

January 2011

DEFINED CONTRIBUTION PLANS

Key Information on
Target Date Funds as
Default Investments
Should Be Provided to
Plan Sponsors and
Participants



G A O

Accountability * Integrity * Reliability

Why GAO Did This Study

To promote the adoption of appropriate default investments by retirement plans that automatically enroll workers, in 2007 the Department of Labor (DOL) identified three qualified default investment alternatives. One of these options—target date funds (TDF)—has emerged as by far the most popular default investment. TDFs are designed to provide an age-appropriate asset allocation for plan participants over time.

Because of recent concerns about significant losses in and differences in the performance of some TDFs, GAO was asked address the following questions: (1) To what extent do the investment compositions of TDFs vary; (2) what is known about the performance of TDFs; (3) how do plan sponsors select and monitor TDFs that are chosen as the plan's default investment, and what steps do they take to communicate information on these funds to their participants; and (4) what steps have DOL and the Securities and Exchange Commission (SEC) taken to ensure that plan sponsors appropriately select and use TDFs? To answer these questions, GAO reviewed available reports and data, and interviewed TDF managers, plan sponsors, relevant federal officials, and others.

What GAO Recommends

GAO recommends that DOL take actions to assist plan sponsors in selecting TDFs to best suit their employees, and to ensure that plan participants have access to essential information about TDFs. DOL raised a number of issues with our recommendations, and we amended one of them in response to their comments.

View [GAO-11-118](#) or key components. For more information, contact Charles A. Jeszeck, (202)512-7215, jeszeck@gao.gov.

DEFINED CONTRIBUTION PLANS

Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants

What GAO Found

Target date funds vary considerably in asset structures and in other ways, largely as a result of the different objectives and investment philosophies of fund managers. In the years approaching the retirement date, for example, some TDFs have a relatively low equity allocation—35 percent or less—so that plan participants will be insulated from excessive losses near retirement. Other TDFs have an equity allocation of 60 percent or more in the belief that relatively high equity returns will help ensure that retirees do not deplete savings in old age. TDFs also vary considerably in other respects, such as in the use of alternative assets and complex investment techniques. In addition, allocations are based in part on assumptions about plan participant actions—such as contribution rates and how plan participants will manage 401(k) assets upon retirement—which may differ from the actions of many participants. These investment differences and differences between assumed and actual participant behavior may have significant implications for the retirement security of plan participants invested in TDFs.

Recent TDF performance has varied considerably, and while studies show that many investors will obtain significantly positive returns over the long term, a small percentage of investors may have poor or negative returns. Between 2005 and 2009 annualized TDF returns for the largest funds with 5 years of returns ranged from +28 percent to -31 percent. Although TDFs do not have a long history, studies modeling the potential long-term performance of TDFs show that TDFs investment returns may vary greatly. For example, while one study found that the mean rate of return for all individual participants was +4.3 percent, some participant groups could experience significantly lower returns. These studies also found that different ratios of investments affect the range of TDF investment returns and offer various trade-offs.

While some plan sponsors conduct robust TDF selection and monitoring processes, other plan sponsors face challenges in doing so. Plan sponsors and industry experts identified several key considerations in selecting and monitoring TDFs, such as the demographics of participants and the expertise of the plan sponsor. Some plan sponsors may face several challenges in evaluating TDFs, such as having limited resources to conduct a thorough selection process, or lacking a benchmark to meaningfully measure performance. Although plan sponsors may use various media in an effort to inform participants about funds offered through the plan, some plan sponsors and others noted that participants typically understand little about TDFs.

DOL and SEC have taken important steps to improve TDF disclosures, participant education, and guidance for plan sponsors and participants. For example, both agencies have proposed regulations aimed at helping to ensure that investors and participants are aware of the possibility of investment losses and have clear information about TDF asset allocations. However, we found that DOL could take additional steps to better promote more careful and thorough plan sponsor selection of TDFs as default investments, and help plan participants understand the relevance of TDF assumptions about contributions and withdrawals.

Contents

Letter		1
	Background	3
	Investment Structures of TDFs Vary Considerably, and Their Design May Reflect Assumptions That Do Not Match Participant Behavior	9
	TDFs Are Likely to Provide a Broad Range of Investment Returns	20
	Plan Sponsors May Face Challenges Selecting and Monitoring TDFs and Communicating to Their Participants	27
	Federal Agencies Have Taken Actions to Address Issues Related to TDFs	34
	Conclusions	38
	Recommendations for Executive Action	40
	Agency Comments	41
Appendix I	Objectives, Scope, and Methodology	44
Appendix II	Studies Reviewed to Assess Ranges of Future TDF Performance	50
Appendix III	Comments from the Department of Labor	51
Appendix IV	GAO Contacts and Acknowledgments	54
Tables		
	Table 1: Recent SEC and DOL Regulatory Proposals for TDF Disclosure Requirements	36
	Table 2: Organizations Contacted during Review	45
Figures		
	Figure 1: Example of a TDF's Fund-of-Funds Structure	5
	Figure 2: Example of a Target Date Fund Glide Path	7
	Figure 3: Selected TDF Glide Paths	10

Figure 4: Representation of TDF Glide Path with Tactical Allocation Option	18
Figure 5: Range of Returns from 2005 to 2009 for the 2010 TDFs with the Largest Market Share	21
Figure 6: 2010 TDF Returns in 2009 with Equity Allocations	22
Figure 7: Potential Outcomes for TDF Ending Account Balances for College Graduates	24

Abbreviations

CIT	collective investment trust
DC	defined contribution
DOL	Department of Labor
EBSA	Employee Benefits Security Administration
ERISA	Employee Retirement Income Security Act
ICI	Investment Company Institute
IRA	individual retirement account
NAICS	North American Industry Classification System
OCC	Office of the Controller of the Currency
PPA	Pension Protection Act of 2006
QDIA	qualified default investment alternative
REIT	real estate investment trust
SEC	Securities and Exchange Commission
TDF	target date fund
TIPS	Treasury Inflation-Protected Security

This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



G A O

Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

January 31, 2011

The Honorable Herb Kohl
Chairman
Special Committee on Aging
United States Senate

The Honorable George Miller
Ranking Member
Committee on Education and the Workforce
House of Representatives

The financial security of millions of Americans in their retirement years will substantially depend on their savings in 401(k) and other defined contribution (DC) plans. To help ensure adequate financial resources for retirement, participants in DC plans must make adequate contributions during their working years and invest contributions in a way that will facilitate adequate investment returns over time. Typically, 401(k) plan sponsors have offered participants a menu of investment options in which they may invest account balances.

The Pension Protection Act of 2006 (PPA) included various provisions designed to encourage greater retirement savings among workers eligible to participate in 401(k) plans, such as provisions that facilitate plan sponsors' adoption of automatic enrollment policies.¹ Under such policies, eligible workers are automatically enrolled unless they explicitly decide to opt out of participation. Because an automatic enrollment program must also include a default investment—a vehicle in which contributions will be invested absent a specific choice by the plan participant—the act also directed the Department of Labor (DOL) to assist employers in selecting default investments that best serve the retirement needs of workers who do not direct their own investments. Since that time, target date funds (TDF)—that is, investment funds that invest in a mix of assets, and shift from higher-risk to lower-risk investments as a participant approaches their “target” retirement date—have emerged as by far the most popular default investment.

¹Pub. L. No. 109-280 (2006) Section 902 of PPA added Code sections 401(k)(13), 401(m)(12) and 414(w). In 2009, the Internal Revenue Service promulgated final regulations addressing automatic enrollment. Automatic Contribution Arrangements, 74 Fed. Reg. 8,200 (February 24, 2009) (to be codified at 26 C.F.R. pts. 1 and 54).

Nonetheless, TDFs have been the subject of considerable recent controversy. While TDFs are designed to decrease the risk of investment losses as a participant approaches the target date, some TDFs designed for those expecting to retire in 2010 experienced major losses during the financial market downturn of 2008-2009, placing the retirement security of many participants in jeopardy. Additionally, TDFs with the same target retirement year performed quite differently in recent years. In order to obtain more information about these and other developments, you asked us to examine a number of issues related to TDFs as qualified default investment alternatives (QDIA). Specifically, we addressed the following questions:

1. To what extent do the investment compositions of different TDFs vary?
2. What is known about the performance of TDFs?
3. How do plan sponsors select and monitor TDFs that are chosen as the plan's default investment, and what steps do they take to communicate information on these funds to their participants?
4. What steps have DOL and the Securities and Exchange Commission (SEC) taken to ensure that plan sponsors appropriately select and use TDFs?

To answer these questions, we conducted in-depth interviews with officials representing selected TDFs, plan sponsors, retirement plan consultants, DOL, SEC, and other experts. The eight TDF managers we contacted account for about 86 percent of the TDF market, as measured by assets under management. We also reviewed available documentation describing the asset allocation of selected TDFs, as well as the rationale behind these allocations. We obtained and summarized data regarding recent performance of various TDFs from Morningstar.² We also reviewed nine studies that, based on various techniques, projected a range of long-term investment outcomes for TDFs. We also reviewed federal laws and regulations.

We conducted our work from December 2009 to January 2011 in accordance with all sections of GAO's Quality Assurance Framework that

²Morningstar is a provider of research that provides data on stocks, mutual funds, and similar vehicles.

are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for any findings and conclusions in this product.

Background

Under DC plans, employees typically must decide whether or not to join the plan, as well as specify the size of their contributions and select one or more investments among the options offered by the plan. About 13 percent of the full-time workforce with access to employer-sponsored plans does not participate in such plans.³ As GAO reported in 2009, existing studies have shown that automatically enrolling employees in 401(k) plans can substantially increase participation rates.⁴ Among other things, automatic enrollment programs require plan sponsors to choose an investment that participants will be defaulted into if they do not make an election on their own. Historically, plan sponsors with such policies have used relatively conservative, low-return investments as the default investment because of fears of fiduciary liability from investment losses. However, the PPA included a number of provisions designed to encourage greater adoption of automatic enrollment, including limited protection from fiduciary liability for plans that automatically invest contributions in specific types of investments as defined by DOL. For example, in the absence of direction from an employee, plans that automatically invest contributions in such funds are treated as if the employee exercised control over management of their savings in the plan. As a result, fiduciaries of plans complying with DOL regulations have some protection against liability for losses that occur as a result of such investments. Fiduciaries—typically plan sponsors—must still satisfy the Employee Retirement Income Security Act (ERISA) fiduciary responsibilities when selecting and monitoring investment options available to plan participants, including QDIAs.⁵ Specifically, plan sponsors who act as fiduciaries and other fiduciaries must act solely in the interest of plan participants and

³Congressional Research Service, *Pension Sponsorship and Participation: Summary of Recent Trends*, Washington, D.C.: Sept. 11, 2009.

⁴See GAO, *Retirement Savings: Automatic Enrollment Shows Promise for Some Workers, but Proposals to Broaden Retirement Savings for Other Workers Could Face Challenges*, [GAO-10-31](#) (Washington, D.C.: Oct. 23, 2009).

⁵See § 624(a) of the PPA and 29 C.F.R. § 2550.404c-5.

beneficiaries, in accordance with plan documents, act with prudence, and offer a diversified set of investment options with reasonable fees. After enactment of the PPA, DOL designated three types of QDIAs including the following:⁶

- **A product such as a TDF (also known as a life cycle fund):** A product that takes into account the individual's age or retirement date and invests in a mix of investments that become more conservative as the participant approaches his or her retirement date.
- **A product such as a balanced fund:** A product that takes into account the group of employees as a whole, instead of an individual, and that invests in a mix of assets with a level of risk appropriate for the group.
- **An investment service such as a professionally managed account:** Unlike a TDF, which is an investment *product*, a managed account is an investment *service* that typically allocates contributions among existing plan options so as to provide a mix of assets that takes into account an individual's age or retirement date and other circumstances.

Of the three options DOL identified, TDFs have quickly emerged as by far the most popular QDIA among plan sponsors who have automatic enrollment programs. As GAO reported in 2009, the percentage of Vanguard Group plans with TDFs as a default investment grew from 42 percent in 2005 to over 80 percent in 2009.⁷ Pension industry experts we spoke with believed the popularity of TDFs will continue to grow in the future.

TDFs are a relatively new type of investment vehicle, and some large TDFs have less than 6 years of history. They are often established as mutual funds in a fund-of-funds structure. That is, the TDF is a composite of multiple underlying mutual funds in different asset classes. As figure 1 illustrates, TDFs consist of an equity component and a fixed income component.⁸ The major asset classes, in turn, may be composed of funds

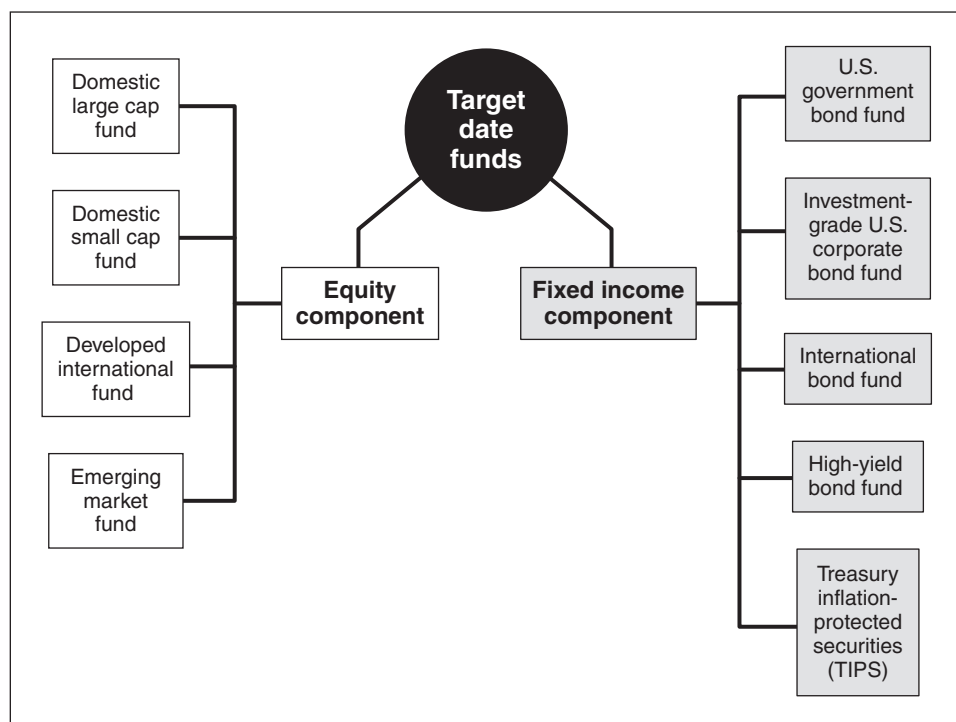
⁶29 CFR §2550.404c-5(e) In addition to these three QDIAs, a plan sponsor may also invest a participant's contributions in a capital preservation fund—a fund designed to preserve principal and provide a reasonable rate of return—for the first 120 days of participation. The final QDIA regulation was promulgated in 2007.

⁷See GAO-10-31.

⁸TDFs may also hold cash, and some also include investments in alternative assets, such as commodities.

representing different sectors of the major asset classes. For example, the equity component may consist of some funds focused on equities of large U.S. corporations, international equities, or equities of smaller companies. Similarly, the fixed income component may consist of various bond funds, such as funds consisting of government and corporate bonds.

Figure 1: Example of a TDF's Fund-of-Funds Structure



Source: GAO.

Note: This chart is for generic illustrative purposes only, and is not intended to illustrate the TDF of a particular investment firm. It is also not an exhaustive list of the asset types that may compose a TDF. For example, a TDF may also hold cash.

A TDF can also be established in forms other than as a mutual fund. For example, TDFs may be offered as collective investment trusts (CIT), which are bank-administered pooled funds established exclusively for qualified plans such as 401(k)s. The responsible bank acts as the fiduciary, and holds legal title to the CIT assets. According to Morningstar, CITs offer a number of potential advantages over TDF mutual funds. For example, they feature lower costs because of factors such as reduced marketing expenses and fewer regulatory filings. Also, because they are not regulated

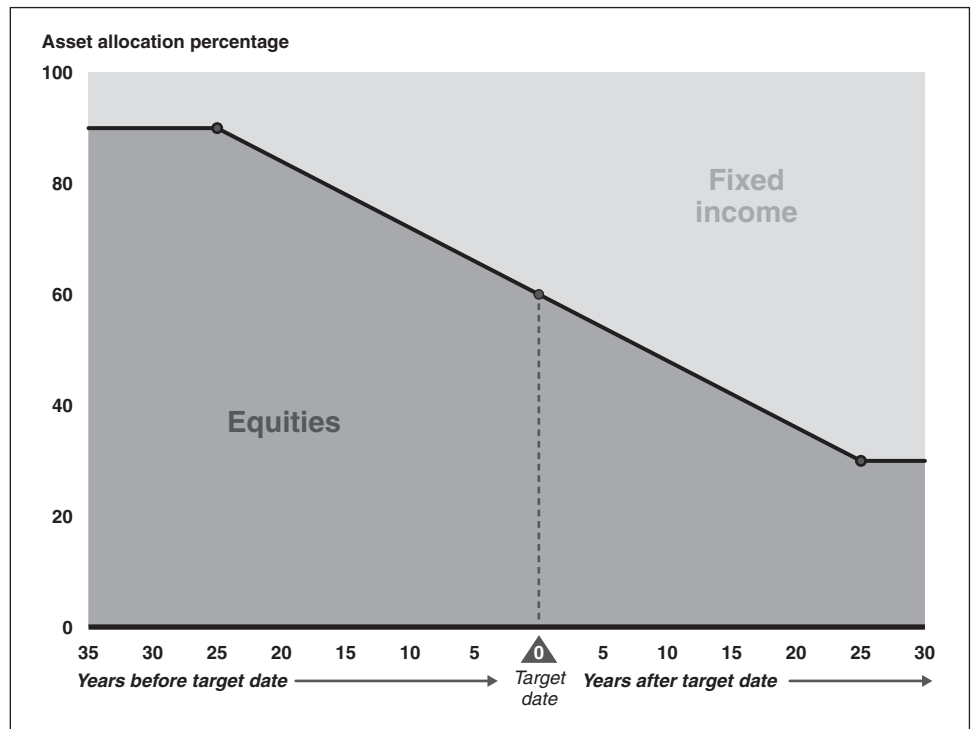
as mutual funds, they can invest in certain vehicles that mutual funds cannot.

Also, some plan sponsors have established customized TDFs, instead of relying on preexisting TDFs offered by investment management firms. For example, a plan sponsor may develop a customized TDF using the existing core investment options it offers. Customized funds can be more precisely tailored to match a plan's objectives and demographics, and offer a plan sponsor greater control over the underlying investments of a TDF. However, one expert noted that because customized funds involve costs greater than those of an already-existing fund, they are generally more popular among larger plan sponsors.

TDFs offer investors a number of potential advantages. First, they relieve DC plan participants of the burden of deciding how to allocate their retirement savings among equities, fixed income, and other investments. TDFs offer participants a professionally developed asset allocation based on their planned retirement date. TDFs thereby can help plan participants and other investors avoid common investment mistakes, such as a lack of diversification and a failure to periodically rebalance their assets.

Second, TDFs are designed to strike a balance between an age-appropriate level of risk and potential investment return. In general, a TDF provider will include a series of funds designed for participants expecting to retire in different years, such as 2010, 2015, 2020, 2025, and so on. A plan participant who is 30 years old in 2011, for example, might be defaulted into a 2045 TDF, while a 55-year-old participant would likely be defaulted into a 2020 TDF. Typically, a TDF will shift from primarily equities to fixed income investments as a participant approaches his or her retirement date, in the belief that fixed income investments generally pose lower risk. This shift can be represented graphically as a line commonly referred to as the glide path. In figure 2 the glide path is the line separating the fixed income component of the investment mix from the equity component of the investment mix. As this illustrates, TDFs allocate a relatively large percentage of assets to equities early, when investors are relatively young, and a much lower percentage as the retirement date approaches. The asset allocation thus becomes more conservative over time, because an older plan participant has a shorter time horizon, fewer opportunities to make contributions to savings, and less ability to recover from downturns in the market.

Figure 2: Example of a Target Date Fund Glide Path



Source: GAO representation of DOL and SEC guidance.

Note: This figure presents one of many potential glide path scenarios for illustrative purposes—different TDFs may feature greater or lesser allocations to equities and fixed income over time, as well as different glide path slopes.

Despite these benefits, TDFs have not been without controversy, especially in the last few years. As a result of the severe financial market turbulence of 2008, some TDFs designed for participants retiring in 2010 lost considerable value, just over 40 percent in one case. Further, according to some experts, many participants were unaware of the risks associated with these investments and that such losses were possible so close to the retirement date. Moreover, TDFs with the same target date also exhibited wide variations in returns.

A number of federal agencies have regulatory responsibilities related to TDFs. The Employee Benefits Security Administration (EBSA) of DOL has general responsibility for protecting the interests of private sector retirement plan participants, and enforcing ERISA’s reporting, disclosure provisions, and fiduciary responsibility provisions. SEC seeks to protect investors and maintain fair, orderly, and efficient markets, and facilitate

capital formation under various securities laws.⁹ Among its various investor protection responsibilities, SEC oversees mutual funds and other key market participants, and promotes disclosure of important market-related information, maintaining fair dealing, and protecting against fraud. SEC also carries out investor education programs, which include producing and distributing educational materials. TDFs established as CITs offered by national banks are regulated by the Department of the Treasury's Office of the Comptroller of the Currency (OCC), which is responsible for regulating and supervising national banks.¹⁰ TDFs established as CITs offered by state-chartered banks or other institutions are regulated by state banking regulators, the Federal Deposit Insurance Corporation, the Federal Reserve Board, or the Office of Thrift Supervision, depending on the institution's charter.

As a result of the controversies surrounding TDFs and at the request of Congress, DOL and SEC held a joint June 2009 hearing on TDFs. Among other issues, the agencies sought testimony regarding how TDF managers determine asset allocations, how they select and monitor underlying investments, and how such information is disclosed to investors. In October 2009, the U.S. Senate Special Committee on Aging held hearings on TDFs and issued a subsequent report.¹¹

⁹Among these laws are the Securities Act of 1933, 15 U.S.C s.77a et. seq. (Pub. L. No. 111-229); the Securities Exchange Act of 1934, 15 U.S.C. § 78a (Pub L. No. 111-257); the Investment Company Act of 1940, 15 U.S.C. s.80a-64 (Pub. L. No.111-257, as amended); and the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1-§80b-21; Pub. L. No. 111-257).

¹⁰See 12 C.F.R § 9.18(a)(2). According to 2009 data compiled by Morningstar, about 79 percent of TDF assets were held in the form of mutual funds, and 16 percent were in the form of CITs. The balance was held in other forms.

¹¹U.S. Senate Special Committee on Aging, *Target Date Retirement Funds: Lack of Clarity among Structures and Fees Raises Concerns*, Summary of Committee Research, prepared by the majority staff of the Special Committee on Aging, U.S. Senate, October 2009.

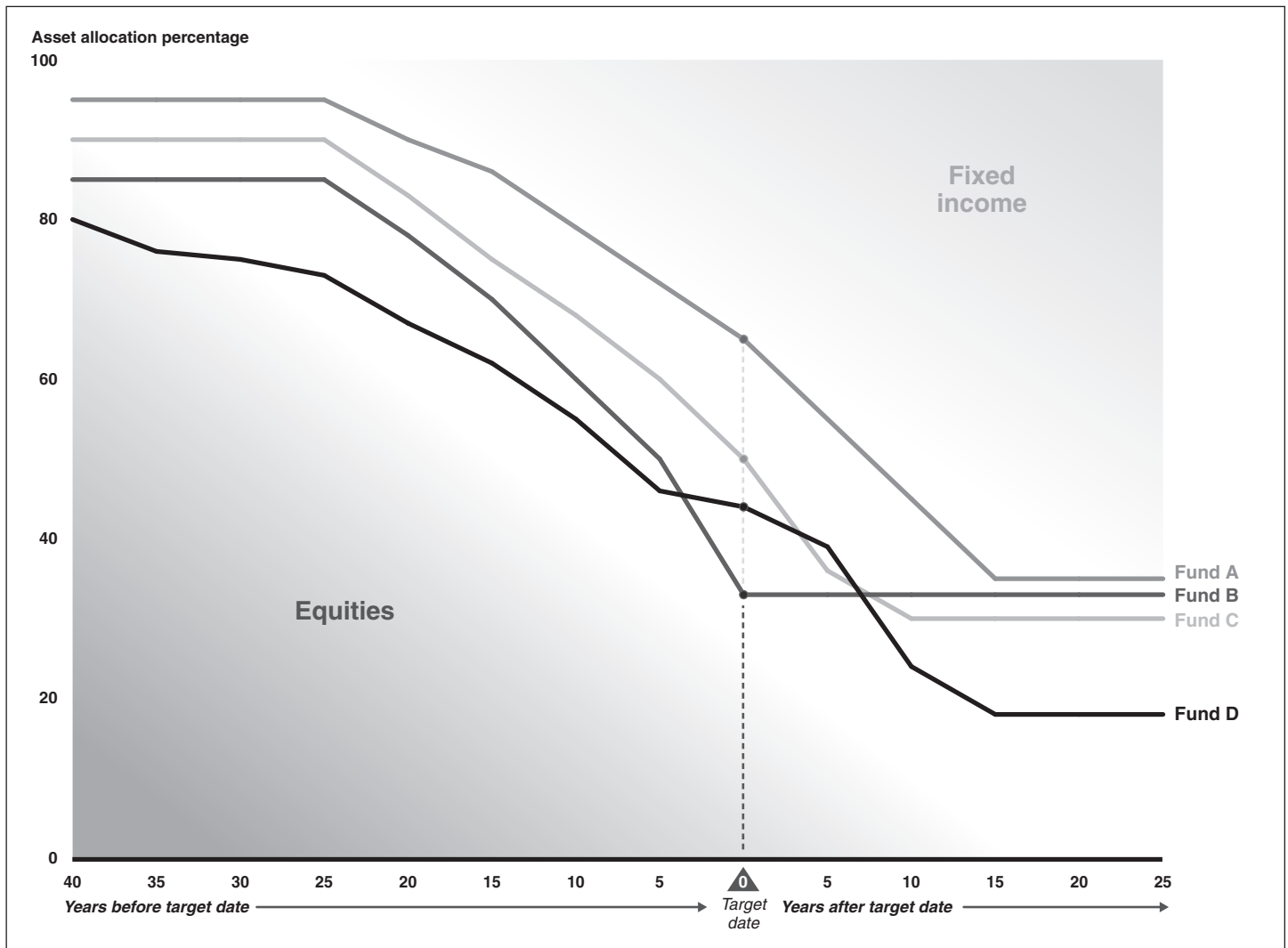
Investment Structures
of TDFs Vary
Considerably, and
Their Design May
Reflect Assumptions
That Do Not Match
Participant Behavior

TDF Allocations Vary
Based on Different
Objectives and
Considerations

TDFs differ considerably in the degree to which they reduce allocation to equities in favor of fixed income investments approaching and after the target date. Each of the eight TDF managers included in our review allocated at least 80 percent of assets to equities 40 years before retirement. However, the rate at which the equity component is decreased and the size of the equity component at retirement can differ considerably. As figure 3 illustrates, one of the TDFs in our review has an equity allocation of about 65 percent at the target date, while another has an equity allocation of about 33 percent.¹²

¹²Figure 3 includes only four examples for purposes of visual clarity. Of the eight TDFs included in our study, the illustration depicts TDFs with a relatively high and a relatively low allocation to equity at the retirement date, as well as two intermediate examples.

Figure 3: Selected TDF Glide Paths



Source: GAO representation of data provided by selected TDF managers.

Note: One of these funds also includes commodities in the non-equity portion of its asset mix. This allocation declines from about 9.8 percent of total assets 40 years before the target date to about 2.0 percent 25 years after the target date.

In addition, some TDF glide paths reach their lowest equity allocation at the presumed retirement date, while others continue to reduce the equity allocation 10 or more years beyond the target date. In figure 3, for example, Fund B reaches its lowest allocation to equity—33 percent—at the target date, and this allocation is maintained for as long as the

participant remains in the fund. In contrast, Fund A reaches the target date with an equity allocation of 65 percent, but the equity allocation continues decreasing for 15 years after the target date, ending at 35 percent.¹³

Differences in the size of the equity component throughout the TDF's glide path may be rooted in different goals and in the treatment of various considerations such as the risk of losing money because of financial market fluctuations—investment risk—and the risk that a participant could outlive his or her assets—longevity risk. For example, two TDF managers whose funds had relatively high allocation to equity at the target date had TDFs designed to ensure that participants do not deplete their assets in retirement. One of these officials explained that even after retirement most participants need the growth that equities can provide and that overreliance on cash and bonds will not yield satisfactory results. According to analyses this manager performed, assuming that participants withdrew 5 percent of their initial savings each year, a strategy allocating 60 percent to equity and 40 percent to bonds would significantly reduce the risk that plan participants would deplete their assets during retirement, compared with a strategy of holding only bonds and cash.¹⁴ Another TDF manager with a relatively high equity allocation at the target date shared similar views, noting that the risk of a participant outliving retirement assets should be the key driver of managing retirement portfolios, and that the manager maintains a significant equity allocation to attain that objective. According to analyses this manager performed, a relatively high equity allocation better ensures that assets will last through a 30-year retirement than a lower equity alternative.

In contrast, TDF managers with significantly lower equity allocations throughout the fund's glide path cited other considerations. For example, the two TDF managers with relatively low allocations to equity at retirement we contacted stressed the potential volatility of equities and the importance of avoiding major losses to retirement savings near or after the target date. An official of one of these funds explained that the goal of the TDF is not to ensure that savings last through the retirement years, but to

¹³According to officials at Morningstar, the large majority of TDFs used by retirement plans continue the glide path beyond retirement. Six of the eight TDFs included in our review do so.

¹⁴This TDF plan manager noted that a rule of thumb for spending in retirement is to withdraw only 4 to 5 percent of the initial savings amount to ensure savings are not depleted. Hence, a 5 percent withdrawal rate may be on the high side of what the analysis considered prudent.

ensure that the maximum number of participants achieve a minimum acceptable level of savings *at* the retirement date. A representative of this TDF manager explained that while this glide path sacrifices the possibility of high investment returns for some participants, it is more important to ensure that as many people as possible arrive at the retirement date with an *adequate* level of savings. This is especially true for defaulted investors who may pay little attention to investment management, the official noted. As this official explained the manager's philosophy, the "pain" of arriving at retirement with insufficient savings outweighs the "pleasure" of arriving at retirement with more than is needed. The glide path of this TDF ends at the target date, and the TDF is not designed to manage assets in the retirement years. Instead, according to a representative of this TDF, it is assumed that participants will use accumulated savings to purchase an annuity at retirement. Similarly, a representative of another TDF said that a low equity allocation was chosen in order to lessen the possibility of severe, unrecoverable losses near retirement. An official of this TDF noted that the risk of investment losses at and after retirement is compounded by the fact that a participant is withdrawing money for living needs. The official noted that while a market loss of 10 percent during the working years can be made up by future contributions and market recovery, it may be difficult to recover from a loss of 10 percent at or just after retirement.

Our contacts with TDF managers revealed that TDFs are also designed based on certain key assumptions about participant actions that may not match what many participants actually do. For example, the glide paths of six of the eight TDFs we contacted extend beyond the target date, and thus seek to manage assets beyond the target date. However, some TDF managers and other experts indicated that this may be a faulty approach for many participants. For example, one TDF manager noted that its research revealed that of all workers who leave an employer after the age of 60, within 6 years, only about 20 percent are still invested in the plan. The official said that about 60 percent roll over into an individual retirement account (IRA), while 20 percent take a lump-sum distribution. A 2009 study of TDF asset allocations and participant behavior found that participants contribute less to their retirement accounts, and borrow and withdraw more, compared with common industry expectations.¹⁵ This study noted that the average participant withdraws over 20 percent of his

¹⁵JP Morgan Asset Management, *Ready! Fire! Aim? 2009: How Some Target Date Fund Designs Continue to Miss the Mark on Providing Retirement Security for Those Who Need it Most*, December 2009.

or her savings per year after retirement, and concluded that partly for this reason, designing a glide path that extends beyond the target date was undesirable. Other experts we contacted indicated that TDFs designed to manage savings in the retirement years may make a flawed assumption when they assume that participants will generally withdraw and spend savings in a methodical, sustainable manner. For example, a representative of a major retirement plan consulting firm stated that participants typically attempt to retain their previous lifestyle by drawing down assets more rapidly than is sound or than TDF managers generally assume.

Conversely, TDF managers who end the glide path at retirement may also be making assumptions that do not match participant actions. For example, representatives of one TDF manager who ends the glide path at retirement explained that the TDF is not designed to manage assets beyond retirement. Instead, the manager bases its income replacement calculations on the assumption that participants will cash out of the TDF upon retirement, and buy an annuity to provide retirement income. However, another TDF manager indicated that very few retirees buy an annuity. Other experts noted that it is not clear how TDF participants will manage withdrawals required for living needs. Further, because widespread adoption of automatic enrollment is a relatively new development, it is not known whether the withdrawal pattern of defaulted investors will differ from existing patterns.

TDFs are also designed based on certain assumptions about contribution rates that may not match what is known about prevailing contribution patterns, or the impact of default contribution rates. Each of the eight TDF managers we contacted considered contribution rates in establishing its asset allocation strategy, and some explicitly noted that these assumptions did not match the general pattern of contribution rates. For example, one noted that while contribution rates are generally lower than levels assumed by its model, it is hoped that rates will increase as workers adjust to DC plans serving as the sole employer-based retirement account. Another TDF manager noted that available data indicated that participant actions are much more varied and volatile than many TDF managers had assumed. According to this manager, participants generally start saving later and do not save at the rates generally assumed. Further, as we reported in 2009, participants who are automatically enrolled can be significantly influenced by the default contribution rate and default

investment.¹⁶ Specifically, we reported that studies had found that some workers would have selected a contribution rate higher than the default rate, had they enrolled in the plan voluntarily. These studies found that default mechanisms have this impact because the default requires no action on the part of the participant. Also some participants may see default policies as implicit advice from the plan sponsor. Because many participants are likely to be automatically enrolled in a TDF, given its emerging role as the predominant QDIA, the default contribution rate, as well as any automatic contribution escalation policy, could have a significant effect on contribution rates to TDFs.

Discussions with plan sponsors indicated that assumptions regarding participant saving and withdrawal patterns involve trade-offs. For example, several TDF managers told us that they had considered a range of contribution and postretirement withdrawal scenarios—to ensure that the TDF was suitable for a range of participants' saving and spending patterns. However, there may be drawbacks to designing TDFs in this manner. For example, one TDF manager noted that designing a TDF in this way could penalize participants who save and withdraw in a disciplined manner. This manager noted that the manager's TDF was designed with certain optimal assumptions in mind, and was not based on actual patterns of cash-out and postretirement spending behavior. The TDF manager explained that designing a TDF to ensure that an optimally behaving investor would not deplete his or her assets is a significant challenge in itself—it would be more difficult, and possibly counterproductive, to take into account actual investor behavior. Another TDF manager indicated that the TDF is designed with a higher equity allocation in the expectation that this will generate higher returns, and thereby, to some extent, compensate for low savings and high withdrawal rates of some participants. Some experts criticized this approach as taking excessive risks to make up for suboptimal participant behavior. For example, a representative of one major consulting firm noted that such an approach could make an underfunded retirement account run out of money even faster in the event of poor market returns.

¹⁶ [GAO-10-31](#).

TDFs' Investment Approaches Differ in other Significant Aspects

While the differences in equity and fixed income allocations distinguish TDFs, these funds also vary in the content and management of these components.

Underlying Composition of Equity and Fixed Income Components

TDFs may vary in the allocations they make to different classes of equity, such as domestic and international. A representative of one TDF told us that the fund has a higher allocation to international equity than most other TDFs because fund managers expect returns in nondomestic markets to be higher in coming years, with little to no additional risk. TDFs can also take distinctly different approaches to selecting and managing their equity portfolios. While some TDF managers we contacted seek mainly to gain exposure to the general domestic or international equity funds, some TDF managers indicated that the manager invests in order to ensure exposure to different investment styles as well. For example, one TDF manager seeks to invest in equities through both “quantitative” and “fundamental” approaches.¹⁷ According to this TDF manager, using both investment styles is intended to smooth the performance curve so that the equity component of the TDF will outperform the market in a smooth rather than erratic fashion.

The fixed income component of the TDFs we examined typically included both traditional fixed income investments, as well as newer vehicles such as high-yield bonds and Treasury Inflation-Protected Securities (TIPS).¹⁸ Although high-yield bonds are generally much riskier than investment-grade bonds, some TDF managers told us they can serve as important diversifiers. One TDF manager said that the returns of high-yield fixed income investments tend to have an inverse relationship with investment-grade fixed income investments and thereby help smooth out the returns of the fixed income component. Nonetheless, because of their high risk, this TDF manager reduces the high-yield bond allocation as a participant nears the target date. Similarly, several TDF managers noted that TIPS are

¹⁷A fundamental approach to selecting equities considers all the factors that affect its cash flow, profits, the industry it operates in, and the economy in general. In contrast, a quantitative approach is a statistical approach and considers such factors as earnings momentum and price momentum.

¹⁸Investment-grade bonds are bonds with high credit ratings, meaning that the issuer is likely to meet its obligations, and can thus offer lower interest rates. High-yield bonds are bonds with a credit rating below investment grade. TIPS are securities whose principal is adjusted by changes in the Consumer Price Index. With inflation, the principal increases, and with deflation, the principal decreases. TIPS pay interest at a fixed rate, which is applied to the adjusted principal.

Passive versus Active
Management

added to the fixed income component in the years before retirement. As one manager explained, the increase of fixed income securities later in the glide path results in greater exposure to inflation, and TIPS offer some inflation protection.

Most of the eight TDF managers we contacted rely on varying degrees of active management, generally in the belief that the returns of such actively managed funds will exceed those of general market indexes over time. For example, representatives of one TDF explained that they believed that the financial markets are not perfectly efficient, and that active management can outperform market indexes with only a modest degree of additional risk.¹⁹ In contrast, one TDF manager and one plan sponsor with a customized fund said they are skeptical of active management, and rely primarily on passively managed funds, which seek to attain performance equal to market or index returns. According to an official of one manager, reliance on passively managed funds offers lower fees to investors. Partly for this reason, the official said that plan fiduciaries should opt for reliance on passive approaches because of their growing use as default investments. Further, such TDF managers expressed skepticism that active managers can persistently outperform the market over time

Some TDFs rely on relatively unconstrained active management, using techniques similar to those used by some hedge funds. For example, one TDF manager we contacted uses some underlying funds based on absolute return strategies, which seek to achieve a positive total return that exceeds the rate of inflation by a targeted amount regardless of market conditions.²⁰ These absolute return funds have no fixed allocations and can shift assets from equities to fixed income or to other asset classes in a relatively unconstrained manner. Also, in an effort to achieve fund objectives, some of these funds use financial instruments such as options,

¹⁹According to investment theory, an efficient market is one in which the price of an asset reflects all information known about that asset, and therefore reflects its true value. As a result, there is little to no opportunity for investment managers to profit by consistently outperforming indexes of the broad market.

²⁰According to this TDF manager, if the absolute return strategies are successful, they would outperform the general securities markets during periods of flat or negative market performance, underperform during periods of strong market performance, and typically produce less volatile returns than the general securities market.

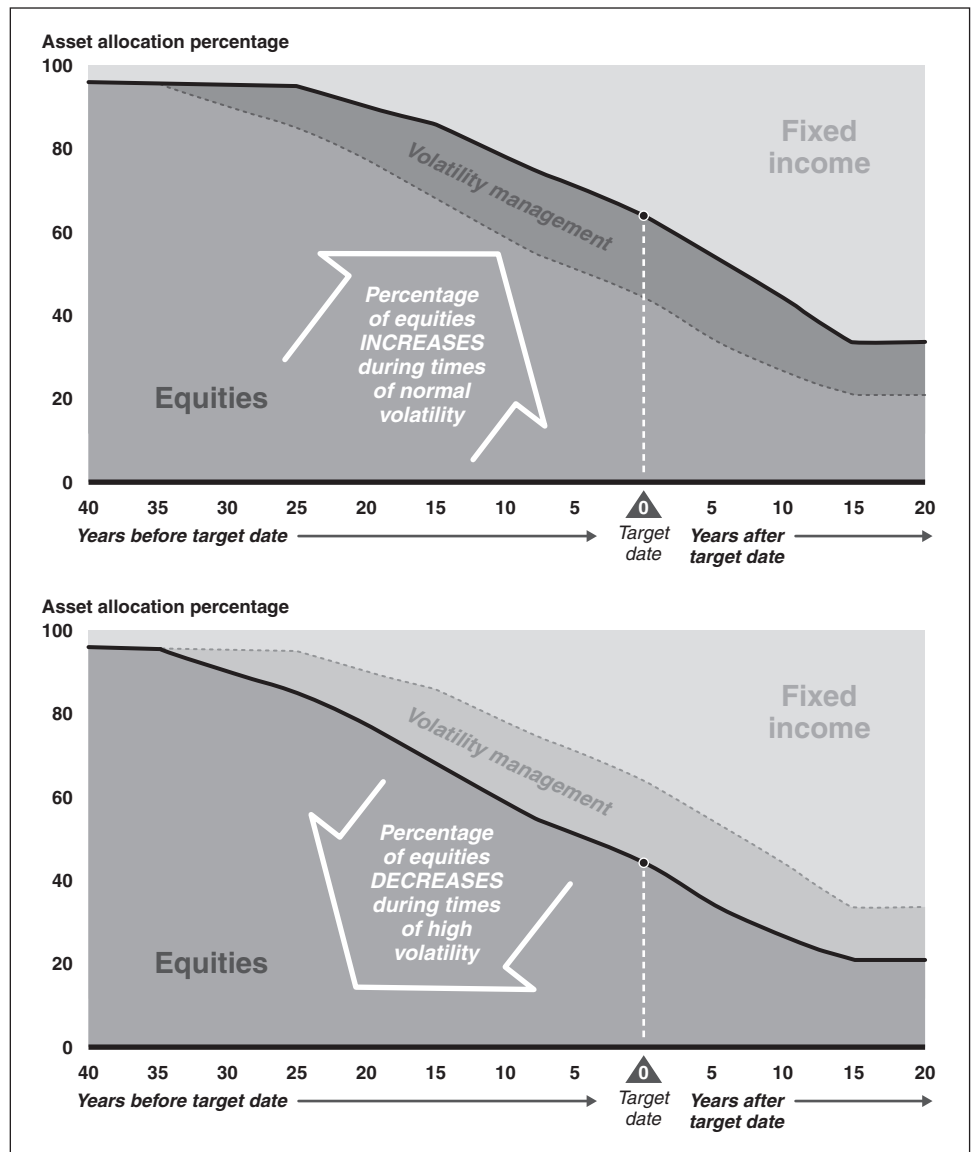
futures contracts, and swaps.²¹ This TDF manager allocates about 60 percent of TDF assets to absolute return funds at and after the retirement date.

Tactical Investment Allocation

Some TDFs permit tactical allocation—the use of short-term investment flexibility to depart from the stated investment strategy of the TDF—while other TDF managers opposed the use of such flexibility. Several TDF managers told us that they use tactical allocation in order to limit volatility and avoid large short-term investment losses, or to achieve greater long-term returns. For example, after the 2008-2009 market decline, one TDF manager adopted a tactical allocation policy with the aim of limiting volatility. Managers of this fund likened their tactical allocation to a shock absorber, and use a number of techniques—such as assessing trends in short-term and intermediate-term volatility and measuring correlations between asset classes—to assess the likelihood of oncoming financial market shocks. On the basis of these metrics, the fund may shift a portion of the equity allocation to fixed income assets if a decline in the equity market is foreseen. Another TDF manager noted that modest tactical asset allocation shifts over time can enhance fund performance, depending on the outlook in the financial markets. This fund will increase or reduce allocations to various asset classes and sectors by plus or minus 5 percent. Figure 4 illustrates an example of a tactical allocation policy—the middle band represents the degree of flexibility the fund manager has to deviate from the strategic equity allocation.

²¹An option is the right to buy or sell a specific security at a specified price at or within a specified time. This may be done regardless of the current market price of the security. A futures contract is an obligation to make or take delivery of a specified quantity of an underlying asset at a particular future time at the price agreed on when the contract was made. A swap is a type of derivative in which two parties agree to exchange assets or cash flows over an agreed period. They can be based on equity indexes, bonds of different maturities, baskets of securities, individual securities, or interest rates.

Figure 4: Representation of TDF Glide Path with Tactical Allocation Option



Source: GAO representation of example provided by a TDF manager.

Three of the eight TDF managers we contacted do not use tactical allocation, preferring to rely on their long-term strategy. One TDF manager noted that severe market events such as the 2008-2009 decline can be likened to a 100-year flood, and that the possibility of such an event was considered in developing its TDF investment strategy. Representatives of

these funds indicated that they had confidence in their long-term strategic allocation.

Use of Alternative Investments

Some of the TDFs in our study invested in alternative asset classes such as real estate investment trusts (REIT), other forms of real estate, or commodities.²² TDFs that invest in alternative assets generally do so to limit volatility or to protect against the effects of inflation. For example, one TDF manager said that it invests in commodities as a form of inflation protection, but noted that because commodities are volatile, they are used earlier in the glide path, for younger workers. Similarly, another TDF manager said that it invests in REITs because they have some characteristics of fixed income investments and some equity-like characteristics, but have not historically correlated to either of these asset classes.

Some TDF managers we contacted who do not invest in such alternative investments expressed some skepticism about the benefits of such investments. For example, one TDF manager noted that nontraditional asset classes and complex investment strategies also come with greater risk and higher costs. For these reasons, the manager believes that such strategies do not offer a reasonable trade-off for the vast majority of retirement investors, especially for those defaulted into 401(k) investments.

Other Aspects of TDFs Can Affect Costs and Available Investments

The fees charged by TDFs vary in both structure and size. For TDFs composed of mutual funds, TDF fees are generally based on the costs of the underlying mutual funds, excluding sales loads and redemption fees. Some TDFs also apply an overlay fee representing the costs of establishing and managing the TDF. For example, one TDF manager explained that the firm does not charge an overlay fee because it believes greater revenues will be earned in the absence of such a fee, as the TDF attracts a greater volume of assets as a result. On the other hand, a TDF manager who did include an overlay fee stated that the effort involved in designing and managing the TDF itself justified imposition of a fee of about 3 basis points—that is, 0.03 percent. According to a 2010 industry analysis, asset-

²²For purposes of this report, we define alternative assets as investments other than those intended to achieve exposure to equities, fixed income investments, or cash. Such investment can include real estate, commodities, and private equity.

weighted expense ratios ranged from 0.19 percent to 1.71 percent.²³ In other words, the costs of the most expensive TDF in the analysis were about nine times the costs of the least expensive fund.

Some TDFs have a “closed” architecture in which underlying funds are limited to mutual funds operated by the firm offering the TDF, while other TDFs have an “open” architecture that may include both proprietary mutual funds and mutual funds managed by other firms. According to TDF managers and others, both types offer certain advantages and trade-offs. For example, some advocates of an open architecture asserted that this approach enables a TDF manager to select the best-performing underlying funds, regardless of who offers them. In addition, some have argued that open architecture removes a potential conflict of interest—the possibility that a TDF manager will invest in a new or poorly performing proprietary fund that is unable to attract sufficient investments on its own. On the other hand, a manager of a closed architecture TDF told us advocates of open architecture assume that there are fund managers who consistently outperform others. This TDF manager asserted that this is not the case. Further, the manager asserted that for some TDF managers, the TDF is or will become the flagship investment fund, and there would be little incentive for a manager to intentionally use a poorly performing fund as an underlying fund in the TDF. A 2010 study by Morningstar acknowledged the debate over open versus closed architecture, but noted that, based on its analysis, there was not a clear performance differential between open and closed architecture TDFs.²⁴

TDFs Are Likely to Provide a Broad Range of Investment Returns

TDF investment returns have varied considerably in the last 5 years, from year to year as well as between similarly dated TDFs in a single year. Over the long term, studies that project TDF performance over a full working career reveal that different age cohorts may experience considerably different investment returns. Finally, comparisons of TDFs with different asset allocations and with other investment options such as balanced funds reveal a number of trade-offs.

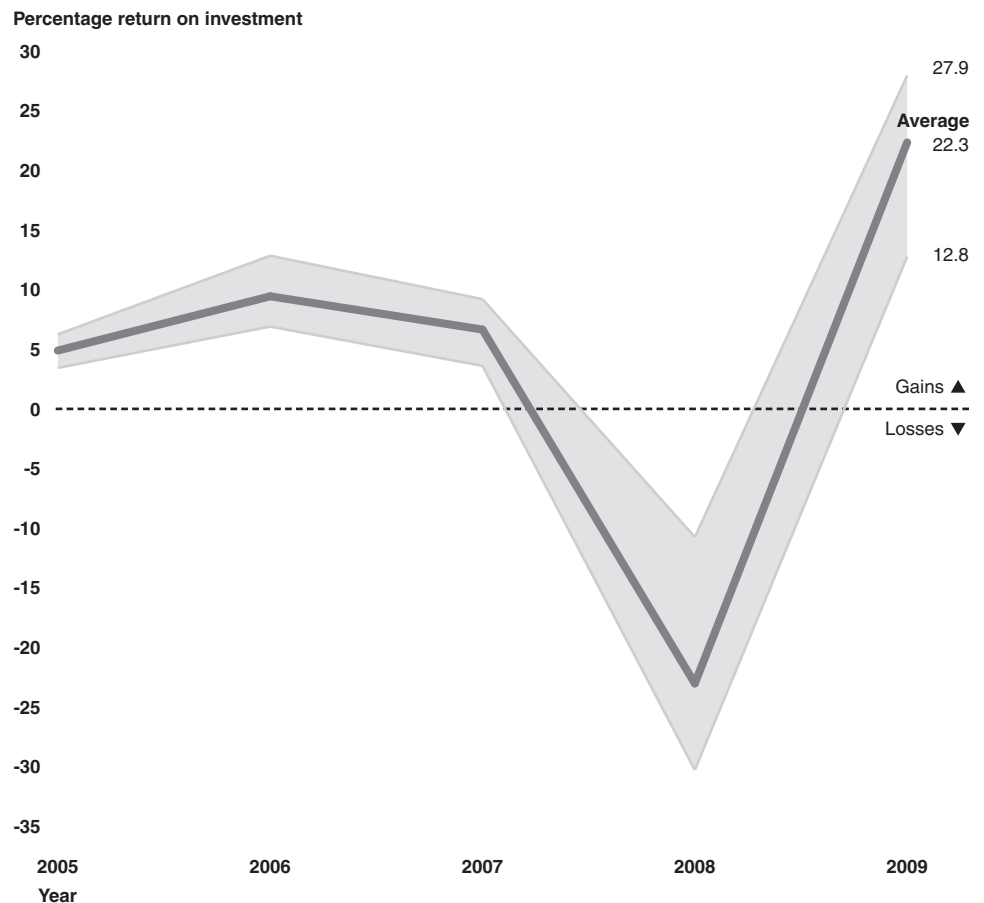
²³Josh Charlson, David Falkof, Michael Herbst, Laura Pavlenko, and John Rekenhalter, *Target Date Series Research Paper: 2010 Industry Survey*, Morningstar.

²⁴Charlson and others, *Target Date Series Research Paper*.

Performance for Similarly Dated TDFs Varied over Recent Years

In recent years, year-to-year performance of TDFs of the same target date has varied considerably. As figure 5 illustrates, of the largest TDFs with 5 years of demonstrated returns, the returns have varied.

Figure 5: Range of Returns from 2005 to 2009 for the 2010 TDFs with the Largest Market Share



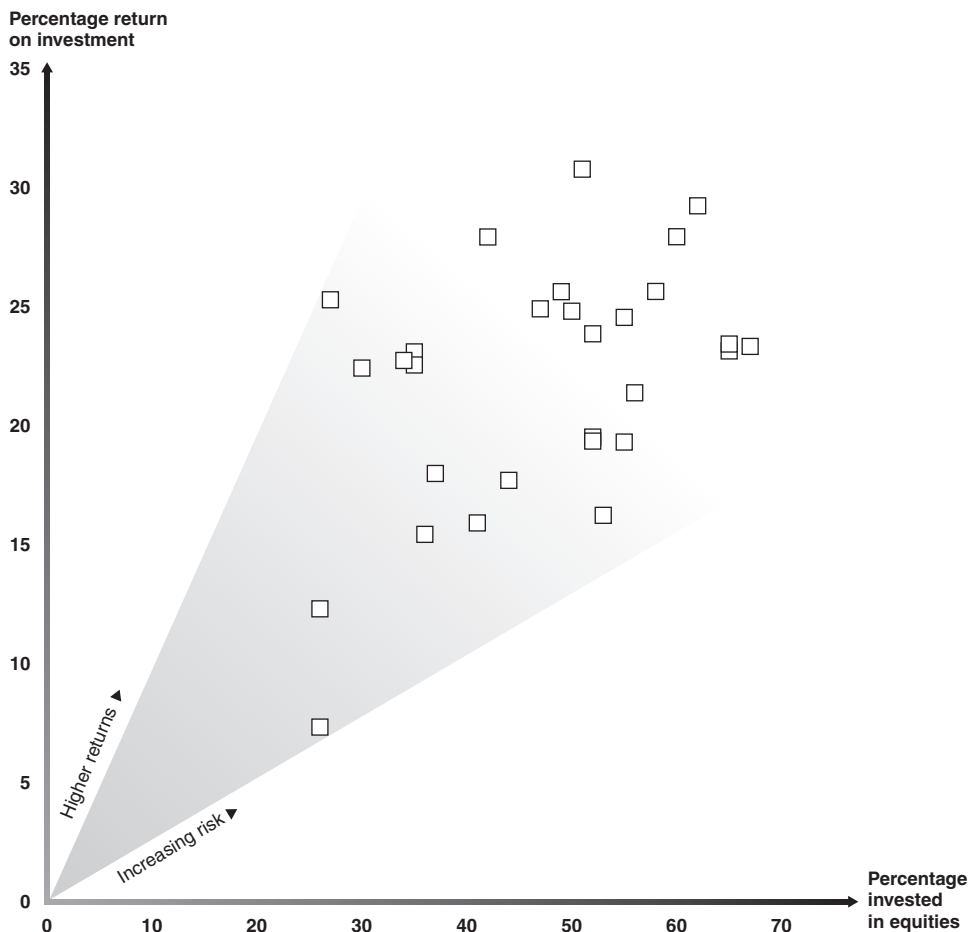
Source: GAO representation of Morningstar data.

Note: Morningstar provided data on the 15 largest 2010 TDFs in terms of assets under management, which represent 98 percent of the TDF market. For this representation, GAO selected the 8 funds that had at least 5 years' worth of return data available. Some TDFs are so new they do not have 5 years of return data. Furthermore, some TDFs contain multiple share classes. Returns from the subclass of shares with the most assets under management are represented.

Investment returns also varied considerably between TDFs of the same target date within each year. For example, according to data from the 2009

Morningstar Industry Survey, in 2008, returns for 2010 TDFs ranged from a loss of about 41 percent to a loss of about 9 percent.²⁵ Conversely, with the market recovery in 2009, returns for 2010 TDFs ranged from gains of about 7 percent to gains of about 31 percent. Figure 6 illustrates 1 year of returns (2009) for 2010 TDFs along with the equity allocations of these TDFs, showing that there is a broad range of returns, even within 1 year, for similarly dated TDFs.

Figure 6: 2010 TDF Returns in 2009 with Equity Allocations



Source: GAO representation of Morningstar data.

²⁵Charlson and others, *Target Date Series Research Paper*.

Because TDFs are designed to be long-term investments, short-term gains or losses need to be put into proper context; that is that these investments are expected to fluctuate in value over time. For example one expert we spoke to emphasized that the reported TDF returns in the last several years were based on the volatile economy. This volatility was not unique to TDFs but seen in varying degrees by other investments over that period of time.

Long-Term Performance of TDFs May Vary among Cohorts

The data from each of the nine studies included in our review showed that participants in different cohorts may experience different investment results.²⁶ For example, a 2006 study used historical earnings data and simulated asset returns to project ending account balances at the retirement date for (1) participants who began investing in different periods of their careers, and (2) participants of different educational levels.²⁷ As figure 7 illustrates, the study found that college graduates who experienced outcomes in the lowest percentile of returns could possibly accumulate savings of about \$116,000, while the outcomes for those at the 90th percentile of returns could possibly accumulate about \$1,270,000—or potentially more than 10 times the savings accumulated by the first percentile. The mean accumulation outcomes for college graduates were about \$743,000. Similar ranges in potential outcomes were found for other educational groups.²⁸

²⁶For a listing of all nine studies we reviewed see appendix II.

²⁷J. Poterba, J. Rauh, S. Venti, and D. Wise, “Reducing Social Security PRA Risk at the Individual Level – Lifecycle Funds and No-Loss Strategies,” paper presented at the Eighth Annual Joint Conference of the Retirement Research Consortium, Washington, D.C. (2006). The authors calculate a wide range of outcomes based on education, investment strategy, and assumptions about historical asset return distributions. The authors model contributions to retirement accounts over a participant’s working life, until retirement at age 63, and combine these contributions with information on the simulated performance of different investment vehicles using actual lifetime earnings histories. They then carry out simulations for various earnings histories with simulated patterns of asset returns to make their conclusions. The authors structure their portfolios so that the percentage of stocks held in the portfolio is equal to the number 110 minus the age of the household head, with the remaining balance held in TIPS.

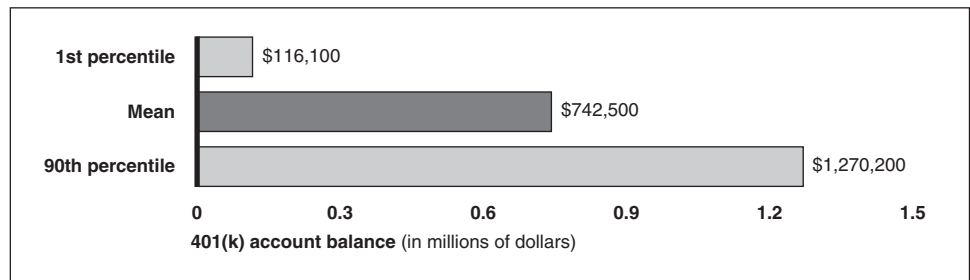
²⁸The study also reported that the outcomes for the lowest percentile of those with a high school diploma could possibly accumulate only about \$83,000, while the outcomes for those in the 90th percentile could possibly accumulate \$1,001,000—12 times the amount accumulated by the first percentile.

Studies of Cohort Risk

In this report, participant cohorts are groups of similarly aged participants whose length of working careers and retirement dates are similar. Because financial market returns will differ over the working lives of participants of different ages, even if all other factors such as contribution levels and investment portfolios remained constant, participants' cohorts are likely to experience significantly different investment returns. Therefore the participants may reach retirement with very different account balances. The risk of being in a cohort that experiences relatively low investment returns is sometimes referred to as cohort risk. It is important to note that while all TDF investors experience cohort risk, cohort risk is not unique to TDFs. All participants in DC retirement plans are exposed to this risk, because DC plans place investment risks solely on individual participants.

The studies we reviewed examined the potential results of cohort risk using various techniques and metrics, and are thus difficult to compare side by side. For example, some studies used historical data on market returns, while others used stochastic techniques, which involve running simulations of thousands of different economic paths to project potential outcomes. Also, the studies used different metrics such as the internal rate of return, account balances at retirement, or the probability of outliving one's assets.

Figure 7: Potential Outcomes for TDF Ending Account Balances for College Graduates



Source: GAO representation of J. Poterba, K. Rauh, S. Venti, and D. Wise. "Reducing Social Security PRA Risk at the Individual Level—Lifecycle Funds and No-Loss Strategies."

Another study found when completing simulations that while some participant cohorts might achieve greater returns than other participant cohorts, a small percentage of individual participants might arrive at retirement with less money in real terms than they contributed to their TDF over their working careers, because of poor returns in the financial markets.²⁹ Specifically, simulations completed in the study resulted in a mean real internal rate of return for the baseline portfolio of about 4.6 percent for all participant cohorts, while two simulated cohorts achieved a 2.4 percent real internal rate of return, or less than half the rate of return that the best-performing cohort achieved at 6 percent.³⁰ Furthermore, the study found that the mean rate of return for all individual participants was 4.3 percent, while individual participants in the 99th percentile achieved 8.5 percent rate of return and the bottom 10th percentile of individual participants experienced a rate of return of 1.9 percent, and those

²⁹B. Bridges, R. Gesumaria, and M. Leonesio. "Assessing the Performance of Life-Cycle Portfolio Allocation Strategies for Retirement Saving: A Simulation Study." *Social Security Bulletin*, vol. 70, no. 1 (2010): 23-43.

³⁰In this study the baseline portfolio invests 85 percent of total value in equities through age 29, with the equity share declining linearly until it reaches 15 percent at age 60, where it remains thereafter. The remainder of the portfolio is invested in the bond fund. The bond fund consists of one-half long-term federal Treasury bonds and one-half 6-month private sector money market instruments.

Trade-offs of Different TDFs' Asset Allocations

participants in the 1st, or lowest, percentile experienced a rate of return of minus 0.1 percent.³¹

Some of the studies we reviewed found that trade-offs exist between higher-equity and lower-equity TDFs. For example, one study found that TDFs using a higher-equity approach resulted in higher average returns relative to a more conservative, lower-equity TDF.³² However, the study also found that higher-equity TDFs increased the chance for an infrequent poor outcome because of the increased risk these investments carry. By comparison, a lower-equity approach will increase the likelihood that the participant cohort will not lose as much money in a downturn in the market, but forgoes the potential for large returns in an upturn in the market. One study found that reducing the risk of extreme outcomes by switching to a lower-equity approach earlier in the glide path involved a heavy penalty in terms of forgone accumulation of wealth.³³ An additional study simulated the use of the TDFs in retirement and found that participants in lower-equity TDFs are subject to a higher shortfall risk—ranging between 14 percent and 22 percent.³⁴ However, TDFs with lower

³¹The study conducted a series of stochastic simulations of 28 birth cohorts between 1915 and 1942, using historical investment returns for the years 1926 to 2008. The study was based on actual lifetime earnings histories. Real asset returns are derived by adjusting nominal values for inflation. Bridges and others, "Assessing the Performance of Life-Cycle Portfolio Allocation Strategies for Retirement Saving: A Simulation Study," 23-43.

³²Bridges and others, "Assessing the Performance of Life-Cycle Portfolio Allocation Strategies for Retirement Saving: A Simulation Study," 23-43.

The study, which used four TDFs that varied in terms of risk exposure and various participant ages, used historical return data in modeling the results. The aggressive TDF resulted in a real internal rate of return averaging 5.1 percent, with the outcomes ranging between -9.5 percent and 17.8 percent. By comparison, the conservative TDF had an average return of 3.9 percent. Returns for the conservative TDF ranged from -5.6 percent to 13.2 percent. The conservative TDF investment model started with 70 percent invested in equities through age 29 and then linearly declines to 10 percent at age 60.

³³A. K. Basu and M. E. Drew, "Portfolio Size Effect in Retirement Accounts: What Does It Imply for Lifecycle Asset Allocation Funds?" *The Journal of Portfolio Management*, Spring (2009): 61-72. This study used four hypothetical TDFs invested in equities, fixed income investments, and cash to perform the modeling.

³⁴John Spitzer and S. Singh. "Shortfall Risk of Target-Date Funds During Retirement," *Financial Services Review*, (2008): 143-153.

Comparison of TDFs with Other Types of Investments

equity allocations may also help participants avoid extremely poor investment returns.³⁵

Some of the studies we reviewed analyzed the potential long-term performance of TDFs compared with other investments, such as balanced funds and all-bond funds.³⁶ In one study, the moderate TDF outperformed the balanced fund in three of the seven age cohorts examined, while the balanced fund performed better in the other four cohorts.³⁷ Further, this study found that the mean return of the aggressive TDF exceeded that of the balanced fund, while the balanced fund mean return exceeded those of the conservative and baseline TDFs.³⁸ Another study found a balanced fund to have similar average returns to a baseline TDF, but with a wider variance in returns.³⁹ The study also modeled a 50/50 balanced fund and found that the balance fund generally performed better than the simulated TDF used for comparison. For example, the study calculated the after-tax income in retirement for a college graduate earning \$55,000 per year who had invested in a TDF versus in a 50/50 balanced fund. If the participant's TDF performed in the top or middle set of outcomes, then the 50/50 fund would outperform the simulated TDF. However, at the bottom 10 percent of possible outcomes, the TDF and 50/50 balanced fund performance would be similar, thereby making payouts from both types of funds at retirement almost the same.

The results of a study we reviewed that compared TDFs with an all-bond fund found that TDFs would outperform the all-bond fund. The study modeled conservative, moderate, and aggressive TDFs.⁴⁰ Assuming

³⁵Bridges and others, "Assessing the Performance of Life-Cycle Portfolio Allocation Strategies for Retirement Saving: A Simulation Study," 23-43.

³⁶Some studies compared TDFs with other investment products and portfolios. However, for the purpose of this report we are focusing on balanced funds and all-bond funds.

³⁷Bridges and others, "Assessing the Performance of Life-Cycle Portfolio Allocation Strategies for Retirement Saving: A Simulation Study," 23-43.

³⁸According to the study, the 50/50 balanced fund average annual returns were 4.9 percent as compared with 4.2 for the conservative TDF, 4.6 for the moderate TDF, and 5.3 for the aggressive TDF respectively.

³⁹P. Brady "What Does the Market Crash Mean for the Ability of 401(k) Plans to Provide Retirement Income?" *National Tax Journal*, vol. LXII, no. 3 (2009): 455-476.

⁴⁰Bridges and others, "Assessing the Performance of Life-Cycle Portfolio Allocation Strategies for Retirement Saving: A Simulation Study." The study compared an all-bond fund composed of half long-term Treasury bonds and half 6-month private sector money market funds with a simulated TDF.

markets behave as they have historically, all three TDFs were projected to have higher average returns than the all-bond fund. The TDFs average return rate ranged from 3.9 to 5.1 percent, while the all-bond fund had an average return rate of 2.1 percent.

Plan Sponsors May Face Challenges Selecting and Monitoring TDFs and Communicating to Their Participants

Plan sponsors and industry experts we spoke to identified several key considerations in selecting and monitoring TDFs, such as ensuring the TDF fits with key characteristics of the workforce. Plan sponsors face a number of challenges in selecting and monitoring TDFs, and some may not take a thorough approach to TDF selection. Although plan sponsors communicate to participants using different media, plan sponsors and others we contacted indicated that the level of understanding of TDFs among plan participants was fairly low, particularly among defaulted participants.

According to Plan Sponsors and Industry Experts, Plans Should Take Several Steps When Selecting and Monitoring TDFs as QDIAs

Clearly Defined Goals and Objectives

Plan sponsors and other experts we contacted noted that the unique and complex nature of TDFs necessitates certain steps in the selection and monitoring processes, above and beyond the steps plan sponsors would take for any 401(k) investment.⁴¹ As one expert noted, TDFs are structured as a long-term, all-in-one investment solution, rather than a single investment product within a broader retirement portfolio. Several plan sponsors and others stated that plan sponsors should first clearly define their goals and objectives for the 401(k) plan's default investment and then choose TDFs that match these objectives. For example, if the goal of the

⁴¹ERISA fiduciaries are required to act solely in the interest of plan participants and their beneficiaries and select and monitor plan investments with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would act. There are a number of steps plan sponsors should take when selecting and monitoring any type of investment in their 401(k)s, including reviewing fund fees and expenses to make sure they are reasonable, assessing and monitoring fund management, and reviewing performance periodically. 29 U.S.C. § 1104.

Matching TDF to Participant Population

401(k) plan is to serve as the sole retirement vehicle for most participants, then a plan sponsor may wish to consider more conservative TDFs as its default investment. Conversely, if the goal of a 401(k) plan is to serve as a supplementary savings vehicle to accompany a defined benefit plan, a more aggressive TDF may be appropriate.

Several plan sponsors and industry experts noted that each plan sponsor's participant population has certain characteristics that should be taken into account when determining which TDF to select as a default investment. For example, one plan sponsor said that its employees generally share similar relevant characteristics—most of its participants will retire before 65 years of age, have access to a defined benefit plan, maintain a reasonable savings rate, and receive 401(k) employer match in company stock. Therefore, the sponsor chose to develop its own customized TDF that would better match its workforce, rather than an off-the-shelf product. Several industry experts noted that a plan sponsor's industry, particularly the salary level and job security or turnover, should be considered when deciding which TDF to choose as the plan's default investment. For example, one expert noted that a glide path with a lower equity allocation would better suit a sponsor with a high-turnover workforce. This is because a participant would be less likely to suffer significant investment losses if he or she were to separate and cash out his or her 401(k) in a depressed equity market. While some plan sponsors and plan consultants may examine the participant population, small plan sponsors with unique and homogeneous workforces may benefit from simply identifying several key characteristics of their participant population and using that insight to inform their choice of TDFs as their default investment.

Similarly, some plan sponsors and others noted that plan sponsors should make an effort to match the TDF glide path and underlying assumptions with other workforce characteristics. In particular, industry experts and plan sponsors cited the importance of considering participants' behavior as it pertains to contribution rates, retirement age, withdrawal patterns during a participant's working career, and actions in retirement, such as drawdown rates.⁴² Little is currently known about participants defaulted into TDFs, because they are relatively new vehicles that only recently have

⁴²Plan participants can withdraw funds from a 401(k) account in advance of retirement through a number of means, such as a loan or a withdrawal due to financial hardship. See GAO, *401(k) Plans: Policy Changes Could Reduce the Long-Term Effects of Leakage on Workers' Retirement Savings*, [GAO-09-715](#) (Washington D.C.: Aug. 28, 2009).

gained popularity as default investments. Consequently, many plan sponsors we spoke with examined their entire participant population to inform their TDF selection process. Similarly, given that QDIAs themselves are relatively new, it is unclear what the behavior of the defaulted population will be over time. Industry experts said that in some cases, a large majority of participants may take a lump-sum withdrawal at retirement, purchase an annuity, or reinvest the balance in a vehicle that the sponsor knows little about. In that case, according to one industry expert, a plan sponsor may wish to consider a TDF that reduces its market risk as the fund nears the retirement date because participants will be taking money out of their TDFs at retirement. In contrast, if most plan participants are going to withdraw funds from the plan at a steady rate throughout retirement, then a plan sponsor may wish to consider a TDF with a more aggressive glide path near the retirement date because the participant would have a longer time to recover from any downturns in the equity market. Furthermore, one industry expert said plan sponsors should examine participant contribution rates and withdrawal patterns, especially the percentage of participants who take preretirement distributions starting at 59½ years old. According to this expert, such distributions could substantially affect the volatility of cash flows and the investment time horizon for the TDF.

Despite the importance placed on workforce characteristics by some of the plan sponsors and experts we contacted, current DOL regulations do not require that plan fiduciaries, such as plan sponsors, consider factors other than a participant's age or target retirement date when deciding whether a TDF, among categories of investment alternatives described in the regulation, are QDIAs within the meaning of the regulation. While the current regulations do not preclude consideration of other factors, DOL has specifically stated that plan fiduciaries are not required to include other considerations in their selection of QDIAs. In the preamble accompanying the final QDIA regulations in 2007, DOL stated that the agency took this position in order to provide plan fiduciaries with certainty that they had complied with the regulation.⁴³ However, as mentioned in the preamble, plan fiduciaries still must satisfy their general fiduciary responsibilities of prudence and loyalty when selecting and

⁴³Default Investment Alternatives Under Participant Directed Individual Account Plans; Final Rule, 72 Fed. Reg. 60,452, 60,461 (October 24, 2007) (codified at 29 C.F.R. pt. 2550). In the same preamble, DOL explained that with respect to balanced funds, another QDIA option, fiduciaries are required to take into account the demographics of the plan's participants in selecting a balanced fund as a QDIA. 72 Fed. Reg. 60,461, 60,462.

monitoring any particular TDF, and these duties require plan fiduciaries to consider other factors in selecting a particular TDF.

Plan Sponsor Expertise and Resources

Because some TDFs are more challenging to monitor than others, some industry experts said plan sponsors should consider their level of expertise and available resources when selecting TDFs. Plan sponsors and industry experts stressed the importance of monitoring and assessing any changes to the TDF glide path or investment strategy because TDFs are not static investments. A TDF may deviate from or change its stated glide path over time, change underlying funds and fund managers, or change investment strategies within an asset class—all of which can have a significant effect on the fund's composition, performance, and fees. Therefore, as one industry expert stated, plan sponsors with limited expertise and resources should not select TDFs with high tactical allocations or other actively managed strategies that allow the TDF manager to deviate significantly from its glide path because they require more active oversight. Similarly, one industry expert said plan sponsors whose investment committees meet only once annually and rely primarily on their record keepers' reports to monitor their investments should not choose TDFs that would require more due diligence monitoring, such as customized funds.

Some Plan Sponsors Face Challenges When Selecting and Monitoring TDFs

Limited Due Diligence

Our discussions with plan sponsors and industry experts indicated that sponsors vary in their approach to TDF selection and monitoring, in part because of several key challenges that some plan sponsors face. First, some plan sponsors, particularly small plan sponsors, who spend the vast majority of their time running their business and administering other benefits and payroll, may have limited resources in-house to conduct a thorough TDF selection process and ongoing monitoring activities. One industry expert noted that this may be a problem, particularly in the small end of the marketplace, where plan sponsors may simply choose any TDF in the marketplace once they determine that all TDFs qualify as QDIAs. Another industry expert stated that most plan sponsors could not even document that they had considered a range of investment managers in

their TDF selection process.⁴⁴ Furthermore, some small plan sponsors may not grasp the basic concepts of TDFs and would not know the steps necessary to properly evaluate and select a TDF. Therefore, some plan sponsors with limited in-house resources may look outside to service providers for advice or to conduct some or all of the steps of the TDF selection and monitoring processes; however, they may be unaware that the service provider may not be a plan fiduciary and may have conflicts of interest in providing advice.⁴⁵

Benchmarking Limitations

The majority of experts and plan sponsors we spoke to said that plan sponsors have difficulty comparing and evaluating the performance of TDFs because of the limitations of currently available benchmarks. According to several experts, traditional benchmarks, such as Morningstar star ratings, that compare the returns of all funds within a category—such as all domestic large cap funds—relative to each other, may not be very useful in evaluating TDF performance. This is because the objectives, asset allocation, investment strategy, and underlying funds that make up a TDF can vary among one another and over time. For example, a TDF with a relatively low allocation to equity may underperform a TDF benchmark during a lengthy rise in the equity market, but this may be an expected short-term consequence of the long-term TDF strategy. If a sustained decline in equity values occurs near or after the target date, the same TDF may outperform the benchmark. One plan sponsor pointed out that TDFs are a relatively new product type and most of them do not have long track records, yet these vehicles have long-term investment objectives (e.g., 40 years at a minimum and much longer if the postretirement phase is included.) Therefore, experts noted that simply comparing returns over a 1-, 5-, or 10-year time period might not be useful in evaluating the long-term appropriateness of the fund.

⁴⁴According to a nationally recognized ERISA expert, such omissions may be considered a breach of fiduciary duty, in light of ERISA's requirement that plan sponsors prudently select and monitor plan investment options, and carefully consider the quality of competing providers and investment products, as appropriate.

⁴⁵On October 22, 2010, DOL published a proposed rule to amend the definition of an ERISA fiduciary that would require any person, with certain exceptions, who gives advice or recommendations as to the selection of investment managers of plan assets to become an ERISA fiduciary. Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2550). A forthcoming GAO report will discuss the potential conflicts of interest of service providers offering advice to plan sponsors and plan participants in more detail.

Some plan sponsors said they developed custom composite benchmarks to evaluate the performance of their individual TDFs. Other industry experts noted that custom composite benchmarks are useful only in measuring whether a manager succeeds in outperforming the general market but that they lack the ability to evaluate a TDF's glide path strategy or investment objectives. Several industry experts and plan sponsors we spoke to said there is no universally accepted benchmark that can be used to evaluate all TDFs. As an alternative to benchmarks, one plan consultant recommended that sponsors use forward-looking metrics that evaluate the risk/reward characteristics and the range of possible long-term performance outcomes of the TDFs—such as retirement income replacement rates and longevity risk (e.g., the risk that a participant will run out of money before death) as alternative evaluation tools.⁴⁶ Several plan consultants said plan sponsors would be best served to examine the fund's glide path and objectives, rather than focus solely on performance.

Role of Record Keepers

Several industry experts we spoke to said record keepers may influence a plan sponsor's TDF selection process.⁴⁷ Several industry experts said some record keepers require plan sponsors to use their TDFs or may offer discounts to entice plan sponsors to use their TDFs. Since the costs and time associated with switching a record keeper can be high—for example, this could entail changes in computer systems, record-keeping and payroll processes, and converting account balances—plan sponsors may feel they have little choice and may not even consider other options. According to Brightscope data, in 2009, 96 percent of 401(k) plans with TDFs that were clients of the largest record keepers use the record keeper's proprietary TDFs.⁴⁸

Two of the 10 plan sponsors we spoke to said they did not look beyond their record keeper's TDFs when selecting their plan's default investment.

⁴⁶Retirement income replacement rates refer to the percentage of a participant's final salary that is matched by the participant's retirement payments, if the participant was to purchase an annuity with the balance of his or her retirement account at the retirement date.

⁴⁷A record keeper is a service provider that provides record-keeping services such as plan administration, monitoring of plan and participant and beneficiary transactions (e.g., enrollment, payroll deductions and contributions, offering designated investment alternatives and other covered plan investments, loans, withdrawals, and distributions), and the maintenance of covered plan and participant and beneficiary accounts, records, and statements.

⁴⁸Brightscope is an independent provider of 401(k) ratings and financial information to plan sponsors, advisers, and participants.

One said it chose not to search for other TDFs in the marketplace because it valued the bundled services approach that its record keeper could provide. This sponsor added that this arrangement made it easy for the plan sponsor to manage the 401(k) plan because it interacts with one provider for most issues it encounters. Another plan sponsor said it used an outside consultant to conduct its TDF search. However, the first step in the consultant's search process was to get a list of funds that were supported by its record keeper. Ultimately, the consultant provided only one recommendation—the record keeper's TDF—to the plan sponsor's investment committee.

Plan Sponsors Provide Defaulted Participants Information on TDFs Using Various Media

Although most plan sponsors we spoke to offered multiple avenues of communications to their participants, the level of information on TDFs provided to plan participants varied greatly from plan sponsor to plan sponsor. Plan sponsors we spoke to provided information to participants on all 401(k) investments using a variety of media, which included new employee packets, flyers, newsletters, Web sites, call centers, and in-person educational sessions. In addition, some plan sponsors provided communications specifically focused on TDFs. For example, one plan sponsor sent a newsletter to participants after the 2008 market downturn that included an article explaining how TDFs should be used. Another sponsor said it provided a Morningstar fund fact sheet on all its 401(k) investments, including TDFs, and the initial and annual QDIA notifications, and provided no further information on TDF investing in general, or the composition of the TDFs offered in the 401(k) plan. In contrast, another plan sponsor said its employee benefits staff meets with new employees to review the TDF's glide path, discuss the age-based nature of the TDFs, and the importance of choosing a TDF with a target date closest to their planned retirement date. They also explained the risks and return characteristics of the TDFs and how they become more conservative over time. New employees also received a packet that included information on the available TDFs. Some plan sponsors relied on service providers to develop and distribute information on TDFs to their participants. One plan sponsor we spoke to said that all participant communications come directly from its record keeper and TDF manager.

Several plan sponsors said they sent initial and annual notifications directly to defaulted participants explaining that participants have been automatically enrolled in the 401(k) plan and defaulted into a specific TDF. However, defaulted participants may receive limited or no information on the principles and objectives of TDF investing, in general, or specific information on the glide path and composition of the TDFs

chosen as the plan's default investment. If this information is not included in the annual communications sent to defaulted participants, then participants must actively seek out information on the TDFs they are invested in through other media, such as Web sites, educational tools and videos, and newsletters.

Plan sponsors and other experts described a number of challenges in effectively educating participants about key aspects of TDFs. Plan sponsors generally indicated that participants understand little about TDFs beyond the basic concept that TDFs are aged-based funds that become more conservative over time. The sponsors also indicated that participants defaulted into TDFs know less about TDFs than an average participant. One consultant said that defaulted participants are typically disengaged and, in general, could not name the fund that their contributions are going into or answer the most fundamental questions about TDFs. Furthermore, several plan sponsors we spoke to said that participants had misperceptions about TDFs, particularly those contributing to TDFs with target dates in the relatively near future. Such participants often believed that their investments were protected because they were close to the retirement date, and were shocked when the values declined significantly, as they did in 2008-2009.

Federal Agencies Have Taken Actions to Address Issues Related to TDFs

Since DOL and SEC held a hearing regarding TDFs in the wake of the 2008-2009 market decline, the agencies have taken several steps to enhance participant protections. These included efforts that focused on educating plan sponsors and participants, and proposed regulations that, if finalized, would require TDF managers and plan sponsors to improve information provided to participants.

Guidance on Selecting and Monitoring TDFs

In early 2010, DOL and SEC jointly published an investor bulletin that provided participants education and outlined considerations for plan participants when choosing a TDF.⁴⁹ The investor bulletin explained the goals, functions, and risks associated with TDFs while directing participants to carefully consider whether TDFs are the best option for them. The investor bulletin also explained that TDFs are designed to make investing for retirement more convenient by automatically changing the asset allocation for the participant's account over time. DOL and SEC

⁴⁹DOL and SEC "Investor Bulletin: Target Date Retirement Funds," May 6, 2010.

emphasized that TDFs carry risk and do not guarantee sufficient retirement income at the retirement date. Because defaulted participants have not generally taken an active role in their investments, some experts expressed doubt that the bulletin would be of value to these participants.

According to DOL officials, the agency is also developing guidance directed at plan sponsors. DOL stated that the guidance was necessitated by the growing popularity of TDFs in 401(k)-type plans and the fact that TDFs are not uniformly designed investment products. According to DOL, the guidance will be designed to assist plan sponsors in their evaluation and selection of TDFs as plan investments, aiming to help plan fiduciaries enhance retirement security for participants. DOL noted that such guidance is needed in light of the importance of understanding the unique characteristics that distinguish TDFs from other types of investments, the differences among the various TDFs available, and how these differences can affect the retirement savings of participants. As of January 24, 2011, the guidance had not been released.

Actions to Enhance TDF Disclosure to Participants by Plan Sponsors

In recent months, both DOL and SEC have issued proposed regulations that would help ensure that plan participants obtain better information about TDFs. SEC proposed regulations addressing the marketing and naming of TDFs in June 2010.⁵⁰ According to the preamble of SEC's proposal, the proposed regulations are intended to address concerns that have been raised regarding the potential for investor misunderstanding that could arise from TDF names and marketing materials. In November 2010, DOL released proposed regulations on target date disclosures.⁵¹ According to DOL officials, their proposal was largely motivated by the joint public hearing held by DOL and SEC in June 2009, after which the agency determined that improvements could be made to the information disclosed to participants concerning their investments in TDFs. SEC and DOL proposed regulations that are summarized in table 1.

⁵⁰Investment Company Advertising: Target Date Retirement Fund Names and Marketing, 75 Fed. Reg. 35,920 (June 23, 2010) (to be codified at 17 C.F.R. pts. 230 and 270).

⁵¹Target Date Disclosure, 75 Fed. Reg. 73,987, (November 30, 2010) (to be codified at 29 C.F.R. pt. 2550). The comment period for the proposed regulation closed on January 14, 2011.

Table 1: Recent SEC and DOL Regulatory Proposals for TDF Disclosure Requirements

SEC-proposed regulations for TDF marketing materials	DOL-proposed amendments to QDIA and other disclosure regulations for TDFs ^a
Prohibiting potentially misleading statements about TDFs	
Certain statements would be considered potentially misleading ^b <ul style="list-style-type: none"> stating that TDFs are a “simple” investment plan that requires little or no monitoring by the participant, or emphasizing a single factor, such as an investor’s age, as the basis for determining that an investment is appropriate. 	Not applicable ^c
Inclusion of general advisory statements	
Advertisements would be required to advise participants that <ul style="list-style-type: none"> factors in addition to age or retirement date should be considered by investors, and the TDF investment is not guaranteed and that the loss of money is possible including at and after the target date. 	With regard to TDFs, fiduciaries must provide <ul style="list-style-type: none"> a statement that participants may lose money by investing in a QDIA, including losses near or following retirement, and that there is no guarantee that investment in the QDIA will provide adequate retirement income.
Disclosure of specific information about TDFs	
Advertisements would be required to disclose information such as <ul style="list-style-type: none"> TDFs that use the target date in the fund name must disclose asset allocation as of that date, immediately adjacent to the first use of the fund name; a table, chart, or graph that illustrates asset allocation over the life of the TDF; an explanation of the asset allocation changes over time, when the TDF will reach its final allocation, and a description of the final asset allocation; and whether asset allocations can be changed without shareholder vote. 	For all QDIAs: <ul style="list-style-type: none"> basic information such as name of the investment issuer, objectives and goals, principal strategies and risks, historical performance, and information on plan fees. Specifically for TDFs: <ul style="list-style-type: none"> asset allocation at the retirement/target date; a table, chart, or graph that illustrates the TDF asset allocation over time; an explanation that the asset allocation changes over time and a description of the final asset allocation; an explanation of the age group for whom the fund is designed, and the relevance of the target date; and any assumptions made about a participant’s contribution and withdrawal intentions on or after the target date.

Source: GAO summary of SEC and DOL proposed regulations.

^aThe proposed DOL requirements specific to TDFs would apply to both participants invested in a QDIA by default and to those who actively choose to invest in a TDF.

^bWhile TDFs are the immediate impetus for the proposed amendments, the proposed amendments would apply to all types of investment companies.

^cAlthough DOL’s proposed regulations do not address this issue, in its notice of proposed rulemaking, DOL requested comments as to whether and to what extent its final rule should include elements or concepts contained in SEC’s rulemaking.

As table 1 shows, the regulations proposed by DOL and SEC contain some similar provisions that, if finalized, would help ensure that both plan participants and investors generally obtain more accurate information

about TDFs. However, there are also some differences in the two agencies' proposed regulations, and the variations in these regulatory approaches are likely a reflection of the fact that each agency has its own purpose and its own authorities and responsibilities. For example, the DOL proposal would require that plan participants receive information on the assumptions about a participant's contributions and withdrawal intentions, which may be especially important for participants relying on a TDF as their main retirement savings vehicle.

SEC received 51 comments on its proposed regulation, and several commenters noted that additional disclosures might have very little impact on a large portion of TDF investors—specifically those who are and will be defaulted into the TDFs. For example, one commenter noted that many defaulted participants may have minimal interest in investing their account assets themselves. Further, the commenter noted that such participants are likely to remain in the default investment throughout their employment with the plan sponsor. Therefore, this commenter said it is especially important for plan sponsors to select an appropriate TDF on behalf of all defaulted participants. On the other hand, two commenters said SEC's proposed amendments could help defaulted participants to better understand the TDF's investment strategy and asset allocation plan, especially if these defaulted participants later choose to become more active investors.

Other Organizations Have Made Alternative Proposals Regarding TDF Regulation

In recent years, industry organizations and others have offered alternative perspectives that could be considered by DOL and SEC as they proceed with their regulatory and guidance efforts.

In June 2009, the Investment Company Institute (ICI), a mutual fund trade organization, published a set of principles aimed at improving disclosures by TDF managers.⁵² For example, the document recommended that TDFs prominently disclose the fund's assumptions about the participants' withdrawal rates at and after the target date, and offered sample language that TDF managers might use. It noted that this information is important because a TDF's asset allocation can vary significantly approaching and after the target date based on such withdrawal assumptions. Also, it noted the importance of illustrating the assumptions that influenced the development of the glide path, and the possibility of glide path

⁵²ICI, *Principles to Enhance Understanding of Target Date Funds*, June 2009.

adjustments, such as a change in the strategic allocation to equities. The principles also stated that the relevance of the target date used in the fund name should be prominently disclosed. For example, the principles noted that such disclosure might prominently state that the fund name refers to the approximate year a participant would plan to retire and stop making contributions to the TDF. Furthermore, if the target date is also the date at which the participant is expected to cash out of the fund, this information could be disclosed as well.

Both ICI and AARP have also offered lists of issues that plan sponsors should consider in selecting TDFs.⁵³ ICI noted several considerations concerning plan participant characteristics, such as whether participants also have access to other retirement benefits, like a defined benefit plan, that plan sponsors should consider when choosing a TDF. AARP suggested that plan sponsors consider plan demographics such as workforce age and participant contribution rates. AARP also proposed that plan sponsors consider the TDF manager's investment objectives and assumptions used for determining these investment strategies and asset allocations. According to AARP, these could include assumptions about contribution and withdrawal rates, retirement horizon, and income needed in retirement.

Conclusions

TDFs are relatively new investments and have gained considerable popularity among plan sponsors as default investments only over the last several years. They are a significant development in the financial services and retirement plan industry, and may become the most common investment option in DC plans in the years ahead. Along with the growth of automatic enrollment policies, TDFs as QDIAs help “automate” certain aspects of DC plan participation that have been left to the discretion of plan participants in DC plans. However, TDFs do not address some of the other limitations of the DC plan system. For example, as with any other DC plan, plan participants contributing to TDFs still bear the full burden of investment risk. While studies have shown that many TDF investors are

⁵³ICI is a national organization representing the mutual fund industry. AARP is a nonprofit, nonpartisan membership organization that provides advocacy for and services to those approaching and in their retirement years. AARP's suggestions were presented in a letter dated July 16, 2009, from David Certner, AARP, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission and the Office of Regulations and Interpretations, Employee Benefits Security Administration, Department of Labor. See www.sec.gov/comments/4-582/4582-28.pdf, last accessed Dec. 3, 2010.

likely to do well, some percentage of participants may realize relatively poor real returns on their investments over their working life.

Further, plan sponsors and others have indicated that the process of selecting TDFs as default investments for 401(k) plans can vary considerably from one plan sponsor to another. To some degree, differences among plan sponsors are inevitable, because larger plan sponsors will generally have the resources to do more planning and research than smaller plan sponsors. However, the responsibilities of a plan sponsor to thoughtfully select and monitor TDFs are all the more important when participants are automatically enrolled and defaulted into the investment chosen by the plan sponsor. While plan sponsors and others we spoke to identified important steps, we found that there are also opportunities to help improve plan sponsor selection of TDFs. Developing guidance and tools could help to improve plan sponsor awareness of the key aspects and differences of TDFs in the marketplace. For example, some plan sponsors may place unwarranted reliance on TDF benchmarks, a practice that may be misleading given the long-term nature and different asset allocation strategies of TDFs. Information about the limitations of these benchmarks could help plan sponsors improve their approach to TDF selection. In addition, some plan sponsors and industry experts stressed the importance of considering workforce characteristics beyond age or retirement date in selecting a TDF. Such characteristics could include the existence of a defined benefit plan, salary level, turnover rate, or participant behavioral characteristics, such as contribution rates and withdrawal patterns.

We commend SEC and DOL for their ongoing efforts to help ensure that plan sponsors and participants select and use TDFs appropriately. In light of the recent emergence of TDFs as a typical default investment, we acknowledge some additional actions may best be taken after more is learned about how default investors use TDFs over the longer term. However, in the interim, DOL could take some additional steps. For example, it is important to note that some participants may not grasp the asset allocations of their TDF and the investment theories on which the allocations are based. This is especially likely for many of the participants who, given the overwhelming popularity of TDFs as QDIAs, will be defaulted into a TDF and may take a passive approach to their retirement savings. With minimal effort, defaulted participants who may have little interest in investments or the TDF asset allocation strategies could benefit from short, simple educational information about key assumptions that TDF managers make about plan participant actions. Accordingly, DOL's proposed amendments to the QDIA regulation include a requirement that

plan sponsors provide any assumptions made about participants' contribution and withdrawal intentions on or after the target date to plan participants. However, it is not obvious from the proposed regulation that plan participants would receive information clearly explaining the potential connections among the assumptions made about participant contributions and withdrawals, the participants' related actions, and their ability to establish and sustain a financially secure retirement.

The current QDIA regulations do not require that plan sponsors consider workforce characteristics beyond a participant's age or retirement date in selecting TDFs as default investments, and the proposed regulatory amendments do not address this issue. As DOL explained when issuing the final QDIA regulations, consideration of other workforce characteristics, apart from age or retirement date, was not required in deciding whether TDFs, among the categories of investment alternatives described in the regulation, are QDIAs within the meaning of the regulation. This is because DOL wanted to give plan sponsors certainty that they had complied with the regulations. We agree that such certainty has value. However, much has been learned about TDFs in the years since the initial regulation was developed. In particular, it is clear that TDFs' asset allocations differ considerably, that these differences reflect different trade-offs regarding key risks, and that specific TDFs may therefore be well suited to the workforce characteristics of some plan sponsors, but not those of others. In satisfying their fiduciary obligations of prudence and loyalty in the selecting and monitoring of particular TDFs as QDIAs, plan fiduciaries may need to be aware of these differences.

Recommendations for Executive Action

We recommend that the Secretary of Labor direct the Assistant Secretary of the Employee Benefits Security Administration to

1. amend the QDIA regulations so that fiduciaries are required to document that they have considered, to the extent possible, whether other characteristics of plan participants, in addition to age or target retirement date, are relevant factors in choosing a QDIA;
2. provide guidance to plan sponsors regarding the limitations of existing TDF benchmarks and the importance of considering the long-term TDF investment allocations and assumptions used in developing the TDF asset allocation strategy; and
3. in its final regulation on target date disclosure, expand the requirement that plan sponsors provide information regarding key assumptions

concerning contribution and withdrawal rates by requiring that participants receive a statement regarding the potential consequences of saving, withdrawing, or otherwise managing TDF assets in a way that differs from the assumptions on which the TDF is based.

Agency Comments

We provided a draft of this report to the Department of Labor, the Department of the Treasury, and the Securities and Exchange Commission for review and comment. The Department of Labor noted that the report accurately highlighted many of the structural and disclosure issues surrounding TDFs, and the challenges that face plan fiduciaries in selecting TDFs. However, DOL did not agree with our first recommendation, which called for it to require that plan fiduciaries, to the extent possible, consider characteristics of plan participants, other than age or retirement date, when choosing a QDIA. Labor reiterated, as we noted in our report, that it had considered and rejected this approach in developing the final QDIA regulations. DOL further stated that it is not clear whether GAO intended that fiduciaries consider some or all of the characteristics GAO mentioned, or how a fiduciary should interpret or apply such characteristics in selecting a TDF. DOL agreed, however, that it may be appropriate for a fiduciary to consider the characteristics that GAO cited, and indicated that the agency will include such considerations in its guidance to plan fiduciaries.

We stand by our recommendation. A great deal has been learned about TDFs since DOL developed its QDIA regulations. As we noted in our report, the asset allocations, risk levels, and assumptions concerning participant disposition of assets at and after the retirement date differ considerably among TDFs. Most recently, as the events of 2008 showed, these differences can have considerable impact on plan participants who are near retirement and thus particularly vulnerable to large investment losses. In light of this, we believe that a consideration of other participant characteristics in the QDIA selection process, to the extent that such information is available to a fiduciary, would better protect plan participants. We agree that it is important for fiduciaries to be certain that they have complied with all applicable regulations, but we believe that our recommendation would not add undue uncertainty or unnecessary complications to the QDIA selection process. Indeed, highlighting the importance of other workforce characteristics, as DOL proposes to do, without amending the QDIA regulations could cause more uncertainty regarding fiduciary obligations. However, in light of DOL's concerns, we have amended our recommendation so that it calls for DOL to require that plan sponsors consider whether other workforce characteristics are

relevant, and document that they have done so. Combined with the guidance that DOL is developing, such a requirement would at least cause a plan fiduciary to consider whether a particular TDF is a reasonable fit for its workforce. As DOL noted in the QDIA regulation, consideration of other characteristics would be permissible but not required.

DOL indicated that it would consider our other two recommendations in the course of its ongoing regulatory and guidance efforts. We understand that DOL would not wish to take a position while its efforts are ongoing. However, we believe that the timing of our recommendation is particularly apt in light of these efforts, and we are hopeful that our work will inform DOL as it works to finalize the regulations.

DOL cited a number of concerns with our third recommendation, which called for the agency to require sponsors to provide information on the potential consequences of saving, withdrawing, or otherwise managing their TDF assets in a way that differs from the assumptions on which a TDF is based. Specifically, DOL said that this would be a very complicated and subjective undertaking, which could affect a plan sponsor's decision to offer a TDF. We disagree. The Department of Labor already proposes to require sponsors to provide information about a TDF's assumptions concerning participants' contribution and withdrawal intentions. Our recommendation seeks to ensure that plan participants understand the significance of these assumptions. An additional statement of the kind we advocate could simply point out to plan participants that contributing at a rate lower than or withdrawing at a rate higher than a TDF's design assumptions could lessen the likelihood of a secure retirement.

We did not receive formal comments from the Department of the Treasury or the Securities and Exchange Commission, and received technical comments from the three agencies, which we incorporated as appropriate.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution until 30 days after the date of this letter. At that time, we will send copies of this report to the Secretary of Labor, the Secretary of the Treasury, the Chairperson of SEC, appropriate congressional committees, and other interested parties. We will also make copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you have any questions concerning this report, please contact Charles Jeszeck at (202) 512-7215. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix IV.



Charles A. Jeszeck
Director, Education, Workforce,
and Income Security Issues

Appendix I: Objectives, Scope, and Methodology

Our objectives were to answer the following research questions:

1. To what extent do the investment compositions of different target date funds (TDF) vary?
2. What is known about the performance of TDFs?
3. How do plan sponsors select and monitor TDFs that are chosen as the plan's default investment, and what steps do they take to communicate information on these funds to their plan participants?
4. What steps have the Department of Labor (DOL) and the Securities and Exchange Commission (SEC) taken to ensure that plan sponsors and participants appropriately select and use TDFs?

To answer the first question, we obtained and reviewed existing literature about TDFs and their investment approaches and interviewed a variety of retirement plan industry experts (see table 2 for a list of organizations we contacted). Second, we conducted case studies with eight TDF managers, which included in-depth semistructured interviews with representatives of the TDF manager and reviewed available documents describing the nature of and reasons for TDF asset allocations. Through these discussions and reviews, we obtained detailed information on each provider's glide path philosophy, underlying funds and holdings, fee structure, and investment strategy and objectives. We also gained a fuller understanding of the investment philosophy, underlying assumptions, and concerns for different types of risks that underlie their approaches.

Table 2: Organizations Contacted during Review

Organizations contacted	Contact regarding objective:			
	1	2	3	4
<i>TDF managers</i> Eight firms that offer and manage TDFs	X	X		
Consultants and service providers <ul style="list-style-type: none"> • Aon Hewitt • Captrust Financial Advisors • Mercer • Summit Financial Group • Target Date Analytics • Towers Watson 	X	X	X	
<i>Government</i> <ul style="list-style-type: none"> • Employee Benefits Security Administration (EBSA), DOL • U.S. Department of the Treasury • SEC 	X	X	X	X
<i>Plan sponsors</i> Ten plan sponsors that use TDFs as their 401(k) plan default investment			X	
<i>Other organizations</i> <ul style="list-style-type: none"> • AARP • American Benefits Council • Academic Expert at Kennedy School of Government, Harvard University • Academic Expert at the University of California, Los Angeles • Academic Expert at the University of Chicago Booth School of Business • Academic Expert at University of Mississippi School of Law • Academic Expert of the Wharton School of the University of Pennsylvania • American Society of Pension Professionals and Actuaries (ASPPA) • Committee on Investment of Employee Benefit Assets (CIEBA) • Fiduciary Counselors • Investment Company Institute (ICI) • Morningstar • Profit Sharing/401k Council of America (PSCA) • Reish & Reicher 	X	X	X	X

Source: GAO.

We selected eight TDF managers for cases studies to provide an understanding of the range of investment approaches taken by TDFs in the marketplace. These eight TDF managers we contacted reflect about 86 percent of the TDF market, by assets under management. Using Morningstar's *Target Date Series Research Paper: 2009 Industry Survey*, we selected TDF managers based on several criteria:

- **Size of assets under management:** We interviewed the top three TDF managers, whose funds account for over 70 percent of the TDF market, as well as other smaller fund managers, according to net asset information collected by Morningstar as of July 30, 2009.
- **Equity allocation at retirement:** We interviewed at least one manager with a high equity allocation (65 percent or more) in its 2010 fund and at least one manager with a low equity allocation (45 percent or less) in its 2010 fund.
- **Returns relative to size of equity allocation:** We interviewed fund managers whose 2010 funds performed either significantly better or worse in 2008 returns than other 2010 funds with relatively similar equity allocations. This factor was chosen because we wanted to understand what drove this difference in returns.
- **Active versus passive management:** We interviewed one fund manager that invested primarily in passively managed underlying funds and seven fund managers that invested primarily in actively managed underlying funds.
- **Length of glide path:** We interviewed at least one TDF manager who employs a “To” glide path (i.e., a glide path that ends at the retirement date) and at least one manager that employs a “Through” glide path (i.e., a glide path that continues to change after the retirement date). TDF glide paths were determined through TDF prospectuses, marketing materials, and Web sites and verified by fund managers.

To address the second question, on the performance of TDFs, we reviewed historical data and performed a literature review of studies completed that project the potential future long-term performance of TDFs. The historical data were obtained from Morningstar. We obtained return data from 2005 to 2009 for the largest 15 TDFs with at least 5 years of performance data. Some TDFs were not included in the sample because the funds had been in existence for less than 5 years. We interviewed Morningstar officials regarding the data’s reliability and their processes for ensuring the reliability of their data, establishing that the data were both relevant and complete.

To determine the potential long-term performance of TDFs, we conducted a literature review and analyzed the results of selected studies. A literature review was conducted and documented with the help of the team librarian. Using a snowballing technique, the studies selected from the

literature review were reviewed, and any other relevant articles mentioned in the studies initially selected through the literature review were obtained and then reviewed as well. Once this list of studies was compiled, the team contacted industry experts, knowledgeable stakeholders, and academics to review the list of studies compiled and identify any additional relevant studies. The new studies were then reviewed. We narrowed down our list of studies based on several screening criteria:

- Was the study based on original quantitative research using actual historical data, stochastic techniques, or other quantitative methods?
- Was the study free from bias and not conducted or commissioned by an organization that develops or markets TDFs or competing investment products or provides services and advice to plan sponsors about TDFs?
- Did the study pass GAO's data reliability standards for completeness, accuracy, and consistency of the data, ensuring that the study was free from bias?

Ultimately, nine studies were chosen based on the screening criteria and served as the basis of our findings on the potential future long-term performance of TDFs.

To answer the third question, we first reviewed relevant federal laws and regulations and relevant literature and spoke with federal officials and employee benefits attorneys to understand fiduciary requirements as they relate to qualified default investment alternatives (QDIA) and TDFs. Second, we interviewed key national organizations and pension industry experts to understand the concerns faced by plan sponsors and their participants regarding TDFs. This included representatives from organizations that represent plan sponsors, such as the Committee on Investment of Employee Benefit Assets, Profit Sharing/401(k) Council of America, and participants, such as AARP. In addition, we interviewed several plan consultants, such as Aon Hewitt, and several record keepers, such as Principal Financial Group, to understand how they work with plan sponsors to select and monitor TDFs. Third, we conducted 10 case studies with plan sponsors of all sizes, which included in-depth semistructured interviews and a review of relevant communication materials given to participants. Through these discussions and reviews, we obtained detailed information on their TDF selection process, ongoing due diligence monitoring activities, and communication provided to participants about TDFs. The results of our plan sponsor case studies were limited by the willingness of plan sponsors to speak with us.

We selected 10 plan sponsors for case studies using a two-step process. First, we used Form 5500 data from DOL to identify plan sponsors that have TDFs as an investment option in their 401(K) plans. We used the Form 5500 data to segment plan sponsors into three groups—small, medium, and large—based on the number of total active participants in their 401(k) plans. Small plans were defined as having 25 to 249 active participants, medium plans as 250 to 4,999 active participants, and large plans as 5,000 or more active participants. Second, we selected plan sponsors from each group to be interviewed as a case study based on three selection criteria: (1) industry of the plan sponsor, (2) level of industry wage earnings, and (3) TDF chosen as default investment. We determined the first criterion by using the North American Industry Classification System (NAICS) codes in the Form 5500 data. We chose plan sponsors across a variety of industries, including financial services, consumer products, professional services, educational services, and agriculture, among others. The second criterion was determined by using the U.S. Bureau of Labor Statistics' national monthly wage analysis data to determine if the plan sponsor is in either a high- or low-wage-earning industry. We chose plan sponsors in both high-wage and low-wage industries. We determined if plan sponsors met the third criterion by contacting the plan sponsor's staff in charge of human resources/benefits and through *Pensions & Investments* data and other industry news articles, where available.¹ Ultimately, we chose to interview six large plan sponsors, two medium-sized plan sponsors, and two small plan sponsors.

To answer the fourth question, we reviewed relevant federal laws and regulations and interviewed agency officials as well as external experts to analyze recent actions taken by DOL and SEC regarding TDFs. First, we reviewed relevant federal laws and regulations that govern TDF disclosures and that govern the use of TDFs in defined contribution plans. Second, we interviewed DOL and SEC officials throughout our engagement and reviewed testimony and documents from the DOL-SEC joint hearing on TDFs in June and July 2009. Third, we reviewed recent actions taken by DOL and SEC, such as the DOL-SEC joint investor bulletin on TDF investing published in May 2010, and SEC's proposed regulation for the marketing and naming of TDFs, and EBSA's proposed regulation on target date disclosures. Finally, we reviewed comments

¹*Pensions & Investments* is an international newspaper of money management that delivers news, research, and analysis for its readership, including executives who manage the flow of funds in the institutional investment market.

submitted on recent proposed federal regulations and spoke with representatives of plan sponsors and plan participants, TDF managers, industry and academic experts, and national organizations that represent TDF managers.

Appendix II: Studies Reviewed to Assess Ranges of Future TDF Performance

Basu, A. K., and M. E. Drew, "Portfolio Size Effect in Retirement Accounts: What Does It Imply for Lifecycle Asset Allocation Funds?" *Journal of Portfolio Management*, Spring (2009): 61-72.

Bodie, Z. and J. Treussard, "Making Investment Choices as Simple as Possible, but Not Simpler," *Financial Analysts Journal*, vol. 63, no. 3, (2007): 42-47.

Brady, P., "What Does the Market Crash Mean for the Ability of 401(k) Plans to Provide Retirement Income?" *National Tax Journal*, vol. LXII, no. 3 (2009): 455-476.

Bridges, B., R. Gesumaria, and M. Leonesio, "Assessing the Performance of Life-Cycle Portfolio Allocation Strategies for Retirement Saving: A Simulation Study," *Social Security Bulletin*, vol. 70, no. 1 (2010): 23-43.

Pang, G., and M. Warshawsky, "Asset Allocations and Risk-Return Tradeoffs of Target-Date Funds," *Journal of Pension Benefits*, (2010): 24-35.

Park, Y., "Plan Demographics, Participants' Saving Behavior, and Target-Date Fund Investments," *EBRI Issue Brief*, no. 329 (2009): 1-41.

Poterba, J., J. Rauh, S. Venti, and D. Wise, "Reducing Social Security PRA Risk at the Individual Level: Lifecycle Funds and No-Loss Strategies," *NBER Working Paper Series 06-07*, (2006): 1-43.

Shiller, R., "The Life-Cycle Personal Accounts Proposal for Social Security: An Evaluation," *NBER Working Paper Series 11300*, (2005): 1-34.

Spitzer, J., and S. Singh, "Shortfall Risk of Target-Date Funds During Retirement," *Financial Services Review*, vol. 17 (2008): 143-153.

Appendix III: Comments from the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Employee Benefits Security Administration
Washington, D.C. 20210



January 5, 2011

Mr. Charles A. Jeszeck
Director, Education, Workforce, and
Income Security Issues
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Jeszeck:

Thank you for the opportunity to review the Government Accountability Office's (GAO) draft report entitled "Key Information on Target Date Funds as Default Investments Should be Provided to Plan Sponsors and Participants." In general, the draft report does a good job of highlighting many of the structural and disclosure issues surrounding target date funds and the challenges facing a number of plan fiduciaries in the selection and monitoring of such funds.

As the draft report acknowledges, the Department of Labor (Department) has taken a number of steps intended to address issues relating to target date funds. In particular, we note that, following a joint public hearing on target date funds, the Department and the SEC issued an investor alert to help investors and participants in 401(k) and similar plans understand the operations of and risks attendant to target date funds. The Department also published proposed amendments to its qualified default investment alternative (QDIA) regulation (29 CFR § 2550.404c-5) and participant-level disclosure regulation (29 CFR § 2550.404a-5). Upon adoption, these amendments will ensure that all participants and beneficiaries, whether or not defaulted into a target date fund, receive information to assess whether a particular target date fund is appropriate for them. Among other things, the proposals require a narrative explanation of how the target date fund's asset allocation will change over time, the point in time when the fund will reach its most conservative allocation, a graphical illustration of how the fund's asset allocation will change over time, and an explanation of what the target date means. The Department invited interested parties to submit comments on the proposals by January 14, 2011. In addition, as discussed with the GAO staff, the Department is preparing informal guidance designed to assist plan fiduciaries in their consideration of target date funds as investment options for their plans.

Turning to the specific recommendations for executive action set forth in the draft report, we submit the following for your consideration.

GAO recommendation: Amend the QDIA regulation so that fiduciaries are required, to the extent possible, to take into consideration other characteristics of plan participants, in addition to age or target retirement date, when choosing a QDIA, regardless of the type of QDIA chosen.

The Department does not agree with this recommendation. The Department considered and rejected the approach recommended by the GAO in developing the final QDIA regulation. The apparent basis for GAO's recommendation is that "some plan sponsors and industry experts stressed the importance of considering workforce characteristics beyond age or retirement date in selecting a TDF." In this regard, the draft report states that "[s]uch characteristics could include the existence of a DB plan, salary level, turnover rate, or participant behavioral characteristics, such as contribution rates and withdrawal patterns." It is not clear from GAO's recommendation whether an amendment to the QDIA regulation should require consideration of all or some of these characteristics in selecting a target date fund. Nor does the draft report explain how a plan fiduciary should interpret or apply such characteristics in selecting a target date fund.

While the Department does not believe the QDIA regulation should be amended to require considerations beyond age and retirement date, the Department does believe that it may be appropriate for plan fiduciaries to take into account many of the considerations identified in the draft report in selecting target date funds for their plan. In this regard, the Department will be including similar considerations in its guidance for plan fiduciaries.

GAO recommendation: Provide guidance to plan sponsors regarding the limitations of existing target date fund benchmarks and the importance of considering the long-term target date fund investment allocations and assumptions used in developing the target date fund asset allocation strategy.

The Department cannot agree with this recommendation because it has not yet completed its review of information and factors that fiduciaries should consider in evaluating a target date fund(s) for their plan. As noted above, the Department is in the process of developing tips to assist plan fiduciaries with the selection and monitoring of target date funds. The Department will consider the GAO's recommendation as it works to complete this guidance.

GAO recommendation: In its final regulation on target date disclosure, expand the requirement that plan sponsors provide information regarding key assumptions concerning contributions and withdrawal rates by requiring that participants receive a statement regarding the potential consequences of saving, withdrawing or otherwise managing target date fund assets in a way that differs from the assumptions on which the target date fund is based.

The Department cannot agree to any specific recommendation in advance of its completing consideration of all the public comments received on the proposed regulation. As noted above, the Department is soliciting comments on amendments to the QDIA and participant-level disclosure regulations that are designed to improve the information furnished to plan participants about target date funds, whether such funds are default investments or merely available investment options under the plan. The GAO's recommendation that sponsors include in such disclosures a statement regarding the potential consequences of saving, withdrawing or otherwise managing target date funds in a way that differs from the assumptions on which the target date

**Appendix III: Comments from the
Department of Labor**

fund is based would appear to be a very complicated and subjective undertaking which could affect a plan sponsor's decision to offer any target date fund option(s).

Again, thank you for the opportunity to review the draft report. Should you or your staff have any questions concerning the statements or requests contained herein, please do not hesitate to contact us.

Sincerely,



Phyllis C. Borzi
Assistant Secretary

Appendix IV: GAO Contacts and Acknowledgments

GAO Contact

Charles A. Jeszeck, Director, (202) 512-7215 or jeszeckc@gao.gov

Staff Acknowledgments

David Lehrer, Assistant Director, and Michael Hartnett, Analyst-in-Charge, managed this review. Ryan Siegel and Nicole Harkin, in consultation with Gene Kuehneman and Kenneth Bombara, also led portions of the research and made significant contributions to all portions of this report.

Luann Moy and Jay Smale provided methodological assistance. Susannah Compton provided assistance with report preparation. Sheila McCoy, Roger Thomas, and Rachel DeMarcus provided legal assistance. Ashley McCall assisted in identifying relevant literature. James Bennett developed the report's graphics. Susan Offutt provided comments on this report. Claudine Pauselli, Lara Laufer, Jeff Miller, Amber Yancey-Carroll, Sharon Hermes, and Paul Schearf verified our findings.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday afternoon, GAO posts on its Web site newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to www.gao.gov and select "E-mail Updates."

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's Web site, <http://www.gao.gov/ordering.htm>.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548

