October 30, 2006

Office of Regulations and Interpretations
Employee Benefits Security Administration (EBSA)
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Department of Labor
Washington, DC 20210

Comments on the Default Investment Alternatives Under Participant Directed Individual Account Plans; Proposed Rule (29 CFR Part 2550)

Submitted by The 401(k) Company, Austin, Texas

SUMMARY

Ladies and Gentlemen:

We ask that you consider amending the proposed rule to explicitly permit the use of asset allocation models as a qualified default investment alternative ("QDIA"). To ensure that the models are professionally and prudently designed, the regulation should set forth certain minimum safe harbor requirements. We also ask that you clarify the fiduciary responsibilities that remain with respect to a QDIA.

When using the term "asset allocation models" or "models," we are referring to what are also referred to as "portfolios," or a "core funds approach." The models may either be risk based or targeted retirement age based, and are automatically rebalanced periodically or dynamically. Typically, in such arrangements, the default investment is one of the models (risk based) or a set of models (targeted retirement age based), selected for its suitability for a plan's participants. While the proposed rule does not forbid asset allocation models as a default option, the failure to afford them the same safe harbor relief under ERISA §404(c) that asset allocation funds have been provided will effectively amount to prohibiting their use as a default. The use of models is well-established, has evolved over a long time, and is often an effective way to lower costs, to provide participants with a simple and effectual way to invest their assets, and to provide a clean structure and process for the formation, selection, and monitoring of all elements of a prudent default investment alternative.

<u>EXPLANATION:</u>

Background:

Founded in 1983, The 401(k) Company focuses exclusively on recordkeeping for participant directed individual account plans. We currently have 100 clients representing 400,000 plan participants with the average client having approximately $207 million in plan assets and 4,200 plan participants. Our comments arise out of our experience primarily in the large plan market. The large plan market segment is important not only because of the number of participants it covers, but because it has always been the forum where beneficial innovation occurs and then migrates to the mid- and small-plan markets (e.g., the movement towards open architecture). Our clients have participants in all 50 states, U.S. territories, and the District of Columbia, representing virtually all sectors of the U.S. economy. The range and depth of our focused experience gives us practical insight to the workings of 401(k) plans.

<u>Discussion:</u>
We commend the Department for addressing impediments that plan sponsors have historically faced with respect to selecting their plans' default investments. The lack of guidance to date has resulted in a significant number of plan sponsors choosing default investment arrangements that minimize the risk of capital loss, with a correspondent reduction of potential investment returns. Such choices have been driven by fears of fiduciary liability that can be alleviated by the proposed rule.

We are now concerned that the proposed rule, as written, may be interpreted in a way that is detrimental, rather than beneficial, to plan participants. That is the risk of safe harbors: if they incorporate elements that support QDIAs that may be inferior, counsel may urge the fiduciaries to use inferior investment arrangements because they meet the safe harbor provisions, and are thus legally "safer." As approximately 85% of large participant directed defined contribution plans intend to satisfy the elements of ERISA §404(c), the vast majority are likely to limit the investment default to a QDIA, and not take on the additional responsibility of utilizing an investment default governed under the general fiduciary rules of ERISA, even though the latter may be in the best interest of participants.

The proposed rule addresses both the manner and the nature of a default investment alternative in order for it to be a QDIA. Our principal concern is with the portions of the proposed rule that deal with the *manner* in which such alternatives are realized.

The Manner of Prudently Selecting Default Investment Options

It is helpful to briefly review the nature of the prudent investment process in the context of the proposed rule:

1. Setting investment objectives, including an assessment of the investment time horizon, consideration of the liability structure (always relevant, but especially for those who are withdrawing funds for consumption such as retirees), determining appropriate risk level, funding requirements, diversification requirements, sophistication of the investor, and suitability issues, such as demographic considerations.

2. Determining strategic asset allocation. Strategic asset allocation addresses the risk, potential return and diversification of an underlying portfolio. It is a long-term allocation to assets that reflect the investment objectives as determined above, and includes a rebalancing policy that corrects for imbalances caused by the differential growth rates of the different asset classes. The weightings of the asset classes are determined by an optimization process that reflects estimates of risk, return, and the correlation of the different asset classes.

3. Determining tactical asset allocation, if any. Tactical asset allocation involves making adjustments to asset exposure according to shifts in the market and economy.

4. Determining the weightings of active and passive management for each of the asset classes. If active management is part of the portfolio strategy, as it typically is, it includes the selection of active managers and managers for the passive investments, if any.

5. Determining the appropriate vehicles for each of the investments, such as separate accounts, collective trusts, mutual funds, and group annuity products.

6. The process includes a periodic review of all of the above, and on an ongoing basis the monitoring of all investment managers (active and passive).

Since the comments to the proposed rule seem to imply that the first alternative, targeted retirement date funds, does not require a fiduciary to take into account the demographics of the plan's participants, it is worthwhile to consider at greater length the first element above (setting investment objectives). Under ERISA, the plan's investment fiduciary must set investment objectives under the prudent man rubrics. Surely the same requirements do apply to targeted retirement date funds.

Even among the targeted maturity funds being sold today, there is a broad range in the risk of products (e.g., the strategic asset allocation) for any given age.[1] Also, while "age" may be a short-hand for the time horizon of the investment in the accumulation phase, it is not the same thing—only the time horizon is relevant. For example, a recent study by the AARP, showed that over half of participants (54.0%) age 21-37 did not roll over their distributions in 2003, but took them in cash.[2] This is an average—at the employer level the rollover level may be much lower (age, gender, account balance and education level are all relevant factors). It may not be prudent for a business with high turnover, for example, to select a QDIA with a relative high equity allocation. Furthermore, the investment time horizon is not the only objective and material factor in determining suitability. It may be prudent for a plan sponsor who offers a defined benefit plan to take that into account in the selection of a default investment alternative.

[1] Joseph C. Nagengast, John Bucci, and William J. Coaker, II, "Popping the Hood: An Analysis of Major Life Cycle Fund Families" Turnstone Advisory Group, LLC 2006.
[2] Satyendra Verma & Jules Lichtenstein, "Pension Lump-Sum Distributions: Do Boomers Take Them or Save Them?" AARP: Public Policy Institute Research Report, August 2006.

Research has shown that risk aversion and wealth (i.e., funding status) are material and independent factors in determining a prudent portfolio. These determinations have to be done at the plan level just as is the case with the second alternative. A professional corporation is measurably and objectively different with respect to these factors than a fast food chain. Employers must consider an extensive amount of data, data which is also used by investment management services. Rapid growth in technology is making the use of such data more accessible.

Furthermore, we have worked with plan sponsors who have looked at all "off the shelf" target maturity products and determined that none had "glide paths" that were prudent for either their diverse employee populations, or the type of employee who is typically defaulted; this would seem to be the type of fiduciary activity that the rule should encourage, not discourage. So it is not the case that the only objective and readily available information relevant to making an investment decision on behalf of the participant is age. If, as discussed later in the proposed rule, plan sponsors can consider the demographics of the plan's participants, they can do so as well with targeted retirement date funds or portfolios. Not all sets of targeted retirement date funds are alike.

One of our concerns is the third requirement for an investment to be a QDIA. The requirement in the proposed rule that a QDIA be managed by an investment manager, as defined in section 3(38) of the Act, or a registered investment company under the Investment Company Act of 1940 is, in our opinion, a narrow standard that will be detrimental to the use of asset allocation models as the investment default; a default currently used by a significant percentage of mid- to large-sized plans.

Strategic asset allocation should be differentiated from *management*. *Management* seeks to deliver an above-market return after fees and costs, through tactical asset allocation, the selection of securities, and the timing of purchases and sales of such securities. *Strategic asset allocation*, which derives from the investment objectives and modern financial theories, sets the policy that blends potential capital appreciation and income. While it may be delegated to an investment manager, typically that is not the case among large institutional clients, such as pension plans, endowments, foundations, and non-participant directed defined contributions plans. Plan investment committees make such decisions, often with the help of a qualified consultant and other professionals.

While investment managers charge asset based fees, consultants charge fixed fees for a given asset/liability study or for a determination or review of an asset allocation policy for the institutional investor. At a given level of scale, asset based fees are excessive relative to the work that is required. How have large plans adapted this to participant directed defined contribution plans? They often utilize the following three (3) tier structure, and this trend has been growing over the last several years:

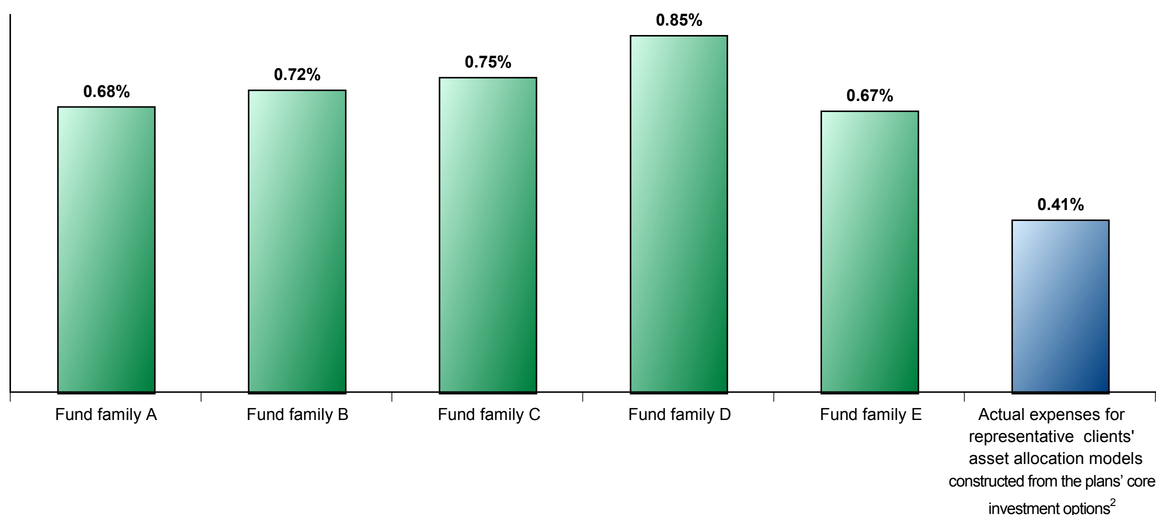
Asset Allocation Models
Core Passive & Active Investment Alternatives
Self-Directed Brokerage or Mutual Fund Window Alternative, and/or Company Stock

The self-directed brokerage alternative is often omitted, but an employer includes it when it might be desirable for participants to have non-core investment alternatives.

Why do many large plan sponsors choose to use asset allocation models over targeted retirement or risk based funds for both participants who make elections and as a default investment?

1. The cost of strategic asset allocation. Developing models has a fixed dollar cost; plan sponsors, recordkeepers, brokerage houses, and other vendors that have developed models for use by participants utilize a qualified consultant to develop and review such models. That cost is significantly less than an asset based fee for essentially a study–not active asset management. Furthermore, the market has already developed cost-effective ways to deliver models. Studies are commissioned by service providers and leveraged over a client base for no charge to the plan. The studies are provided periodically, adjusting the models as needed, by distinguished consulting firms with a national reputation in the field of strategic asset allocation. Under the fiduciary duties of loyalty, prudence and diversification, the investment committee chooses the use of models for default investments. This is similar to the policies implanted in defined benefit plans and non-participant directed individual account plans. Even where the investment committee must rely on mutual funds as the underlying investments within the models, they can use institutionally priced shares or consider cost for each mutual fund selected. Also, some investment committees are reluctant to add an ERISA §3(38) investment manager asset based charge to a default investment when effective lower cost solutions are available.

Average Expense Ratios of the Top Five Actively Managed Targeted Retirement Date Fund Families[1]



[1]Fund expense data is based on the fund expenses detailed in the prospectus of each fund family's least expensive targeted retirement date fund share class as of October 15, 2006. Conservative income model expenses were not included for the purpose of this illustration.
[2]Asset allocation model expenses are provided for two clients of The 401(k) Company with excess of $1.5 billion in plan assets and 35,000 in plan participants

2. Utilization of alternative investment vehicles. The emerging trend in the large plan market is to use separate accounts for actively managed investment alternatives, and collective trusts for passive investments.

There are many compelling reasons: lower cost (investment management fees, on average, are about *half* the cost of investment management fees in mutual funds); ability to control mandates about style, leverage, risk; to control turnover; to reduce liquidity costs (i.e., the costs of purchasing and selling securities as a result of cash flows) by limiting them to the plan's requirements; to have access to boutique managers as well as mutual fund managers (many of which also provide separate account management); and to simplify the plan for participants so as to encourage better usage. The trend is to reduce the cost of such alternatives and is making them more accessible to plans in the mid-market and even the small plan market. This is a trend that greatly benefits plan participants and should not be discouraged.

3. The desire to use their selected and monitored "best of class" core options as the basis for an "auto pilot" diversified solution for both participants who make an election as well as those who are defaulted into an investment portfolio.

4. Ability to monitor each underlying manager separately, and to replace the manager without having to replace the remaining managers.

5. Ability to monitor each model, without having to change all the models in order to change one.

6. Open architecture–mutual funds are often limited to proprietary funds, or by design must include them; even flexible architecture (i.e., choosing from a list of a few hundred) is a far cry from open architecture and prevents the plan sponsor from selecting the best of class for each core option.

7. Ability to decide on the active and passive split among core alternatives. The vast majority of large institutional investors utilize both active and passive alternatives to reduce active manager risk and control costs, since passive investments are substantially less expensive, especially at the institutional level. Most product solutions–targeted retirement date based funds and risk based funds–are 100% active solutions.

8. Opportunity to eliminate the cost impact of potential self-dealing and conflicts of interest inherent in mutual funds that make strategic (and tactical) asset allocation decisions. Such mutual funds are not subject to ERISA's prohibitions, as the underlying assets are not considered plan assets. For example, investment managers make more money from actively managed funds than index funds, and while the decision to use mostly or all actively managed funds with a targeted retirement age fund or risk based fund may be sincere, there is financial gain in that decision. The process of separating the strategic asset allocation from the investment process insures that no such conflicts taint the process, both because that is the desire of the plan sponsor and because it then comes under the requirements of ERISA. Conflict of interest involves much more than the active/passive decision–such as the funds

selected (some are more profitable than others), the type of fund (high yield vs. government bond), and so on.

9. Modification of a model without changing investment managers, and visa versa. Significant demographic changes may occur through growth, reductions, acquisitions and spin-offs, and the models can be redesigned for the changed suitability factors.

10. Adaptation to future improvements, such as risk-based targeted retirement date models.

11. Communication and participant education issues.

    a. Asset allocation models are an extremely effective form of participant investment education as recognized in the DOL Interpretive Bulletin 96-1.

    b. QDIAs are *also* investment alternatives, and it is well known that participants who do select their investment options will often treat targeted retirement date or risk based funds as one fund among many, thus negating the purpose. The model structure makes clear it is a strategy that utilizes the underlying monitored investment alternatives, and one either elects the strategy or designs their own. Numerous studies have found that participants tend to misuse asset allocation *funds,* and the use of models can alleviate the confusion.[4]

12. Ability to structure the accumulation phase separately from the payout phase (and the transition phase). While this issue has always been present, the approaching retirement of nearly 80 million baby boomers is highlighting concerns and prompting creation of new solutions for the difficult task of consuming one's retirement savings. All funds and all models include strategic asset allocation in the post retirement years, which will continue to operate unless the participant elects otherwise. Products in the market today have substantial variance in the risk and strategy in the post-retirement years.[5] What may be prudent in the accumulation phase may be imprudent in the post-retirement phase.

Models are as effective as mutual fund products as an "auto pilot" solution to default investment of participant balances and contributions, and any rule regarding QDIAs should not undo solutions in place that have been prudent and effective for over two decades. *If the relief from fiduciary liability for such low cost, prudent and effective models is less than it would be for utilizing a more costly set of mutual funds, then it would be the rare plan sponsor who would not yield to the force of the rule.* It would replace one problem (relying too heavily on short-term investments) with another problem, reversing the trend to lower costs, open architecture, and rigorous selection and monitoring of each component of the investment process.

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[4] Joe Morris, "Vanguard: Lifecycle Often Misused," *ignites.com*, July 6, 2006.
[5] Joseph C. Nagengast, John Bucci, and William J. Coaker, II, "Popping the Hood: An Analysis of Major Life Cycle Fund Families" Turnstone Advisory Group, LLC 2006.

It is clear that the Department of Labor is concerned about the quality of the advice given to the participants and about the protections afforded participants. It is possible that participants could end up with poor asset allocation models, just as could happen with investment managers and mutual funds in the height of the technology bubble when many plans only offered tech-heavy mutual funds, plus a money market and employer stock. No good models could come from such a poor selection of underlying investment choices, even with the absence of employer stock in models. Especially in small firms, there is a chance that a leader with unwise investment ideas could design harmful models for participant usage.

To alleviate this risk, our recommendation is that the proposed rule be modified to include asset allocation models as a QDIA if certain minimum requirements are met regarding the structure and basis for the asset allocation models.

We believe the following elements should be in such an asset allocation model safe harbor:

1. *Specific application of the "prudent person familiar with such matters" portion of the prudent man rule. This could be met in one of three ways—with certain conditions applying to any of the alternatives:*

    a. The models are designed by a qualified firm with expertise in asset allocation and such models are generally suitable and prudent for retirement plans. The firm should not be required to be a named fiduciary to the plan, as this would substantially increase the cost for little, if any benefit. Professionally designed models are still professionally designed models, and just as mutual funds are not fiduciaries to the plan, but are subject to the scrutiny of fiduciaries operating under the strictures of ERISA, so it should be also with respect to firms that provide asset allocation models.

    b. The custom design of models with the assistance of a qualified consultant who is a registered investment advisor.

ERISA is a dynamic law, as it recognizes that developments in the investment field and in technology can change what is prudent. The standards of prudence in the 1930's, the 1960's and today are substantially different in their impact on prudent investment portfolios. Therefore, under both of the above scenarios, the models should be monitored at least annually. A report on the structure, basis and rational of the models should be provided by the firms in alternatives (a) and (b). The reports should be reviewed and approved by plan fiduciaries. This process does not differ in substance from the process that works well under ERISA for defined benefit plans and non-participant directed defined contribution plans. However, it provides detail in the application to the use of models as a QDIA. The selection of a vendor would still be subject to the fiduciary rules governing the selection and monitoring of any vendor that provides services to an ERISA plan.

2. *The models would utilize core investments that meet certain standards.*

    a. Core investments would include at least three (3) distinct asset classes, including equities and fixed income classes. There can be more than one option in each asset class as is often the case, but similar options would be grouped together for purposes of this proposed safe harbor.

    b. Core investments (taken together for each identified asset class) should be internally diversified, covering a wide range of securities within the asset class. An exception should be made for short-term investment funds (e.g., money market funds) investing exclusively in short-term U.S. Treasury Bonds.

    c. Core investments, when viewed together, should provide the elements to construct a broadly diversified portfolio that takes both risk and potential return into account.

    d. While this is presently only an emerging trend, it does happen that a model will utilize a core investment that is not offered as an investment alternative to participants outside of the model. The reason for this is that the plan fiduciaries deem it is not suitable as an investment alternative because of its risk characteristics, but because of its low correlation with the other asset classes, it reduces the risk and increases the potential return of the models. Such "sleeves" often are added by a plan sponsor because of their effectiveness in the employer's defined benefit plan.

3. *When models are used as a QDIA, the plan should have a written investment policy statement that sets forth the requirements, standards and process for the selection and monitoring of the model (or set of models as is the case with target maturity models), and written minutes of investment meetings should document compliance with the investment policy statement. While we believe this is beneficial-even essential-for all plans and all elements of the investment process, it is not a requirement of ERISA to have such a written statement. By requiring its use for the safe harbor for the use of models as a QDIA, it helps ensure that the process will be followed and held to the standards of ERISA as individual fiduciaries come and go throughout time.*

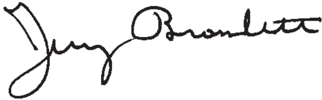
In summary, we ask that you consider amending the proposed rule to clarify the fiduciary responsibilities that remain with respect to a QDIA, and permit the use of asset allocation models with a safe harbor that sets forth certain minimum requirements that assures they are professionally and prudently designed.

We also recommend that the proposed rule be amended to reflect that suitability considerations be made explicitly part of the process with all three alternatives that deal with the nature of a QDIA. Furthermore, we recommend that "age" be replaced with "time-

horizon" or some similar phase, with a note that age may be a chief factor (along with expected retirement age) in determining time-horizon, but not necessarily the only one.

If you have questions regarding these comments or would like to discuss any of the enclosed, please contact Kenneth Robertson, Executive V.P. and Chief Investment Officer at (512) 344-3003 or Deborah J. Ebner, Senior V.P. and Chief Counsel at (512) 344-3006. Thank you for your consideration of these comments.

Sincerely,



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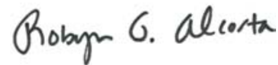

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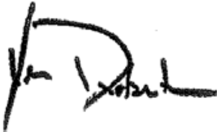

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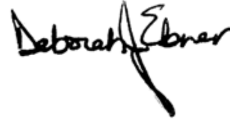

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