

CERTIFIED FINANCIAL PLANNER

BOARD OF STANDARDS, INC.

STATEMENT OF
CERTIFIED FINANCIAL PLANNER BOARD OF STANDARDS, INC.
BEFORE THE
UNITED STATES SENATE
SPECIAL COMMITTEE ON AGING
ON
DEFAULT NATION:
ARE 401(k) TARGET DATE FUNDS MISSING THE MARK?

October 28, 2009

Chairman Kohl, Ranking Member Corker, and Members of the Special Committee, thank you for the opportunity to submit this statement as part of the record for the Special Committee on Aging hearing on October 28, 2009, titled “Default Nation: Are 401(k) Target Date Funds Missing the Mark?” Certified Financial Planner Board of Standards, Inc. (CFP Board) appreciates the opportunity to address the use of target date funds in 401(k) plans.¹ CFP® professionals are heavily involved in retirement planning, and many are employees, agents, or registered representatives of fiduciary advisers under ERISA. Target date funds have been around for over ten years, but their increased popularity is directly related to their treatment as a qualified default investment alternative under the Pension Protection Act of 2006.

Target date funds, appropriately managed, can be beneficial to investors. They generally have low minimum investment requirements, professionally managed portfolios, and low maintenance requirements. Absent target date funds, employers would likely default employees into money market funds, which have proven to be inadequate retirement savings tools as they generally fail to keep pace with inflation. However, we have serious concerns that target date funds are fundamentally misleading to investors because they are allowed to be managed in ways that are inconsistent with the reasonable expectations created by the name of the funds. The recent financial crisis has only magnified these concerns, as in 2008, thirty-one funds with a 2010 target date—presumably intended for individuals nearing retirement—averaged losses of 25%.² Accordingly, we commend the Special Committee for its work in reviewing the use of target date funds and the need to protect investors from misleading and harmful practices.

I. Target Date Funds Are Misleading to Investors in 401(k) and Other Retirement Plans

At the joint hearing held by the Securities and Exchange Commission (SEC) and the Department of Labor’s Employee Benefits Security Administration in June 2009, there was much discussion of whether a target date fund’s glide path should be designed to change “to” or “through” the target date, with many panelists arguing that a fund’s glide path should continue to change through the target date. CFP Board believes, given the reasonable expectations created by the name and marketing of the fund, that a target date fund’s glide path should be designed to change “to” the target date. First, investors understand the target date in a fund’s name to mean the date at which they expect to access the savings in the fund. The focus on a “to” or “through” determination should focus on investor expectations and not on the desires of fund managers.

¹ CFP Board is a non-profit organization that acts in the public interest by fostering professional standards in personal financial planning through setting and enforcing education, examination, experience, and ethics standards for financial planner professionals who hold the CFP® certification. CFP Board’s mission is to benefit the public by granting the CFP® certification and upholding it as the recognized standard of excellence for personal financial planning. CFP Board currently regulates over 60,000 CFP® professionals who agree, on a voluntary basis, to comply with our competency and ethical standards and subject themselves to the disciplinary oversight of CFP Board under a fiduciary standard of care. Financial planning professionals provide services that integrate knowledge and practices across the financial services industry. Financial planners work with their clients to determine whether and how they can meet their life goals through the proper management of their financial resources. Financial planning typically covers a broad range of subject areas including investment, income tax, education, insurance, employee benefits, retirement, and estate planning.

² Mary L. Schapiro, Chairman, Securities and Exchange Commission, Address to Mutual Fund Directors Forum Ninth Annual Policy Conference: Critical Issues for Investment Company Directors (May 4, 2009), *available at* <http://sec.gov/news/speech/2009/spch050409mls.htm> [hereinafter Schapiro Address].

Second, target date funds are marketed as “cruise control” retirement savings tools that will meet the investor’s retirement goals at the target date. However, these marketing materials do not clearly explain that investment decisions by the fund managers often take into account factors beyond the retirement date, including other investments, time horizon, and risk aversion, and thus continue an aggressive investment strategy past the target date. Finally, the name of the fund is the most important consideration to investors as even if they read and comprehend disclosure materials, no amount of disclosure can override the misleading nature of a target date fund’s name.

The use of a target date in a fund’s name carries with it a generally understood message to investors. For example, the name “Target Date 2010” says to the investor: “This fund will invest in an appropriate mix of investments for someone retiring around the year 2010.”³ The use of the year 2010 in the name of the fund implies that, by 2010, the fund will contain an asset allocation of equity and fixed-income investments that will be subject to relatively low market volatility and will provide the investor with ready access to cash assets. In contrast, a Target Date 2050 Fund would be expected to contain an allocation of equity and fixed-income investments that would subject the fund to substantially more risk, which is necessary to allow for growth in the fund over time that will, at a minimum, outpace inflation.

In simplest terms, we can all agree that an 80% stock/20% fixed-income allocation in a Target Date 2010 Fund would be inappropriate for a 65-year-old retiree, just as an 80% fixed-income/20% stock allocation in a Target Date 2050 Fund would be inappropriate for a recent college graduate. The asset allocations in these types of plans should reflect the anticipated timeframe in which the investor will need to access those funds. Yet target dates are being used to label funds that have combinations of investments that are well outside expected, generally accepted asset allocations for the targeted investor. In fact, as SEC Chairman Mary Schapiro has recognized, target date funds are subject to widely varying strategies among fund managers, with 2010 target date funds ranging in performance from minus 3.6% to minus 41% in 2008.⁴ A person who planned to retire in seven months who thought he was invested in a safe Target Date 2010 Fund with low volatility but who lost 41% last year would be devastated. A loss of up to 41% of assets from a fund labeled 2010 is completely inconsistent with an investor’s reasonable expectation that his or her assets would not be subject to such high market volatility. We recognize that less than one year later, these losses have been partially recovered as the market has rebounded from historic losses. However, this type of volatility—losses of up to 41% one year followed by gains of up to 30% the following year—is exactly what target date funds are supposed to avoid as the target date approaches.

We must underscore an important point: it can be perfectly appropriate for investors approaching retirement to employ aggressive investment strategies with their 401(k) funds. Such investors may have a variety of other assets that can be tapped for their living expenses and they can legitimately choose to expose themselves to risks in their 401(k) plans in order to grow their assets enough to last thirty years after retirement. These are the very types of judgments that

³ Letter from Fund Democracy & Consumer Federation of America to Mary Schapiro, Chairman, Securities and Exchange Commission (Apr. 7, 2009) (on file with author).

⁴ Schapiro Address, *supra* note 2.

financial planners—taking into consideration an investor’s complete financial history and goals—help their clients make on a daily basis.

That is not what is at stake with target date funds. Such funds are marketed as “auto pilot” or “cruise control” investments pegged to an investor’s expected retirement date. They are aimed at investors who do not have a financial planner or advisor, or the time, desire, or ability to monitor their investments themselves. By their very name, they create a reasonable expectation that such a fund will have sufficiently reduced volatility and its assets will be available for the investor’s use as of the target date. Target date funds are not the appropriate vehicles for implementing aggressive retirement investment strategies for those nearing retirement.⁵

It is not an answer to say that misleading fund names can be cured with effective disclosures. Appropriate disclosures must be required and provided; but we must recognize, in determining appropriate investor protections, the reality that disclosures are very often not read and more often not fully understood. Despite our ongoing education and efforts to engage consumers in reading disclosures, CFP Board continues to hear from CFP® professionals who explain that their clients do not want to receive, let alone read, disclosure documents. If they receive disclosures by mail, they just throw them away; if they receive them electronically, they complain that they must delete them. Under current rules, a Target Date 2010 Fund could have an 80% stock/20% fixed-income allocation as long as the fund’s extremely aggressive investment objectives and strategies are disclosed in the fund’s prospectus. We believe that this is fundamentally misleading to investors and that no amount of disclosure is adequate to counteract the reasonable expectations created by a fund’s name.

II. Industry Standards for Asset Allocations in Target Date Funds Can and Should Be Established to Protect Investors

The SEC can and should take steps to strengthen its securities regulations to protect investors from the use of misleading target date fund names. In 2001, the SEC adopted a misleading fund names rule—Rule 35d-1—that defines four types of funds for which the name may be materially deceptive and misleading. Because of the latitude under the rule for fund managers to correct misleading fund titles through disclosures in the fund’s prospectus, the rule has not been enforced as to target date funds in a manner that provides adequate investor protection. We recommend that the SEC amend Rule 35d-1 to provide that a target date fund’s

⁵ While not a focus of this hearing, we must note that inappropriate asset allocations in target date funds affect not only 401(k) plans, but also 529 plans. Just as overly aggressive investment strategies can be inappropriate for those nearing retirement, an 80% stock/20% fixed-income allocation would be wholly inappropriate for a target date fund underlying a 529 plan for a 2010 high school senior. The parents of such a child would reasonably expect a stable funding source as college tuition payments near. Instead, many parents were left with insufficient funds to pay college tuition for their children, primarily because of the misleading nature of certain 529 plan investment options. As with target date funds, the asset allocations in 529 plans should reflect the anticipated timeframe in which the investor will need to access those funds. To go one step further, as Chairman Schapiro recognized, “A target date fund underlying a college investment or so-called 529 plan . . . would need to more closely track its target date since it is far more likely that investors would need access to their investment at or near the fund’s target date.” *Id.*

name is materially deceptive and misleading unless the fund's investments fall within an acceptable range of asset allocations consistent with its name.

We recognize that there are differing viewpoints among investment professionals regarding the appropriate allocation of assets as investors approach retirement, and agree that some variation is entirely appropriate and that there is no such thing as a "perfect" allocation. Nevertheless, we believe that appropriate ranges of asset allocations, based on reasonably accepted industry practices, can be established for each date reflected in a target date fund. The goal would be to align target date funds' glide paths and asset allocations with investor expectations—namely that a target date fund's glide path is designed to change *to* the target date.

Establishing industry standards for asset allocations in target date funds is a reasonable undertaking. A panel of experts in retirement planning and investment allocation could be established from the financial services industry, including experts in ERISA, registered investment advisers, and CFP[®] professionals. They could be tasked with developing a schedule that lists acceptable ranges for categories of investments that are consistent with reasonable industry practices for each date reflected in a target date fund. The ranges of allocations would identify acceptable industry parameters that would reduce the fund's exposure to market volatility consistent with the fund's target date.

The Thrift Savings Plan Lifecycle Funds established for employees of the United States Government and members of the armed services are an example of such reasonable industry standards. The Lifecycle Funds have asset allocations that reduce exposure to volatility over time, with the understanding that greater risk can be taken the longer one has before making withdrawals from the account. As of January 1, 2009, an L Income fund was invested in 80% government securities and bonds and 20% securities, with the time horizon for immediate access to the funds. Similarly, an L 2010 fund was invested in 70% government securities and bonds and 30% equity securities, with a time horizon between 2009 and 2014. In contrast, an L 2040 fund had an allocation of 80% securities and 20% government securities and bonds, with a time horizon of 2035 or later.

CFP Board is not advocating that the Lifecycle Funds represent the only acceptable allocation of assets; rather, they can serve as a baseline upon which ranges of allocations that reflect acceptable industry standards can be established. With the establishment of acceptable ranges, target date fund managers will be able to implement investment strategies within those ranges of asset allocations to enhance the fund's performance. This will allow for the promotion of competition among funds, while at the same time protecting target date fund assets from exposure to inappropriate risk that is inconsistent with an investor's reasonable expectation.

III. Stricter Regulations Are Especially Important Given the Default Investment Status of Target Date Funds

Establishing acceptable ranges of asset allocations for target date funds is especially important given that target date funds qualify as qualified default investment alternatives, also known as QDIAs, under the Pension Protection Act of 2006. The fact that the federal

government has qualified target date funds as QDIAs sends two important messages. First, it conveys to employers that the government believes that the allocations in target date funds are appropriate for individuals based on their expected date of retirement. An employer generally defaults its employees into target date funds based on an employee's age and work history with that employer. Such defaults are based on the assumption that the employee will be living off the account's lump sum when the employee reaches retirement age. Target date fund options—if they are to qualify as QDIAs under the Pension Protection Act—should reflect appropriate asset allocations consistent with this assumption.

Second, qualification of target dates funds as QDIAs conveys to employees that the government is making an appropriate investment decision on their behalf. Employees who are defaulted into a target date fund often make no further decisions related to that fund. The presumption of government approval leads many investors to assume that their retirement funds are invested in a fund designed to ensure their retirement security. Yet without additional government guidelines, many default target date funds have proven to have inappropriate asset allocations for individuals approaching retirement age.

Qualifying target date funds as default investment alternatives serves an important public policy goal. It allows employers to place their employees in default investment options that are designed to outpace inflation—something that defaulting funds into money market funds proved incapable of doing. In fact, over the past four years the percentage of employers using target date funds as a default contribution option has increased from 5% to 60%.⁶ However, if target date funds are to be used as default investments, the funds themselves must be managed so as to provide appropriate asset allocations consistent with their titles.⁷

IV. Conclusion

We urge the Special Committee to work closely with the SEC and Department of Labor to establish appropriate protections to ensure that target date funds can continue to be used as QDIAs with confidence that they reflect appropriate, industry-sanctioned investment decisions on behalf of plan participants. While we commend the SEC and the Department for the actions they have taken to enhance disclosures to investors in target date funds, enhancing disclosures is not the sole answer and more must be done.⁸ In June, we urged the Department to work with the

⁶ *Id.*

⁷ The same issue arises in the context of 529 plans: because they are offered by government entities, 529 plans create the appearance of government approval. This in turn causes investors to assume a fund is appropriate to ensure the availability of funds as of the target date to pay college tuition without scrutinizing the fund's asset allocation. As we have seen, some states permit dangerously aggressive asset allocations in 529 plans, which can result in catastrophic losses in a bear market. See Jason Zweig, *Did Your College Savings Plan Blow Up on You?*, WALL ST. J., Mar. 20, 2009, available at <http://online.wsj.com/article/SB123758112211598861.html> (noting the equity exposure possible in several states for college-aged students, including Maine (0% cash), New Mexico (0% cash), North Carolina (43% stocks and bonds), Oregon (40% stocks), Rhode Island (40% stocks, 55% bonds, and 5% cash), and Utah (65% stocks)). If 529 plans are to come with a government "stamp of approval," they must have asset allocations that are in line with investor's reasonable expectations.

⁸ See U.S. Department of Labor, EBSA Field Assistance Bulletin No. 2009-3 (Sept. 8, 2009), available at <http://www.dol.gov/ebsa/regs/fab2009-3.html>; Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4546, 4564 (Jan. 26, 2009).

SEC to put in place a process to develop accepted industry standards that would ensure that target date funds are not misleading to consumers on either extreme—too much cash for the young investor or too much equity for the investor near retirement. Should the SEC fail to move toward needed investor protections in the management of target date funds, we believe the Department should proceed on its own to regulate target date funds, or alternatively, should rescind such funds' eligibility as QDIAs.

CFP Board stands ready and willing to provide assistance to the Special Committee, as well as the SEC and the Department of Labor, in the development of needed industry standards for target date funds. CFP Board's Public Policy Council recently established a strategic public policy goal to promote practices in the delivery of financial services that protect our nation's investors and consumers. The creation of industry standards for target date funds sold through 401(k) or other retirement plans is squarely in line with this strategic objective. CFP Board is well positioned to support such a standards setting effort by contributing professional resources. CFP Board could facilitate the participation of CFP[®] professionals who are experts in retirement fund allocations as well as serve as a catalyst for the participation of other industry experts.