CASE STUDY: TARGET DATE FUNDS

To: Securities and Exchange Commission
From: Research Staff
Date: March 10, 2010
Re: Considerations related to possible adoption of new target date fund regulations

As you requested, the research staff has compiled information concerning target date funds, in order to assess whether additional regulation of these funds should be implemented. We have provided background information and outlined a number of proposals that have been suggested.

1. Introduction

Target date funds, also known as life cycle funds, are popular investment vehicles designed for investors who anticipate retiring at the fund’s “target date.” Life cycle funds hold diversified portfolios of stocks, bonds, and other assets, and this asset mix automatically rebalances to keep the portfolio composition in line with a pre-specified asset allocation pattern, which becomes increasingly conservative as the target date approaches. The process by which a fund shifts its assets is known as the “glide path.”

Although they share these basic characteristics, target date funds differ from one another in a number of significant respects. Different funds, even those sharing the same target date, may vary widely in terms of asset allocation. For example, the equity allocations of funds with a target date of 2010 range from 26% to 72%.¹ The shape of the

¹ Josh Charlson et al., Morningstar Target-Date Series Research Paper: 2009 Industry Survey 6-8 (September 9, 2009) (available at...
glide path also varies, as the gradual decrease in equity weightings may maintain a consistent slope, become steeper over time, or follow a stepped pattern. Additionally, target date funds may be categorized as either “to” or “through” funds. Whereas the glide path of a “to” fund generally becomes flat once an investor reaches the target date, the glide path of a “through” fund continues to change past retirement, finally reaching a landing point around ten to twenty years after the target date.

Target date funds have been available since at least 1988. These funds have grown significantly over the past decade, increasing from $5.5 billion in assets in 2000, to over $150 billion in assets in 2007, to more than $204 billion in assets by May 2008. In 2007, assets in target date funds made up approximately seven percent of total assets in 401(k) plans. The increase in popularity is due in part to the designation, in 2007, of target date funds as a Qualified Default Investment Alternative (QDIA), thereby allowing their use as default investments where a participant does not actively select a different investment option.

Most target date funds experienced significant losses during the recent financial crisis. In 2008, short-dated target funds averaged losses of 25% to 30%, while long-dated


2 See id. at 10.

3 Id. at 11.


6 Craig Copeland, Use of Target-Date Funds in 401(k) Plans, 2007 4 (EBRI Issue Brief, no. 327, March 2009).
funds lost an average of nearly 40%. However, performance varied widely from fund to fund. For example, performance for 2010 target date funds ranged from minus 9% to minus 41%. These recent losses have lead many to call for increased regulation of these funds, and the Securities and Exchange Commission held a joint public hearing on this issue with the Department of Labor in June 2009.

2. Background

A. Life Cycle Finance Generally

Several economists have published papers addressing the topic of life cycle finance. In laying out a set of “generally accepted investment principles,” Bodie and Crane asserted that, in general, the percentage of assets invested in equities should decline as an investor ages, with a popular rule of thumb being that the percentage in equities should be equal to 100 minus the investor’s age. They cited two reasons for recommending such allocations. First, human capital generally carries less risk than equity, and as a person ages, the value of human capital typically decreases as a proportion of that person’s total wealth. Second, a greater percentage of an individual’s assets should be placed in risky investments when that individual has greater flexibility to vary his or her labor supply by working more hours or delaying retirement, and younger

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7 Charlson et al., supra note 1, at 3.
8 See id. at 7.
individuals tend to have more opportunities to alter their labor supply.11 This principle provides a foundation for the investment strategies of target date funds.

A few studies have analyzed the variables that affect individuals’ investment decisions over the life cycle. Cocco, Gomes, and Maenhout developed a model to calculate optimal portfolio and savings decisions. They found that availability of labor income increased demand for equities in the optimal portfolio, particularly early in life, but that the introduction of a small probability of a disastrous labor income draw significantly reduced an investor’s average equity allocation.12 The study observed that the share of an investor’s portfolio allocated to equities generally decreases with age as labor income, which carries relatively low risk, comes to represent less and less of an individual’s total wealth, causing investors to shift their portfolios to less risky assets to offset this change.13 The study also found that ignoring labor income when developing an investment strategy creates great utility costs.14 The authors concluded that these results supported investment advice to shift portfolio composition toward less risky assets as investors age but noted that this advice did not take into account risk aversion and riskiness of labor income.15

11 Id. at 15. See also Zvi Bodie, Robert C. Merton, & William F. Samuelson, Labor Supply Flexibility and Portfolio Choice In a Life-Cycle Model (Nat’l Bureau of Econ. Research, Working Paper No. 3954, 1992) (examining the effect of labor decisions on portfolio choices and concluding that the ability to alter labor supply in the future leads investors to assume greater investment risks, explaining why young investors may take greater risks than older investors).
12 Joao F. Cocco, Francisco J. Gomes, & Pascal J. Maenhout, Consumption and Portfolio Choice over the Life Cycle, 18 REVIEW OF FINANCIAL STUDIES 491, 526 (2005).
13 Id. at 527.
14 Id. at 527.
15 Id. at 527.
The results of a study conducted by Schooley and Worden generally supported the idea that investors make portfolio allocations according to risk tolerance and time horizon, finding that, even before the introduction of life cycle funds, a sample of generally wealthy individuals were managing their investment portfolios consistent with their risk tolerances and financial-planning horizons.16

B. Investor Selection of Target Date Funds

A few studies have examined the circumstances and demographic characteristics that influence investors’ selection of target date funds. Mitchell, Mottola, Utkus, and Yamaguchi analyzed the effects of the introduction of life cycle funds on 401(k) decision-making and discovered both intended and unintended effects.17 They found a strong “default” effect, whereby life cycle funds, when offered as default investments, altered portfolio allocations as a result of inertia.18 They also observed a “framing” effect, as life cycle funds, when offered on a non-automatic enrollment basis, reframed a complex investment decision into a more simple choice for investors.19 Additionally, they found that the offering of life cycle funds had an unintended “spillover” effect, as some investors used the funds in an unexpected way, by holding them in addition to other investment options rather than as a complete portfolio as intended.20

In an earlier study, Mitchell et al. observed that new plan entrants as well as younger, lower paid, and female participants were more likely than other investors to

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18 Id. at 8.
19 Id. at 8.
20 Id. at 5.
adopt target date funds.\textsuperscript{21} In a separate study, Copeland also found that, compared to those who do not invest in target date funds, the average target date investor was about 2.5 years younger, had about 3.5 years less tenure, received a salary about $11,000 lower, and had about $25,000 less in their account.\textsuperscript{22} Another study found evidence of a correlation between the demographics of a participant’s 401(k) plan and both equity allocations of target date fund investments and contribution rates. Specifically, it found that target date fund participants in 401(k) plans dominated by low-income and short-tenure participants tended to hold target date funds with lower equity allocations, compared to those in plans dominated by high-income and longer-tenure participants.\textsuperscript{23} It also observed that participant contribution rates were higher for those in plans dominated by middle- or high-income and mid- or long-tenure participants than for those in low-income, short-tenure plans.\textsuperscript{24}

C. Performance Compared to Other Investment Options

Several recent papers have compared the performance of target date funds to that of other retirement investment options. Poterba, Rauh, Venti, and Wise simulated a variety of different 401(k) asset allocation strategies.\textsuperscript{25} They found similar retirement wealth distributions from target date fund investment strategies and from strategies with a constant fraction of the portfolio allocated to equities.\textsuperscript{26} They concluded that the

\textsuperscript{22} Copeland, supra note 6, at 5.
\textsuperscript{23} Youngkyun Park, Plan Demographics, Participants’ Saving Behavior, and Target-Date Fund Investments 10-14 (EBRI Issue Brief, no. 329, May 2009).
\textsuperscript{24} Id. at 6-10.
\textsuperscript{25} Poterba, Rauh, Venti, & Wise, supra note 4.
\textsuperscript{26} Id. at 19.
expected utility of the various asset allocation strategies depended upon the expected return on corporate stock, the investor’s relative risk aversion, and the amount of the investor’s non-401(k) wealth available upon retirement.27

In another study, Spitzer and Singh compared three different target date fund strategies to six portfolios that had fixed stock and bond allocations.28 They found that the portfolios with a fixed stock allocation between 50% and 70% had lower shortfall rates and higher balances remaining after thirty years than did any of the target date fund portfolios.29

In a third study, Pang and Warshawsky conducted an analysis comparing investment performance of a balanced fund and a life cycle fund, using average market asset allocations.30 They found that the balanced fund, which maintained a constant mix of equity and fixed-income instruments, was likely to outperform the life cycle fund in terms of long-term capital appreciation but that its more aggressive approach increased the risk of losses as retirement neared.31 They found that the life cycle fund better limited downside risk and performed reasonably well in building wealth; however, they noted that the average life cycle fund has a large cash position at retirement which allows for fewer hedging opportunities and may expose participants to the risk of volatility in life annuity prices.32

27 Id. at 24-25.
28 John J. Spitzer & Sandeep Singh, Shortfall Risk of Target-Date Funds During Retirement, 17 FINANCIAL SERVICES REVIEW 143 (2008).
29 Id. at 151.
31 Id. at 225.
32 Id.
3. Current Regulatory Framework

The Securities and Exchange Commission has jurisdiction over target date funds that are organized as mutual funds under the Securities Act of 1933 and the Investment Company Act of 1940. However, the SEC lacks jurisdiction over some investment plans that function as target date funds, such as bank-sponsored collective investment trusts.33 The SEC also does not regulate 401(k) plans or the use of the Qualified Default Investment Alternative (QDIA) designation. Under the federal securities laws enforced by the SEC, target date funds, like all mutual funds, must meet certain prospectus disclosure requirements. In its prospectus, each fund must disclose material information concerning its investment objectives, strategies, and risks, and include a table displaying comprehensive information about the costs of investing. Target date funds typically include in their prospectus an illustration of the fund’s glide path, information on what occurs when the fund reaches the target date, an explanation of the way that the asset allocation becomes increasingly conservative, and a description of the specific risks related to target date fund investments. Each prospectus must also disclose the costs of the target date fund itself as well as the costs associated with any underlying funds that make up the target date fund’s investment portfolio.34

The Department of Labor enforces the fiduciary, reporting, and disclosure provisions of the Employee Retirement Income Security Act of 1974 (ERISA) that apply

34 Id. at 8.
to employee benefit plans.\textsuperscript{35} Title I of ERISA establishes standards of conduct for plan fiduciaries and makes fiduciaries accountable for making prudent decisions regarding the selection and monitoring of plan providers and investments.\textsuperscript{36} In order to encourage 401(k) plan sponsors to adopt automatic enrollment programs, Congress enacted the Pension Protection Act in 2006.\textsuperscript{37} In October 2007, the DOL issued final regulations on QDIAs pursuant to the Pension Protection Act. Investments designated as QDIAs are eligible for relief under Section 404(c) of ERISA, which provides liability protection to pension plan fiduciaries for investment results of participant accounts that are placed in default investments.\textsuperscript{38} The DOL regulations designated targeted retirement date funds as one of three general categories of funds that can qualify as a long-term QDIA, with the other categories being balanced funds and managed accounts.\textsuperscript{39} To meet the definition of a target date fund within the QDIA regulation, a fund must apply generally accepted investment theories, be diversified, and provide varying degrees of long-term appreciation and capital preservation based on the age, retirement date, or life expectancy of participants. The QDIA regulation does not include any requirements concerning the composition of target date funds or the ratio of stocks and bonds.\textsuperscript{40}

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\item \textsuperscript{36} Id. at 8.
\item \textsuperscript{37} Id. at 3.
\item \textsuperscript{38} Joan McDonagh, A Christmas Present from the DOL – Final QDIA Regulations, 15 Journal of Pension Benefits, Winter 2008, at 5.
\item \textsuperscript{39} Id.
\item \textsuperscript{40} Borzi, supra note 35, at 4.
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4. Concerns

Recent criticisms of target date funds tend to fall into four general categories: risk and asset allocation, communication and disclosure, fees, and use as a QDIA.

A. Risk and Asset Allocations

At least two studies have shown that target date funds can help to bring an appropriate level of risk to an investor’s portfolio. A study conducted by Mitchell, Mottola, Utkus, and Yamaguchi found that for investors voluntarily using life cycle funds as a complete portfolio, the adoption of the life cycle fund eliminated extreme asset allocations, improved portfolio efficiency, and decreased exposure to nonsystematic risk.\(^41\) They found that for investors using life cycle funds in addition to other investment options, the introduction of the life cycle fund reduced variability in equity holdings, lessened extreme asset allocations, and reduced nonsystematic risk.\(^42\) In another study, Pang and Warshawsky analyzed the tradeoffs between risk and return for target date funds.\(^43\) They determined that target date funds are risky but beneficial, since evidence suggests that the retirement portfolios of most individuals lack an optimal balance, which target date funds can provide.\(^44\)

Nonetheless, much of the recent criticism of target date funds centers on the contention that funds have assumed too much risk by adopting excessively large equity allocations. Funds have increased equity exposure in two ways: first, by increasing equity allocations along the glide path, and second, by extending the glide path out

\(^{41}\) Mitchell, Mottola, Utkus, & Yamaguchi, supra note 17, at 16.
\(^{42}\) Id. at 17.
\(^{43}\) Pang & Warshawsky, supra note 5.
\(^{44}\) Id. at 14.
beyond the target date. Some, speculating on the causes of this phenomenon, have asserted that fund managers have an incentive to use overly aggressive asset allocations in order to increase their own profits and to compete with the short-term performance of other funds, thus fueling an “equity allocation arms race.” Some have also attributed high equity allocations to efforts by fund managers to attempt to take advantage of a strong equity market so as to make up for insufficient savings and guard against risks posed by inflation and outliving savings. Several critics of target date funds have pointed out the losses experienced by fund participants over the past year, with one such critic claiming that many target date fund participants who experienced losses in 2008 would have had positive returns if they had remained in their old default options. He also asserted that such down years in the stock market can lead participants to reduce contributions, which are at least as crucial for accumulation as investment returns.

Critics have voiced concern not only that target date funds contain excessive equity allocations, but also that equity exposure differs significantly from fund to fund. According to one comment submitted for our joint hearing, 14 of the 2010 funds listed by one investment research company had an equity allocation greater than 60%, whereas 15 of the 2010 funds held less than 30% in equities, and one fund held less than 19% in

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47 Lauder, supra note 46, at 2.
49 Id. at 2.
equities. Additionally, that comment pointed out that risk and investment results depend not only on levels of equity allocations, but also on the specific stocks that are selected, which also vary among different funds. Some critics have expressed great concern with these large variations in equity, as they believe that target date fund investors often make decisions without professional advice and fail to do sufficient research on possible investments, particularly when such funds have been specifically approved as investment options by a retirement plan sponsor. Furthermore, some have asserted that because individuals are led to believe that one target date fund is an appropriate investment until retirement, they tend to stay in that fund until the target date, despite changes in lifestyle and financial status that may alter their appropriate level of risk.

Some have also offered another critique related to risk, asserting that the design of target date funds is overly simplistic because appropriate investment risk depends on many factors in addition to age. They argue that consequently, use of target date funds may lead participants to assume inappropriate levels of risk.

B. Communication and Disclosure

A second line of criticism focuses on a perceived lack of adequate communication and disclosure, particularly regarding asset allocation strategies and methodology. Many have argued that more clear and comprehensive disclosure is essential in order to enable

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51 Id. at 3.
52 Bullard & Roper, supra note 46, at 2, 7.
54 One comment went so far as to deem the concept of age-based risk to be a “dangerous investment myth.” Id. at 4.
individuals and plan fiduciaries to make appropriate investment decisions. For example, some assert specifically that the difference between “to” funds and “through” funds is not clearly communicated. An industry survey by Morningstar also noted that most fund prospectuses report only allocations for stocks, bonds, and cash, failing to report allocations to sub-asset classes. Advocates of greater disclosure requirements argue that such information should be made publicly available, as it would help individuals and plan sponsors to choose appropriate funds and monitor their performance. Offering another related criticism, some have asserted that the names of funds fail to convey sufficient information about asset allocation strategies and risk levels. Some argue that fund names not only fail to inform but actually mislead investors. These critics claim that fund names containing a specific target date strongly imply that those funds have an asset allocation within an expected range, while fund managers have actually used allocations that differ widely and may fall outside that range. They argue that fund names should be required to include more information in order to allow for greater differentiation between funds.

Critics have also pointed out that ineffective communication has contributed to a lack of investor understanding of target date funds, asset allocations, associated risks, and differences between funds. They note that many participants use target date funds incorrectly, by using them in conjunction with other funds rather than as a complete

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56 Charlson et al., supra note 1, at 10.
57 Bullard & Roper, supra note 46, at 3-7.
portfolio.\textsuperscript{58} One comment asserted that investors had largely selected target date funds based on good recent performance, regardless of the target date.\textsuperscript{59} That comment also suggested that investors lack patience, abandoning target date funds when they become disappointed by fund performance that fails to live up to their unrealistically high expectations.\textsuperscript{60} Another comment noted that most participants have virtually no investment experience and fail to review fund options prior to making an investment decision, to monitor the performance of their investments, or to regularly adjust their asset allocations.\textsuperscript{61} It stated that some investors actually believe that target date funds “mature” on the target date and then shift immediately to 100\% investment in lower risk securities.\textsuperscript{62}

C. Fees

Fees vary among target date funds. More than fifty percent of target date fund series have asset weighted expense ratios of more than one percent.\textsuperscript{63} However, some funds do have significantly lower expense ratios, with Vanguard leading the industry as a low-cost provider with a 0.19 percent asset weighted expense ratio.\textsuperscript{64} The size of the fees charged by an individual fund depends largely on which one of two different approaches to portfolio allocation that fund company has chosen. One approach is to adopt a fund of funds structure, composed of existing single-strategy mutual funds. Most target date

\begin{footnotesize}
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\item Edelman, \textit{supra} note 50, at 3.
\item \textit{Id.}
\item David A. Krasnow, SEC Comment at 1 (June 5, 2009) (\textit{available at} http://www.sec.gov/comments/4-582/4582-16.pdf).
\item \textit{Id.} at 1-2.
\item Charlson et al., \textit{supra} note 1, at 19.
\item \textit{Id.} at 20.
\end{enumerate}
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funds, including three fund series that account for more than 70% of industry assets, use this arrangement.\textsuperscript{65} Taking another approach, some target date funds hold securities directly in a master pooling arrangement.\textsuperscript{66} Moreover, some funds charge management fees, known as “overlay fees,” in addition to the fund’s expense ratio.\textsuperscript{67}

Some have expressed concern at the tendency of target date funds to invest only in underlying funds run by the same company, rather than examining many different options to find the best and lowest cost investments.\textsuperscript{68} Many critics have asserted that target date funds charge excessive fees, largely because they use traditional mutual funds, in a fund of funds structure, rather than exchange traded funds.\textsuperscript{69} They accuse these funds of “double-dipping,” as participants must pay fees to the target date fund manager as well as management fees to the other funds in which the target date fund invests.\textsuperscript{70}

D. Use as a QDIA

Comments submitted for the hearing expressed disagreement about the use of target date funds as a QDIA, with some arguing that such use should not be permitted\textsuperscript{71} and others defending target date funds as important QDIAs.\textsuperscript{72} Those concerned by asset allocations of target date funds find their acceptance as a QDIA particularly troubling. They have argued that allowing use as a QDIA conveys government approval, which may

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\item \textsuperscript{65} \textit{Id.} at 16.
\item \textsuperscript{66} \textit{Id.}
\item \textsuperscript{67} \textit{Id.} at 21.
\item \textsuperscript{69} See \textit{e.g.} Allan D. Grody, SEC Comment at 3 (June 12, 2009) (available at http://www.sec.gov/comments/4-582/4582-23.pdf); Chris Tobe, \textit{supra} note 48, at 2.
\item \textsuperscript{70} See Michaud & Michaud, \textit{supra} note 53, at 5.
\item \textsuperscript{71} See \textit{e.g.} Michaud & Michaud, \textit{supra} note 53, at 6
\item \textsuperscript{72} See \textit{e.g.} Lauder, \textit{supra} note 46, at 1; Nagengast, \textit{supra} note 45, at 2.
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lead investors to assume that such funds are appropriate investment vehicles, and have observed that investors who are defaulted into a fund frequently make no further decisions concerning their retirement portfolio. Some have also complained that there is no regular oversight over QDIAs, with no annual audit or periodic inspections required.

5. Proposals

A number of individuals and organizations, in comments submitted for the joint hearing as well as in academic papers, have offered a variety of suggestions for improving target date funds, a number of which call for increased government regulation. These suggestions have largely focused on four types of proposals: limiting risk, increasing disclosure, limiting fees, and modifying QDIA status. The SEC must now decide whether to adopt new regulations in order to implement any or all of these proposals. The SEC must also consider how to coordinate its action with the DOL and whether to defer to the DOL on certain issues.

A. Proposals to Limit Risk

Two main proposals have been suggested to limit the level of risk assumed by target date funds. The first proposal urges government regulators to set specific requirements for fund asset allocations and glide paths. Some have advocated that the SEC, with the help of independent experts, establish industry standards of acceptable


ranges of asset allocations for target date funds of different durations.\textsuperscript{75} It has also been suggested that the baseline asset allocations established for federal government employees in the Thrift Savings Plan could be used as a guideline.\textsuperscript{76} Defending this proposal, one comment pointed out that fund managers would still be able to select appropriate investment strategies within the accepted ranges, allowing for competition among funds.\textsuperscript{77} Supporters of the proposed regulation argue that restricting glide paths would not only limit risk but also help to better align asset allocations with investor expectations.\textsuperscript{78} They acknowledge that more aggressive investment strategies may be appropriate for some individuals but suggest that those investors who wish to pursue such individualized strategies do so through other investment vehicles.\textsuperscript{79}

However, others object to this increased regulation of fund design, and the findings of several studies seem to provide some support for this position. In a working paper, Pang and Warshawsky noted that optimal asset allocation depends on individual preferences and other benefits received; for example, if an individual also has a defined pension plan, that individual can maintain a more aggressive portfolio.\textsuperscript{80} They concluded that this complexity makes it difficult to set asset allocation constraints that are suitable for a majority of investors.\textsuperscript{81} Similarly, Viceira noted that participants with earnings that demonstrate high volatility or strong correlation with stock returns should maintain

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  \item \textsuperscript{75} See e.g. Mohrman-Gillis, \textit{supra} note 73, at 2; Bullard & Roper, \textit{supra} note 46, at 7.
  \item \textsuperscript{76} Mohrman-Gillis, \textit{supra} note 73, at 2.
  \item \textsuperscript{77} Marilyn Capelli Dimitroff, DOL Comment at 4 (June 18, 2009) (\textit{available at} http://www.dol.gov/ebsa/pdf/cmt-07200902.pdf).
  \item \textsuperscript{78} Bullard & Roper, \textit{supra} note 46, at 7.
  \item \textsuperscript{79} See e.g. Dimitroff, \textit{supra} note 77, at 3.
  \item \textsuperscript{80} Pang & Warshawsky, \textit{supra} note 5, at 14.
  \item \textsuperscript{81} Id. at 14-15.
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portfolios with a smaller equity allocation. Viceira also advised that investors who anticipate receiving pension income from Social Security or a traditional defined benefit pension plan select target date funds with target dates long after their expected retirement date, since the pension income provides a bond-like investment similar to labor earnings. In another paper, Park also concluded that his empirical observations regarding the correlation between demographics and equity allocations and contribution rates seemed to suggest that any examination of the impact of various glide paths on retirement success rates should account for plan demographics.

Many comments submitted by those who object to government regulation of glide paths argued that innovation and flexibility, in terms of glide paths and underlying investments, enables managers to best meet participants’ varying needs and react to changing market conditions. They pointed out that flexibility allows for creation of more individualized glide paths for specific plan sponsors, which can take into account factors beyond retirement date such as expected defined benefit payment, average retirement age, and average allocation to company stock. Some declared that no

83 Id. at 20.
84 See Park, supra note 23, at 14. Park noted, however, that participant contribution rates may become more uniform through increased use of automatic enrollment and automatic contribution escalations, and that under such circumstances, a single glide path may be more likely to provide a strategy appropriate for investors with varying demographic characteristics. Id. at 33.
general consensus exists regarding the best target date fund investment strategy.87 Opponents of glide path regulation also emphasized the trade-offs between different types of risk and asserted that the government should not limit equity exposure, as participants can earn a premium over time for taking on additional risk, which can help reduce several other risks, including outliving savings, high costs of health care, and inflation.88

Some opponents of increased glide path regulation argued that no need exists for additional regulations under ERISA directed toward target date funds because ERISA adequately addresses target date funds. They pointed out that ERISA requires fiduciaries of a participant-directed plan to make a range of investment alternatives available to plan participants, who can select the most appropriate investment options, and requires material information about investment alternatives to be made available to participants in plain English, so they can make informed decisions.89 One comment expressed concern about fiduciary liability under regulations mandating a specific glide path, arguing that if such regulations are adopted, they should also provide that plan fiduciaries may not be held liable for any negative outcome based on a fund’s glide path.90 Finally, opponents of increased regulation of fund design emphasized that target date funds are long-term investments whose performance cannot be judged based on one or two particularly bad

89 Ugoretz, supra note 87, at 3-5.
90 Klausner, supra note 85, at 3.
quarters, but rather must be evaluated over a period of years.91 Noting that target date funds cannot guarantee a lifetime income, one opponent of glide path regulation suggested that retirees be encouraged or required to place some of their retirement savings into a lifetime annuity.92

The second proposal involves requiring funds to take into account characteristics beyond an investor’s age, in order to better match the risk tolerance of individual investors with the risk level of their target date fund. Several academic papers have suggested means by which funds can take into account other such factors beyond age. In a working paper, Basu, Byrne, and Drew proposed adoption of a dynamic asset allocation strategy in which those allocations are based on cumulative investment performance of the portfolio relative to the investor’s target.93 Under such a strategy, asset allocations could be modified to become more aggressive or more conservative.94 Drew and Basu found this dynamic allocation strategy to produce better terminal wealth outcomes in 75% to 80% of cases than a strictly age-based investment strategy.95 In another paper, Viceira, stressing the diversity of risk tolerance and human capital among investors, suggested that funds adopt cost-effective means of personalization, such as creating separate “aggressive,” “moderate,” and “conservative” funds for investors with different levels of risk tolerance.96 He also proposed creating funds designed specifically for individual firms that sponsor defined contribution pension plans, as these funds could

91 See e.g. Barclays Global Investors, supra note 86, at 11.
92 Moslander, supra note 88, at 7.
94 Id. at 20.
95 Id. at 21.
96 Viceira, supra note 82, at 19-21.
more accurately reflect the human capital risk characteristics of the firm’s average employee, offer reduced exposure to stocks in the company’s industry, avoid investing in the company’s stock entirely, and adopt glide paths with equity allocations that take into consideration the correlation between wages in the industry and aggregate stock returns.\textsuperscript{97}

In a third paper, Bodie and Treussard, like Viceira, stressed that optimal allocation strategy differs depending on risk aversion and exposure to human capital risk and proposed that alternative “safe” target date funds be established for investors with greater risk aversion or exposure to human-capital risk.\textsuperscript{98}

A study by Gomes, Kotlikoff, and Viceira also appears to support the creation of funds taking into account risk tolerance. Gomes et al. examined the welfare costs of constraining investors within popular default investment options in defined contribution plans, as compared to the average portfolio allocation those investors would have followed if unconstrained.\textsuperscript{99} They found that target date funds designed to match an investor’s risk tolerance and investment horizon had small welfare costs and could be approximately optimal.\textsuperscript{100} However, they found that where investors have varying risk tolerance, target date funds can be very costly, and they suggested that the mutual fund industry might consider offering life cycle funds based on both risk tolerance and age.\textsuperscript{101}

Nonetheless, some oppose any proposal that would require fund companies to

\textsuperscript{97} Id. at 19-22.
\textsuperscript{100} Id. at 13-14.
\textsuperscript{101} Id. at 14.
create multiple target date funds that carry different levels of risk. These opponents argue that much of the appeal of target date funds lies in their simplicity, which allows them to serve as effective investment vehicles for participants who lack the time or expertise to manage a retirement portfolio, and that requiring companies to provide multiple fund options would detract from this simplicity, confuse participants, and add to plan costs.\textsuperscript{102}

**B. Proposals to Improve Communication and Increase Disclosure Requirements**

In order to address concerns about inadequate disclosure, the SEC could consider adopting new disclosure requirements specifically for target date funds. Comments submitted to the SEC and DOL suggested a variety of different proposals for improving disclosure and transparency. For example, one comment suggested the creation of a publicly available side-by-side comparison chart of various funds’ glide paths.\textsuperscript{103} Another advocated requiring a clear, standardized “fact sheet” that highlights the potential risks of target date funds and includes the following information: a universal target date benchmark, an illustration of the fund’s glide path versus the universal benchmark, and illustrations of potential losses versus the universal benchmark.\textsuperscript{104} Yet another recommendation involved requiring fund prospectuses to provide a clear explanation of the objectives of the fund.\textsuperscript{105} Other proposed required disclosure included funds’ definition of the asset classes or investment categories used to construct the glide path, methodology used to determine asset allocations, current allocations, rules that


\textsuperscript{104} Lauder, supra note 46, at 3-4.

\textsuperscript{105} Nagengast, supra note 45, at 2.
govern rebalancing of allocations, and the date after which no further changes would be made to asset allocations. However, some disagreed about the need for special disclosure rules for target date funds, contending that plan sponsors should simply comply with existing disclosure rules that apply to other defined contribution plans. One comment specifically requested that the DOL and the SEC coordinate any new regulation of disclosure, so that separate disclosure rules are not created under the Investment Company Act and ERISA, which could result in participants receiving two different disclosure pieces for the same potential investment and end up confusing or overwhelming investors.

The SEC could also adopt new regulations concerning the names that may be used for target date funds. For instance, one comment proposed a framework for more clearly naming target date funds in order to convey three essential characteristics: investment horizon, transition risk (described as relative risk of unexpected outcomes resulting from steepness of glide path), and aggression. Another individual suggested that the SEC amend Rule 35d-1, which deals with misleading fund names, to provide that a target date fund name is misleading unless its asset allocations fall within an acceptable range consistent with its name. Opponents of such regulations have responded that more information, beyond fund name, is always required to make an appropriate investment.

107 Klausner, supra note 85, at 2.
108 Kent, supra note 87, at 3.
110 Dimitroff, supra note 77, at 4. Under Section 35(d) of the Investment Company Act, it is unlawful for a mutual fund to adopt any materially deceptive or misleading words as a part of its name. See Donohue, supra note 33, at 9.
decision and that name changes to existing funds would confuse current investors.\textsuperscript{111}

Additionally, the SEC could consider enacting a program aimed at improving investor education about how to use target date funds, and several comments submitted for the hearing advocated this approach.\textsuperscript{112} However, others expressed skepticism that education efforts would improve participant outcomes, given the large amount of information and rapid developments in the field of investment management, and suggested it is more prudent to assume that individuals will not become educated investors.\textsuperscript{113} One comment pointed out the challenges involved in persuading participants to read this information, noting that target date funds were designed precisely to provide an investment portfolio for such disengaged participants.\textsuperscript{114}

\textbf{C. Proposals to Limit Fees}

The SEC could consider adopting new regulations related to fees charged by target date funds, and at least two different recommendations have been suggested to help encourage the reduction of fees. One proposal would require QDIAs to invest only in low cost index funds or index fund exchange traded funds, in order to limit fees.\textsuperscript{115} A second plan would allow for payment of fund managers only after those managers demonstrate that they have outperformed a static benchmark on a risk and skill adjusted basis.\textsuperscript{116}

\textsuperscript{111} See Kent, supra note 87, at 3.

\textsuperscript{112} See e.g. David Kosterlitz, supra note 103, at 1; Krasnow, supra note 61, at 2; Moslander, supra note 88, at 3.


\textsuperscript{114} Ameriks, supra note 88, at 3.

\textsuperscript{115} Michaud & Michaud, supra note 53, at 5.

D. Proposals to Ban or Regulate Use of Target Date Funds as QDIAs

Finally, the SEC or DOL, or both agencies, could take steps to increase monitoring and regulation of QDIAs. First, the SEC could provide specific securities registration for funds seeking QDIA status, which might require, for example, that each fund prospectus describe that fund’s QDIA capabilities and compliance and prohibit use of funds without this registration as a QDIA.117 Second, the SEC could use its authority to challenge false or misleading representations about QDIA investments under its jurisdiction.118 At the same time, the DOL could consider requiring an annual audit for all QDIA vendors in order to monitor compliance with ERISA regulations.119

The agencies could also decide to adopt some or all of the changes that have been proposed to the process by which fiduciaries select funds. One proposal advocated that the DOL require vendors to take into account other variables beyond age, such as accumulated wealth, to determine QDIA investment choices.120 Another suggested that regulators ensure that fiduciaries perform due diligence in selecting funds and encouraged the DOL to issue compliance assistance to fiduciaries selecting and monitoring target date funds, similar to compliance assistance on 401(k) plan fees issued by the DOL.121 Yet another proposed improving fiduciary transparency by requiring the identification of each plan fiduciary and disclosure of basic professional information, in the same manner in which mutual funds disclose information concerning their directors,

117 See DALBAR, supra note 74, at 18.
118 See id. at 2.
119 See id. at 19.
120 Id. at 3.
officers, and portfolio managers.\textsuperscript{122} Under a different proposal, the SEC would require a
majority of mutual fund directors to be qualified and independent, with at least two
independent directors who possess CFA designation.\textsuperscript{123} This would help to address the
criticism that fund boards may not possess sufficient independence and may not be doing
enough to serve shareholders.\textsuperscript{124}

\textsuperscript{122} Dunne, \textit{supra} note 106, at 4-5.
\textsuperscript{123} See Chris Tobe, DOL Comment at 2 (June 17, 2009) (\textit{available at
http://www.dol.gov/ebsa/pdf/BCAP061709.pdf}),
\textsuperscript{124} See Charlson et al., \textit{supra} note 1, at 26.