with it will
2 allocate to increasingly reckless asset selections. When
3 they fail, they'll dismiss it as an six-sigma event, but it's
4 hard to discourage speculative investments into commodities,
5 junk bonds or undeveloped markets.

6 Some solutions have been suggested today. I'm not
7 sure that a wider variety of Target Date Funds are the
8 answer. They require as much professional guidance as target
9 risk funds but with less transparency and more complexity.
10 However, passively allocated index funds make sense as the
11 default risk investment. I'm thinking about the concept of a
12 market portfolio.

13 The default risk-less investment is more
14 interesting. Cash is one option, but annuities are another.
15 And just to say sort of a crazy portfolio -- proposal, you
16 could allow people to buy at a fair market price into the
17 greatest annuity there is out there, which is the social
18 security.

19 The only open question left is what percentage of
20 wealth an individual can afford to risk, which part to have
21 risk-less, which part to have in a passive market portfolio.

22 Unfortunately there's no one size fits all answer to this.

23 MR. DOYLE: Thank you. I actually have lots of
24 question, but to start with Mr. Michaud, the target risk

1 fund, I guess in my mind when you think about it in the
2 context of a qualified default, it presupposes information
3 about the risk tolerance of a particular participant, and I
4 think the assumption was that that's not information that is
5 objectively available from participants who have essentially
6 opted not to affirmatively participate in the system.

7 So I'm just curious. Who's going to make that
8 determination about the appropriate level of risk for a
9 particular participant?

10 MR. RICHARD MICHAUD: What we have proposed then,
11 and perhaps it's something new here, I don't know, it's as
12 much Robert's idea as mine, but it has to do with a 60/40
13 TRF. And the economic balance between the stocks and bonds
14 in any economy is a reflection of the risks in the economy.

15 And so, did you want to explain that a little bit?

16 MR. DOYLE: I mean, is that essentially a
17 balanced-fund type approach?

18 MR. RICHARD MICHAUD: That is --

19 MR. DOYLE: We have that as an option under our
20 regulations, one of three, but it is an option.

21 MR. RICHARD MICHAUD: And that's if it's done well,
22 if it's not actively managed, if it's done with perhaps ETFs,
23 it is a very good default fund. And as I was saying earlier,
24 the Swedish social security system found that 70 percent of

1 their participants would prefer to be in such a fund, okay.
2 For someone who is informed or has advice and so on, then
3 they can find alternatives that are appropriate for their
4 long-term investing and so on.

5 What you've heard today again and again is that
6 TDFs are okay, but they're not quite okay because maybe we
7 should add this or maybe we should add that or maybe we
8 should have multiple glide paths, and then we have to ask
9 that question. The point is that you're going to have to
10 deal with this issue anyway. And what you have heard today
11 is nothing more than this argument resurfacing in many, many
12 guises.

13 MR. DOYLE: And I -- just one more question then
14 I'll share.

15 The Barclay's representative talked about income
16 replacement versus stable consumption. Is there confusion
17 over those concepts and how do you communicate those in a way
18 that both employers and participants understand the strategy?

19 MR. CASTILLE: And maybe the earlier comments
20 touched on that.

21 The Target Date Fund universe has grown to
22 represent a large variety of investment styles, and I think,
23 if you look at them closely, I think they're all trying to
24 satisfy a different particular investment outcome. And some

1 of them are focusing on being able to maximize the amount of
2 income that can be replaced as a percentage of what final
3 salary is and others are saying what is -- our approach has
4 been more to say what do participants want in retirement.

5 We think they want a more stable, the ability to
6 have some confidence so they can draw upon their savings in a
7 stable fashion and do that.

8 So I don't think that there's the recognition yet
9 in the Target Date Fund space that the funds themselves are
10 actually pursuing different investment objectives that are
11 going to lead to different outcomes, and, until you get to
12 the big event that illustrates that, wow, you know, there's a
13 big dispersion in these funds here.

14 MR. DOYLE: Maybe what I ask the panel generally is
15 one strategic philosophy in the context of a default
16 investment better than another?

17 MS. LUCAS: And I would say no. I think the beauty
18 of the Target Date Fund industry today is that it's got a
19 wide variety of glide paths that are available. A few years
20 ago, there were a few, and it was very limited. Now we've
21 got a wide variety.

22 And again, we know that there are a wide variety of
23 needs out there. We work closely with plan sponsors to
24 determine, you know, if they've got a DB plan, perhaps they

1 need a different glide path. If they have -- if they are
2 aware that people are taking their money out of the plan and,
3 in fact, it's their intention that that's what happens,
4 they're not encouraging people to necessarily keep their
5 money in the plan, they need a different glide path than if
6 they are actively encouraging people to keep their money in
7 the plan.

8 So we would, at Callan, believe that this is a
9 virtue of the industry, this wide variety that we have today.

10 MR. COHEN: Yeah, I would actually -- I've looked
11 at a lot of Target Date Funds, and some of them have
12 published a lot about their research, and we think that all
13 Target Date Funds should so people understand their
14 methodology.

15 See, I think this whole idea that's been going
16 around that some want retirement income, others want growth,
17 others don't want to run out of money, I think it's all the
18 same thing to me. It's all we're trying to fund people's
19 income needs and their holding a standard of living in
20 retirement.

21 And I think a lot of it, if you really read the
22 methodologies, comes down to two different things. One is
23 different assumptions, so different assumptions on what you
24 assume for, for example, the withdrawal rate in retirement

1 and the savings rate and things like that, those who kind of
2 tend to assume that people are going to take out more than
3 they should or not save enough.

4 Those tend to be sometimes more aggressive because
5 they need to make the assets work, where there's others that
6 use more of a kind of a baseline-type approach tend to be
7 more conservative. So I think it's all trying to answer the
8 same question.

9 And then I think the other reason is because they
10 all -- there's a different definition of risk sometimes.
11 Some of it's sort of a shortfall risk that, you know, you're
12 just going to -- how far are you going to fall short below
13 your target. Others are more at kind of an all-or-nothing
14 risk whereas either you make it or you don't. And when you
15 do those different types of risk, you can come out with
16 different results, but I think in the end everyone's trying
17 to do the same thing.

18 MR. RICHARD MICHAUD: But again, I think that,
19 going back to the issues we raised, there are just so many
20 things besides age that should be related to long-term
21 investing, okay, the stock/bond ratio. I mean I've been
22 involved in many studies for defined benefit plans, defined
23 contribution plans, wealthy individuals, many, many different
24 kinds. Some of my earliest work was widely copied by some of

1 the people who may be here even in some of the master trust
2 departments.

3 The issue of how to think about risk for investing
4 is not age-based, okay. That is a myth. And so what you have
5 is basically a convenient way to sell funds, okay. And what
6 you are doing is ignoring the way that really needs to be
7 addressed. And it may not be a simple solution.

8 But misinformation is much worse than no
9 information, much worse than no information. You've got
10 people who are changing their lifestyles, okay, over time
11 getting married, getting divorced, a reduction in health,
12 changes in wealth level, all of these things. And you're
13 going to put them on a glide path? Does this make any
14 investment sense?

15 MR. COHEN: Maybe I think an important point is
16 glide paths don't slope down because of time horizons. They
17 slope down because of the nature of contributions into a
18 401(k) plan. And this is sort of the human capital argument.
19 So it's not that young people can take more risk because
20 they don't care as much and older people, they get more risk
21 averse or that they have a longer time horizon to make up for
22 losses.

23 Really, if you got all your money that you were
24 ever going to contribute at 25 and invested it, then you

1 should probably have a single-risk profile the whole time,
2 because then it doesn't matter. If you're never making
3 contributions or distributions, then it never matters what
4 the order of those returns are.

5 But because of the way that, really like I said
6 before, for young people most of their wealth is actually in
7 the form of future contributions, which is really, for most
8 people, bond-like. It's, you know, those who are going to
9 get kind of steady contributions into the plan, so in order
10 to offset that, you can take higher risk in your asset
11 allocation, in your asset portfolio, younger on, but as you
12 go and deplete your human capital, now most of your wealth
13 becomes financial wealth. That's why you need to start
14 de-risk as you get closer to retirement because now, in order
15 really to mean a similar risk profile across the entire glide
16 path.

17 MR. DONOHUE: Could I ask a question? One of the
18 things I've been thinking about as I've listened to many of
19 the panelists talk today, it seems that there's very heavy
20 equity allocations very early on, for the younger, but it
21 really doesn't mean anything because there's very little
22 money there, and so there's taking a lot of risk with a
23 little bit of money because it doesn't matter.

24 What is the difference in the outcome or expected

1 outcome if there isn't as heavy an equity allocation in the
2 very beginning as you run your studies? Is it really helpful
3 or is it harmful to have that heavy equity allocation and the
4 volatility that comes with it?

5 MS. LUCAS: Yeah, we -- we actually looked at this
6 just recently, and we looked at the average Target Date Fund
7 glide path, and we found that it is actually vastly superior
8 to a glide path that rolls down to zero percent, so one that
9 is much less heavily equity-oriented than the average.

10 And what we found that is, if you look at
11 historical simulations going back all the way to 1926, and
12 we've heard a little bit about this earlier today as well,
13 that, in fact, this glide path that is more heavily equity
14 allocated is superior in every simulation including one
15 ending in 2008 over a 30- or 40-year period.

16 So what we find is that it's superior to having a
17 100 percent cash because what's happening is people are able
18 to accumulate over that period of time, you know, a very
19 substantial amount of money relative to their worth in cash.

20 MR. DONOHUE: I think my question was in the very
21 beginning, it's the slope of it; in other words, 100 percent
22 equity versus 70, does it matter that much in the early age,
23 in the early part of a fund?

24 MR. COHEN: Yes. I mean, I think it's a risk worth

1 taking, and certainly, you know, you're going to have
2 negative periods, but that's the time that you, you know,
3 you're always going to have to take risk in order to have
4 appreciation, and that's the time to take risk.

5 We actually -- we've done work where we say let's
6 look at a negative two standard deviation event. Now,
7 granted, we just went through a negative six standard
8 deviation event, but a negative two standard deviation event,
9 again, because you're at 90 percent equities for a
10 30-year-old, it's going to be a large account balance
11 decrease for that year, but the impact on ending wealth is
12 something like two or 3 percent of their portfolio whereas a
13 negative two standard deviation event for someone at
14 retirement, even though they're only going to have 30 some
15 percent in equities, is actually going to even have a much
16 greater impact. So that's the time to take risk. It is the
17 worthwhile time to do it, we think.

18 MR. CASTILLE: We have similar findings, that small
19 changes in the initial equity allocation leads to small
20 outcomes and changes in outcome, and obviously on the order
21 of what you're talking about, 30 percent, that would be
22 pretty substantial.

23 MR. DONOHUE: And take the other end of somebody
24 reaches retirement. There's a benefit, at least as I always

1 understood it, that one gets from periodically investing in
2 that, I mean, if you have volatile assets you're buying more
3 when they're cheap and less when they're rich.

4 On the distribution side, you have the opposite
5 effect. If you want to take out a periodic payment from an
6 investment, you wind up selling more when it's low and
7 selling less when it's high. And if you have a constant
8 allocation in volatile assets, how does that work out? Is
9 that a wise choice?

10 MR. RICHARD MICHAUD: I was going to say -- I was
11 going to say for that type of question, and I've heard that
12 question before earlier, retirement distribution investing is
13 different. I do not see this as any kind of glide path at
14 all solution. It really needs to be thought through. And
15 again, the retirement distribution idea is not as an open
16 question in financial theory currently. It is not well
17 understood.

18 One of the interesting reasons about that is that
19 really qualified, highly qualified academics have not paid
20 attention to this study, this kind of issue. So -- and to
21 some extent, we, as practitioners, are a little bit on our
22 own in terms of how to solve this problem. But in my own --
23 well, our work and in my own view of understanding of the
24 problem, it's a very different answer, and it has to be done

1 differently. It is not a glide path.

2 Did you have something to say about either the
3 other question, Bob?

4 MR. ROBERT MICHAUD: I had sort of two comments.
5 One is clearly we didn't experience a six-sigma event. What
6 happened last year is a lot more likely than that. I mean,
7 when people talk about six-sigma events, they're assuming
8 some sort of modeling. Clearly the model they were assuming
9 was wrong.

10 As far as sort of your last two questions go, I'm
11 not sure I can answer the question, but I can answer the
12 intuition behind the questions, which is, I think, does it
13 matter, you know, when someone is only investing \$10 a month
14 whether they're 100 percent equities or leaving it under a
15 mattress? And the answer for them is, probably not so much.

16 But fund managers aren't rewarded on how much of
17 your money did they -- how much money did they make for you.
18 They're more managed and more measured on what was the total
19 performance of the fund. And so by sticking people without
20 much money into highly aggressive portfolios, then over the
21 lifetime of the fund you have this really great, you know,
22 hopefully, a really great return at the beginning that's
23 going to keep you above water relative to your peers for a
24 long time. I'm just thinking sort of from a, you know, game

1 theory perspective of how someone might rationalize this.

2 MS. LUCAS: And I would just add that I would
3 agree, that's a very important consideration and one that I
4 mentioned in my testimony is you need to look at the
5 longevity risk and you need to look at what is the
6 probability that these assets will last through retirement
7 until age 70, 80, 90, and then evaluate the risk of running
8 out of money. And that's a huge consideration taking into
9 account a certain level of draw down.

10 MR. DOYLE: Any other questions?

11 MR. SCHEIDT: I have one follow-up question. Has
12 anyone done any research to see whether high equity
13 allocations for younger workers is actually a deterrent to
14 investing in the Target Date Fund? I can imagine that some
15 workers that don't have a lot of money for retirement don't
16 want to risk losing a big portion of that small amount that
17 they have, that they would rather invest more conservatively
18 at the outset until they have a bigger pot to take a risk
19 with.

20 MS. LUCAS: I would agree with you that this is the
21 behavior we see, and it's actually pretty counterproductive.

22 When people are in their 20s and they're investing on their
23 own, they are as conservative as people in their 60s
24 according to the data I've seen from participant databases.

1 And that's an issue because, you know, as Josh said, they
2 should be taking more risks. That's when they're in the
3 ultimate position to be taking that level of risk is when
4 they're younger.

5 But the good news is that when we look at the
6 behavior last year of participants across ages and Target
7 Date Funds, even during the worst of the downturn, money was
8 going into these Target Date Funds on a net basis, not coming
9 out. People who are defaulted into Target Date Funds have
10 shown very little sensitivity to the volatility of these
11 funds.

12 MR. CASTILLE: I think the gentleman from EBRI has
13 a lot of that data that you were asking about as how
14 different age groups, when you segment them, how they
15 responded in the course of this crisis.

16 And the other thing to consider is they'll make
17 that -- they'll get back even more quickly because their
18 contributions as a percentage of their account balance is
19 greater. So if they continue to contribute, they'll get back
20 faster.

21 MR. COHEN: And I just saw a study, I think it was
22 Vanguard, so correct me if I'm wrong and I misquote it, but,
23 again, those who got defaulted in tended to really stay with
24 the options, but the interesting -- the biggest change in

1 behavior was for someone who signed up for the first time in
2 2008 for example. They look at all the options, and they
3 tend to go more conservative just because they look at the
4 rate of returns. And you would look back if someone had --
5 you know, for example, in 2003 when the market recovered, the
6 people who signed up that day or that year tend to have the
7 higher returns.

8 So it shows (a) that defaulting people is very
9 powerful because inertia is powerful, and (b) getting them
10 the right decision at the beginning of time of enrollment is
11 really important too because that's really going to impact
12 their future contributions.

13 MR. RICHARD MICHAUD: And while both sides of this
14 issue -- I mean, there are younger people taking a lot of
15 risk fairly recklessly in many cases, if they do not have
16 much money and they're not likely to have a whole lot of
17 money in their lifetime.

18 On the other hand, wealthy people really want to
19 keep up with their lifestyle and just putting all of their
20 money in a fixed rate type of annuity is not going to
21 maintain their lifestyle over time. So there are just all
22 kinds of situations for which these things really don't work.

23 And the interesting thing is even empirically, I
24 mean unless everybody thinks that everybody's crazy, and I

1 don't feel that way at all, the way it works is that on
2 average young people don't put much money in equities, and
3 then it sort of grows over time as you increase your level of
4 wealth and you're into your career, and then finally it does
5 start to decline. But interestingly, that's also, if you
6 condition it with respect to education level, it's pretty
7 much flat.

8 So it's the whole issue here of misinformation is
9 worse than no information, in my view at least, and giving
10 people explicit, transparent kinds of investments as opposed
11 to the multiplicity of these TDFs, it's going to happen if
12 they're not regulated and continue to be regulated as QDIAs.

13 MR. SCHEIDT: Okay, I just have one more question.
14 This is for Lori Lucas. You talked about through-funds and
15 to-funds. What is the key information that a plan sponsor
16 needs to know in deciding between the two types of funds?

17 MS. LUCAS: I think the key that they need to
18 understand is, what is the expected behavior of participants
19 in retirement? What do they see happening and do they
20 anticipate that people will be using these funds through
21 retirement or are they, in fact, going to at age 55 go into
22 an annuity, which, by the way, only 3 percent of participants
23 do that, roll their money out into maybe a similar Target
24 Date Fund?

1 You know, there's ways of observing it. It's also
2 somewhat difficult to observe if they do roll their money
3 out, you're not sure what they're rolling it into. But most
4 plan sponsors, when we talked to them, have a pretty good
5 idea of their own policy, whether they're trying to encourage
6 people to stay in the plan or not, and they have a good idea
7 of, you know, what they've seen in terms of participant
8 behavior.

9 And I think those are very -- at least those two
10 are very valuable, a very valuable beginning to understand,
11 you know, to what degree are we comfortable with equities
12 through retirement.

13 MR. DOYLE: Thank you. And I'd like to thank the
14 panel as with all the panels today. This has been
15 fascinating. We'll take a short ten-minute break.

16 (A brief recess was taken.)

17 MR. DOYLE: And we shall now begin the last session
18 of the day, not last panel. We will have no more breaks
19 between now and the end.

20 (Laughter.)

21 MR. DOYLE: So if you missed the break, I don't
22 know what to tell you. And we shall now begin.

23 MR. LAUDER: First of all, thank you to the DOL and
24 the SEC for setting up this forum. It's been very valuable,

1 I think, for all of us today. I've been both baffled and
2 dazzled all at the same time with some of the things we've
3 heard, but thank you very much for setting this up.

4 My name is Jim Lauder. I'm the CEO of Global Index
5 Advisors. We are a registered investment advisor. While our
6 main business is managing target date assets for our partners
7 at Wells Fargo Bank and State Street Global Advisors, our
8 firm was also a pioneer in the space of target date index
9 development. We designed the first, and until very, very
10 recently the only target date indexes in the industry back
11 in -- starting in 2004, 2005.

12 I was invited here today to speak on three topics.

13 First, understanding Target Date Funds, selecting Target
14 Date Funds and then monitoring Target Date Funds. And I
15 intend to honor that structure with a little bit of added
16 brutal honesty based on some of the things, the questions
17 that we've heard today that I think maybe the answers didn't
18 come out fully. And I hope you appreciate my brutal honesty
19 more than my wife does.

20 First of all, understanding Target Date Funds,
21 we've heard several great definitions of Target Date Funds,
22 and there's really nothing more complicated to it. So I'm
23 not going to waste your time with giving you my version of
24 reducing risk over time, yada, yada, yada. But I thought I

1 would make a couple of points about what Target Date Funds
2 are not. I think we've heard it a few times with other
3 panelists, but I think it's important to reiterate that,
4 number one, what they aren't. They are not a substitute for
5 disciplined, practical savings habits by participants. You
6 cannot solve the savings problem that we've had over the last
7 several years with any type of investment product. It's just
8 not going to happen.

9 More than ever before the responsibility for
10 target -- or for retirement success rests on the shoulders of
11 participants. We've seen over the last several years what
12 many people have referred to as the demise of the DB plan.
13 And now, even in this environment, we're seeing contributions
14 or matching contributions from the defined contribution
15 providers starting to be removed because of the burden that
16 that places on these companies.

17 So I think more than ever the responsibility for
18 our success as savers and retirement savers rests on the
19 individuals. And for us as providers, product providers and
20 fiduciaries, we need to be aware of that and be sensitive to
21 those needs.

22 They are not a replacement for education and
23 communication. You know, I think that was one of the reasons
24 why people said that we came up with this idea of Target Date

1 Funds was because it was so difficult to educate and
2 communicate the participants and get them to do the right
3 things. It's not a substitute. What it does do is it
4 changes the nature of that education and communication.

5 Instead of trying to make expert investors out of
6 all the participants in the plan, now we're free to focus on,
7 look, Participant Sue, Joe, what do you need to retire, to
8 have to be at a state of retirement readiness? Is it 70
9 percent of your income or what you project to be your income
10 at retirement? Is it ten times or 12 times your ending
11 salary?

12 Those are the kinds of things that we need to focus
13 our education and our communications on now. And we have a
14 very fiducially -- what I believe is still a fiducially sound
15 product foundation for doing that kind of education.

16 They do not, and I think we've heard this, they do
17 not in most cases offer investors contractual guarantees as
18 to the return of their principal or to any kind of lifetime
19 income. And I think it's very sad from some of the
20 information that we heard earlier from the behavioral group
21 that was up here that that has been the belief of some of
22 these people that have bought into Target Date Funds.

23 So what are some of the other characteristics of
24 Target Date Funds and the nature of their use that need to be

1 discussed? I think the sources of performance or portfolio
2 behavior is very important, addressing various types of
3 retirement risks, the dangers of designing financial products
4 for the average participant. I think those are three areas
5 that with worth discussing today.

6 First and foremost, glide path. We have all talked
7 about glide paths today. That does basically result in 90
8 percent of the behavior of any portfolio. That's not just an
9 average number, but that's based on years and years of study
10 that your average mixed asset class portfolio, about 90 to 92
11 percent of the returns of the behavior is based on the asset
12 allocation, not security selection.

13 There's no magic optimizer out there or exciting
14 new asset class that can offset the impact of a provider's
15 glide path, period. For a bit of that brutal honesty that I
16 mentioned earlier, let me just tell you that in the face of
17 financial catastrophe or severe market meltdowns like we've
18 had, asset classes have a nasty little habit of becoming
19 very, very correlated with one another. And that's what
20 we've seen over the last two years.

21 So nobody can talk about their exposure to
22 commodities or to REITs or anything else. Saving them from a
23 poorly designed or a mismatched view of risk for a set of
24 participants, it's not just there.

1 Second, providers are making some significant
2 decisions and setting expectations on how well they manage --
3 or how they manage two primary types of investment risk,
4 participant longevity risk and volatility risk. The nature
5 of those risks are quite different. Longevity risk is fairly
6 predictable. It discriminates mostly against people that
7 don't save enough for retirement.

8 Volatility risk on the other hand, discriminates --
9 it does not discriminate actually. It's very random, and
10 it's based on the sequencing of returns and the time value
11 fluctuations that those differences in returns actually cause
12 to participants that are close to retirement.

13 To skip ahead, selecting Target Date Funds, I think
14 some of the most important things here in this area would be
15 to help plan sponsors get their minds straight on what it
16 takes to select an appropriate Target Date Fund or a QDIA.
17 And it's not so much about understanding Target Date Funds as
18 it is about understanding themselves, their roles as a
19 fiduciary and their participant base.

20 I think, first of all, they have to understand
21 their participant base may not be the same as them as far as
22 their risk tolerance. You usually have people that are on an
23 investment committee. You've got CFOs. They might be a lot
24 more sensitive to risk than you are sitting in that chair as

1 a fiduciary.

2 Secondly, I think it's very important to know that
3 participants care about the magnitude of potential outcomes
4 much more than they do about the probability of those
5 outcomes. And I believe we've had several questions on that
6 today.

7 Let me give you an example. New Orleans, 2005. On
8 August the 28th, there was only a 29 percent chance that that
9 hurricane was going to hit New Orleans. Those levees were
10 designed to withstand an average median Category 3 hurricane.
11 Those people had a pretty good chance of surviving and not
12 being displaced. Things should have been okay. In actuality
13 99.9976 percent of the U.S. population was unaffected by
14 Hurricane Katrina.

15 So what we are talking about as far as this
16 modeling and Monte Carlo simulations and our view of, gosh,
17 we're trying to get, you know, nine out of ten people okay?
18 The problem with that is where do you think the impact, the
19 magnitude of that event before that .0003 percent of the
20 population was? Pretty darn significant. Is that okay?

21 And I think we have to ask ourselves as fiduciaries
22 and as providers what level of collateral damage, what I call
23 "participant collateral damage," is okay when you're running
24 these models? They really don't care. Numbers don't have

1 souls. They're tools. And you have to remember that. Those
2 people in the tales are real people.

3 And I think there was another question earlier
4 about how does the meltdown like we've had recently affect
5 those people in the tales, and it does affect all of them.
6 So it's not just affecting 5 percent of your population over
7 time. Every single participant that is age 55 up has been
8 devastated or a great many of them have been devastated by
9 Target Date Funds here recently. So I think it's very
10 important to keep that in mind.

11 Let me make just one real quick point, if I can,
12 about some of the things we think would be important for
13 potential fixes for this space. First, let me say that our
14 target 2010, our Wells Fargo 2010 fund had a return of about
15 minus 10 percent last year. Our Today fund had a minus 3
16 percent return compared to the 25 percent return for the
17 industry for 2010s and I think 20 percent for today's.

18 So we're basically target date heroes right now.
19 We're rock stars. But you know -- and if you guys regulated
20 this industry and brought people more in line with the way we
21 run things, it would be a boon for me personally. It would
22 be a huge financial boon for me for you to regulate and say,
23 gosh, you were right and everybody else was wrong. Do I
24 believe that's the answer? No.

1 Contrary to what we heard on the last panel that
2 we're all greedy and that's all we care about, I don't think
3 that's the right answer. I think that the answer might lie
4 in better communications to plan sponsors as they're choosing
5 QDIAs. I've submitted in my written testimony to the panel
6 some ideas on a target date fact sheet that could be used by
7 plan sponsors that they would have to sign off on that have
8 things like what are the maximum draw downs? If this is the
9 glide path, what are the -- what's the worst case scenario
10 for these participants during the retirement red zone or, you
11 know, five years before retirement, five years after?

12 It could be down 20 percent. It could be down 30
13 percent. You need to initial it as a fiduciary for that plan
14 and say I understand that this is the worse case scenario,
15 and I agree that this is an acceptable level of risk for my
16 participant base, those kinds of things.

17 I think we also, lastly, we have to make sure that
18 we eliminate the opportunities for the gamesmanship and the
19 returns and jacking up the equity exposures to play peer
20 group games to be a top quartile performer next quarter. And
21 I think you can also do that through communication by making
22 product providers, in advance of any kind of change to their
23 glide path, communicate with that same type documentation
24 that says, look, I'm changing my glide path, I'm increasing

1 the equity and this is the new worse case scenario. And you
2 as a fiduciary that has selected me already as a QDIA need to
3 initial on this dotted line that you still understand that,
4 and you still feel that this is predictable and has a --

5 MR. DOYLE: Thank you.

6 MR. LAUDER: Thank you very much.

7 MR. MORTON: My name is Chip Morton and I'm with
8 the Corporate Advisors Group, and I'm an independent
9 retirement planning consultant. We offer advisory services
10 through Raymond James, and as they like me to say, these are
11 my views and not necessarily the views of the firm as a
12 whole.

13 As you three gentlemen that heard me at the advice
14 hearing know, that I speak from the heart and not from the
15 wallet. I'm here on my own dime, and I speak for the
16 participants. I was named one of the top five retirement
17 plan advisors this year by Plan Sponsor Institute, so I'm
18 good at what I do. But I do think that the participants
19 often, in this academic environment in these hearings, get
20 forgotten, and I'd like to sort of be the color guy and add a
21 little bit of down homeyness, if you will, to the testimony
22 to let you know a few things.

23 A few things that I did pick up in just listening
24 throughout the day, first, Pension Protection Act. I

1 applauded it back in October. Great job. We acknowledge
2 that advice is necessary, that participant direction just
3 doesn't work. They haven't done a good job for 30 years.

4 And the pilot doesn't come in the back of the plane
5 and ask you to fly the plane, so nor should we ask
6 participants to make, you know, decisions. It doesn't matter
7 if they're a neurosurgeon or a janitor. Everybody has a
8 different lot in life and a different area of expertise. So
9 I don't want to give up.

10 We have to realize that Target Date Funds -- we're
11 all here to try to find a solution to rendering advice in a
12 mass basis without being able to economically sit down
13 one-on-one. So to that degree, target dates are a solution.

14 Several years ago there was a big move to eliminate
15 proprietary funds by recordkeepers by saying, oh, well, this
16 is XYZ Fund Company's 401(k), and we need to have 60 percent
17 of the funds be ours and then you can go outside. Well,
18 obviously, that helped their profitability, and we spoke
19 against that several years ago.

20 It's interesting to me that here we sit, and many
21 of the funds that are here testifying they're a single family
22 of funds, so it's almost like we've gone kind of back-doored
23 the policies that were made five or six years ago to prohibit
24 a proprietary environment because one of the premises of a

1 Target Date Fund is it assumes that you will put all of your
2 money into that Target Date Fund, you know, not half of it in
3 the target date and then mix it up over here. It needs to be
4 able to be -- if it has a glide slope methodology, it needs
5 to be able to hit that glide slope, and it can't be done if
6 you don't have all the money. So it seems that there's a
7 great commercial reason why a lot of people are very
8 interested in pushing Target Date Funds. But speaking for
9 the participants, I really don't care how profitable they are
10 to some of the large mutual fund complexes.

11 So I wanted to throw that in as well as we talked a
12 lot about QDIAs. Do you know how much money really goes into
13 a QDIA in the true sense of a QDIA where somebody doesn't
14 fill out a form and there's a deferral made on the
15 participant's behalf? Hardly any money goes in under that
16 scenario. It's very rare that a human resources department
17 doesn't track down somebody and get them to fill out the
18 form.

19 So what we're really talking about here is not QDIA
20 in the sense that if they don't make a positive election,
21 then money's thrown in for them. And actually with a lot of
22 matches being stopped lately, it even limits, so let's not
23 get hung up on QDIA.

24 What I think we need to talk about is opting into

1 professionally managed solutions whether it be Target Date
2 Funds or what I'm going to talk about in just a moment. The
3 bottom line is we do need to do something to opt them in at
4 the plan level. But a QDIA by default -- it's not really a
5 default. It's a positive consulted -- consultive approach
6 that I would go to a plan sponsor, and have with many of
7 mine, and said let's default them into a better solution.

8 And also, I don't know that we would really be here
9 if we didn't have the perfect storm two years after PPA
10 started using QDIAs. I hate to use a catastrophic analogy,
11 but it comes to mind, the flight from Brazil to France was
12 struck by lightening. I don't think the pilot did anything
13 wrong. I don't think the glide slope that the plane was on
14 was incorrect. Probably no malfunction of any systems.

15 But just like our economy and the mortgages and the
16 greed and everything that caused this, I think that we have
17 to look at the situation that we might be over-thinking this
18 whole thing. I think if we had Target Date Funds for the
19 last 30 years, nobody would be complaining, and the average
20 account balance instead of being \$40,000 and the average
21 participant is 42 years old, not nearly enough to strike any
22 kind of retirement, even 20 years out, would probably be
23 three and four times that had there been some disciplined
24 approach rather than participant direction.

1 So in my last 30 seconds, I would offer that as I
2 spoke of before, I believe managed accounts are a far
3 superior solution to Target Date Funds. An independent
4 consultant like myself does a very good job, we all do, of
5 looking at all the funds available at any given vendor and
6 screening with our screens those funds and picking a great
7 platform. This fund is large value, mid value, large growth,
8 et cetera, and building out a platform.

9 We called that 404(c) for years, but it didn't do
10 any good because as good of a platform as we built, guess
11 what? Nobody really knew how to do it. The average
12 participant has what? Three funds. Why? Because they
13 either put everything in the guaranteed because they don't
14 get it, or they chase returns and pick the two best returns
15 in the statement that's already 6, 8, 12 weeks old, and they
16 chase the return, and that's not a good investment policy
17 either.

18 So we know there's a problem there. So -- I'm
19 already over, but managing accounts is the solution where we
20 still build the platform, but we pick an independent glide
21 slope, whether it be a Wilshire or an Ibbotson or a
22 Morningstar or Avatar, and I can't name them all, sorry. But
23 you pick a glide slope and we consult based on the
24 demographics the same way we pick funds for the platform, and

1 you marry the two together.

2 But again, mutual fund complexes don't really push
3 for that because they don't make as much money because why?
4 They don't get all the pieces of the pie. But they have
5 healthy competition. That's capitalism. They want to get as
6 many pieces of the pie as possible so they compete through
7 our screening, and if they make three or four slots, great.
8 But again, it's not as commercial for them as getting all the
9 pieces in a Target Date Fund.

10 And the other limitation is a lot of recordkeeping
11 systems can't handle a third-party glide slope producer, if
12 you will, or manager, to plug into the system, so therefore a
13 lot of record keepers want to push for Target Date Funds
14 because they're easier for the recordkeeping system, and you
15 don't have to spend millions of dollars with Sungard or
16 internally to build the platform out.

17 But again, I don't really care how expensive it is
18 if the right solution for the participant is a managed
19 accounts. And it is possible, then I think that that's a
20 solution that we really need a hearing on that as well, you
21 know. But it doesn't get as much play, again, because it's
22 not got so much commercial value.

23 So I would leave you saying that managed accounts,
24 I think, is a solution that needs to be mentioned today

1 because it really creates the effect of Target Date Funds.
2 And sure, we have to figure out what's the glide slope and
3 what not.

4 But I will say this, with an average payroll
5 bridge -- now, listen. It reads birthday, okay. Same as the
6 Target Date Fund. It reads gender. There are studies that
7 say males and females have different risk tolerances. State
8 of residence, salary, deferral as it relates as a percentage
9 to the salary.

10 All that gives it a little bit more information for
11 the computer to build a model. Far better than just the
12 birth date, just like the gentleman earlier said. But again,
13 it's not something we had a hearing on, but it's a far better
14 solution. But again, it doesn't have the big commercial
15 backing, but it should, because we're all here in America at
16 the Department of Labor doing these testimonies, and we don't
17 want to forget capitalism, because, frankly, a Target Date
18 Fund is a bit socialist, if you look at it. And particularly
19 as it pertains to all the funds being proprietary and rammed
20 down somebody's throat. So with that there's my color, and I
21 will close.

22 MR. DOYLE: Thank you.

23 MR. DUNNE: Hard to follow that.

24 MR. LAUDER: Actually there's no time for you two

1 because he and I took all of it between the two of us.

2 MR. DUNNE: What you forget is that I'm Irish.

3 MR. MORTON: You do have a cool accent.

4 MR. DUNNE: We can talk till the cows come home.

5 Thank you very much. My name is Richard Dunne. I'm the
6 founder of QDIA.com. It's a service to help 401(k) plan
7 sponsors increase retirement security, reduce fiduciary risk
8 and eliminate excessive costs using ERISA Qualified Default
9 Investment Alternatives. I previously submitted fairly
10 extensive written material for the panel's consideration.

11 And in the time available today, and very much in
12 the light of the earlier testimony we've heard, I've actually
13 decided to focus on just one of the areas covered in that
14 testimony. So on the off chance that anyone wants to hear my
15 views on improving fiduciary transparency, improving
16 performance and risk monitoring, particularly as it relates
17 to glide path disclosure and index construction, I'd ask you
18 to please refer to the written comments while I focus on
19 improving decision-making processes.

20 Retirement plan fiduciaries are routinely expected
21 to make complicated decisions involving competing and
22 sometimes conflicting demands, multiple options, limited
23 resources and uncertain outcomes. The way in which decisions
24 are made critically affects the quality of the results

1 achieved.

2 Now, ERISA wisely reflects this by focusing on the
3 quality of decision-making processes when determining whether
4 a fiduciary has acted prudently. However, based on my
5 experience over particularly the last ten years, I find that
6 the decision-making procedures used by many fiduciaries have
7 not evolved to keep pace with the increasing complexity of
8 the choices they are required to make.

9 So conceptually Target Date Funds are designed and
10 management is quite simple. We've heard that today. But
11 every testament we've heard today talks about the complexity
12 of these things. They raise complicated issues, and,
13 therefore, they result in a very wide variety of different
14 product offerings all to achieve the same basic simple,
15 supposedly simple objective. So no single product can
16 simultaneously be best on every single selection or decision
17 criteria, and therefore inevitably plan sponsors have to make
18 a series of tradeoffs.

19 Most decision-making methods used by plan sponsors
20 and their advisors today focus on a single measurement at a
21 time, and they do a very poor job of balancing multiple
22 selection criteria. Very often decision-makers use some
23 combination of simplified screening or scoring methods to
24 reduce the number of decision variables to a level where they

1 can intuitively identify their preferred choices.

2 Such methods suffer from severe deficiencies.

3 Screening fails to reflect the relative importance of
4 different criteria and fails to take into account the degree
5 of performance difference on each criterion. The value of
6 many scoring systems is severely limited because of the way
7 in which the scores are assigned. Using a flawed methodology
8 might actually be more dangerous than helpful because it
9 creates a superficial impression of being systematic when in
10 reality it fails to meet minimum requirements for validity
11 and effectiveness.

12 Unfortunately most fiduciaries are so busy dealing
13 with day-to-day operational issues, they rarely have time to
14 consider the effectiveness of their decision-making
15 processes. Furthermore, while the pension industry is
16 overflowing with investment and legal experts, it severely
17 lacks expertise in decision process management.

18 Perhaps, therefore, it's not surprising that on the
19 rare occasions that pension governors do review
20 decision-making procedures, the focus is usually on meeting
21 legal and regulatory requirements rather than improving the
22 quality of the decisions they are making.

23 Many plan sponsors, consultants and fund managers
24 continue using traditional methods despite their known

1 weaknesses because they think the only alternative is to
2 embrace unfamiliar solutions that might prove even more
3 dangerous, so even when the logic recommends itself, the
4 logic of a new approach, the potential unknowns places it too
5 far outside their comfort zones.

6 Fortunately, there is a viable solution to this
7 impasse. The challenges of deciding complex issues involving
8 multiple quantitative and qualitative decision-making
9 criteria are not unique to the investment industry. A
10 discipline called Multiple Criteria Decision-Making and their
11 methods have been the subject academic research and used
12 successfully for decades in a myriad of challenging
13 solutions.

14 So by looking beyond our own industry's borders, we
15 can actually draw on a wealth of global standards, proven
16 methods and practical experience to help us tailor an
17 effective solution to all these complicated issues we've been
18 debating today and hearing about. But most of the leading
19 decision-making management methods are unknown to pension
20 fiduciaries and fund managers even though each has at least a
21 30-year global pedigree.

22 Furthermore, techniques such as Analytical
23 Hierarchy Process, Adoptive Conjoint Analysis, Rasch
24 Measurement Scales, maximum difference, they may sound very

1 daunting, particularly to a newcomer. I mentioned them
2 earlier to someone with a Ph.D., and he said, that goes over
3 my head. But actually these methods are conceptually
4 extremely easy to understand, and they've each been
5 implemented in software programs that have been designed to
6 be intuitively easy to use by non-experts.

7 Moreover, they're not theories. They are practical
8 operational tools that have been extensively proven in
9 real-world use including the commitment of multiple billions
10 of dollars in capital investment programs both in the private
11 and the public sector.

12 It takes a rare combination of integrity, insight
13 and initiative for a plan sponsor to independently seek out
14 and implement better solutions. Fortunately, such leaders do
15 exist, which is how the system slowly evolves towards better
16 outcomes. I believe, however, that solving fundamental
17 problems of poor decision-making is sufficiently important
18 and urgent that it needs the kind of catalytic effect that
19 can best be achieved through direct support from the
20 regulatory agencies.

21 I therefore recommend that the Department and maybe
22 the SEC also initiate a program specifically to help plan
23 fiduciaries improve the quality of their decision-making
24 processes. This program might start by encouraging voluntary

1 disclosure by plan sponsors of a written investment policy
2 statement for Target Date Funds and other Qualified Default
3 Investment Alternatives combined with guidance from the
4 agencies in the form of model decision-making processes that
5 could be adopted and incorporated into such a statement.

6 The goal would be to eventually have all plan
7 assets managed using decision-making processes that meet
8 three essential standards that I set out in my written
9 testimony and to which I would refer you since I'm also
10 running over time.

11 The benefits of successfully implementing such a
12 program would be, A, to provide an impetus for the entire
13 retirement industry to upgrade its decision-making methods
14 and tools, to reduce individual fiduciary risk and to help
15 both individual decision-makers and the industry as a whole
16 more easily repeat past success and identify opportunities
17 for further improvement.

18 Regulators play a crucial role, and you're already
19 providing strong leadership in relation to Target Date Funds.

20 But plan sponsors, their advisors and fund managers, all of
21 us in this industry, we all have to make the effort necessary
22 to deliver investment products that will help, not hinder,
23 plan participants in achieving the retirement income security
24 they deserve.

1 Thank you.

2 MR. DOYLE: Thank you.

3 MR. HARVEY: Thanks again, and thank you all for
4 permitting this testimony. I'd like to say that my approach
5 is perhaps a little bit different from what you're heard
6 today, which is really more of a diagnostic one, looking at
7 the problem of Target Date Funds as defined by losses, by
8 complaints, and so forth and so on. My presentation is
9 supported by the written materials I've distributed, so I'm
10 not going to go through all of those details.

11 In the way of background, where we're coming from
12 is a perspective of expertise in both the ERISA side of the
13 world as well as the investment company side of the world and
14 being a plan sponsor of what could be one of the first
15 automatic enrollment plans in the -- universe. So we have
16 some hands-on experience in that regard.

17 We found basically two root causes for the problems
18 associated with Target Date Funds today. The first of the
19 root causes I would describe as non-compliance with federal
20 regulations. Non-compliance may sound strong, but I think
21 you'll get the point later on. Ineffective enforcement has
22 permitted several aspects of both ERISA and investment
23 company regulation to be ignored.

24 The second root cause is faulty investment

1 practices that are, in fact, permitted. These faulty
2 investment practices come under the category within the QDIA
3 and the PPA language of generally accepted investment
4 theories. We have sort of an open window in terms of what
5 is, in fact, a generally accepted investment theory.
6 Surprisingly, in our work we have found virtually no problems
7 with asset allocations in Target Date Funds. And I will
8 touch on that momentarily.

9 Let's talk about the non-compliance issues first.
10 One of the things that we have been doing over the last
11 several years is literally evaluating whether or not Target
12 Date Funds and QDIAs in general comply with the associated
13 regulations across the board, whether they be securities
14 regulations or labor type regulations.

15 I have four examples to give you here. One is
16 discrepancies that exist between the presentations made in
17 fund prospectuses and the QDIA regulations. To quote out of
18 the QDIA regulations, "they must be designed to provide
19 varying degrees of long-term appreciation and capital
20 preservation." Sounds simple, but you try to find a fund
21 prospectus, interpret a fund prospectus to determine whether
22 or not that standard is met. To say it's difficult is an
23 understatement. It literally doesn't exist. So the process
24 of selection of a proper QDIA, if, in fact, you're using the

1 regulations and the prospectus, is extremely difficult.

2 The second point has to do with self-dealing among
3 Target Date Funds. I think a couple panels earlier talked a
4 bit about the idea of self-dealing in that universe.

5 The third one is something that I have not heard
6 discussed today, and that is the participant notices. The
7 idea that you're going to default a participant into an
8 investment implies that that participant is not familiar with
9 investing and is not going to be trained and provided with
10 the education. However, as an industry what we've done is
11 we've not met that standard that says it's calculated to be
12 understood by that particular defaulter. So we literally
13 write communication for a sophisticated investor and give
14 that to these folks who are -- who don't meet that standard.

15 The fourth point is fund prospectuses permit
16 providers to charge exit fees within 90 days of QDIA
17 regulations even though that is, in fact, explicitly
18 prohibited in the regulations. I would have to say the
19 number of prospectuses that permit that is daunting.

20 The conclusion we draw from that is that we need
21 some level of oversight, and the notion that plan sponsor
22 oversight will take care of it, I think, is both impractical
23 and ineffective. Maybe in the case of large plans, the 10
24 percent of plans that have the kind of capability, it works,

1 but in 90 percent of plans where you've got a human resource
2 manager, you know, trying to get their daily work done,
3 they're not going to be addressing issues of whether or not,
4 you know, the prospectus of a QDIA is in line with the
5 regulations.

6 The second point, and I'll try to run through this
7 quickly, has to do with faulty investment practices. While
8 asset allocation is very widely used in the industry among
9 Target Date Funds, we generally found them to be consistent
10 with the stated investment theory and policy. So it's not
11 that firms are going off the reservation, they're working
12 within the structure that exists there.

13 The question I have for you there is, how much
14 difference would it make in a portfolio that had General
15 Motors stock if instead they had General Motors bonds to
16 provide the higher fixed income component?

17 The answer is in 2008 it probably would not have
18 made very much difference. The point here is the asset
19 allocation schemes, the asset allocation procedures that we
20 have seen seem to be consistent, and they're doing that which
21 they are supposed to do.

22 So what are the flaws? What are the problems? We
23 have identified and we're going to mention -- I'm going to
24 mention five of them here. One is the dependence on asset

1 classes being uncorrelated.

2 The whole theory that asset classes are
3 uncorrelated is an issue, and we do not have an answer for
4 the case where they do become correlated as they did back in
5 2008. There is no answer. We have not heard anybody address
6 the issue of what do you do when the stocks and the bonds
7 both go down? How is that working?

8 The second is there's no provision to limit losses.
9 And this is really coming not from investment perspective as
10 much as it is from a consumer perspective or I should have
11 said participant perspective. The participant is really
12 interested in finding out how their QDIA can limit their
13 losses, and we have not heard that discussion. I think it's
14 an important thing that we ought to consider within the
15 context of QDIAs.

16 The third has to do with leverage and margins. We
17 have all kinds of constraints with investment companies as
18 far as how much margin risk they can take, and so forth. But
19 to the best of my knowledge, there is absolutely no
20 restriction on how much leverage is permitted within the
21 assets in the portfolio. So we prevent excessive leverage in
22 the portfolio itself, visibly, but the underlying assets can
23 have as much leverage as needed. I think there is some need
24 to address that.

1 The fourth, I think we've heard discussed in the
2 earlier panel, and that's the notion of using a single
3 criterion, age, to solve a multi-dimensional problem,
4 retirement investment. The idea that by simply looking at
5 age, you can project exactly what somebody's investment
6 should be for the rest of their life I think is to say that
7 it's false is an understatement.

8 Finally, we have labels that imply things that are
9 not really true. When you have a 2030 retirement fund, most
10 people would interpret that, as we've heard discussed before,
11 as a fund that you would use if you're going to retire in
12 2030. The fact of the matter is no fund fits all people's
13 circumstance.

14 So the fact that we're promoting these kinds of
15 theories, these kinds of things that go beyond just the name,
16 but it's also included in the material -- the fact that you
17 give the impression that this is the solution for everybody.

18 If you're going to retire in 2030, by golly, the only
19 question you have is which 2030 fund you want to use, which
20 is patently false. I think there are more important
21 decisions.

22 MR. DOYLE: I think I'm actually going to have to
23 cut you off so we can have a little time for questions and
24 stay reasonably on schedule. So with that I will turn to my

1 fellow panelists.

2 MR. SCHEIDT: I just wanted to highlight one aspect
3 of Mr. Lauder's written testimony. I think, and maybe you
4 can elaborate a bit, you talked about an effective
5 communication strategy would be to develop a universal target
6 date index, and then have some graphic illustration about how
7 the particular Target Date Fund's glide path differs from the
8 benchmark, and then a narrative description of how the
9 manager of the Target Date Fund can -- has discretion to go
10 beyond the glide path percentages. And if you would just
11 elaborate on that, that we be helpful.

12 MR. LAUDER: Absolutely. And I think your last
13 point first, it's one thing to put a glide path in a
14 prospectus. It's an entirely different thing to live by that
15 glide path when you see your competing fund managers change
16 theirs in order to jockey for position. So that's a good
17 point, and I think people need to address that.

18 Your first thing as far as our ideas for a
19 standardized what I call kind of a fiduciary target date fact
20 sheet would indeed have a universal benchmark not to judge
21 the absolute performance of the universe of Target Date
22 Funds. There will never be a single index benchmark that
23 fits the bill because of the difference in philosophies, but
24 just to help people understand the difference between some

1 standards, they have some benchmark.

2 You know, I think the other key to that, that
3 fiduciary fact sheet for Target Date Funds, to help plan
4 sponsors understand what they are buying into, is to put
5 these things in terms that are really from the participant's
6 perspective, so as opposed to just saying, oh, this index
7 could return a minus 10 percent in this kind of environment,
8 change it to where you talk about, you know, potential dollar
9 amounts. You know, put it in terms of a participant to say,
10 yeah, this could be a maximum draw down, because that's
11 really what participants experience. They don't care about
12 rolling 12 months. They care about maximum draw downs.

13 To put it in terms of, gosh, how many years' worth
14 of contributions did they just lose? And I think when you do
15 that exercise on the numbers that we've tossed out all day
16 about the average return for a 2010 fund, it's even more
17 frightening if you take that 25 percent, convert that to a
18 number of years worth of contributions that those people just
19 lost. It's about 25 years worth of contributions that just
20 went away, gone.

21 So I think that's the key to do an effective
22 communications piece, a standardized communication piece, is
23 to put it in terms that people can understand, and say, gosh,
24 this is the way my participants experience. We're not

1 talking about statistics here, we're talking about real
2 people that have been on the work line or the call center for
3 30 years. If we subject them to this kind of risk, they
4 could lose 30 years worth of contributions. It could take
5 them 20 years to recover. Whatever it is, recovery time.

6 So I think it's very important, again, that the
7 benchmark would not be for the purposes of judging fund
8 providers' performance, absolute performance, but just to
9 give people a benchmark and what that would mean for -- at
10 the participant level.

11 MR. MORTON: I'd like to add something again. The
12 problem with any of the disclosures, we've already
13 acknowledged they don't know how to pick their own funds. Do
14 you really think they're going to understand the correlation
15 between glide slopes and benchmarks? That's the problem.
16 Look at my coal miner clients. Many of them don't read and
17 write.

18 The problem is they need professional management.
19 You don't go to your defined benefit manager and ask them to
20 explain all their methodology. You know, I was at a defined
21 contribution summit last week, and somebody, a frustrated
22 plan sponsor spoke up, and said, what's the answer? And he
23 said, well, the only real answer is to go back to the defined
24 benefit plans. And everybody laughed.

1 But the point being is you're not going to get them
2 to understand all this methodology. We've already
3 acknowledged with the PPA that they're got going to know how
4 to mix up their own funds. For God's sake, they're not going
5 to understand all the smart people stuff we've heard today.

6 MR. SCHEIDT: My point in raising this was there
7 are different ways to communicate information to people.
8 There may be plan fiduciaries that will understand a graphic
9 presentation. There are others who will understand narrative
10 descriptions. There are financial planners who will be able
11 to use this information if it is made available to them. And
12 I thought your ideas were worthwhile.

13 MR. LAUDER: Thank you. And again, just to make
14 sure that everybody understands, that was intended to be a
15 fact sheet for fiduciaries, not for the individuals. I agree
16 wholeheartedly that if I went and I tried to explain my
17 methodology, below mean variance, Markowitz-based
18 optimization, they wouldn't get it. I mean, this is purely
19 for helping people select a prudent QDIA for their
20 participants.

21 MR. DUNNE: If I may add a comment on that, please.
22 I agree with what you're saying that the communication level
23 have to match the ability of the recipient to understand it.
24 But in relation to the indexes, I think we have to be very

1 careful in what index is used if it's going to be a single
2 index. And I think two comments.

3 One is if it becomes -- well, it obviously can't
4 become a single commercial company's index because that's
5 just not -- that's not fair in a sense commercially, so it
6 becomes some kind of a regulated -- a regulatory decision as
7 to what it should be, that is the danger of creating a super
8 index, which essentially kills innovation around that because
9 everybody would just want to conform to it no matter what you
10 say.

11 What I haven't heard today is reference to
12 liability indexes. Essentially, although by the time someone
13 comes to retirement what they actually do after it, we've
14 heard, there's great variety in what they're going to do.
15 But I take your point. Come up with some way of expressing
16 it that people -- they can relate to it.

17 And I do think a way to relate to it is to say that
18 essentially at the end we want to fund a lifetime annuity.
19 Whether you buy it or not is your own choice beyond that.
20 But as an absolute basic to live, there should be some flow
21 of income coming in.

22 And so there is a price on that. There is a market
23 price. There are providers. The insurance industry will
24 provide that and others can calculate it.

1 So what I would recommend -- I agree with the idea
2 of having an index, but I would ask you please to look at, if
3 you're going to do an official one, a liability-based index.

4 And so what you're really looking at is when you're looking
5 at the performance of the funds as you go forward, it's the
6 return on the fund on your asset side versus the changes in
7 the present cost of buying a given annuity, lifetime annuity
8 stream in the future. And so people can see what I have
9 today is worth this to me if I want it down the road as an
10 annuity. I don't have to buy it. And as the returns change,
11 like you're saying, you'll see this in the reduction in the
12 annuity.

13 So instead of telling someone even you've lost --
14 you've have to work for five more years, which may or may not
15 be true depending on the model, you can tell them precisely
16 today, given what you've just lost in 2008, the annuity
17 income stream you can now buy with your pension has gone down
18 from, you know, whatever, a couple of thousand a month to a
19 couple of hundred a month for the rest of your life when you
20 retire. I think that would get people's attention.

21 MR. GOHLKE: Let me just follow up on something Lou
22 mentioned. Among the reasons for TDF problems you mentioned
23 faulty investment practices?

24 MR. HARVEY: Yes.

1 MR. GOHLKE: Is that in the context of the
2 investment manager not following guidelines in either the TDF
3 portfolio construction or the underlying funds if it's a fund
4 or funds?

5 MR. HARVEY: More of the former than the latter,
6 frankly. Let me just quickly just sort of go over it. One
7 of the principles in Target Date Funds is the lack of
8 correlation among asset classes. Right? Now, that's a
9 generally accepted principle up until 2008 that there is --
10 their asset classes are uncorrelated and we can take
11 advantage of that.

12 So that to me is a fault. Is it a fault of the
13 investment manager that he didn't know anything better? No.
14 I think it's perhaps more a realization today that that
15 assumption is in fact a faulty one. You take other things
16 like provisions to limit losses is another area I talked
17 about. We've heard more discussions these days about
18 absolute return funds, which is in response to that. It's a
19 realization that participants are, you know, very concerned
20 that an investment will limit losses. I think that should be
21 part of, if you will, the promise of a QDIA.

22 You see, if I'm making my own investment choices, I
23 can adapt for those things. I can say I want a portion of my
24 portfolio in a stable-value fund, and I'm going to limit the

1 losses there. If I'm in a QDIA, that concept, which is a
2 very important human behavioral concept, is lost. So the
3 point is not so much who did something wrong but what is
4 structurally wrong with the theories that we're using.

5 MR. GOHLKE: Thank you.

6 MR. DOYLE: Okay. Thank you very much. We
7 appreciate your contribution to today's hearing.

8 MR. DOYLE: If you want to start, go for it.

9 MS. TUTTLE: Certainly, I'm Anne Tuttle. I'm the
10 General Counsel of Financial Engines. Thank you for the
11 opportunity to testify today.

12 Financial Engines is an independent investment
13 advisor founded by Bill Sharpe, who was awarded the Nobel
14 Prize in economics in 1990, and Joe Grundfest, a former SEC
15 Commissioner.

16 We offer investment services to plan participants
17 through leading employers including 112 of the Fortune 500
18 reaching more than 7.4 million participants. We provide both
19 discretionary investment management through our managed
20 accounts program and non-discretionary investment advice
21 through our online advice services, in each case as a plan
22 fiduciary and fiduciary to the plan participants.

23 We also provide access to investment advisor
24 representatives via the phone and retirement evaluations

1 which provide an assessment for the participant of their
2 forecasted retirement income taking into consideration their
3 401(k) balance, any defined benefit plan balance and other
4 assets. This helps participants to understand where they
5 stand. We offer this advice on an individualized basis. Our
6 portfolios are unique. More than 73 percent of our
7 portfolios are unique.

8 To talk about not just disclosure but engaging the
9 participant, let me tell you the story of Sally. Sally is an
10 actual plan participant who called our investment advisor
11 representatives to receive a retirement checkup, which is a
12 20 minute process. She's 58, a long-haul dispatcher and
13 recently divorced.

14 She told us she wanted 30 thousand dollars in
15 retirement income, and that was about 70 percent of her
16 pre-retirement income so that matched kind of general rules
17 of thumb.

18 But her Social Security and 401(k) gave her a
19 protected retirement forecast at a median of only \$20,000.
20 Well, it turns out Sally was a good saver and she had other
21 assets. And when we took those into consideration, her
22 median forecast was \$27,000.

23 Our representative discussed working longer. Well,
24 she would have none of that, not even one year longer, but

1 she was willing to change her savings rate. And she
2 increased her savings rate from 10 percent to 17 percent.
3 She also told us that she did have a pension benefit from a
4 former spouse. Taken altogether her median retirement income
5 forecast reached \$32,000.

6 She told us she had a fear of working until she was
7 85, but now she had better information and she had increased
8 her savings. She didn't hold Target Date Funds, but we
9 believe that a best practice plan design can include both
10 Target Date Funds and managed accounts. In fact we see this
11 in practice. 73 percent of our plan sponsors use both Target
12 Date Funds and managed accounts.

13 Why is this? Well, we have heard a lot today about
14 different participants having different preferences. We
15 analyzed 429,000 participant portfolios before management
16 began, and we saw that the range of risk preferences is
17 demonstrated by their actual equity holdings were
18 dramatically different for younger employees and employees
19 who were closer to retirement.

20 At age 25 the range of equity holdings was between
21 80 percent and 92 percent, a spread of 12 percentage points.

22 At age 60, the range was 25 percent in equity to 71 percent
23 in equity, now a range of 46 percentage points.

24 We've also done a case study with a large Fortune

1 500 company, which rolled out managed accounts and Target
2 Date Funds at the same time. Three years later we saw that
3 the average age of the participants using Target Date Funds
4 was 35 versus the average age of the participants using
5 managed accounts was 45. This is consistent with the recent
6 EBRI study as well, finding greater usage of Target Date
7 Funds among younger participants.

8 Participants have different approaches to their
9 401(k). These differences mean that the disclosure is needed
10 both for sponsors and participants to get the right fit. The
11 sponsors need better visibility into the underlying holdings
12 and the glide path. The industry can do a better job of
13 disclosure for participants around expenses, risks and,
14 again, their fit.

15 And we can go beyond disclosure to participant
16 engagement. We need to engage participants to actually show
17 them in the context of their own circumstances, whether they
18 are holding Target Date Funds or other assets, where they
19 stand today, the probabilities of reaching a retirement goal
20 and how to improve their situation.

21 When we've done retirement checkups as a pilot by
22 phone, we have a hundred participants where we have before
23 and after data. And what we've seen is less than 25 percent
24 had an even likelihood of meeting their retirement income

1 goal at the beginning of the process, but close to 60 percent
2 were able to bring their forecasted income up toward their
3 goal by increasing savings or delaying their retirement,
4 making a change to risk preference or making other updates to
5 their retirement plan.

6 We should allow participants to make decisions
7 about the relative amounts of equity in their defined
8 contribution account in the context of these savings
9 preferences, desired retirement ages and when they will need
10 the income from their 401(k).

11 Thank you.

12 MR. MOORE: Thank you for the opportunity to add
13 information to this discussion. My name is Ed Moore, and I'm
14 president of Edelman Financial Services based in Fairfax,
15 Virginia.

16 Our firm provides financial advice to thousands of
17 individuals and families, and we currently manage more than
18 three and a half billion in assets. Unlike other firms that
19 primarily service high net worth investors, our firm caters
20 to the middle class.

21 Our hands-on experience advising clients allows me
22 to give you an in-the-trenches perspective on how Target Date
23 Funds are actually being used by ordinary consumers.

24 Our experience has taught us that Target Date Funds

1 pose specific dangers to investors, and I would like to
2 describe these problems and offer two simple solutions that
3 can help protect investors.

4 Obviously, American workers are responsible for
5 making their own investment decisions regarding retirement
6 plans at work. Yet, in a 2006 survey by John Hancock, 69
7 percent of workers admitted they lack investment knowledge.
8 67 percent said they fear -- their fear of market volatility
9 prevented them from managing their 401(k) properly.

10 So Target Date Funds would seem to solve this
11 problem, the theory that a Target Date Fund would allocate a
12 person's assets based on a projected retirement date.
13 Someone planning to retire in 20 years would choose a 2030
14 fund. The person requiring sooner might choose a 2020 or
15 2015 or 2010 fund.

16 But in concept, this doesn't work. In practice
17 this doesn't work. No two Target Date Funds are alike. They
18 don't have the same asset allocation, investment holdings,
19 turnover rate or glide path. The result is that investors
20 are gambling that the Target Date Fund offered by their plan
21 is right for them.

22 Morningstar lists 153 Target Date Funds that have a
23 date of 2010; total assets in January, 22 billion. Yet,
24 there's little consistency in the funds' holdings. According

1 to the review we conducted, 14 of the 150 funds hold more
2 than 60 percent of their assets in stocks, 15 percent hold
3 less than 30 percent, and one had only 19 percent in stocks.

4 The ordinary investor in a retirement plan would not know
5 the difference between these or the implications of these
6 allocation changes.

7 The 2008 returns for these funds were just as
8 broad. According to Morningstar, 6 of the 150 2010 funds
9 lost more than 40 percent of their value last year while four
10 lost only 10 percent. Again, a huge disparity.

11 A final problem is that many workers don't know
12 that Target Date Funds are comprised of other funds. As a
13 result, most of those who use Target Date Funds use them
14 incorrectly. If you use a Target Date Fund, you're supposed
15 to put all your assets into that single fund allowing the
16 fund to provide you with the asset allocation and glide path
17 that's appropriate.

18 But a 2009 white paper by Janis Capital Group found
19 that most of the people who owned Target Date Funds in their
20 401(k) plan own six funds including both Target Date Funds
21 and other mutual funds. Nearly two-thirds incorrectly believe
22 that Target Date Funds need to be combined with other funds
23 to create a diversified portfolio.

24 According to the Thrift Savings Board, which

1 oversees a retirement plan used by employees of the federal
2 government, 55 percent of plan participants who use the
3 plan's L funds, the lifecycle funds, also have money in other
4 funds offered by the plan. 16 percent, in fact, have money
5 in every fund in the Thrift Savings Plan.

6 It's even worse in private sector plans. According
7 to Vanguard, which offers its own version of lifecycle funds,
8 63 percent of plan participants use L funds in addition to
9 other funds.

10 So the problem occurs for two reasons. First, each
11 fund is permitted to create its own allocation, investment
12 holdings and glide path without any constraint, and they're
13 permitted to change their asset allocation at will.
14 Secondly, workers are being given access to these investments
15 without the understanding they need in order to make informed
16 investment decisions.

17 Edelman Financial Services offers two simple,
18 easily implemented solutions to help solve these problems.
19 First, prohibit the use of the funds -- of dates in the
20 funds' name. Allowing funds to refer themselves solely by
21 year is highly misleading, especially since there are no
22 industry standards regarding portfolio construction or
23 management.

24 Second, require these funds to disclose their asset

1 allocation and glide paths and require them to adhere to
2 them. By showing investors how funds are constructed and how
3 they'll evolve over time, investors will be able to better
4 determine if the funds are suitable.

5 This methodology is commonly used by Section 529
6 plans very effectively, and there's no reason the approach
7 can't be used here. These two simple improvements will
8 dramatically help investors make better informed and
9 effective decisions.

10 We're pleased the SEC and Department of Labor is
11 taking on the task of investigating Target Date Funds. Thank
12 you for the opportunity to appear today.

13 MR. DOYLE: Thank you.

14 MR. MCGATHEY: Good afternoon. Thank you for the
15 opportunity to be here today. My name is Randal McGathey.
16 I'm an independent professional in the financial services
17 industry, having spent 26 years with a firm that provides
18 products and services to institutional investors. The last
19 two years with that firm were spent doing operational product
20 development work related to Target Date Funds.

21 I believe the Target Date Funds are valuable
22 retirement investment products. That notwithstanding, the
23 current practice of using the target date as the sole product
24 descriptor is insufficient and potentially misleading. The

1 target date, per se, does not convey important
2 characteristics of each product's particular nature.

3 These products need to be more specifically labeled
4 in order for one to be differentiable from others with the
5 same target date but significantly different risk return
6 profiles, i.e., the glide paths. Without the ready
7 disclosure of this information, there remains a significant
8 risk of misunderstanding the product's essential nature,
9 resulting in mistaken product selection and erroneous
10 expectations by participants and undesired outcomes even
11 though those outcomes may well have been expected based on
12 the product's design.

13 Therefore, I suggest a framework is needed by which
14 to organize Target Date Funds, and then more transparently
15 and consistently describe and disclose their differentiating
16 characteristics. This organizational and descriptive
17 framework should also enable more meaningful comparative
18 analysis of risk and performance.

19 The framework should first be concerned with the
20 time horizon of Target Date Funds, specifically the point in
21 time on the glide path relative to the target date that the
22 funds reach its lowest risk profile. There is significant
23 variability in this factor among funds with the same target
24 date, as we've heard a lot about today.

1 While the variability of this factor from one fund
2 to the next is typically viewed as a single continuum ranging
3 from before the target date to well after, I believe that
4 it's instructive and valuable to sort funds into two types
5 based on this factor, those that reach their respective
6 lowest risk point before the target date versus those that do
7 so after.

8 Those that reach their minimum risk level by or
9 before the target date, I refer here as accumulation type.
10 These allow or even expect that the investor will make a
11 separate decision at the retirement date as to how to
12 redeploy the assets in a separate retirement income and
13 investment program.

14 This type defers to the premise that the time just
15 prior to and following the target date is the period during
16 which an investment loss has the greatest negative impact.
17 The counterpoint to this reduced risk is the commensurate
18 reduced investment return.

19 The funds that reach their minimum risk level after
20 the target date, I refer to as lifecycle type, these expect
21 that the investor will remain in the same Target Date Fund
22 throughout the entire retirement savings lifecycle,
23 incorporating both the asset accumulation and the retirement
24 income components into one product. Most Target Date Funds

1 are, in fact, this type.

2 The objective for pushing the minimum risk point
3 later into the cycle in these funds is to increase investment
4 return supported by the rationale that the funds have a
5 longer investment horizon, as we have heard eloquently today.

6 The counterpoint is the increase risk of loss later in the
7 retirement savings lifecycle including the time adjacent to
8 the retirement date.

9 Either type may be a good selection if done so
10 knowingly and properly in the context of other retirement
11 savings. However, either could deliver undesired outcomes if
12 expectations were for the other type. Therefore, it is
13 important to know which is which.

14 Target Date Funds do not typically describe and
15 obviously disclose this characteristic, the point at which
16 they reach the minimum risk level, in a way that easily
17 supports its consideration in comparison to other funds. The
18 negative consequence to that fact is the products that are
19 dissimilar in this regard may be compared to each other, in
20 which case some products will appear to be more aggressive as
21 measured by equity allocation than others and to an extent
22 that may raise concern.

23 I suggest, however, that the investment horizon
24 should be considered before two funds are compared to each

1 other. As described some Target Date Funds will, by their
2 essential design, have greater equity allocation later in the
3 cycle, but I suggest that is not greater aggression but,
4 rather, a different product type, such as suggested by
5 accumulation versus full lifecycle distinction.

6 Therefore, products should first be sorted by type
7 or at least graded by the position of their minimum risk
8 level relative to the target date before undertaking
9 comparative analysis. Only after organizing the products
10 this way can one come to meaningful conclusions about
11 relative aggressiveness.

12 Again, if the distinction is not made and one is
13 compared to another that is dissimilar, the exaggerated
14 perception of their difference in aggression might result in
15 unfavorable and perhaps even very unfavorable conclusions and
16 understandable but greater than do broad-based remediation
17 for Target Date Funds in general.

18 All this is said in support of Target Date Funds.
19 The use and debate about frameworks can advance our better
20 understanding and disclosure and better use of Target Date
21 Funds. It is my view that a well-disclosed and properly
22 selected Target Date Fund can deliver more and more
23 consistent positive outcomes than leaving the formulation and
24 execution of the investment strategies to those individuals

1 themselves.

2 Thank you.

3 MR. KRASNOW: Good afternoon, gentlemen. Excuse
4 me. My name is David Krasnow. I am the founder and
5 president of a company called Pension Advisors in Cleveland,
6 Ohio. I'm honored to be here today.

7 While many people testifying in both on this panel
8 and previous panels are executives and have been involved in
9 the creation of Target Date Funds, I believe I bring a unique
10 perspective, in that I spend a high amount of my time
11 actually in front of plan participants as well as plan
12 sponsors. The common denominator that I have not heard a lot
13 of today is what is going on at the plan participant level.

14 While the specific problem of the day is Target
15 Date Funds and the perfect storm that we have fallen in as a
16 result of 2008, the real problem goes to the education or
17 their lack of education on the plan participant level. I
18 also read the John Hancock study, which in essence said that
19 69 percent of all plan participants are, in essence,
20 financially illiterate.

21 From my firsthand experience, I find that this
22 number is probably 15 to 20 percent higher than that. And
23 this is a problem that's not going to go away, and it needs
24 to be addressed.

1 The hearings that are taking place today on Target
2 Date Funds probably should have taken place five years ago
3 before it was let out of the barn, but now we're trying to
4 kind of fix the problems that have taken place.

5 The creation of Target Date Funds was the latest
6 and greatest financial tool to help the financially literate
7 be able to participate effectively in retirement plans. The
8 concept is a great concept. I'm not going to go into the
9 detail that I've heard before here today, but it's a great
10 concept. In essence, the idea is it ages with you.

11 But before it was properly researched, it was put
12 out to the masses. For that, there are many in the industry
13 and beyond who share in the responsibility and the blame.
14 The problem in a nutshell is that unlike most funds there are
15 no categories differentiating Target Date Funds. What we
16 have is a free for all or what I like to refer as the wild,
17 wild, west.

18 J.P. Morgan did a report breaking down Target Date
19 Funds, and they broke them into different categorizations.
20 They broke it down and could be looked at in one of two ways
21 or one of four ways.

22 What I've heard here today and what I like to look
23 at them is two distinct and different ways. The first is
24 going to be based on retirement. So let's call that target

1 for retirement, which when a person gets into it the idea is
2 they're getting in thinking when is my retirement year. And
3 the idea is this will age with them. It will have more in
4 bonds and less in equity as they get to retirement.

5 The second, which, frankly, I'm not sure, having
6 dealt with participants firsthand, has a real place inside of
7 retirement funds, is the lifetime where this is the
8 methodology where fund companies are looking out for the
9 benefit of participants saying you need retirement benefits
10 well beyond retirement, and this is something that has not
11 been disclosed adequately to plan participants.

12 Very often the mutual fund explanation to
13 everything in regard to investments is it's in the
14 prospectus. Asking somebody who's financially illiterate to
15 read a prospectus is not realistic.

16 An example that I did is while there are 153
17 different 2010 Target Date Funds, there is 32 in the A share,
18 which is the lowest expense ratio of the institutional.
19 I went through the 32 myself yesterday. And what I was
20 looking at is I was looking at from highs to lows.

21 The best performing fund in 2008 was minus 3.5
22 percent. The worst performing fund was in excess of minus 41
23 percent. The best performing fund had 90 percent bonds,
24 which, in my opinion, is proper for somebody who's going to

1 be retiring in the year 2010.

2 The worst performing fund had 31 percent bonds or
3 in excess of 69 percent of the assets in equity. To me, this
4 is complete system failure for the financially illiterate
5 participant inside of retirement plans.

6 What has made this situation exponentially worse is
7 that as part of the Pension Protection Act of 2006, the
8 Department of Labor, again, as we've discussed, has approved
9 three different types of funds with target dates being one of
10 those funds. This coupled with automatic enrollment has been
11 like pouring fuel on a fire.

12 The solution I recommend is this. There needs to
13 be clear categorization of the Target Date Funds. Call them
14 target date retirement. Have another category called target
15 date lifetime. They need to be clearly categorized and rated
16 as such.

17 There needs to be mandatory suitability questions
18 provided by vendors to plan sponsors. People need to know
19 what they're buying and ultimately providing to their plan
20 participants.

21 There needs to be real information to plan
22 participants. As somebody who does both group and individual
23 meetings, I have had people walk in and look me in the face
24 when they have lost 30 to 40 percent, and these are people

1 that understand. Many people in Target Date Funds just got
2 run over by a truck and don't know why.

3 In conclusion, participants have been misled. I
4 agree with Senator Kohl's comments that inadequate oversight
5 could jeopardize American's retirement security. And I will
6 take that one step further and say inadequate oversight has
7 jeopardized many Americans' retirement security.

8 Many Americans who know that they're far from being
9 financial experts bought into the target date concept,
10 trusting that what they had bought had been investigated and
11 was all it appeared to be. Many of these people, people I
12 see every single day, may never be able to retire.

13 This morning, my wife and I, we were having a
14 conversation about this panel today, and she asked me if a
15 person could convert their lifetime target funds to
16 retirement target funds. I said that -- could it convert
17 their -- that's correct, their lifetime to target. While the
18 answer's a simple yes, they would be locking in a loss that
19 they would never recover from. Their only hope at this point
20 is to remain in the unsuitable aggressive investments and to
21 hope that this volatile market can recover in time for them.

22 People have worked too hard for too long for their
23 nest eggs, but because of carelessness, they're not going to
24 be able to retire. They expect better, deserve better, and

1 as everybody involved with these, we need to do better.

2 Thank you.

3 MR. DOYLE: Thank you.

4 Questions? Okay. Just to kind of follow-up on
5 your last point about the failure, and I guess more
6 specifically where you see the failure arising. Is this a
7 communication issue that when one looks at the description of
8 these funds it's not clearly articulated? Is it the
9 investment strategy? The asset allocation? Glide path?
10 What is it that one would do?

11 Because I guess at a superficial level, and as
12 we've thought about it in the kind of QDIA context, as a
13 default with respect to participants who have potentially
14 opted not to actively participate themselves and make
15 investment decisions on their own behalf, but having a
16 mechanism, not necessarily a particular product, but a
17 mechanism that undertakes on their behalf a gradual decrease
18 in the kind of the mix from equity to more conservative
19 investment made sense.

20 What did we do wrong here? What -- or what can we
21 do better?

22 MR. KRASNOW: In my opinion, I think what's gone
23 wrong is that there was a great concept put out there of
24 Target Date Funds. The concept is great. For the

1 uneducated, you know that when you're 25 years old, you
2 should be aggressive, and when you're 55 years old, you
3 should be conservative. It's remote control investing that's
4 going to age with you.

5 But what was not put on to -- was any sort of
6 requirements or regulations on the investment companies
7 themselves. Every different company, and I've sat here for
8 the last couple to three hours and heard everyone's own
9 commercial and own methodology, there needs to be uniform
10 methodology or restrictions put on the Target Date Funds. If
11 you categorize a Target Date Fund that is based on your --
12 the year you're going to retire, then the bond and equity
13 component would hold in place.

14 But part of the J.P. Morgan study illustrates that
15 there's four different boxes where, frankly, every company
16 has been allowed to put their own stamp on that. As a result
17 of that, it has been a free for all, and the company that
18 finished worst in performance in 2008 was near the top in
19 2007. Why? Because they had a high equity performance.
20 They were cheating to get higher percentage rankings, which
21 gets more equity, which gets more -- again, and I mean no
22 disrespect. It's an absolute free for all.

23 And so it needs to be regulated. It needs to have
24 simply like an investment policy statement on the retirement

1 years that will track it. We can't be in a situation, if we
2 have another 2008, with the amount of equity that people are
3 going to retire in 2010 are losing between 35 and 40 percent
4 of their retirement overnight.

5 MR. DOYLE: But do you accept the proposition that,
6 in defining the glide path, so to speak, it would be
7 reasonable to take into account if their defined benefit plan
8 or other benefit so that there would be variations in how the
9 glide paths are determined from plan to plan?

10 MR. KRASNOW: And I do believe there should be
11 variations. There is no one right answer for everything
12 across the board, but it needs to be disclosed.

13 MR. DOYLE: Well, that's what I'm getting at. So
14 is this an issue where the plan sponsor -- let's just start
15 with the plan sponsor. They're kind of the first line of
16 defense, so to speak, for the participant. They're actually
17 choosing the fund or funds to make available. Are they not
18 understanding how these funds operate?

19 MR. MOORE: In some cases there are Target Date
20 Funds and there are 30 or 50 or 100 other funds as well, so
21 it's -- they're offering a smorgasbord of choices for
22 investment for participants.

23 The issue is matching up the risk tolerance with
24 the investment. And as long as the participant understands

1 that the -- that there is a risk or recognizes what the risk
2 is for a particular investment and feels comfortable with
3 that, and it goes down 30 percent or 40 percent, then that's
4 okay.

5 But those that got blindsided because they didn't
6 recognize -- they thought they were buying something
7 different than what they were actually buying, that's the
8 issue.

9 At our firm as registered investment advisors, we
10 have an investment program and we have 70 different
11 portfolios from super conservative to super aggressive. We
12 actually have something that we call a guide to portfolio
13 selection where someone goes in and they answer a series of
14 questions and they come to a particular portfolio. By doing
15 that, then there's a match.

16 So if they're aggressive, they're conservative,
17 they want to invest for the long-haul or if they want to pull
18 all their money out in two or three years, their investments
19 will be dramatically -- tailored dramatically differently.
20 And I think that's what's lacking, is the understanding by
21 the participants of what they own.

22 MR. KRASNOW: And my simple answer is no, I do not
23 think the plan sponsors often understand. I think they rely
24 heavily on the advisor, the vendor, and then top down also in

1 regulating bodies such as the SEC and Department of Labor to
2 patrol them.

3 One of the things that we provide for all of our
4 clients on a quarterly basis is we do a review of all funds,
5 and we break them into specific categories. We're going to
6 benchmark every large cap value fund versus every other large
7 cap value fund. In comparing the two 2010 Target Date Funds,
8 it's like comparing an elephant versus a zebra because
9 they're both animals. They're different animals, and they
10 need to be differentiated, but that's what we're doing.

11 Everything has been lumped into one thing. And so
12 the disclosure is not there, and I think it starts with
13 differentiating between classes, and then it needs to be
14 disclosure from a top down level, from the government to the
15 different vendors, from the vendors to the plan sponsors,
16 plan sponsors to plan participants.

17 MR. DOYLE: Okay. Thank you very much.

18 MR. DONOHUE: When you're looking at Target Date
19 Funds and trying to make some selection or some means of
20 selecting, typically for funds one can look at past
21 performance at least in terms of how a fund has behaved, get
22 a sense of what was maybe the worst period that they had.
23 But here you have funds that, by their nature, are changing
24 their allocations over time, which makes that, I would think,

1 information less useful unless you have attribution in terms
2 of where returns were coming from so that you could get a
3 sense of whether -- if it was really -- most of their
4 performance was, their positive performance was coming from
5 equities and they weren't doing a really good job with bonds.

6 But the noise from the equity outweighs what was
7 going on in the bonds, but if it's moving heavily into bonds,
8 one would then anticipate, at least with respect to possible
9 outcomes, that this fund will not perform quite as well as it
10 has in the past relative.

11 How would you address that? Or how do you address
12 it?

13 MR. KRASNOW: How do I address it. The first thing
14 is that, and I'm going to say that people who step into
15 retirement plans as advisors but don't do it on a daily
16 basis, they do it as maybe you're a stockbroker who's doing
17 it for a friend, they're often guilty of chasing performance,
18 which is a dangerous game. You're chasing the return after
19 it's been done.

20 What we do is we dig into the statistical
21 information and the analytics of the fund. And so we saw the
22 storm arising several years ago with the lifetime funds, and
23 we have steered our clients clear of the lifetime target date
24 theory. We have stuck to the retirement. While we very much

1 counsel our participants that retirement doesn't end the day
2 you retire and get your gold watch and walk out the door, you
3 need to make sure you've got income sustaining for the rest
4 of your life.

5 We don't feel like it's the proper due diligence of
6 our plan sponsors to make the decision for you today at age
7 55 that's on a glide path going until 90. We want it to be
8 until your retirement, age 65. So we dig into the statistics
9 and the analytics, and we disclose, and our clients are aware
10 of the two different types of Target Date Funds.

11 And frankly, I read the article about this and was
12 so passionate about it that I responded and, again, very
13 pleased to be here today to kind of state my opinions because
14 I think everyone has got their heads and hearts in the right
15 place, but it's not being delivered with the way that it
16 could or should be. And unfortunately you don't realize that
17 until we have a year like 2008 to kind of slap us all in the
18 face a little bit.

19 Did I answer your question, sir?

20 MR. DONOHUE: (Nodding.)

21 MR. KRASNOW: Okay. If not, just -- I'll come up
22 for air at some point, so.

23 MR. PIACENTINI: Let me ask a different question.
24 So you're saying that you favor the approach where you have a

1 very low concentration of equity at the retirement date.
2 Other witnesses in earlier panels have said that with that
3 strategy you actually end up with a higher possibility of
4 running out of money or if you live a long time or if you
5 live in a high inflation environment, you're trying to have a
6 steady income stream you're taking out, you actually need the
7 stock. Without it you'll have a higher possibility of
8 running out of money.

9 Do you think that analysis is just wrong, the
10 conclusion is wrong or, if not, then why do you still hold --

11 MR. KRASNOW: I'm not going to say that that is
12 wrong. I'm going to tell you my opinion from meeting with
13 individuals who work in manufacturing facilities in
14 Cleveland, Ohio, is that these people are looking at the
15 finish line, which is retirement. And we want to educate
16 them on what's going to take place post retirement and how
17 they need to, whether it's annuities or Social Security or
18 other form of income or pension plans, they need to make sure
19 they've got that income in place for the next 25 to 30 years.

20 In my opinion to have people who have got more than
21 five years in more than probably 30 percent equity, in my
22 opinion, and that's all it is, in my opinion, that's
23 irresponsible. I understand that you have to have different
24 investments to keep the income sustained, but with a

1 five-year duration or shorter, you're taking on a lot of risk
2 and not giving yourself the opportune time to recover.

3 MR. MOORE: And I would just respond by saying that
4 as long as an individual knows that I'm either going towards
5 the finish line at age 62 or 65 or I'm going to be invested
6 for a lifetime. The problem with doing it at age 65 is when
7 that person retires and they're 90 percent in bonds, then
8 they're going to have to then pack their bags and go to some
9 other form of investment, be it their bank or with an
10 investment advisor or some other vehicle because that's
11 probably not an appropriate allocation for them for the next
12 25 or 30 years of their life.

13 MS. TUTTLE: We have actually as well published
14 research looking at ways to handle longevity risk, and in
15 some cases that is a use of annuities. By setting aside a
16 relatively small amount of the portfolio at retirement, an
17 annuity can be purchased, which will begin to pay out at age
18 85. Now you're able to maximize the use of that portfolio
19 around a finite time frame, which is actually able to raise
20 the amount of income that the participant could experience.

21 MR. MCGATHEY: I think, likewise, it's important to
22 differentiate between the full lifecycle versus the
23 accumulation fund, because by making that distinction and
24 offering people the choice, you begin to help them understand

1 the two different approaches to Target Date Funds.

2 So by differentiating whether that's -- there needs
3 to be something in the name so that not all funds that carry
4 the same date are perceived as being the same by offering
5 them the choice. One being different from the other, they'll
6 begin to understand the two approaches to Target Date Funds.

7 And I think it's not necessary necessarily for us to decide
8 or certainly for me to decide which is better. Participants
9 will decide which they want.

10 The important thing is for them to understand the
11 difference. And one of the ways that you help people to
12 understand the difference, I believe, is by naming those
13 differences and making that distinction sort of public and
14 up-front, easy for them to find as opposed to being somewhere
15 else by comparing glide paths on prospectuses or fund sheets,
16 make it something that's obvious, discernable, easily
17 differentiable one from the other.

18 MR. DOYLE: One more question.

19 MR. SCHEIDT: Is there any information that is not
20 contained in the fund prospectuses that would be helpful to
21 you as investment advisors in advising your clients about
22 Target Date Funds or is there a better way of presenting that
23 information that is already in there to make your jobs
24 easier?

1 MR. KRASNOW: The first part of your question, is
2 there additional information, there are many -- and there's a
3 lot of people that don't know this. There's a lot of
4 prospectuses that also have a supplemental prospectus, the
5 second piece of that.

6 Frankly, I think what you ought to do is we ought
7 to provide almost like a summary plan description of the
8 prospectus which breaks down the highlights and details of it
9 in something that your average 22-year-old could read and
10 understand.

11 And so we've had some super intelligent people up
12 here today, but would the average person understand what they
13 were saying or the methodology of what they're meaning? The
14 answer is probably not. And so to the best of my knowledge
15 it's all covered in the combination of prospectus and
16 supplement prospectus, but by throwing a dictionary at them
17 isn't solving it.

18 And somebody said it before, sometimes too much
19 information isn't the right answer. Sometimes less is more.
20 Almost a summary plan description of the prospectus in a
21 couple of pages telling them the expenses, the objectives,
22 the asset allocation. At the end of the day, participants
23 are financially illiterate, and, again, 70 percent plus, and
24 a lot of them are still not going to do it. But I think we

1 have an even better chance to reach them by doing something
2 more simplified.

3 MR. SCHEIDT: Help is on the way. The SEC just
4 adopted rules requiring funds to provide that sort of
5 information in short form.

6 MR. KRASNOW: So that wasn't my idea? Okay.

7 (Laughter.)

8 MR. SCHEIDT: It's a good idea.

9 MR. MOORE: Just one other quick point on the
10 prospectus, when it says that equity exposure could be 20 to
11 90 percent, that's what a -- that's what you'll read in a
12 prospectus, and that's just not definitive enough for an
13 investment advisor to select that fund, so we look more at
14 actual, what they're actually doing as opposed to what they
15 state in the prospectus.

16 MR. DOYLE: Okay. Thank you gentlemen.

17 Our utmost appreciation for the patience of our
18 last panel. It's been a long but incredibly informative day
19 at this point. We appreciate your hanging in there.

20 MR. DREW: Well, good afternoon, and thank you very
21 much for the opportunity to testify before this committee on
22 the subject of Target Date Funds. My name is Mike Drew. I'm
23 a professor of finance at the Griffith Business School.

24 I have to disclose this afternoon that I'm also a

1 member of the Investment Committee of QSuper, the pension
2 fund for public servants in the State of Queensland in
3 Australia, so therefore the views I express today are mine
4 and do not necessarily reflect the views of the QSuper Board
5 of Trustees.

6 Colleagues, given the detailed discussion we've had
7 today about the glide path, I'd like to open with an aviation
8 analogy. As is very well known and well-documented, the
9 majority of general aviation accidents occur during take off
10 and landing. The setting of the glide path is, that is the
11 aircraft's line of descent to land, is a deceptively complex
12 problem.

13 While principles exist, for instance, a
14 conventional aircraft let down to a runway is typically along
15 a glide path of three degrees, the experience of the pilot,
16 advanced instrumentation and ground-based equipment must work
17 in concert to mitigate under- or overshooting. This analogy
18 lies at the heart of my testimony today.

19 Target Date Funds employ pre-determined age-base
20 rules that switch the asset allocation through time, and
21 typically it's a unidirectional approach to the problem.
22 However, airplanes, like Target Date Funds, do not operate in
23 a vacuum. Issues like the GFC and the changing correlations
24 of portfolio components within these funds require careful

1 management. Accident prevention programs train pilots to
2 deal with the effect of wind shears on the glide path to
3 insure a safe landing, so we could, for the sake of argument
4 this afternoon, think of the GFC as an extreme form of wind
5 shear.

6 Why, then, in the current design of Target Date
7 Funds, do we not incorporate downside volatility events like
8 the GFC as a feedback mechanism to evaluate the glide path of
9 lifecycle funds?

10 With my colleague, Dr. Anup Basu from QUT, we've
11 undertaken research that considers the various wealth
12 outcomes under conventional lifecycle asset allocation rules.
13 These findings are available in the current edition of the
14 Journal of Portfolio Management and have been submitted for
15 the record.

16 Our evidence suggests that the general increase in
17 portfolio size as one approaches retirement is significant
18 from an asset allocation perspective. It is our conjecture
19 that the key issue for the design of Target Date Funds is to
20 decide when you expose the largest amount of money to growth
21 asset classes such as equities.

22 To operationalize these ideas, we examined the case
23 of a hypothetical retirement plan participant with an
24 investment horizon of four decades. We consider hypothetical

1 strategies, which we term contrarian strategies, which invest
2 none or much less in volatile -- in less volatile assets like
3 bonds and cash when participants are younger and then switch
4 to stocks as they get older; that is, we test the mirror or
5 reverse direction of conventional TDFs. We then look at the
6 final wealth outcomes and evaluate them against traditional
7 or conventional lifecycle products.

8 Using stochastic simulation techniques, we find
9 that the contrarian strategies defy conventional wisdom.
10 Switching to risky stocks from conservative assets over time
11 produce far superior wealth outcomes in all but the most
12 extreme cases; that is, the 5 percent worst outcome or
13 beyond.

14 Importantly for the design of these default
15 products, the outcomes are not symmetrical. For the worst
16 outcomes the difference between the conventional and the
17 contrarian is only about 8 percent. We're talking tens of
18 thousands of dollars at retirement, relatively immaterial.
19 However safe the 90th percentile, the difference is around 55
20 percent and is around a million U.S. dollars in terms of the
21 contrarian outperforming the conventional.

22 This demonstrates that the size of the portfolio at
23 different stages of the lifecycle exerts substantial
24 influence on the investment outcomes and therefore should be

1 carefully considered when making asset allocation decisions.

2 It is very important to stress that we are not
3 advocating that contrarian approaches to lifecycle funds are
4 the most appropriate way forward. What our research has
5 confirmed is that from a risk/reward perspective, by
6 investing conservatively during such a crucial phase,
7 lifecycle strategies recommended by many advisors may
8 sacrifice significant growth opportunities and can be counter
9 productive to the participant's wealth objective.

10 More importantly, this does not seem to be
11 compensated adequately in terms of the risk of potentially
12 adverse outcomes. In short, conventional Target Date Funds
13 seem to provide very limited downside protection while
14 materially capping the upside potential. Is there a
15 solution?

16 In our current working paper with Dr. Alistair Burn
17 from the Edinburgh Business School, we explore what we call
18 the next generation of Target Date Funds that take a dynamic
19 approach to the asset allocation problem. Dynamic TDFs have
20 at their core a performance feedback loop that keeps risk on
21 the table when investors are below the target balance and
22 provides de-risking of the fund when investors are ahead of
23 their savings goal.

24 The research findings are encouraging in that the

1 dynamic lifecycle funds considered in the paper have
2 favorable risk/reward characteristics against conventional
3 Target Date Funds. They seem to fall in a superior manner
4 even against static asset allocation balance funds. And the
5 thing that's most encouraging about the research is that up
6 to certain accumulation targets, they dominate a 100 percent
7 stock portfolio.

8 In summary, the idea of lifecycle or Target Date
9 Funds where risk is reduced on the basis of age is a very,
10 very elegant concept indeed. However, as our aeronautical
11 colleagues have taught us, the glide path is a deceptively
12 complex problem, and it is much more than a simple,
13 predetermined rule.

14 I would like to formally acknowledge and thank the
15 Vice Chancellor of Griffith University, Professor Ian I.
16 Conner, the Pro Vice Chancellor of Business, Professor
17 Michael Powell and our Department Chair, Professor Christine
18 Smith, for supporting my travel to attend the hearing today.

19 Thank you again for the opportunity to testify, and I
20 sincerely look forward to your questions.

21 MR. DOYLE: Thank you.

22 MR. TOBE: Thank you for letting me appear here
23 today. My name is Chris Tobe. I am a senior consultant for
24 B Cap, an institutional pension consulting firm in

1 Louisville, Kentucky, and also a trustee for a large public
2 pension plan. I've been a state regulator and was a major, I
3 guess, critic of this, of Target Date Funds in the 2007
4 letters as a member of the stable-value industry.

5 So I was kind of there from the beginning and have
6 always thought that the target date industry has kind of been
7 flawed because, again, we, you know, what's happened in
8 reality is an oligopoly has come out to dominate market
9 share, and, of course, it's very high fees for a handful of
10 firms.

11 And however, I think there are specific actions
12 that DOL and SEC can take to make diversified portfolios,
13 including Target Date Funds, work better for investors. And
14 I'll get to that.

15 So the target date industry is really, when we take
16 a look at it from a big picture, is an oligopoly of four or
17 five providers dominating the market. And once a plan
18 chooses from one of the oligopolies, then they lose pretty
19 much control of the selection of the underlying managers for
20 their risk return and underlying fees, and these providers
21 have, in my opinion, no effective independent oversight as a
22 few mutual fund trustees may oversee 150 or more plans for
23 that same large firm making their oversight, in my opinion,
24 ineffective.

1 Now, DOL's QDIA mandate has, in my opinion, kind of
2 forced defaulted investors, some of the most vulnerable
3 people out there, from low risk/low fee, kind of what we call
4 stable-value products, into higher risk, higher fee and, in
5 this particular case, negative return target date products,
6 at least for the time being.

7 So you know, again, all government employees,
8 including those with the SEC and DOL, participate in the
9 Thrift Savings Plan. The Thrift Savings Plan, to 2002,
10 outperformed, an example, Fidelity, which is probably pretty
11 average of the higher equity ones, by nearly 15 percent in
12 2008, or 1500 basis points. Well, you know, reasonable --
13 well, equity allocations had a major part of that. Another
14 difference was that the TSP was allowed and was able to
15 invest in a stable-value-like fund called the G fund that,
16 again, helped its return.

17 Wharton Professor David Babble has stated that
18 target date mutual funds because they exclude stable value
19 are not on the efficient frontier making them inferior to
20 plans like the TSP who can use non-mutual funds. Again, some
21 of this goes back to the 2004 SEC decision to not allow low
22 risk/low fee stable-value mutual funds, which has effectively
23 prevented a lot of the current Target Date Funds from
24 providing some of the best risk return and outcomes for

1 participants.

2 Ten basic recommendations, and a lot of these are
3 really to do not only with Target Date Funds but the entire
4 industry which I think will be underlying things that can be
5 done by the DOL and SEC. I think the DOL should broaden fee
6 disclosure for all bundle options, but even try to work into
7 the bundle insurance companies -- I know that's getting a
8 little out of jurisdiction -- where there are many of these
9 plans that I call roach motel plans where you can check in
10 but cannot check out without paying a huge penalty. And I'd
11 like to see the DOL broaden themselves to some of these
12 insurance products.

13 I think that the DOL should redesign its compliance
14 structure around size of plans. This is a -- there's a \$4
15 trillion DC market out there. The top 1,500 plans make up
16 half of the assets. So two trillion is spread over 1,500
17 plans and the other two trillion is spread over 650,000
18 plans.

19 Some kind of tiered regulation where you would have
20 people looking at all the plans under one million, the plans
21 from one to 20 million and 20 million plus, I think, would
22 lead to better oversight. There's such a difference in fee
23 structures between these types of plans that I think that
24 some kind of tiering there would create more effective

1 regulation.

2 Again, I have a theory that I think that, you know,
3 if you do tier it, plans over \$20 million should have an
4 independent investment consultant to help select options.

5 Again, a lot of this is part of, you know, DOL and SEC
6 putting resources where the dollars are. If 80 percent of DC
7 assets are in four or five providers, you should maybe
8 consider more oversight for those particular providers.

9 One question is, I think, the SEC, and I alluded to
10 this before, should limit the number of mutual fund boards
11 independent trustees sit on to five since, I just took an
12 example, Fidelity, but there would be other ones that are
13 like it. Target funds, the trustees in Fidelity target funds
14 over see 161 funds. And again, I think again SEC should look
15 to get the majority of fund directors to be qualified. The
16 independent ones would also be varied to get more
17 specifications on how qualified they are.

18 I think that the DOL should reinstate stable value
19 as the fourth QDIA option so that people will have -- the
20 plans will have the ability to use that if they want to
21 instead of target date and other funds.

22 And of course, I think SEC should lift its ban on
23 stable-value mutual funds and re-look at that and that the
24 DOL should broaden its reach to both nonprofit 403(b) and 457

1 plans so they cover all Target Date Funds, not just the ones
2 in 401(k).

3 So that's all I have today, thank you.

4 MR. DOYLE: Okay. Thank you.

5 MR. FOLEY: Well, thank you for the opportunity to
6 testify and thank you for your fortitude in taking in all of
7 this information over the course of the day.

8 My name is Mark Foley, and I'm here representing
9 Prudential, which is a leading investment manager,
10 recordkeeper and guarantee provider for 401(k)s and other
11 qualified plans.

12 In defining default investment alternatives for DC
13 plans, the Department of Labor stated that one of its
14 objectives was to insure that, quote, "The regulation is
15 sufficiently flexible to accommodate future innovations and
16 developments in retirement products," unquote. My testimony
17 will focus on exactly the kind of innovations and
18 developments anticipated in the regulation as this first
19 generation, as a prior commenter said, most folks have got
20 their hearts in the right place but this first generation of
21 Target Date Funds is not finishing the job of providing
22 retirement security.

23 Participants remain vulnerable to critical risks
24 that threaten their ability to retire when planned. That

1 vulnerability was demonstrated in dramatic fashion during
2 2008 when even Target Date Funds designed for participants,
3 as mentioned earlier, retiring as soon as 2010 lost as much
4 as 41 percent of their value.

5 A secure retirement requires more than just a well
6 diversified portfolio. DC participants need to generate
7 retirement income and protect that future income stream. A
8 worker's ability to retire should not be dependent on the
9 current state of the financial markets. Target Date Funds
10 enhanced with income guarantees are part of the solution.

11 Here participants keep investing in the Target Date
12 Fund as they currently do. However, as the fund approaches
13 its target date and the participants approach retirement, an
14 income guarantee is activated. The specifics may vary, but
15 the guarantee will have five key features.

16 First, it generates an income base at the time of
17 activation, likely five to ten years before retirement. The
18 income base is used to determine a participant's guaranteed
19 level of retirement income. It initially equals the
20 participant's market value and can never be less than that
21 amount plus additional contributions.

22 Second, the income base may increase in the years
23 before retirement depending on market performance, but it can
24 not decline.

1 Third, after retiring the participant will receive
2 a guaranteed level of annual income for life set at a
3 percentage such as 5 percent of the income base at
4 retirement. In this example, a \$300,000 income base
5 translates into \$15,000 a year in lifetime income.

6 Fourth, during retirement the income base will
7 never decline as long as withdrawals don't exceed the
8 guaranteed level of annual income. It may even increase
9 depending on market performance.

10 Finally, both before and after retirement, the
11 participant retains full control of his or her assets and is
12 able to withdraw varying amounts of those assets.
13 Withdrawals before retirement will lower the income base
14 proportionately as will withdrawals after retirement that
15 exceed the guaranteed level of income.

16 It's important to note that these innovations were
17 anticipated in the regulation defining QDIAs which explicitly
18 allows Target Date Funds with benefit guarantees to qualify
19 as a QDIA.

20 With respect to fees, once the guarantee is
21 activated, a guarantee fee is charged and not before. It is
22 visible, transparent and fully disclosed to both plan
23 fiduciaries and plan participants. The asset allocation of a
24 Target Date Fund with an income guarantee safely enables

1 greater equity participation than a typical Target Date Fund
2 in the years both immediately before and after retirement and
3 hence potentially greater opportunity for growth.

4 This combination also provides critical flexibility
5 for the participant if, for example, unexpected health care
6 costs arise. This flexibility is particularly important
7 because many retirees are likely to find themselves in just
8 that position with major medical expenses at some point.

9 Finally, any assets remaining at the time of death
10 would be available as a bequest to heirs. This could be a
11 significant amount particularly if the markets had
12 appreciated during retirement or if the participant had a
13 short lifespan in retirement.

14 Combining Target Date Funds with income guarantees
15 adds additional levels of oversight and protection to
16 participants. Since the guarantees come in the form of
17 insurance contracts, they are subject to the rules and
18 requirements of multiple state departments of insurance.
19 These regulations include specific valuation and reserving
20 requirements to insure that the insurers can meet the
21 obligations of the guarantees.

22 Combining Target Date Funds with income guarantees
23 offers four unique benefits to retirement plan participants.
24 First, it provides a simple, automatic source of guaranteed

1 retirement income from the DC plan. Second, it provides a
2 straightforward way for participants to begin thinking about
3 their DC plan as a stream of retirement income rather than
4 just a pile of cash.

5 Third, it offers flexibility to meet unforeseen
6 emergencies because participants can always take out more or
7 less than their guaranteed amount. Paradoxically, the mere
8 presence of this flexibility may help more people feel
9 comfortable sticking to their plans and preserving their
10 source of retirement income rather than taking a lump sum.

11 Finally, it provides an incentive for participants
12 to keep their dollars in the qualified plan after retirement.

13 This keeps them under the watchful eyes of plan fiduciaries
14 and lets them enjoy the additional oversight afforded to
15 qualified plans by the Department of Labor and other
16 appropriate regulatory bodies.

17 At Prudential we know these kinds of solutions are
18 more than theoretical. As of March 31st over 120 plan
19 sponsor and several thousand of their participants have
20 enjoyed the flexibility, control and peace of mind afforded
21 by Prudential products with the kind of guarantees I just
22 discussed.

23 As the Department and the Commission consider how
24 to enhance the protections for plan participants, we would

1 ask that you keep in mind the space for innovations and
2 developments in retirement products including income
3 guarantees which can be part of the solution.

4 Thank you, and I look forward to your questions.

5 MR. DOYLE: Thank you, very much.

6 MR. BREMEN: I guess you saved the best for last.
7 Good afternoon and thank you for your time today. My name is
8 Ross Bremen. I'm a partner at NEPC in The Defined
9 Contribution Consulting Group. Sitting to my left is Steve
10 Charlton, who's head of all consulting at NEPC.

11 By way of background, NEPC is one of the largest
12 investment consulting firms in the country. Our investment
13 advice and recommendations are unbiased and without conflict.
14 We do not manage investment products. We accept our role as
15 a fiduciary and serve the singular interest of both plan
16 sponsor and the participants they represent.

17 Our firm consults to over 275 clients with assets
18 of nearly 300 billion, including over a hundred defined
19 contribution plans with total assets in excess of 70 billion
20 representing accumulated assets of a million participants.
21 NEPC has over a decade of experience working with Target Date
22 Funds, and virtually all of our clients have TDFs.

23 We're here today to represent the defined
24 contribution plan sponsors we work with and to share with you

1 the fact that over the last many years these sponsors have
2 spent a tremendous amount of time selecting and monitoring
3 their Target Date Funds. The potential outcomes of these
4 hearings that may result are of great interest to these plan
5 sponsors. They have concerns that proposed regulations could
6 undo important decisions that they've made with regard to
7 their plans.

8 Turning our attention to the facts at hand, 2008
9 was a sobering experience for market participants. The year
10 will be known for many things when historians do their post
11 mortems. It will likely be remembered predominately as the
12 year in which fundamentals were cast to the sidelines and
13 diversification did not work. Virtually every risk-bearing
14 asset class lost ground, some historically by wide amounts.
15 Active management recorded one of its worst years ever.

16 For years, NEPC has recommended reducing equity
17 exposures and maintaining returns through increased
18 diversification and use of alternative investments. Our
19 clients have done that, which is the reason why they have now
20 collectively outperformed national averages for 20 of the
21 23 years that we've been in existence.

22 Last year the median institutional portfolio was
23 down 24 percent. Data from J.P. Morgan indicates that
24 workers close to retirement were down 32 percent on average.

1 These numbers don't surprise us. They're consistent with
2 every other study that we've seen that institutional
3 investors outperform retail investors.

4 It's our belief that in absence of good,
5 diversifying alternative investments, equities need to be
6 held in high weights in Target Date Funds to meet income
7 replacement needs and to manage longevity risk. However,
8 high equity is NEPC's second best idea.

9 We tell clients that in a portfolio of 60 percent
10 equities, the equity content accounts for 90 percent of the
11 risk. Encouraging greater adoption of alternative
12 investments within Target Date Funds will reduce risk and
13 provide the returns participants need from these investments.

14 It will make Target Date Funds more defined-benefit like in
15 design.

16 Regulators should consider clarifying safe harbor
17 rules for custom target date solutions as these programs are
18 at the forefront of introducing alternative assets and have
19 produced, in many cases, better results than the packaged
20 products. Regulators should also consider whether daily
21 valuation is necessary or whether Target Date Funds would
22 benefit from a move away from daily valuation.

23 One of our main concerns is that regulation will
24 reduce the options available to plan sponsors as opposed to

1 increasing the options. We worry that additional
2 restrictions could guarantee the outcomes that they're
3 intending to thwart.

4 Now, let's turn our attention to another point.
5 Target Date Funds are the best of the three qualified default
6 investment alternatives. The market recognized it.
7 Participants bought into it, and the regulators supported it.

8 Any effort to unwind the QDIA regulations would be a
9 significant step backwards in our view.

10 On the matter of whether investors understand
11 Target Date Fund risk, we must recognize the limits of what
12 we can realistically achieve with education and
13 communication. We cannot make the average investor, the
14 average American, an investment expert. Two equity funds are
15 difficult to tell apart from one another. Why would two
16 Target Date Funds be any different?

17 Products with similar names, 2010 for example, can
18 have very different equity contents, and that's okay. Today
19 plan sponsors make the decision on which target date series
20 to offer in their programs. And in our experience they make
21 very informed and considered decisions, decisions that are
22 right for their populations. Regulations that make Target
23 Date Funds more uniform are not needed and placing limits
24 around innovation and choice is generally not a good idea.

1 Along the lines of innovation, participants could
2 benefit from greater use of guaranteed income solutions to
3 offset the real concern of longevity risk. Clarification
4 around the use of insurance products in Target Date Funds and
5 as the QDIA could be a tremendous catalyst for progress. The
6 current regulations do not give sponsors comfort and they are
7 rightfully hesitant to partner with an insurance company for
8 what might be a 60-year commitment without some sort of
9 support or protection.

10 In conclusion, the unfortunate truth is that the
11 dominant retirement savings system in the U.S. requires the
12 average American to be an investment expert. TDFs represent
13 the best efforts to date to de-mystify retirement investing
14 for the average American and the best way we believe for most
15 defined contribution programs to meet their ultimate goal.

16 Regulators should encourage the continued
17 development and evolution of TDFs. Any efforts to mandate or
18 legislate the equity content in Target Date Funds would be
19 bad for the industry and bad for Americans, particularly if
20 the regulation leads managers to shift more assets to cash
21 and bonds than to diversifying alternative assets.

22 On a final note, we would also add that if
23 regulations mandated early participation in higher savings
24 rates, all of this would be a very different conversation.

1 We'd like to thank you for the opportunity to speak
2 with you today. NEPC recognizes the critical importance of
3 defined contribution plans for American workers and is
4 committed to working on their behalf to increase their
5 retirement security.

6 MR. DOYLE: Thank you.

7 MR. DONOHUE: A question for the panel excluding
8 Michael. Michael is the sole voice that has talked about an
9 alternative that seems to have outcomes that one would
10 embrace, but it seems to be different than the construction
11 that has happened for most. And I guess it's a shame,
12 Michael, we put you at the end because it could have been
13 interesting dialogue for some of the others.

14 But what's your reaction to Michael's research?

15 MR. DREW: Just say "good."

16 MR. TOBE: Yeah, good, good.

17 (Laughter.)

18 MR. TOBE: This is a difficult -- you know, this is
19 a difficult area. You know, there were so many good ideas
20 today, you know, and there's so many different ways of doing
21 this that you all have such a tough job of just trying to
22 figure out. But you know, I agree with a lot of the things
23 that Ross was saying. I mean, you really cannot -- you know,
24 right, you got to let innovation go in this market. There's

1 no way to regulate that. And I think that's the real theme
2 that I would -- that you can't really -- you can't put too
3 much regulation on innovation.

4 There's a lot of different ways to skin this cat,
5 and we got kind of -- as a regulator, I mean, you know,
6 there's -- you have very limited things you can do, and I
7 think limiting that would be a mistake.

8 MR. DREW: I concur with that.

9 MR. BREMEN: Yeah, I would agree. If a plan
10 sponsor took a look at a product that had an interesting and
11 clear methodology and it seemed to work and they felt that it
12 would be appropriate for their participants, then a plan
13 sponsor should have the ability to include that option for
14 their plan.

15 MR. TOBE: But I've always been a freedom of choice
16 proponent. Again, when I wrote the 2007 letter, one of the
17 issues that some participants wanted to keep a -- they had a
18 very -- a work force that may have had a DB plan or had --
19 was only -- the average worker only worked three or four
20 years for them, so a stable-value was still an appropriate
21 QDIA for them. So you know, as flexibility for the plan
22 sponsor has been something, you know, in support of, you
23 know, Target Date Funds and other options need to be held out
24 so that they can do that.

1 MR. PIACENTINI: I have a question for Mr. Foley.
2 When you were talking about the income guarantee product, you
3 gave an example of a 5 percent withdrawal rate. Was that
4 intended to be a realistic number or is that just
5 illustrative? Is that actually the amount in a product like
6 that that can be taken out every year, and if so, beginning
7 at what age?

8 MR. FOLEY: What we typically see in the
9 institutional marketplace is 5 percent would be a realistic
10 amount. It will vary depending on the solution, but that's
11 typically starting at age 65, but that would be a viable
12 percentage.

13 MR. PIACENTINI: Okay. And just -- I don't know if
14 you have an answer for this, but in rough order of magnitude,
15 the example you gave was a \$300,000 balance that would then
16 be drawn down at this 5 percent rate -- I guess not actually
17 not drawn down, the balance would be retained.

18 MR. FOLEY: No, the source of income in this
19 solution is taking withdrawals from the Target Date Fund and
20 the promise is that, if the withdrawals in the investment
21 performance exhaust the Target Date Fund, then the insurer
22 would be making payments. So the critical thing that it
23 avoids is the irrevocable annuitization decision that
24 otherwise accompanies more traditional forms of annuity.

1 That's where you get the flexibility and the control for the
2 participant.

3 MR. PIACENTINI: Okay. That's all right. Now I
4 understand. And to make this work, you said there is a fee,
5 a guarantee fee.

6 MR. FOLEY: That's correct.

7 MR. PIACENTINI: And the order of magnitude of that
8 relative to the numbers you gave?

9 MR. FOLEY: In the institutional marketplace,
10 again, it's going to vary. A reasonable proxy would be 1
11 percent or 100 basis points.

12 One thing I would note is that when you look at
13 that fee combined with a Target Date Fund's investment
14 management fee, which for round numbers would be anywhere
15 from 50 basis points to a hundred basis points, if you
16 compare that solution on an all end cost of roughly 150 to,
17 say, 175 basis points, to get a comparable solution,
18 because such solutions are available in the retail market,
19 they will typically run, based on the latest NAV Morningstar
20 data, in the order of 3.25 to 3.5 percent in total.

21 So these solutions really do have the ability to
22 deliver institutional pricing and some of the benefits I
23 mentioned relative to the involvement of the plan fiduciary
24 and their execution of their fiduciary responsibility in

1 evaluating these.

2 MR. DONOHUE: Mark, a follow-up question on that.
3 Do you impose, then, restrictions on the portfolio in terms
4 of -- if it starts -- loses half its value that it has to go
5 more into bonds? Are there any requirements?

6 MR. FOLEY: In the solutions that we offer in the
7 institutional market, we need to evaluate and underwrite the
8 investment guidelines and the glide path before we bring the
9 fund on board. Once we bring the fund on board, as long as
10 it's following those guidelines, we do not require any
11 changes to that. That's part of the risk that we're
12 accepting as an insurer.

13 MR. BREMEN: If I could just add a few comments
14 relating to just insurance products in general. It's clearly
15 one of these areas where innovation needs to be allowed to
16 continue unless the government and regulators wanted to push
17 it along. Insurance products are very interesting, right?
18 They provide a guarantee, to combat longevity risk, that
19 participants always have an income stream.

20 But there are challenges with income solution
21 products. For example, if you look at what the regulations
22 say today -- and we're speaking about this. These are the
23 conversations that we have with plan sponsors, is they
24 evaluate these products. If you look at what the regs say

1 insurance products, annuities are not precluded from being a
2 QDIA. So the word is precluded, so the implication is that
3 annuities may be okay, but are they truly recommended?

4 If you look at what the final annuity regs say from
5 a selection perspective, one of the requirements is that a
6 sponsor has to be able to evaluate the ability of the
7 insurance provider to meet its obligations, which is, as we
8 said, you certainly could be -- you could have a relationship
9 with the investment for 60 years, and as we've seen in more
10 recent periods, especially most recently, insurance companies
11 can certainly have troubles of their own.

12 As it relates to the characteristics of the funds
13 specifically, we've already talked about fees in response to
14 a question, but there are also issues around portability. A
15 lot of these products are set up with certain plan
16 recordkeepers and not others, and so if a plan sponsor moved
17 from one recordkeeper to another, they might have to give up
18 the benefit that participants have been paying for for years.

19 Also, if participants were in the income solution and then
20 they move out and then they move back in, they've given up
21 the annuity benefit that they've accumulated.

22 So we've already also talked about the best in
23 class question. Are these the best in class investments or
24 are they proprietary in nature?

1 So this is clearly one of those areas where if
2 regulators start to put restrictions around products, you
3 might not see what might be one of the best products for
4 participants come to fruition, unless, of course, the
5 government wanted to take the position that these things are
6 excellent, and by the way we recognize that there are some
7 issues with the insurance industry and we're going to provide
8 a backstop of last resort to make everyone feel comfortable.

9 MR. PIACENTINI: I have one last question for
10 Professor Drew. So if I understood, you were talking about a
11 possible product design where de-risking, as you called it,
12 would be tied to approaching or reaching your target rather
13 than to age. And I guess my question is when you say
14 "de-risking," is that potentially compatible with moving into
15 what we've just talked about as an income guarantee type of
16 product?

17 MR. DREW: Yes, thank you very much for the
18 question. If I could respond with sort of a paraphrase from
19 the chairman of Berkshire Hathaway, when it comes to playing
20 bridge, he says, it pays to look at the cards. And that's
21 essentially the analogy I'm giving today is that we see a lot
22 of Target Date Fund design as investment managers fighting
23 essentially with one arm tied behind their back because
24 they're heading toward some nebulous goal of a large amount

1 of money in accumulated balance. This tends to throw all
2 sorts of risk management strategies out.

3 So we find a great deal of difficulty in the
4 efficacy of age-based or simply switching on the basis of age
5 we can't find empirical support for it. Even when you look
6 at the worst outcomes -- and as some previous panels have
7 said, like investment classes correlate to plus 1 and they
8 all go down. So whether you're in a conservative,
9 aggressive, 100 percent equities, when you look at the
10 economics of the balance in the worst sort of, you know, 5,
11 10 percent outcomes, the annuity stream you can purchase is
12 very poor indeed. It doesn't matter what you're in.

13 But by going through a system where you are taking
14 this risk off the table without looking at the target, you're
15 actually capping the -- distribution which is the big problem
16 with the -- we argue, which is the problem with this sort of
17 fund design. So we even could foresee a day where in the
18 sort of innovations we're presenting in the next generation,
19 the de-risking process, as you said, could be thought of as
20 even banking returns and buying longevity products and things
21 like that with those kind of returns.

22 But the anchor is always there. The feedback
23 loop -- why would you today post the GFC for a 45-year-old
24 crystallize losses today because the glide path is sort of on

1 autopilot to take risk off the table today?

2 You know, if you think about distribution of
3 returns, you know it's highly skewed and highly peaked. And
4 you've got to get all of these sort of small positive returns
5 to get yourself out of the draw down. And all you're
6 actually doing by following this sort of blind glide path is
7 you're removing the -- distribution to get you out of the
8 hole.

9 So that's the idea is that, respectfully, what
10 we're doing is we're anchoring one corner of the triangle in
11 the next generation of Target Date Funds. Richard before
12 said it could risk-based. It could be 10 to 12 times your
13 accumulated, you know, pre-retirement salary. It could be an
14 income. That's irrelevant. We can lock the triangle in and
15 have the discipline of the feedback loop continuing through
16 time and absolutely part of annuity purchases, part of
17 longevity risk type products built in can be a standard part
18 of the design in the next generation.

19 MR. DOYLE: Thank you.

20 MR. CHARLTON: If I could just add to that. I
21 thought this was a great session, a great talk. And you
22 know, de-risking a portfolio comes in a lot of different
23 ways. We like to talk about it like a defined benefit type
24 portfolio where you can start to incorporate insurance and

1 guarantee that income stream over time. And you know, to
2 de-risk a portfolio, I think you could systematically take
3 pieces out of a portfolio and put it into an insurance-type
4 product to guarantee that income to do effectively what's
5 been described.

6 The problem is the hurdles that are in today's
7 system wouldn't allow you to do that as Ross was talking
8 about primarily because it's single insurer, you don't have a
9 multiple pool of insurance products, you don't have a final
10 backstop. In addition to that, fees, even at 1 percent, are
11 relatively high.

12 I think most in the institutional world would hope
13 that that number comes down and hope that the government
14 steps in and tries to force that number lower. You know, 1
15 percent plus the management fee, I think, is still too high.

16 So there are many factors at play here, and
17 probably the most important, that I think some of the other
18 panelists have mentioned is that most plans, defined
19 contribution plans, are designed to have a lump sum at the
20 day people retire or near thereafter so you effectively kill
21 exactly what we're talking about doing here today.

22 So you know, think about how that works. You
23 designed this program at the employer level. People invest
24 in this program and then you allow them to take all their

1 money out and put it somewhere else. You're effectively
2 taking out the best in all plan designs and allowing people
3 go and do whatever they want with it.

4 MR. DOYLE: Okay. Thank you very much. Now for
5 closing remarks.

6 MR. DONOHUE: On behalf of the Securities and
7 Exchange Commission, I would like to thank each of the
8 witnesses for your participation in today's joint hearing.
9 Your written submissions and most particularly your
10 participation directly with us today will greatly inform our
11 deliberations going forward. We have a lot to think about
12 and a lot to contemplate in this area as we determine what
13 actions might be appropriate.

14 I also want to take a moment to thank the staff of
15 the Department of Labor, most especially Robert Doyle, who
16 championed the idea of this joint hearing, but also Fred Wong
17 and Kristen Zarenko. You all made this possible and I thank
18 you for that.

19 Additionally I want to thank Jennifer McHugh,
20 counsel to the Chairman, and Tara Buckley of my staff for
21 their leadership in helping us to develop this joint hearing.

22 I thank my colleagues as well, and now I'll turn the
23 microphone over to Bob Doyle to officially close today's
24 instructive hearing.

1 MR. DOYLE: Thank you very much. And I, of course,
2 join you in thanking them. We are very blessed to have
3 wonderful staff that work so hard to make all this work so
4 smoothly.

5 Just kind of on a technical note to remind
6 everyone, we are going to keep the record open for 30 days to
7 allow those who testified today to supplement the record. We
8 will also accept any submissions on behalf of other
9 interested parties who did not have an opportunity to testify
10 today, and we will make every effort to get those, whatever
11 the submissions are, up on our websites as soon as we
12 possibly can.

13 And with that, again, we thank everyone for their
14 participation and we will formally close this hearing.

15 (Applause.)

16 (Whereupon, at approximately 5:30 p.m., the hearing
17 was concluded.)

18