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Target Date Fund Joint Hearing

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And

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Good morning, Chairman Schapiro and Deputy Secretary Harris. My name is Karrie McMillan, and I am the General Counsel at the Investment Company Institute, the national association of the U.S. mutual fund industry. On behalf of ICI and its members, which are entrusted with the retirement savings of 46 million U.S. households, I am pleased to testify here today about target date funds.

The Role of Target Date Funds in Retirement Savings

Defined contribution plans are a true success story of U.S. public policy. Institute research on public attitudes toward 401(k) plans tells us that Americans strongly support the current 401(k) system and greatly value the savings and tax incentives 401(k)s provide. They find that plans help them think of the long term and make it easier for them to save. Many households indicate they probably would not be saving for retirement if it were not for their defined contribution plans.[1] Contrary to popular belief, DC plan participants have stayed the course during the most recent market turmoil. Only 3.7 percent stopped contributing to their defined contribution plans in 2008, fewer than one in 25 took any withdrawal in 2008, and about one in seven changed the asset allocation of their account balances.[2] ICI estimates that 474,800 plans were serving 49.8 million active 401(k) participants in 2008.[3]

This hearing was inspired, in large part, by the market turmoil of the last two years—a bear market that is wider, deeper, and more unsettling than any in generations. That turmoil has taken a significant toll on retirement plans of all types. We are all mindful of the declining balances workers have seen—and that these declines are especially hard on workers nearing retirement. Because this downturn has hit a wide range of asset classes, diversified investments such as target date funds have not been immune. So we welcome this examination of how target date funds are constructed, used, and understood.

Target date funds are an important innovation used in defined contribution plans as well as in other individual retirement account savings vehicles. At the end of 2008, $109 billion invested in target date mutual funds was held in defined contribution plans, and another $31 billion in such funds was held in IRAs.[4] Institute data on mutual funds shows that target date mutual funds received $42 billion in net new cash flow during 2008 and $56 billion during 2007, compared to $22 billion in 2005 and $4 billion in 2002. In 2009, through the end of April, target date mutual funds received $13 billion in net new cash flow. As of the end of April, approximately $176 billion was invested in target date mutual

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[1] Investment Company Institute, *Retirement Saving in Wake of Financial Market Volatility* (Dec. 2008), available at http://www.ici.org/pdf/ppr_08_ret_saving.pdf.

[2] *See* http://www.ici.org/pressroom/news/09_news_recordkeeping.

[3] *See The U.S. Retirement Market, 2008*, ICI Fundamentals, vol. 18, no. 5 n. 22 (June 2009), available at http://www.ici.org/pdf/fm-v18n5.pdf.

[4] *See The U.S. Retirement Market, 2008*, ICI Fundamentals, vol. 18, no. 5.

funds.[5] At year-end 2007, more than two-thirds of 401(k) plans in the EBRI/ICI database[6] included target date funds in their investment menus.[7] In plans that offer target date funds, 37 percent of participants had at least some portion of their account in these funds. To put these statistics in perspective, about 7 percent of total assets in 401(k) plans in the EBRI/ICI database were in target date funds at the end of 2007.

Target date funds provide an efficient way for an investor to invest in a mix of asset classes through a single fund that both rebalances its asset allocation periodically and becomes more conservative over time. Research confirms that asset allocation is one of the most important factors in long-term portfolio performance. Target date funds invest in multiple asset classes, ranging from domestic and international stocks to corporate and government bonds and cash. To achieve the same benefits with a self-managed portfolio, an investor would have to select and monitor a number of individual funds and regularly transfer money between them. Target date funds are also designed to avoid the extreme asset allocations observed in some retirement accounts. Research shows that, left to their own direction, some young workers invest very conservatively, by allocating all, or almost all, of their accounts to fixed income investments, while some participants nearing retirement invest very aggressively, allocating all, or almost all, of their accounts to equity investments.[8] Target date funds follow professionally designed asset allocation models to eliminate such extremes.

Enhancing Understanding of Target Date Funds

It is important that employers selecting target date funds for plan menus, and 401(k) plan participants and IRA investors selecting target date funds for their retirement investments, understand the key

[5] This number only includes assets in registered open-end investment companies, or mutual funds. The Investment Company Institute tracks data on the assets of registered investment companies and does not have access to data for funds that are not registered investment companies, such as funds offered by banks or insurers.

[6] The EBRI/ICI database includes data on target date funds offered as mutual funds, collective investment trusts, and other investment vehicles. The EBRI/ICI database is the largest, most representative repository of information about individual 401(k) plan participant accounts. As of December 31, 2007, the EBRI/ICI database included statistical information about 21.8 million 401(k) participants, in 56,232 employer-sponsored 401(k) plans, holding $1.425 trillion in assets. *See* Holden, VanDerhei, Alonso, and Copeland, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007*, ICI Perspective, vol. 14, no. 3, and EBRI Issue Brief, no. 324, Investment Company Institute and Employee Benefit Research Institute (Dec. 2008), available at http://www.ici.org/pdf/per14-03.pdf.

[7] *See 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007*, ICI Perspective, vol. 14, no. 3, and EBRI Issue Brief, no. 324, *supra*.

[8] *See 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007*, ICI Perspective, vol. 14, no. 3, and EBRI Issue Brief, no. 324, *supra*.

features of the funds. Employers and investors should be aware of how a particular target date fund intends to reach its investment objective and what risks the fund's strategies might entail.

Target date funds are a type of balanced fund, and as is the case generally with balanced funds, their portfolio compositions can differ significantly. While all target date funds provide for more investments in equities for younger investors and more investments in fixed income for investors near or at retirement, the asset allocation paths, or glide paths, used by different fund providers vary.

The target date in a fund's name refers to an investor's expected retirement date, and all target date funds generally contemplate that an investor will stop making contributions to the fund at the target date. Some providers design their target date funds to reach their most conservative asset mix at or shortly after the target date. These funds place a higher priority on producing immediate income and preserving assets at retirement age.

Many other providers design their target date funds to reach their most conservative asset allocation 10, 20, or more years after the target date. These funds emphasize the need to earn higher returns at and after retirement age, in order to increase assets and generate income later in retirement. Target date funds also differ in the percentage of their initial allocation to equity, the rate at which they reduce equity exposure, the amount of equity exposure in their most conservative asset allocation, and whether a manager follows a preset glide path or can actively manage the asset allocation along the glide path within specified limits.

While target date funds that are mutual funds currently do a good job in describing their objectives, risks and glide paths in their SEC-mandated prospectuses and fund marketing materials, we do see gaps in the public's understanding of these funds. In early 2009, the Institute formed a working group of its members to assess how understanding of target date funds could be enhanced. The ICI Target Date Fund Disclosure Working Group included representatives from a broad range of member firms, representing more than 90 percent of target date mutual fund assets. The Working Group reviewed existing disclosures applicable to target date funds, determined that the public's understanding of target date funds could be enhanced by identifying key pieces of information that should be prominently conveyed by target date funds, and developed *Principles to Enhance Understanding of Target Date Funds* that spell out this key information and provide an illustration of sample disclosure.

All target date fund products used for retirement savings—whether offered by a mutual fund provider, a bank, an insurance company, or an investment adviser offering customized target date funds—can use these Principles. The Principles are not meant to substitute for disclosures otherwise required by securities laws or other applicable law. A copy of the *Principles to Enhance Understanding of Target Date Funds*, including a mock-up of a fund fact sheet that illustrates the Principles, is attached to this testimony.

The five key pieces of information are as follows:

First, *the relevance of the "target date" used in a fund name, including what happens on the target date*. A fund should explain that the date in a target date fund name represents the approximate year when an investor is assumed to retire and stop making new investments to the fund.

Second, *the fund's assumptions about the investor's withdrawal intentions at and after the target date*. Depending on the fund's design, a fund could explain that it is designed for an investor who will spend all or most of his or her money in the fund at retirement. Or, the fund could state that it is designed for an investor who plans to withdraw the value of the investor's account in the fund gradually after retirement.

Third, *the age group for whom the fund is designed*. The fund should indicate that it is designed for an investor in a specific age group or planning to retire at or about a specific year.

Fourth, *an illustration of the asset allocation path (or glide path) that the target date fund follows to reduce its equity exposure to become more conservative over time*. At a minimum, the illustration should highlight the asset allocation (in appropriate broad asset classes) at the target date and at the point at which the glide path is expected to reach its most conservative asset allocation. The fund should include a simple narrative explaining the same information. If a fund manager has the flexibility to deviate from the glide path, the disclosure should state this and include the applicable parameters.

Fifth, a *statement, added to the risk disclosure the fund provides, that the risks associated with a target date fund include the risk of loss, including losses near, at, or after the target date, and that there is no guarantee that the fund will provide adequate income at and through the investor's retirement*.

As an additional effort to enhance public understanding of target date funds, the Institute has published "Frequently Asked Questions about Target Date or Lifecycle Funds." These FAQs address a range of topics, including the meaning of the date in a target date fund name, why the asset allocations in funds with the same target date might vary, and how target date funds are regulated. The FAQs are available to the public on ICI's website,[9] and a copy is attached to this testimony.

Regulating Target Date Fund Names or Asset Allocations

Securities and Exchange Commission Chairman Schapiro, among others, has questioned whether the names of target date funds are confusing or misleading to investors and whether there are additional

[9] *See* http://www.ici.org/faqs/faqs_target_date.

controls that the SEC should impose on the use of a target date in a fund's name.[10] The ICI Target Date Fund Disclosure Working Group reviewed the current naming convention and considered alternative naming conventions or additional controls that could be imposed on the use of a target date in a fund's name.

When the Commission adopted Rule 35d-1, the fund names rule, it explicitly recognized that a mutual fund's name does not tell the investor all that he or she needs to know about the fund. In particular, the Commission stated that "[t]he Commission believes that investors should not rely on an investment company's name as the sole source of information about a company's investments and risks. An investment company's name, like any other single piece of information about an investment, cannot tell the whole story about the investment company."[11] Like the terms "balanced" fund, "growth" fund, or "value" fund, the target date fund name does not, and is not intended to, explain to investors all they need to know about the fund.

The target date in a fund's name refers to an investor's expected retirement date. That is the date an investor is assumed to stop making contributions to the fund—a key event that is taken into account in the design of *all* target date funds. We acknowledge that the reference to expected retirement age does not convey all the information that an investor needs to evaluate a target date fund. It does not state what the fund's allocation to stocks, bonds, and cash might be at that date, or indicate whether the fund is designed for an investor who plans to spend the assets at retirement or for an investor who intends to withdraw assets gradually.

Accordingly, we considered whether target date fund names should refer, instead, to the date at which a target date fund reaches its most conservative asset mix. After reflection, however, the Working Group did not endorse this approach for two reasons: it will not convey what the asset allocation is at that point, and it also will not inform the investor whether the fund is designed to provide the most conservative asset allocation shortly after retirement or at some later date. Given these weaknesses, we think that including a date at which the fund becomes most conservative in the fund name will not do a better job of telling the investor all he or she needs to know about the fund than does the current target date naming convention.

We also considered the possibility of not including any date in a target date fund name. Working Group members strongly believe, however, that omitting this reference point would provide investors

[10] *See, e.g.,* Testimony Before the Subcommittee on Financial Services and General Government by Chairman Mary L. Schapiro, U.S. Securities and Exchange Commission (June 2, 2009). Section 35(d) of the Investment Company Act of 1940 prohibits any registered investment company from adopting as part of its name any word, or words that the Commission finds are materially deceptive or misleading by rule or order. The Commission adopted Rule 35d-1, the fund names rule, defining certain fund names as materially deceptive or misleading. Rule 35d-1 does not address target date funds.

[11] *See* SEC Release No. IC-24828 (Jan. 17, 2001).

with less information than they have today, particularly because the expected retirement date that is used in names today is a point in time to which investors easily can relate.

Finally, we considered adding descriptors to the name that would identify the fund as "moderate," "conservative" or "aggressive." Ultimately, the Working Group rejected this approach. There are no objective standards to determine whether a fund is "aggressive" or "conservative" or "moderate," and the Commission has never mandated such standards. We do not believe there is any justification for the SEC or Department of Labor to create these labels.

We also do not believe the agencies should seek to regulate the asset allocations of target date funds. In the 70-year history of mutual fund regulation, the government has never regulated the investment choices of mutual funds—nor should it start now. Similarly, the Department of Labor has not prescribed standards on what constitutes a prudent investment. Doing so would undermine the fiduciary role of employers who sponsor retirement plans and have a strong history of responsibly evaluating investment options for their workers. Regulation would also take away choice, stifle innovation, and substitute government's judgment for that of portfolio managers, employers, investors, and the marketplace.

We strongly believe that investor understanding of these important and valuable products should be enhanced through disclosure and educational efforts rather than by regulating target date fund names—particularly when those changes would not improve the amount or quality of information available to investors—or by imposing controls on target date fund asset allocations. The fund industry has taken the first steps to enhance public understanding by providing the *Principles to Enhance Understanding of Target Date Funds* and target date fund FAQs, and stands ready to work with regulators and retirement industry participants to further enhance understanding of target date funds.

QDIAs

Target date funds are among the types of long-term investments that can serve as "qualified default investment alternatives," or QDIAs, under a Department of Labor regulation issued in 2007. The QDIA regulation was a response to the directive from Congress, under the Pension Protection Act of 2006, to issue a rule defining what investments could qualify as default investments, into which the plan could invest the account of a participant who had not given instructions on the investment of his or her account. Congress mandated that qualified default investments include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both. In the QDIA regulation, the Department concluded that target date funds satisfy this mandate. The framework of the Department's QDIA regulation is sound, and we recommend against reversing course based on the experience of one highly unusual period in the market.

The QDIA regulation not only eliminated great uncertainty for employers, but also is helping ensure that defaulted participants are appropriately invested for the long-term in a diversified vehicle

containing a mix of asset classes, including both equity and fixed income exposure. The Department was correct, and effectuated Congressional intent, in requiring that a QDIA contain a diversified mix of asset classes designed to provide for long-term appreciation and capital preservation. Although the rule does not allow investments designed solely for capital preservation to qualify as long-term investment defaults, it does not foreclose the use of conservatively invested QDIAs. There is ample room within the QDIA requirements for plan sponsors to select a conservative default investment.

Conclusion

We applaud the Securities and Exchange Commission and the Department of Labor for examining target date funds. We share the commitment of the Commission and the Department to assure that the interests of plans and their participants are protected in connection with the use of target date funds in retirement plans and that understanding of these useful investments is enhanced. We pledge to work with regulators and the industry to enhance investor understanding of these important products.