



# CALLAN ASSOCIATES<sup>INC.</sup>

**Testimony before the Department of Labor, Employee Benefits Security Administration  
and Securities and Exchange Commission concerning**

**Target Date Funds and Similar Investment Options  
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**Lori Lucas, CFA, is a Defined Contribution Practice Leader  
Callan Associates Inc.**

Thank you for the opportunity to testify at this important hearing on Target Date Funds and Similar Investment Options. My name is Lori Lucas and I am the Defined Contribution Practice Leader for Callan Associates – one of the largest independently-owned investment management consulting firms in the country. We provide consulting services to more than 300 large fund sponsor clients who are responsible for more than \$1 trillion in assets. Our client services include strategic planning, plan implementation, monitoring and evaluation, and education and research.

I am responsible for setting the strategic direction of Callan's DC business, providing DC support both internally to Callan's consultants and externally to Callan's clients, and developing research and insights into DC trends for the benefit of clients and the industry. My comments are based on more than 20 years of experience as a DC and an investment consultant, and I would like to cover four key areas:

## 1. Varied Approaches of Target Date Funds

The introduction of target date funds to DC plans in general, and specifically as Qualified Default Investment Alternatives (QDIAs), represents an important advancement for long-term retirement income potential within these plans. According to the Callan DC Index<sup>TM, 1</sup> since 2006,

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<sup>1</sup> The Callan DC Index<sup>TM</sup> is an equally weighted index tracking the cash flows and performance of approximately 70 plans, representing more than 800,000 defined contribution participants and nearly \$50 billion in assets. The Index is updated quarterly and reflects 401(k) plans as well as other types of defined contribution plans.

the typical DC plan has underperformed the typical corporate defined benefit (DB) plan by 2.3 percentage points on an annualized basis.

The difference in performance between the two plan types, demonstrates the difficulty that 401(k) participants have in replicating the professional investment management and diversification of pension plans. Target date funds are meant to provide DB-plan like professional management and diversification.

During the market collapse of 2008, target date fund performance —particularly, the performance of 2010 funds — ranged widely. This is due to the highly varied approaches of target date funds across the industry. In a recent study of major target date fund providers, Callan found that equity allocations in 2010 target date funds range from more than 60% to less than 20%. Similarly, the percentage in equities during retirement also varies. For some funds, the low point in equity allocation coincides with retirement (age 65). At that point, the asset allocation becomes “static” through retirement. In other cases, the equity allocation does not becoming “static” until age 70 or in some instances even later. In summary, the concept of time horizon is interpreted many different ways by target date fund managers.

Is the fact that there is no standard approach to target date fund investing good or bad? We know that this is consistent with the wide range of investment approaches sponsors of DB plans take. Asset allocation can vary substantially depending on the unique circumstances, investment goals, and risk tolerance of each DB plan sponsor. To a large extent, the same factors apply to DC plans. For example, some DC plans are the sole employer-sponsored savings vehicle for participants, while others act as a supplement to a DB plan. If the DC plan is viewed as a supplemental plan because employees have a DB income stream available to them, a plan sponsor may argue that the risk tolerance of employees is higher, and the target date fund can afford to have more in equities. This is only one example. The Employee Benefit Research Institute (EBRI) and others have also documented how differences in plan demographics can necessitate different target date fund approaches.<sup>2</sup> For example, EBRI found that lower-wage

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<sup>2</sup> Plan Demographics, Participants’ Saving Behavior, and Target-Date Fund Investments. Youngkyun Park, May 2009 EBRI Issue Brief.

participant populations were best suited to a different level of risk in target date fund glide paths than higher wage participant populations.

Stated differently, one-size-fits-all works no better in the DC plan than it does in the DB environment. The current robustness of target date fund solutions helps meet the varying needs of plan sponsors and their participants.

## 2. Evaluation and Monitoring Approaches for Target Date Funds

Having a wide variety of target date solutions makes the evaluation process complex. Currently, target date fund performance analysis is very basic. Indeed, a Callan survey found that 85% of target date fund managers use proprietary benchmarks in evaluating the performance of their target date funds. Such benchmarking offers very limited insight into the drivers of target date fund performance since the focus is on measuring excess return only.

The first step in evaluating target date funds should be to determine an appropriate, objective index or benchmark. Proprietary benchmarks are not objective in that they merely mimic the asset allocation design of the target date fund being benchmarked and give no insight into the strengths and weaknesses of the asset allocation design. This is a significant drawback in that asset allocation ultimately is a dominant long-term driver of performance.

As of today, no standard third-party target date index has emerged. Callan has developed its own target date index, the Callan Target Date Index, in order to measure the efficacy of various competing target date fund glide paths. Callan's approach is straightforward: we base our index on the glide paths (or asset allocations) of all of the available target date funds in the market. A consensus glide path index reflects the range of target date funds available to the plan sponsor. By comparing the target date fund to the consensus glide path, the plan sponsor can make a knowledgeable determination as to whether any differences from the consensus are acceptable or desirable. This knowledge should help minimize surprise when the performance of a sponsor's chosen target date funds varies significantly from competing target date offerings due to differences in glide paths.

A more fundamental question about target date fund glide paths is how the plan sponsor should determine which one is right for the plan. DB plans use asset-liability modeling to answer such questions. For target date funds, the equivalent is retirement income adequacy analysis. This analysis helps plan sponsors understand what level of a participant's pre-retirement income the target date fund glide path is expected to replace with a reasonable probability of success. Is it geared to replace 40% of pre-retirement income. 50%? More? And what is the probability that it will do so? After all, the role of target date funds is to help participants achieve their retirement goals. Retirement income adequacy analysis allows the plan sponsor to measure the probability of a successful outcome.

There are two other measures that are critical to target date fund glide path analysis. One is a measurement of the interim risk to which target date funds may be exposing participants — especially individuals near retirement. Longevity risk is the other risk. Since many target date funds are geared to take investors not only up to, but through retirement, what is the target date fund's risk of investors outliving their wealth given their income needs?

Beyond the glide path, the quality of the implementation of the target date fund needs to be evaluated. This includes active management value added, the value added of tactical asset allocation “tilts,” and the value of style tilts within the asset allocation. Peer group analysis can be used to get at these factors, allowing plan sponsors to disentangle implementation effects and whether the target date manager is adding value through implementation relative to similar target date funds.

Finally, it is important to understand target date fund fees. That is not to say that the target date fund must have the lowest fees available. Indeed, diversifiers such as emerging markets equity can drive up the cost of target date funds — but could arguably lead to potentially improved outcomes. It is important that target date fund fee analysis takes into account the potential value added of both the asset classes included in the glide path and the underlying managers.

The analysis described here is admittedly multi-faceted. But that reflects the complexity of target date fund products, and their critical role in DC plans. Many in the industry predict that target date funds will ultimately hold the majority of DC assets. They have a lot of moving pieces, and

can offer surprises —as we saw last year — if the plan sponsor does not understand how all the pieces fit together.

### 3. Custom Target Date Solutions

In 2008 the adoption of custom target date funds among large defined contribution plans seemed to accelerate. As large plan sponsors reviewed the total returns of their target date mutual funds in 2008, those who were surprised by the performance clearly saw the downside of delegating control over the glide path or the underlying managers of the target date funds.

Custom target date funds are developed by tailoring the glide path to the specific plan and its participants. This can be done by the plan sponsor, a consultant, or an investment manager. Often, the core funds within the plan are used as the underlying investments of the glide path. According to a Callan survey, 25% of plan sponsors say they either have a custom target date fund or that they plan to have one in 2009. That's up from 18% in 2007. The benefits of custom target date funds are that they allow the plan sponsor to tailor the asset allocations to the participant population; they allow "best in class" funds to be used in the portfolios; they leverage the due diligence efforts of core options; and they may create significantly lower fee structures than off-the-shelf products such as mutual funds.

Although the QDIA regulations allow plan sponsors to use custom target date funds, many plan sponsors still hesitate because of actual or perceived differences in fiduciary responsibility and potential fiduciary liability of using custom target date funds versus off-the-shelf target date funds. Establishing fiduciary parity between custom and off-the-shelf solutions would be useful, and would likely result in the positive effect of increased adoption of custom target date funds by large plans.

### 4. Communication of Target Date Funds

As my last point, I'd like to address target date fund communication. Today, communication focuses heavily on the concept of matching the target date fund to one's retirement year. There is a good reason for this: it keeps the target date fund selection process simple for plan participants.

Unfortunately, in the drive to keep communication straightforward, some key concepts appear to be getting lost.

The degree to which target date funds continue to pursue capital appreciation strategies near or during retirement needs to be clarified in the communication. Target date funds that continue to have equity allocations that glide down during retirement, with substantial equity positions near or past age 65, should be positioned as “lifetime funds.” This would clarify that investment in the fund isn’t intended to terminate at retirement, but to continue years after, thus necessitating some continued risk-taking in order to combat the potential damaging effect of inflation during retirement.

As mentioned earlier, Callan recommends that plan sponsors take into account retirement income adequacy measures, shorter-term worst-case scenarios for target date funds, as well as the risk of running out of money in retirement. Such measures could be simplified and adapted for participants to help them better understand the risk/return trade offs of their target date fund investment.

Of course, it is important to recognize that target date funds are most commonly used as defaults in DC plans, and participants aren’t prone to second-guessing the fund into which they are defaulted. As such, the beneficial effect of improved communication is likely to be modest.

In closing, while target date funds are meant to be simple for DC participants to use, they are quite sophisticated under the hood. This isn’t a drawback of target date funds, but over the long-term, a strength. We have come far as an industry with target date funds — but it is time for areas such as benchmarking and communication to catch up with the advancements we have made on the investment side. Callan would be pleased to offer our analysis, our experience, and our consulting expertise in helping complete work on these issues.

Thank you again for the opportunity to share Callan Associates’ views on this important topic.