TARGET DATE RETIREMENT FUNDS: LACK OF CLARITY AMONG STRUCTURES AND FEES RAISES CONCERNS

SUMMARY OF COMMITTEE RESEARCH

PREPARED BY THE

MAJORITY STAFF

OF THE

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CONTENTS

Forward………………………………………………………………………………………… 4
Select Aging Committee Hearings…………………….…………………………………… 5
Executive Summary……………………………………………………………………… 8
Introduction……………………………………………………………………………….. 8
Background……………………………………………………………………………… 10
Pension Protection Act of 2006 Encourages Automatic Enrollment Policies………………… 11
Adoption of Automatic Enrollment Has Grown Considerably With Plans Overwhelmingly
Adopting Target date Funds as Default Investment…………………………………... 12
Although Popular Investment Tools, Design and Transparency of
Target date Funds Raise Concerns …………………………………………………… 13
Agencies Taking Steps to Evaluate Target date Fund Concerns…………………………… 18
Conclusion……………………………………………………………………………. 19
Acknowledgments……………………………………………………………………… 21

Foreword

The Special Committee on Aging (Aging Committee) has a long history of examining various aspects of both the defined benefit and defined contribution pension industry. Most recently, the Aging Committee held hearings reviewing the recession's effect on older American's retirement income, including whether individuals have adequate pension benefits and coverage as well as whether retirement-related federal government programs—such as the Pension Benefit Guaranty Corporation and the Social Security Administration—are performing effectively.

Since the economic downturn, I have become increasingly concerned that plan sponsors and participants may not be receiving adequate information regarding the risk associated with certain 401(k) products, such as target date retirement funds—investment vehicles designed to automatically adjust to more conservative investments as one approaches retirement. Today, more and more companies are automatically enrolling their workers into these types of plans due to Department of Labor's ruling that these funds qualify for "safe harbor" relief from fiduciary liability. In fact, many have suggested that these funds will be the retirement savings vehicle for the vast majority of Americans in the future.

While well-constructed target date funds have great potential for improving retirement income security, it is currently unclear whether investment firms are prudently designing these funds in the best interest of the plan sponsors and their participants. In fact, an Aging Committee investigation conducted in early 2009 found significant differences in the asset allocations and equity holdings within these funds, raising questions about whether plan sponsors and participants understand the underlying assumptions and risk associated with these products. Therefore, I requested that the U.S. Department of Labor and the U.S. Securities and Exchange Commission examine these funds, and I commend the agencies for taking steps to do so.

The Aging Committee's hearing on October 28, 2009, together with this staff information paper represent an attempt to outline concerns related to target date funds. This staff report summarizes the Aging Committee's actions to date and presents findings from various sources, including Committee hearings, government reports, and academic research.

My hope is that this paper will assist Members of Congress, their staffs, and the general public in better understanding the potential benefits and challenges associated with these types of investment funds.

HERB KOHL, *Chairman*

SELECT AGING COMMITTEE HEARINGS

Senate Special Committee on Aging hearings

On October 24, 2007, the Senate Special Committee on Aging held a hearing on "Hidden 401(k) Fees: How Disclosure Can Increase Retirement Security," which examined the effect hidden 401(k) fees can have on retirement savings and the need for simple and clear disclosure. The Committee heard testimony from: Barbara Bovbjerg, Director of Education, Workforce and Income Security Issues, GAO; Bradford Campbell, Assistant Secretary of Labor, the Employee Benefits Security Administration; Jeff Love, Director of Research, AARP; Mercer Bullard, assistant professor, University of Mississippi School of Law; Michael Kiley, President, Plan Administrators, Inc.; and Robert Chambers, Esq., Partner, Helms, Mulliss & Wicker LLC and Chairman of the American Benefits Council.

LEGISLATIVE ACTION:

Increasing the Transparency of Pension Fees. Under ERISA, there are currently no requirements to clearly disclose the record keeping and investment fees charged for managing a 401(k) account. Yet, a small difference in fees, when compounded annually, results in large difference in final retirement savings. In the 111th Congress, Rep. George Miller (D-CA, 7th Congressional District) introduced H.R. 1984, the *401(k) Fair Disclosure for Retirement Security Act*, and Senators Tom Harkin (D-IA) and Herb Kohl (D-WI) introduced S. 401, *the Defined Contribution Fee Disclosure Act*, to amend ERISA to require the disclosure of fees to both plan sponsors and participants. If passed, this legislation could increase overall retirement security without cost to the American taxpayers. The House bill passed through the House Committee on Education and Labor in June 2009.

On April 30, 2008, the Senate Special Committee on Aging held a hearing entitled, "Leading by Example: Making Government a Role Model for Hiring and Retaining Older Workers" evaluating the federal government's efforts to hire and retain older workers. The Committee heard testimony from: Barbara Bovbjerg, Director, Education, Workforce and Income Security Issues, US Government Accountability Office, Robert Goldenkoff, Director, Strategic Issues, US Government Accountability Office, Nancy Kichak, Associate Director, Strategic Human Resources Policy, Office of Personnel Management, Thomas Dowd, Administrator, Office of Policy Development and Research, Employment and Training Administration, US Department of Labor, Max Stier, President and CEO, Partnership for Public Service, Chai Feldblum, Co-Director, Workplace Flexibility 2010.

LEGISLATIVE ACTION:

Remove the pension penalty for seniors to continue working in a phased retirement:
In the 111th Congress, Senator Herb Kohl (D-WI) joined Senator George Voinovich (R-OH), the ranking member of the Senate Homeland Security and Governmental Affairs Committee's Subcommittee on the Oversight of Government Management, the Federal Workforce and the District of Columbia, in introducing S. 469 the *Incentives for Older Workers Act*, which includes a provision that removes the penalty under defined benefit pension plans that reduces the pension of full-time workers who take a lower salary while reducing their hours in a phased retirement. This penalty affects more than three million Americans in private pension plans that are calculated, in part, by their final year pay.

On July 16, 2008, the Senate Special Committee on Aging held a hearing entitled "Saving Smartly for Retirement: Are Americans Being Encouraged to Break Open the Piggy Bank?" to examine the reported increase in leakage and to explore ways to protect American's retirement savings. The Committee heard testimony from: Christian Weller, Senior Fellow, Center for American Progress; Mark Iwry, Principal, Retirement Security Project; David John, Principal, Retirement Security Project; Gregory Long, Executive Director, Federal Retirement Thrift Investment Board; John Gannon, Senior Vice President, Financial Industry Regulatory Authority; Bruce Bent, Chairman, The Reserve.

LEGISLATIVE ACTION:

Reducing the "Leakage" of Pension Savings. In conjunction with the July 2008 hearing, the Aging Committee requested that the U.S. Government Accountability Office (GAO) study the extent to which Americans tap into their accrued retirement savings prior to retirement. In August 2009, GAO issued *401(k) Plans: Policy Changes Could Reduce Long-term Effects of Leakage on Workers' Retirement Savings*, which suggested that Congress consider changing the requirement for the six-month contribution suspension following a hardship withdrawal, as well as recommended that the Secretary of Labor promote greater participate education on the importance of preserving retirement savings, and that the Secretary of the Treasury clarify and enhance loan exhaustion provisions to ensure that participants do not initiate unnecessary leakage through hardship withdrawals. In conjunction with the 2008 hearing, Senators Charles Schumer (D-NY) and Herb Kohl (D-WI) introduced S. 3278 in the 110th Congress, to limit the number of 401(k) loans to three and prohibit the widespread use of 401(k) debit cards.

On February 25, 2009, the Senate Special Committee on Aging held a hearing entitled "Boomer Bust? Securing Retirement in Volatile Economy," which examined the economic downturn's effect on retirement security, particularly for those on the brink of retirement. The Committee heard testimony from: Jeanine Cook, a Baby Boomer from Myrtle Beach, South Carolina; Dallas L. Salisbury, President & CEO, Employee Benefits Research Institute; Dean Baker, Co-Director, Center for Economic and Policy Research; Ignacio Salazar, President & CEO, SER - Jobs for Progress; Barbara B. Kennelly, President & CEO, National Committee to Preserve Social Security and Medicare; Deena Katz, CFP, Associate Professor, Texas Tech University, and Chairman, Evensky & Katz.

On May 20, 2009, the Special Committee on Aging held a hearing entitled "*No Guarantees: As Pension Plans Crumble, Can PBGC Deliver*," to consider whether the federal government's Pension Benefit Guaranty Corporation (PBGC) has the capability to fulfill its mission to insure the pensions of nearly 44 million Americans, at a time when several of the country's largest automobile companies are teetering on the edge of bankruptcy. The question of PBGC's governance came amidst allegations of mismanagement by the agency's former director, Charles E.F. Millard, who deviated from PBGC's conservative investment strategy just before the market downturn. In addition, the PBGC Inspector General alleged that Millard improperly influenced the procurement process surrounding the restructure of the Corporation's investments. The Committee heard testimony from: Dallas L. Salisbury, President and CEO, Employee Benefits Research Institute; Barbara Bovbjerg, Director, Education, Workforce and Income Security, U.S. Government Accountability Office; Rebecca Anne Batts, Inspector General, Pension Benefit Guaranty Corporation; Vincent Snowbarger, Acting Director, Pension Benefit Guaranty Corporation; and Charles E.F. Millard, Former Director, Pension Benefit Guaranty Corporation.

LEGISLATIVE ACTION:

Strengthening the Pension Benefit Guaranty Corporation's Governance Structure. In May 2009, PBGC reported an accumulated deficit of about $33.5 billion. Moreover, the hearing revealed that the PBGC Board of Directors had not met since February 2008 despite the economic downturn, and that PBGC lacked certain procurement safeguards. On the basis of the Committee's findings, Senators Herb Kohl (D-WI), Russ Feingold (D-WI), Claire McCaskill (D-MO), and Michael Bennet (D-CO) introduced S.1544, which expands and strengthens PBGC governance and oversight, in part, by expanding the PBGC's board of directors, redefining the Inspector General's reporting structure, and adding additional procurement safeguards.

AGING COMMITTEE MAJORITY STAFF INFORMATION PAPER

Executive Summary

Target date retirement funds—also referred to as lifecycle funds—are a type of mutual fund that automatically rebalances to a more conservative asset allocation as the participant approaches their retirement target date. These funds offer investors certain advantages generally not offered by other types of investment vehicles by purporting to offer participants a beneficial long-term asset allocation strategy, while lowering financial risk as participants approach retirement. Since the Department of Labor designated target date funds as an appropriate investment default option in response to the enactment of the Pension Protection Act of 2006, more than $140 billion in net monies have entered into target date funds, and 96 percent of plans that offer automatic enrollment policies are using target date funds.

Although target date funds have proved popular with participants and have won the approval of many investment professionals, the losses suffered by target date funds during the economic downturn raised concerns about the design and transparency of these funds. For example, an Aging Committee investigation found that the allocation of assets among stocks, bonds, cash-equivalents varied greatly among target date funds with the same target retirement date, with select firms' 2010 target date funds' equity holdings ranging anywhere from 24 to 68 percent. It was also unclear to what extent plan sponsors educate their participants on these funds, as well as how fiduciary standards would be enforced.

In response to the Aging Committee's concerns, officials from the Department of Labor's Employee Benefit Security Administration (EBSA) and the Securities and Exchange Commission (SEC) held a joint hearing on June 18, 2009, to hear testimony on the investment of 401(k) and other retirement plans in target date type plans in an effort to determine the need for additional guidance. Witnesses at the hearing addressed how target date fund managers determine asset allocations and changes to asset allocation; how they select and monitor underlying investments; the extent to which the foregoing, and related risks, are disclosed to investors and the adequacy of that disclosure; and the approaches or factors to compare and evaluate target date funds. At the time of this writing, EBSA and SEC were continuing to coordinate and evaluate what steps should be taken to address target date funds, specifically for those funds used as default options and directed at a less financially-sophisticated participant.

Introduction

Since they were first introduced several decades ago, 401(k) plans have become the principal retirement savings vehicle for millions of U.S. workers. According to the Bureau of Labor Statistics, 51 percent of workers in the private sector participated in an employer-sponsored retirement plan of some kind in 2007.[1] Only 20 percent of all private-sector workers were covered by traditional pensions—also

[1] Patrick Purcell and John Topoleski, *401(k) Plans and Retirement Savings: Issues for Congress*, R40707, Congressional Research Service, July 14, 2009.

called defined benefit or "DB" plans—whereas 43 percent participated in 401(k) plans and other defined contribution plans (DC).[2] Twelve percent of workers participated in both types of plans.[3]

Unlike employees with more traditional defined benefit pensions, most employees with defined contribution plans—such as 401(k) plans—choose to participate in their employer's plans and generally decide the amount they want to contribute and how to invest it. Thus, they bear the responsibility for funding and managing their investments in a way that seeks to achieve sufficient benefits in retirement. The worker's account balance at retirement will depend on how much the individual contributed to the plan over the years and on the performance of the assets in which the plan is invested.

The majority of assets held in DC plans are invested in stocks and stock mutual funds, and as a result, the decline in the major stock market indices in 2008 greatly reduced the value of many families' retirement savings.[4] According to the Federal Reserve Board, assets held in DC plans fell from $3.73 trillion at year-end 2007 to $2.66 trillion at year-end 2008, a decline of 28.7 percent.[5] The decline would have been even greater if not for ongoing contributions to the plans by workers and employers. Furthermore, the rise in unemployment resulting from the downturn has had a detrimental impact on retirement savings, due to participants' need to use their accrued retirement savings. The removal of retirement savings prior to retirement—a phenomenon referred to as leakage—can affect a participants ultimate preparedness for retirement, especially when the funds are removed and not replaced.

The economic downturn has shed light on concerns affecting the retirement system in the United States. This report highlights issues specifically related to the composition and use of target date retirement funds. The following information presented in this report is based on an Aging Committee investigation, government reports, literature reviews, interviews with financial experts and government officials, and industry analyses. As part of this review, the Aging Committee also collected and reviewed information on EBSA's enforcement practices to determine the extent to which EBSA focuses on target date funds composition and transparency. The Aging Committee also reviewed information highlighting the Securities and Exchange Commission compliance and enforcement efforts related to target date funds.

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[2] Employers may sponsor defined benefit (DB) or defined contribution (DC) plans for their employees. DB plans promise to provide a benefit that is generally based on an employee's years of service and salary. (See 29 U.S.C. § 1002(35).) DB plans use a formula to determine the ultimate pension benefit participants are entitled to receive. Moreover, an employer bears the investment risk, and must ensure that the pension plan has sufficient assets to pay the benefits promised to workers and their surviving dependents. Under a DC plan, such as a 401(k) plan, employees have individual accounts to which the employee, employer, or both make contributions, and benefits are based on contributions, along with investment returns (gains and losses) on the accounts. (See U.S.C. § 1002(34).) Not all DC plans are 401(k) plans, but 401(k) plans hold about 67 percent of DC plan assets. Other DC plans include 403(b) plans for non-profit employers, 457 plans for state and local governments, and miscellaneous other DC plans. Increasingly, 403(b) plans and 457 plans operate similarly to 401(k) plans. In this report the terms "401(k)" plan and "defined contribution" plan are used interchangeably unless a distinction is noted in the text.

[3] U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2007,* Summary 07-05, August 2007. The sample represented 108 million workers.

[4] On October 11, 2007, the Standard & Poor's 500 Index of common stocks reached an intra-day high of 1,576, an all time record for the index. On March 6, 2009, the S&P 500 fell to an intra-day low of 667, a decline of 57.7 percent from its all-time high. Over the next three months, stock prices climbed 41 percent. The S&P 500 closed at a value of 943 on June 1, 2009. This was 40 percent lower than the index's highest level in October 2007. By July 7, the S&P 500 had fallen to 881.

[5] Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States: Flows and Outstandings*, Fourth Quarter 2008, March 12, 2009, p. 113.

Background

Private-sector pension plans are generally classified either as defined benefit or as defined contribution plans. Defined benefit plans generally offer a fixed level of monthly retirement income based upon a participant's salary, years of service, and age at retirement, regardless of how the plan's investments perform. In contrast, defined contribution plans, such as 401(k) plans, benefit levels depend on the contributions made to the plan and the performance of the investments in individual accounts, which may fluctuate in value. Named after section 401(k) of the *Internal Revenue Code*, traditional 401(k) plans allow workers to save for retirement by diverting a portion of their pretax income into an investment account that can grow tax-free and be withdrawn without penalty after age 59 1/2.[6]

Employers and employees may make pretax contributions, up to certain limits, to individual participant accounts. In 2009, participants may contribute up to $16,500 per year. The 401(k) account balance is a function of both the contributions made to the accounts over a career as well as the investment performance of the account. About one-half of all U.S. workers participate in some form of employer-sponsored retirement plan. Participation in 401(k) plans rose steadily from fewer than 8 million participants in the mid-1980s to over 70 million participants in 2006—the most recent year for which data were available. The assets in 401(k) plans also increased significantly over the same time period, from less than $100 billion to over $3 trillion.[7] Current law limits participant access to their retirement savings in their employer-sponsored retirement plans so that the favorable tax treatment for retirement savings is limited to savings that are, in fact, used to provide retirement income. Only under certain circumstances do federal regulations allow 401(k) plan sponsors to provide participants with access to their tax-deferred retirement savings before retirement.

The Internal Revenue Service (IRS), within the Department of the Treasury, and EBSA are primarily responsible for enforcing laws that govern defined contribution plans. IRS interprets and enforces provisions of the *Internal Revenue Code* that apply to tax-qualified pension plans. EBSA enforces the Employee Retirement Income Security Act of 1974's (ERISA) reporting and disclosure provisions and fiduciary responsibility which, among other things, concern the type and extent of information provided to plan participants. In addition, the SEC is responsible under federal securities laws for regulating and examining entities registered with SEC, such as investment advisors, managers,

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[6] The *Internal Revenue Code*, as amended, exempts certain early distributions from the penalty if the distributions are made to a beneficiary or estate on or after death; made on account of total and permanent disability; made as part of a series of substantially equal periodic payments over the life expectancy of the owner or life expectancies of the owner and the beneficiary; equal to or less than deductible medical expenses (7.5 percent of adjusted gross income); made due to an IRS levy of the plan; made to individuals called to active duty after September 11, 2001, and before December 31, 2007; made to a participant after separated from service with an employer in or after the year that he or she reaches age 55; made to an alternate payee under a qualified domestic relations order; dividends from employee stock ownership plans; or made to an individual whose main home was located in a designated hurricane disaster area and who sustained an economic loss by reason of the hurricane. Additionally, some plan sponsors offer Roth 401(k) plans that allow plan participants to make elective after-tax contributions through payroll deduction. 403(b) plans are similar to 401(k) plans, in that they typically permit both sponsors and participants to make pre-tax contributions, but are designed for public education entities and tax-exempt organizations that operate under I.R.C. §501(c) (3). Participants in these plans are generally limited to investing in annuity contracts issued by insurance companies and custodial accounts invested in mutual funds.

[7] For 2006 estimates, see Investment Company Institute, "The U.S. Retirement Market, 2007," *Research Fundamentals*, vol. 17, no. 3 (2008).

and investment companies that often provide services to pension plans. While the SEC does not draw authority from ERISA, the SEC coordinates with EBSA for consultation and exchange of information as directed by a Memorandum of Understanding signed in July 2008.[8]

Pension Protection Act of 2006 Encourages Automatic Enrollment Policies

To encourage retirement savings, Congress enacted the Pension Protection Act of 2006 (PPA), which, in part, removed impediments to employers adopting automatic enrollment policies, including exemptions from legal liability for market fluctuations. In encouraging employers to adopt automatic enrollment, PPA directed the Department of Labor to assist employers in selecting "default investments" that best serve the retirement needs of workers who do not direct their own investments.

DOL's final regulation provided safe harbor relief from fiduciary liability for investment outcomes if employers met certain criteria, one of which being that assets must be invested in a "qualified default investment alternative" (QDIA) as defined in the regulation.[9] However, it does not identify specific investment products. Rather, the regulation describes mechanisms for investing participant contributions. DOL noted that the intent is to ensure that an investment qualifying as a QDIA is appropriate as a single investment capable of meeting a worker's long-term retirement savings needs. The regulation also states that a QDIA must be managed by either an investment manager, plan trustee, plan sponsor or a committee comprised primarily of employees of the plan sponsor that is a named fiduciary, or be an investment company registered under the Investment Company Act of 1940.

One of the product mechanisms DOL elected as a QDIA was the target date fund—also referred to as lifecycle funds—a type of mutual fund that automatically rebalances its asset allocation following a predetermined pattern over time to a more conservative asset allocation as the participant's target date for retirement approaches. As the participant nears retirement age, the investment allocation is shifted away from higher-risk investments, such as stocks, and moved toward lower-risk investments, such as bonds and cash equivalents. The asset allocation path that changes over time is known as the glide path, which is based on the number of years to and beyond the target date. A target date fund is a lifecycle fund designed to achieve a particular (generally conservative) mix of assets at a specific date in the future, which is usually the year when the participant expects to retire. These funds are named accordingly (e.g. 2010 Target date Fund).

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[8] Department of Labor and the U.S. Securities and Exchange Commission. *Memorandum of Understanding Concerning Cooperation between the U.S. Securities and Exchange Commission and the U.S. Department of Labor*, July 29, 2008.

[9] 29 CFR Part 2550; RIN 1210–AB10; *Default Investment Alternatives under Participant Directed Individual Account Plans*, Federal Register / Vol. 73, No. 84 / Wednesday, April 30, 2008. The final regulation provides for four types of QDIAs: 1) a product with a mix of investments that takes into account the individual's age or retirement date (an example of such a product could be a lifecycle or targeted-retirement-date fund); 2) an investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (an example of such a service could be a professionally-managed account); 3) a product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund); and 4) a capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt-out of participation before incurring an additional tax). A QDIA generally may not invest participant contributions in employer securities.

Automatic Enrollment Has Grown Considerably With Plans Overwhelmingly Adopting Target date Funds as Default Investment

According to the U.S. Government Accountability Office (GAO), defined contribution plan sponsors are increasingly adopting automatic enrollment policy plans (in which workers “opt-out” of plan participation rather than “opt-in”) to encourage their employees to save for retirement.[10] Available data indicate that plans with automatic enrollment policies are overwhelmingly adopting target date funds as their default investment. For example, 87 percent of Vanguard group plans with automatic enrollment had target date funds as a default investment at the end of 2008, compared to 42 percent in 2005.[11] (See table 1.)

Table 1: Vanguard Defined Contribution Plans with Automatic Enrollment

Default automatic Enrollment Rate	**2005**	**2006**	**2007**	**2008**
1 percent	4%	3%	3%	2%
2 percent	23%	20%	17%	13%
3 percent	46%	52%	56%	60%
4 percent	12%	10%	10%	10%
5 percent	10%	8%	7%	7%
6 percent or more	5%	7%	7%	8%
Default automatic increase rate				
1 percent	31%	57%	66%	75%
2 percent	0%	2%	2%	2%
Voluntary election	44%	27%	23%	16%
Service feature not offered	25%	14%	9%	7%
Default Fund				
Target date fund	42%	63%	81%	87%
Other balanced fund	33%	26%	15%	11%
	75%	**89%**	**96%**	**98%**
Money market or stable value fund	25%	11%	4%	2%

Source: Vanguard, 2009.

Conversely, the use of balanced funds, money market funds, and stable value funds default investments have declined significantly.[12] GAO stated that this trend toward target date funds as a

[10] Automatic enrollment is a practice where an employer enrolls eligible employees in a plan and begins participant deferrals without requiring the employees to submit a salary deferral request.

[11] 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.: October 2009).

[12] Both money market and stable value funds were often used as default investment before PPA because employers were concerned about legal liability investments they had chosen declined in value as a result of market fluctuations. As a as result, they invested workers’ contribution in such low risk, low-return default investments.

default investment vehicle is corroborated by data from Fidelity investments, which showed that, as of March 2009, 96 percent of plans with an automatic enrollment policy used target date funds, up from 57 percent at the end of 2005.

In addition, the Employee Benefit Research Institute (EBRI) reported in March 2009 that workers who were considered to be automatically enrolled in a 401(k) plan were more likely to invest all their assets in a target date fund. The study indicated that except for participants in the largest plans (more than 10,000 participants), more than 90 percent of those automatically enrolled into target date funds had all of their allocation in target date funds.[13] Most recently, EBRI reported that for year-end 2008, nearly seven percent of 401(k) assets in plans they reviewed were invested in lifecycle funds.[14] Moreover, EBRI reported that almost 44 percent of participants under age 30 had assets in a target date fund.[15]

The research firm Morningstar, Inc. also noted in September 2009 that the popularity of target date funds remained relatively unaffected by the recent economic downturn. They suggest that cash flows were on track to set a record, accumulating at an annualized rate of $60 billion over the first seven months of the year. In total, more than $140 billion in net monies have entered into the target date funds since the start of 2007, according to the firm.[16]

Although Popular Investment Tools, Design and Transparency of Target date Funds Raise Concerns

Although target date funds have proved popular with participants and have won the approval of many investment professionals, the losses suffered by target date funds during the economic downturn raised concerns about the design and transparency of these funds. In early 2009, the Aging Committee conducted an investigation of these funds, which revealed that the date in the name of the target date fund was not consistent with the design of the fund, making these funds difficult for investors to evaluate and compare. In fact, the Aging Committee found that allocation of assets among stocks, bonds, cash-equivalents varies greatly among target date funds with the same target retirement date, with firms' 2010 target date funds' equity holdings ranging anywhere from 24 to 68 percent. (The Aging Committee's review of select, large 2010 target date funds found that many funds had equities exposure at or well over 50 percent.) Since that time, a study by the investment research firm, Morningstar, Inc., corroborated the Aging Committee's findings, noting that among target date 2010 funds, stock allocations ranged from 26 percent of assets to 72 percent of assets.[17] As a comparison, in January, 2009, the Thrift Savings Plan's "L2010 Fund" for federal employees who plan to retire in 2010 held 70 percent of its assets in bonds and 30 percent in stocks.[18] Similarly, the Dow Jones Target Date Indexes propose that a fund's asset class allocation should have an equities exposure of approximately 28

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[13] Craig Copeland, *Use of Target date Funds in 401(k) Plans, 2007*, Issue Brief 327, Employee Benefit Research Institute, (Washington, D.C.: March 2009). EBRI's analysis was based on information maintained by the Employee Research Institute/Investment Company Institute database.
[14] Jack VanDerhei, EBRI; Sarah Holden, ICI; and Luis Alonso, EBRI; 401(k) Plans Asset Allocation, Account Balances, and Loan Activity in 2008, Issue Brief No. 335, Employee Benefit Research Institute, (Washington, D.C.: October 2009).
[15] EBRI, Issue Brief 327.
[16] Morningstar, Inc. *Target date Series Research Paper: 2009 Industry Survey.* September 9, 2009.
[17] Morningstar, Inc. *Target date Series Research Paper: 2009 Industry Survey.* September 9, 2009.
[18] CRS, R40707.

percent at the target date.[19] In December 2008, the average 2010 fund had more than 45 percent of its assets invested in stocks.[20]

Fund performance also varied greatly during the bear market of 2008. The S&P Target date 2010 Index Fund, a benchmark of fund performance, fell 17 percent in 2008. The fund holds 60 percent of its assets in bonds and other fixed-income securities and 40 percent in equities. The Deutsche Bank DWS Target 2010 Fund fell just 4 percent in 2008, whereas Oppenheimer's Transition 2010 fund fell 41 percent. For the federal Thrift Savings Plan, shares of the "L2010 Fund" fell 10.5 percent in 2008.

Because of the losses resulting from the financial downturn, industry experts have raised concerns about investors' understanding of the construction of the glide path and its effect on the funds asset allocation. There are varying opinions on whether a target date fund is designed to terminate at the time of retirement or is intended to account for a participant's post-retirement needs. Documentation provided to the Aging Committee by select firms indicated that many of these funds were designed to take into account and mitigate (1) market risk, (2) longevity risk, and (3) inflation risk.[21] Many of the firms' materials suggested that these funds were not intended for a participant to cash out their retirement savings at the projected retirement date. Instead, the funds were designed to provide income for the years during retirement as well. However, it is unclear whether participants were aware of this plan design.

While there are valid arguments to support different approaches for constructing a glide path, individuals' behavior at retirement may minimize certain financial risks. According to recent research, it is common for an individual to take a lump-sum distribution of their assets at the time of retirement. For example, a study by the Vanguard Center for Retirement Research estimated in that 2008 about half of retired households between the ages of 55 to 75 tapped into their long-term accounts, typically as a large, one-time withdrawal generally to address living expenses. Only two out of ten households spent down their accounts on some type of systematic or regular income payment program.[22] Moreover, a survey conducted by Investment Company Institute found that 54 percent of respondents took some or all of their balance as a lump-sum distribution, and of those respondents, 86 percent rolled over some or all of the balance to an Individual Retirement Account or otherwise reinvested the assets. The remaining 14 percent spent all the proceeds of the distribution.[23] Because many participants take such

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[19] According to Dow Jones over the life of each target index the relative risk of the index will range from a more aggressive portfolio that incurs approximately 90 percent of the risk of the composite stock market index (Stock CMAC) in the beginning to a conservative portfolio that incurs approximately 20 percent of the risk of the stock CMAC 10 years after the index reaches its "target date". The Dow Jones "Today" Index aims to hold risk constant at 20 percent of the risk of the stock CMAC and is a benchmark for a conservative, balanced portfolio an investor might hold 10 years after reaching retirement.

[20] Patrick Purcell and John Topoleski, *401(k) Plans and Retirement Savings: Issues for Congress*, R40707, Congressional Research Service, July 14, 2009.

[21] Market risk is the risk of adverse market movements. Longevity risk is the risk of outliving one's savings. Inflation risk is the risk that inflation can eat away at the purchasing power of accumulated savings possibly very rapidly.

[22] Gary R. Mottola and Stephen P. Utkus, Vanguard Center for Retirement Research, *Spending the Nest Egg: Retirement Income decisions among older investors*, Volume 35, October 2008. The results in this report are based on a national online panel survey of older Americans, age 55-75, with $50,000 or more of accumulated financial assets. A total of 1,478 respondents participated in the survey, which was conducted in May 2008.

[23] Investment Company Institute. *2009 Investment Company Fact Book*: A *Review of Trends and Activity in the Investment Company Industry*, 49th Edition, 2009.

withdrawals, the need for a more aggressive asset allocation to manage for risks like longevity may be minimized, because participants' often do not maintain their assets in their target date fund throughout their retirement. Therefore, participants—especially those who are less sophisticated and defaulted into these funds—may lock in large losses, such as those experienced in 2008.

In addition to potential design weaknesses and participant misunderstandings, the fees associated with target date funds—as well as all 401(k) plans—can have a significant impact on the amount of income saved for retirement. For example, a 1-percentage point difference in fees can significantly reduce the amount of money saved for retirement. Assume an employee of 45 years of age with 20 years until retirement changes employers and leaves $20,000 in a 401(k) account until retirement. If the average annual net return is 6.5 percent—a 7 percent investment return minus a 0.5 percent charge for fees—the $20,000 will grow to about $70,500 at retirement. However, if fees are instead 1.5 percent annually, the average net return is reduced to 5.5 percent, and the $20,000 will grow to only about $58,400. The additional 1 percent annual charge for fees would reduce the account balance at retirement by about 17 percent.

According to a September 2009 report by Morningstar, Inc., the average expense ratios vary widely,[24] ranging from 0.19 percent to 1.82 percent, a difference of 163 basis points.[25] (See table 2.) The research firm noted that more than half the target date fund industry has annual expense ratios exceeding 1 percent.[26] However, Morningstar indicated that target date fund expense ratios will more than likely decline in the coming years, in part, due to the wide price gap between funds.

Table 2: Target date Series Asset-Weighted Average Expense Ratios

	Asset Weighted Expense Ratio %	Total Assets in Millions $	Industry Target date Assets %
Vanguard Target Retirement Series	0.19	41,051	21
USAA Target Retirement	0.64	512	0
TIAA-CREF Lifecycle Series	0.69	2.674	1
NestEgg Dow Jones Series	0.69	91	0
Fidelity Freedom Series	0.69	71,835	37
Harbor Target Retirement	0.70	89	0
Schwab Target Series	0.72	569	0
T. Rowe Price Retirement Series	0.73	31,998	16
Wells Fargo Advantage	0.81	2,882	1
Allianz Global Inv Solutions	0.83	186	0
Columbia Retirement Portfolios	0.83	17	0
JP Morgan SmartRetirement	0.86	1,209	1
American Century LIVESTRONG	0.88	1,472	1
RiverSource Retirement Plus Series	0.88	127	0
Barclays Global Inv LifePath Series	0.91	2,196	1

[24] Expense ratios are fees and expenses incurred by mutual fund investors, such as the management fee (the amount the fund's investment adviser charges for managing the fund), the fund's other operating expenses (such as fund accounting or mailing expenses), as well as commissions to broker-dealers to execute trades for their fund.

[25] A basis point is a unit that is equal to 1/100th of 1 percent, and is used to denote the change in a financial instrument. For example, 1 percent change = 100 basis points, and 0.01 percent = 1 basis point. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

[26] Morningstar, Inc. *Target date Series Research Paper: 2009 Industry Survey.* September 9, 2009.

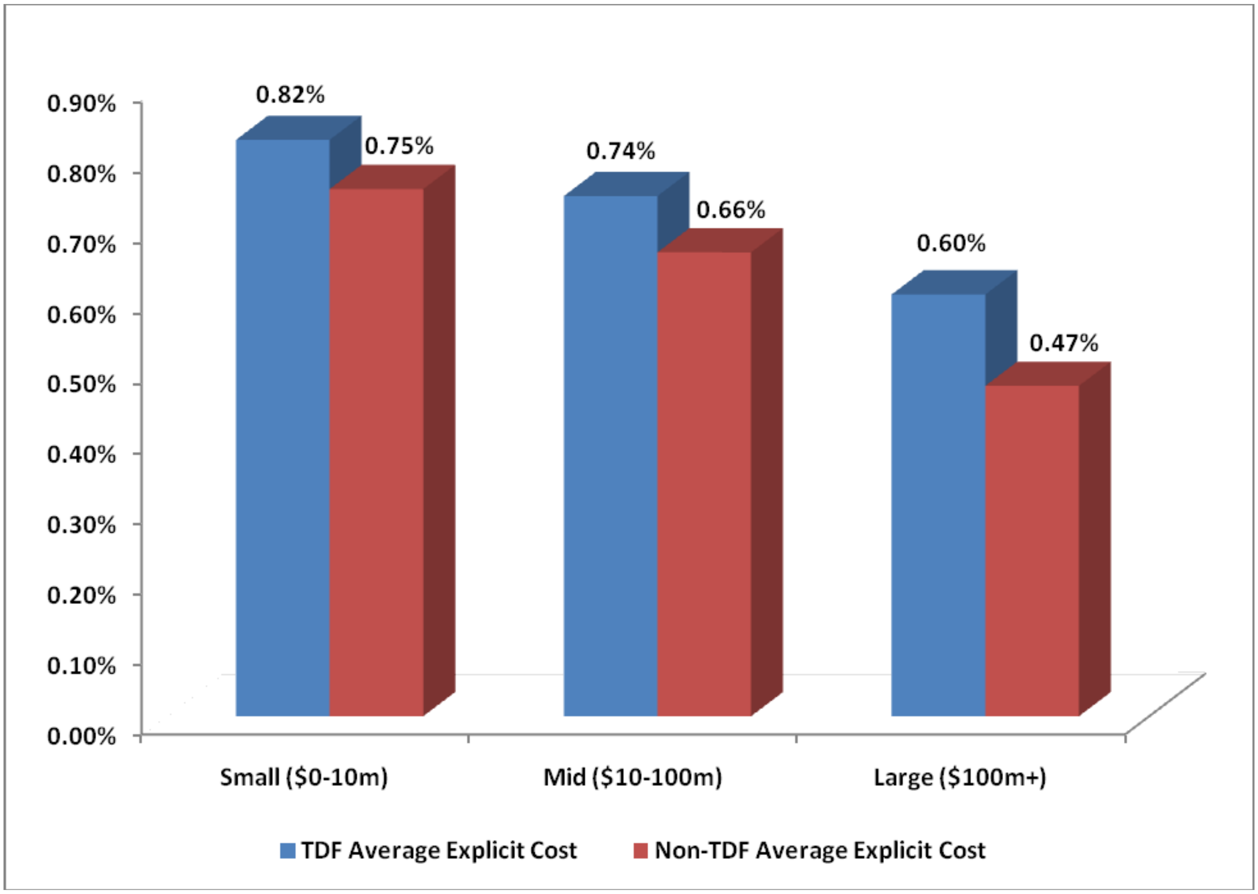
ING Index Solution	0.94	139	0
John Hancock Lifecycle Series	0.95	2,223	1
AllianceBernstein Retirement Str	0.95	1,631	1
Hartford Target Retirement	0.97	126	0
American Funds Trgt Date Rtrmt	0.98	4,321	2
Russell Distribution	0.98	8	0
Old Mutual	0.99	4	0
Vantagepoint Milestone Series	1.02	717	0
Goldman Sachs Retirement Str	1.02	75	0
Principal LifeTime Series	1.03	11,620	6
MassMutual Life Insurance Co	1.04	1,004	1
Russell Lifepoints	1.06	486	0
Fidelity Advisor Freedom Series	1.07	7,330	4
Guidestone Funds MyDestination	1.10	419	0
Nationwide Target Destination	1.11	295	0
DWS LifeCompass Series	1.13	487	0
MainStay Retirement Series	1.14	177	0
Manning and Napier Target	1.14	126	0
Putnam RetirementReady Series	1.14	250	0
Maxim Lifetime	1.15	2	0
Rayden/Wilshire Target Date Series	1.15	4	0
ING Solution Series	1.15	2,746	1
PIMCO RealRetirement	1.22	17	0
Van Kampen Retirement	1.29	47	0
AIM Independence Series	1.31	41	0
State Farm Lifepath Series	1.32	2,152	1
Legg Mason Partners Target Retire	1.34	12	0
BlackRock Lifecycle Prepared Series	1.36	36	0
MFS Lifetime Series	1.38	208	0
Franklin Templeton Retirem Series	1.44	54	0
Seligman TargetHorizon ETF Series	1.57	120	0
Oppenheimer LifeCycle Series	1.73	187	0
SunAmerica	1.82	298	0

Source: Morningstar, Inc.

BrightScope, Inc. also found that target date funds have higher expense ratios than the rest of the core portfolio in 401(k) plans. Their data assessment suggest that target date funds have internal fees that are between 10 to 25 percent more expensive than other funds on the core menu, which they suggest may be partially explained by management overlay fees—management fees layered on top of the underlying funds' expense ratio.[27] (See fig. 1.)

[27] BrightScope, Inc. is an independent provider of 401(k) ratings and financial intelligence to plan sponsors, advisors, and participants in all 50 states. BrightScope's data is based on investment menus for 6,978 small plans, 4,201 mid-sized plans and 1,667 large plans.

Figure 1: 401(k) Investment Menu Expense Ratio: Target Date Fund Compared to the Core Menu



Source: BrightScope, Inc.

In addition to varying expense ratios within target date funds, pension plan service providers or the various outside companies may also charge fees which are deducted from an individual's savings. These fees for services are either "bundled" or "unbundled." Bundled providers are typically large financial services companies whose primary business is selling investments. They bundle their proprietary investment products with affiliate-provided plan services into a package that is sold to plan sponsors. In contrast, unbundled or independent providers are primarily in the business of offering administrative services with a ''universe'' of unaffiliated, non-proprietary investment options. Bundled providers disclose the cost of the investments to the plan sponsor, but do not disaggregate the costs of the administrative services, whereas unbundled providers disclose both since the costs are paid to different providers. According to a House Committee on Education and Labor report, many participants do not have a clear understanding of fees and expenses charged by service providers.[28] In fact, some of the fees are not even known to the plan sponsor because they are directly paid by service providers.[29]

While target date funds that are mutual funds include several layers of investor safeguards—such as regulatory and disclosure requirements under the federal securities laws—mutual fund companies that offer target date funds are not subject to the fiduciary requirements of ERISA. Rather, a plan's fiduciary—usually the employer who sponsors the plan—selects and monitors target date funds for use in the plan's investment lineup. However, plans sponsors generally do not have a choice in selecting the underlying funds, and instead must choose from a portfolio of propriety funds typically constructed by the firm. In fact, nearly 92 percent of companies offering target date funds used a packaged product, according to a survey from the Profit Sharing/401(k) Council of America. As a result, some investment firms may include low performing funds in their portfolio in an effort to garner more assets.

Under ERISA, mutual fund companies are generally not subject to fiduciary rules since mutual funds are regulated by the Investment Company Act of 1940. However, in March 2009, Avatar Associates, an investment manager, suggested in a letter to the Department of Labor that mutual funds that offer a target date fund should be subject to ERISA. In its request for an advisory opinion, Avatar argued that ERISA never expressly addressed whether mutual fund companies that use proprietary funds to create target date funds and other fund-to-funds accounts should be exempt from ERISA's fiduciary obligation. Moreover, Avatar suggested that there is an embedded conflict of interest when mutual funds include their own proprietary funds in their target date funds, noting concerns of self-dealing.[30] At the time of this writing, DOL was reviewing the merits of Avatar's request.

Agencies Taking Steps to Evaluate Target date Fund Concerns

On the basis of the Aging Committee's findings, Chairman Kohl requested that Secretary of Labor Hilda Solis and Chairwoman Mary Schapiro of the Securities and Exchange Commission direct their agencies to take action to review the design, composition, and disclosures associated with target date funds.[31] In response to the Aging Committee's concerns, EBSA and SEC held a joint hearing on June 18, 2009, to hear testimony on the investment of 401(k) and other retirement plans in target date type plans to determine the need for additional guidance. Witnesses at the hearing addressed how target date fund managers determine asset allocations and changes to asset allocation; how they select and

[28] *401(k) Fair Disclosure and Pension Security Act of 2009,* Mr. George Miller of California, from the Committee on Education and Labor, U.S. House of Representatives, Report together with Minority Views [To accompany H.R. 2989] Report 111-244, Part 1. July 31, 2009.

[29] In an effort to increase fee transparency, Sens. Tom Harkin (D-IA) and Herb Kohl (D-WI), in the 111th Congress, introduced S. 401, *the Defined Contribution Fee Disclosure Act*, to amend ERISA to require the disclosure of fees to both plan sponsors and participants. In addition, Rep. George Miller (D-CA, 7th Congressional District) introduced H.R. 1984, the *401(k) Fair Disclosure for Retirement Security Act.*

[30] Self-dealing is a form of conflict of interest that involves the conduct of a trustee, an attorney, or other fiduciary that takes advantage of his or her position in a transaction and acting for his or her own interests rather than for the interests of the beneficiaries of the trust or the interests of his or her clients.

[31] U.S. Senate Special Committee on Aging. See http://aging.senate.gov/letters/targetdatedol.pdf and http://aging.senate.gov/letters/targetdatesec.pdf.

monitor underlying investments; the extent to which the related risks are disclosed to investors and the adequacy of that disclosure; and the approaches or factors to compare and evaluate target date funds.

Prior to the June 2009 hearing, the ERISA Advisory Council studied the issues related to target date funds and concluded that the Department of Labor should provide more specific guidance as to the complex nature of target date funds and the methodology necessary for plan fiduciaries who are responsible for selecting and monitoring these funds as a prudent investment alternative in a defined contribution plan. The Council also recommended that DOL should develop participant education materials and illustrations to enhance awareness of the value and the risks associated with these funds.

At the time of this writing, EBSA and SEC were continuing to coordinate and evaluate what steps should be taken to address the differences and risks associated with target date funds, specifically for those funds used as default options and directed at a less financially sophisticated participant.

Conclusion

Automatic enrollment of workers in 401(k) plans has proven to be an effective means of increasing plan participation rates. Because such policies are being increasingly adopted by defined contribution plan sponsors in the wake of the Pension Protection Act of 2006, many additional workers will be brought into plans that might not otherwise have participated, and will be defaulted into target date retirement funds. Despite the potential for increasing savings, several of the concerns with target date funds mentioned in this report—including plan design and transparency—have led plan sponsors and participants to misunderstand these products, and in some cases suffer large losses. Moreover, it is vital that action be taken to ensure that the fees associated with certain target date funds are disclosed, as well as steps to clarify the fiduciary responsibility of not only plan sponsors, but also those companies that construct these funds.

As the Aging Committee explores ways to strengthen target date funds, additional questions should be explored to determine the merits of qualified default investment alternatives. Therefore, in August 2009, Chairman Kohl requested that the GAO review the appropriateness of the funds classified as QDIAs, including target date funds and suggest measures to increase transparency. Specifically, the Aging Committee asked GAO to examine the following questions:

1) What is known about the characteristics of the plans that offer qualified default investment alternatives (QDIA) and the participants that are invested in them;

2) How do composition and investment returns of various QDIAs compare to one another and what characteristics of the QDIAs that demonstrated the best performance;

3) What steps do plan sponsors and administrators take to ensure that plan participants are informed of the benefits and risk associated with QDIAs;

4) What are the advantages and disadvantages of existing QDIAs, and what changes, including QDIA declassification, could be made to better ensure that these vehicles help to provide a more sound retirement savings strategy; and

5) To what extent does the Department of Labor monitor plan sponsors and service providers' selection of target date funds to ensure they meet the qualified default investment alternative criteria?

The Aging Committee anticipates GAO will release a report addressing these questions in the fall of 2010.

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