Morningstar's To-Do List for Target-Date Regulators

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Target-date funds have long captured the attention of 401k consultants and plans sponsors, but recently they've come on Washington's radar screen as well. Last month, the Department of Labor and the SEC sponsored hearings on target-date funds, which have become the default retirement option in many defined-contribution plans and therefore the focus of plan sponsors' and consultants' fiduciary efforts.

The trigger for the hearings was the abysmal performance exhibited by some target-date funds in 2008, particularly those with target dates near retirement. The hardest-hit 2010 funds lost as much as 41%--that's particularly painful for those investors who planned to draw from their retirement nest eggs within a few years. As a result, plan sponsors and in some cases their consultants have come under fire for failing to uphold their fiduciary duty to plan participants.

Washington seems poised to weigh in on target-date funds, and there's no shortage of opinion on how regulators should approach this issue, particularly among plan sponsor and their consultants. Our fund analysts have long covered target-date funds and they've been keeping close tabs on the hearings. They've also given thought to the appropriate outcome of the closer regulatory scrutiny. Here are their thoughts on the matter:

A Focus on Disclosure, Not Performance

It's understandable that regulators have been caught up in the alarming 2008 performance numbers, but we urge regulators not to get too caught up in this part of the story. Yes, risk-management practices fell apart at some of the worst-performing funds. But the average 2010 target-date fund in our universe lost 23%, certainly not a figure to rejoice over, but not altogether catastrophic in a year when the S&P 500 Index lost 37% and many non-Treasury bonds got hammered in an environment of poor liquidity and credit downgrades. Shorter-dated target-date funds were never intended to be risk-free investments; most invest substantial portions of their portfolios in stocks so that investors' savings may grow more substantially in the decades following retirement. Thus, these funds are not immune from the potential risks and volatility of the equity markets. The bigger issue, in our view--and the one where governmental agencies could do a better job of communicating to plan sponsors and investors just how their target-date funds are put together, what sort of risks those funds take on, the philosophy behind the construction of the funds, what the *target date* in their name actually means, and how their particular target-date series is distinctive from others in the industry. Such disclosure would aid the plan sponsor and consultant in conducting the necessary due diligence to select and monitor the target-date funds in their plans. Specifically, here's what we'd like to see ...

1. A true, detailed breakdown of funds' glide paths

Most fund companies make available to the public only the broad asset classes in their glide paths--stocks, bonds, and cash. We'd rather see fund companies provide the specific asset-class breakdown, including assets dedicated to less common areas, such as emerging markets, high-yield bonds, REITs, and commodities. As we've studied target-date funds, we've seen high-yield exposures ranging from 0% to 13% of assets and emerging-markets allocations from 0% to 10%, both of which can have a big impact on the fund's overall return and risk profile. To adequately evaluate and monitor the target-date funds in their plans, plans sponsors and consultants need to know exactly what's inside them.

Some fund companies already provide the level of detail that we think plan sponsors and participants need. At T. Rowe Price, for example, the firm's Web site cover page for the target-date funds provides tabs that show tables and pie charts to illustrate both the broad stock and fixed-income glide paths as well as detailed breakdowns within each major asset class. We think that the SEC should require all fund companies to follow T. Rowe's lead and provide detailed descriptions of the funds' glide paths.

2. A better discussion of risk

It's one thing to see a fund's glide path, but it's also important to know the rationale behind it. Some funds are primarily concerned about longevity risk, so they tend to keep stock weightings high, even near or during retirement, so the assets have a better opportunity to keep growing. Other firms see market risk as the greater threat. They tend to devote more to fixed-income allocations near retirement and less to equities, in an attempt to preserve capital. At either end of this spectrum, we've seen strategic equity allocations from as low as 21% to as high as 79% among 2010 funds. When markets were riding strong in 2006, most target-date funds were primarily focused on longevity risk; in the wake of 2008's market collapse, the conversation has reversed, with market risk now getting all the buzz. sponsors and consultants can decide based on the demographics of Plan the employee base whether longevity or market risk, or both, is relevant to a plan, and select funds accordingly. But they can't make that call without understanding the funds' approaches. In addition, we think plan sponsors can help participants use target-date funds more effectively by educating them about their target-date funds' approach to asset allocation. But they can't do that without more information. Industry regulators need to require funds to discuss the rationales behind their glide paths as part of the funds' prospectuses. Some companies, such as AllianceBernstein and T. Rowe Price, have been ahead of the curve in making available on their Web sites the research that goes into their glide paths, but more firms must be willing to take this step.

3. An explanation of the date in the funds' names

SEC chairman Mary Schapiro has stated publicly that she's concerned that the target dates listed in fund names may be misleading to investors because they imply that investors are cashing out once they hit retirement. That may be overstating matters, but it's true that fund companies treat the so-called target date in different ways. Some continue to adjust the asset allocation so that it's more conservative (with less equity exposure and more fixed-income) until the investor is 10 or 15 years past the retirement date. This makes sense because an investor's risk profile continues to evolve even after he or she has retired. Other target-date series, however, keep the allocations static beyond the target date. This may be because the firm assumes that investors will move their money into an annuity or other investment program when they retire or because it aims to preserve capital. Either way, to fulfill their fiduciary responsibilities, plan sponsors and consultants need to understand how a target-date fund handles asset allocation in the retirement years. And the disclosure as it stands now can make that information difficult to find and understand.

We think fund companies can do a better job of explaining their approaches to investors and plans sponsors. Changing fund names alone probably won't do the trick. In their prospectuses, Web sites, and educational materials, target-date series need to provide a crystal-clear picture of what sort of investing time frame they envision after retirement and how much risk they expect to take along the way.

4. A record of deviations from strategic allocation

A glide path is intended to be a long-term policy, based on fundamental research and extensive research and modeling. Some fund management teams, though, try to gain an edge on that long-term allocation by engaging in tactical allocation--usually involving bets on the shorter-term direction of one asset class versus another (for instance, high-yield bonds versus Treasuries).

If a target-date series does allow tactical allocation, investors and plan sponsors should be made aware that this may happen and know who on the team is responsible for making such calls. Then plan sponsors or their consultants can evaluate whether those managers are experienced and whether they've been successful in the past. Moreover, it's important to know how far the managers can deviate from the strategic weights. Tactical allocation is a highly specialized skill with the potential to go awry if a manager misreads a short-term trend. Management letters in the fund's annual and semiannual reports should explicitly address the types of moves and deviations they've been making. Such disclosure will aid sponsors and consultants in monitoring the performance of the target-date funds in their plans.

5. A clear description of costs

Plan sponsors should pay keen attention to target-date fund fees because they can have a major impact on the participant's overall investment results. These funds may be the participant's primary investment for 30, 40, even 50 years, a period in which the compounding effect can significantly increase the impact of fund costs. We've been looking at target-date fund fees, and the lowest average family annual expense ratio among share classes with significant assets is 0.19%, and the highest is 1.4%. Those more-expensive funds prevent more than 1% of an investor's wealth from compounding annually, which could mean that an investor has tens of thousands of dollars less in retirement savings. Consequently, a good fiduciary should make every effort to limit the impact of fees.

Unfortunately, fund companies have created a dizzying array of retirement share classes, whereby different employers may pay different expenses based on plan size, services offered, and other factors. Retail-oriented series like Vanguard and Fidelity Freedom, however, keep things simple with one, attractively priced share class. Another point to note is that some fund companies have temporarily waived certain management or other fees to keep costs competitive, but whether those waivers will remain in force over the long term is an open question.

Of course, fund companies are already required to disclose fee information, but it's typically buried deep in the regulatory documents. A simplified fee structure and better up-front disclosure would be a boon to the participant and plan sponsor alike.

Peeling Back the Onion

All of these suggestions are really just a starting point to help plan sponsors and consultants do their job and to help shareholders be better owners of target-date funds. One target-date manager visiting Morningstar's offices likened the process of looking into target-date funds to peeling an onion: Every time you pare away one layer, you find another layer underneath. Target-date funds have been marketed as a one-decision, lifetime investment. Yet these funds are far more complex than they appear on the surface, and the differences in structure, quality, and fees can have a great impact on retirement savings plans.

This complexity is one of the reasons Morningstar has developed research focused on target-date funds, which we'll release to Morningstar Direct℠ subscribers later this year. Fund companies have a lot of work to do to make target-date funds more transparent to plan sponsors and participants. We hope that one outcome of the joint SEC-DOL hearing is a movement toward tougher disclosure requirements for target-date funds. Thorough, complete, and clear disclosure not only helps plan sponsors and consultants fulfill their fiduciary duties and due diligence requirements, we believe it would also ultimately result in better investment decisions by and for plan participants.