

**Written Testimony for Joint Session of the
U.S. Department of Labor and the Securities and Exchange Commission
*On Target Date Retirement Funds***

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The U.S. Department of Labor recently sanctioned a new class of default investments for DC retirement plans (known as qualified default investment alternatives or QDIAs) under the Pension Protection Act. The aim of this new policy was to improve portfolio allocations among participants who fail to indicate a choice as to how their retirement accounts should be invested, so they may be ‘defaulted’ into an investment portfolio elected by the sponsor. One popular type of QDIA, known as lifecycle or target maturity funds, are investment options that radically simplify portfolio allocation decisions. In a lifecycle fund, plan participants invest in a portfolio based only on an expected year of retirement. The fund’s portfolio manager then takes responsibility for all portfolio construction decisions, including initial allocations, daily rebalancing, and portfolio changes over the lifecycle. Often these target date funds are selected by plan sponsors as default investments in the 401(k) context; as such they can alter portfolio allocations.

For several years, I have been studying the investment implications of including target date funds used by 401(k) plans. In one recent study, we focus on target date funds as mechanisms to “frame” investment decisionmaking, recasting what is for many a difficult portfolio allocation problem into a simpler one requiring employees only to forecast their likely retirement dates (Mitchell, Mottola, Utkus and Yamaguchi, 2009). We show, consistent with other studies, that there are important default and framing effects. Thus target date fund adoption rates among who use them as intended, putting all their retirement money in a given age-appropriate single lifecycle fund, are nearly 60% higher when the funds are designated as a default investment option. And in voluntary (non-default) settings, these funds tend to be held as a pure investment strategy by workers with characteristics often associated with low levels of financial experience and financial literacy - namely the young, low-income, and low-wealth investors (Lusardi and Mitchell 2008).

We also show that introducing target date funds has an important yet unexpected “spillover” effect, which is that many people adopt them as a *mixed* strategy, holding not only lifecycle funds but other investment options as well. Also surprisingly, the number of mixed investors is almost as large as the number of *pure* investors. Moreover, mixed adopters are typically in the middle-income and middle-wealth categories, and those felt to be unsophisticated or naive. Furthermore, the spillover effect also produces meaningful changes to these mixed

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adopters' portfolios, including reducing their extreme portfolio allocations, enhancing age-based variation in equity exposure, and reducing idiosyncratic risk.

In a related study, we show that portfolio products like target date funds which discourage active trading in 401(k) plans are likely to produce superior risk-adjusted returns and ultimately higher retirement saving (Yamaguchi, Mitchell, Mottola, Utkus 2006). High turnover rates in pension accounts surely harm investment performance, so funds that reduce transaction costs can improve returns. This is particularly important in the 401(k) context since, in the commingled investment offerings of most DC plans, transactions costs are borne by all holders, not just the traders. Target date funds are also most likely to appeal to workers lacking financial literacy, including women, the least educated, and the young (Lusardi and Mitchell, 2008).

In sum, "choice architects" who seek to remedy perceived deficiencies in individual decision-making with a 'behaviorally informed' strategies must look to empirical evidence on the actual impact these have on behavior. In the 401(k) context, we show that default and framing mechanisms do alter individual behavior, but the full impact of changing decision environments is much broader than might be expected. Because target date or lifecycle funds add no new asset classes to the retirement plans we examine, the spillover effect clearly measures the appeal of the unique decision framing they offer: that is, they replace the need to undertake a complex portfolio construction process with a simple requirement to indicate an expected retirement date. Understanding the potential spillover effects when altering choice architectures is thus essential, including the magnitudes of such effects and whether their impact is detrimental or benign.

References

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