Off The Mark:

Target Date Funds, 401(k) Plans, and Truth In Advertising

By Ary Rosenbaum, Esq.

When it comes to consumer products and food products, we have stringent labeling requirements. Products must have the contents to support that they are Made in the USA, organic, and juice in order to put that claim on their products and there are penalties by the Food and Drug Administration (FDA) and the Federal Trade Commission (FTC) if those claims can't be backed up. The FTC forced Kellogg's to remove packaging that said Rice Krispies boosted immunity and the FDA took General Mills to task for its Cheerios advertising that would have the product a drug under federal law. Unfortunately, there were no stringent labeling and advertising requirements for target date funds, so the nest eggs of countless participants were decimated in the last bear market.

Target date funds were supposed to be manna from heaven; they could simplify the investment decisions of plan participants as they could be the one fund that participants could invest in, instead of being confused by the few dozen different mutual funds that a 401(k) plan could offer. Target date funds could also serve well as a Qualified Default Investment Alternative (QDIA) for participants enrolled through automatic enrollment or those who failed to properly fill out a deferral election form. Target date funds were supposed to be the answer from the mutual fund industry for confused plan participants and plan sponsors everywhere.

As with many promises out there, target date funds didn't deliver. They were supposed to be this one stop shop mutual fund that would shift its asset allocation to more fixed income as the years get closer to the target date. We can argue about what the target date really should be (retirement or death) or whether asset allocation should automatically shift on some arbitrary date or based on what is actually happening in the market. Why target date funds failed was not because of their poor returns during the last bear market, but the confusion it caused plan participants when they were actually developed to eliminate confusion.

My biggest problem with target date funds is that they had absolutely no labeling requirements, so participants would be confused as to what a 2015, 2020, or 2025 fund really meant. Before the last bear market, a participant who thought they would retire around 2010, naturally would have selected a 2010 target date fund. The assumption was that such a fund would be more heavily invested in fixed income securities with very little equity exposure. 2010 target date funds lost an average of nearly 24 percent in 2008, according to the Securities and Exchange Commission (SEC). Losses ranged from 9 percent to a whopping 41 percent. That is a 32 percent difference for participants that are supposed to be in the same boat, retiring in 2010. Imagine the participants invested in the 2010 target date fund that lost 41 percent, almost half of their retirement nest egg was wiped out with retirement just a few years away by a fund that they thought had limited equity exposure.

When it comes to fruit juice, beverages that are 100% juice may be called "juice."

Any beverages that are diluted to less than 100% juice must have the word "juice" qualified with a term such as "beverage," "drink," or "cocktail." When it came to target date funds, there were no such stringent requirements on what a 2015 target date fund was supposed to stand for. A 2015 fund from Vanguard could have had a totally different glide path or equity mix than a 2015 fund from Fidelity had. For example, a comparison of target date 2015 funds conducted in 2010 by Morningstar showed that the Alliance Bernstein 2015 Retirement fund had an allocation of 71 percent stocks, 28 percent invested in bonds and 1 percent cash; and the Vanguard Target Retirement 2015 fund was 60 percent stocks, 37 percent bonds, 3 percent cash. That was an 11% difference in the weighting of equities in two target date funds with the same target date. Am I missing something? According to its review, the SEC said that target date funds with the same target date had equity exposures that ranged from 25 percent in stocks to 65 percent. That is quite a big target.

So the target date definition had almost no meaning. It reminds me of when Judge Elihu Smails asked Ty Webb in Caddyshack on how he measured himself against other golfers if he didn't keep score. Naturally, Ty said he measured himself by height. So if the 2020 in a 2020 target date funds didn't stand for a specific equity percentage, the participant would only know what was in the fund if they read a prospectus and annual report and we know how many participants read those. Participants could have been helped by investment education provided by the 401(k) plan sponsor, but most plans do not do a very good job of educating participants.

After the failed promises of Target Date Funds in the last bear market, the SEC proposed new rules that would require target date fund marketing materials to disclose the asset allocation as a tag line with the fund's name the first time that the name is used. The rules would also require mutual fund companies to provide investors with a graphic depiction of asset allocation for the life of the fund from the start date to target date. Mutual fund companies would also have to provide investors with a statement explaining that the asset allocation changes over time and what the final asset mix will be.

To add to further governmental scrutiny, the Department of Labor (DOL) issued a proposed rule to amend the QDIA regulations. Under the proposed rules, plan sponsors would be required to issue to participants and beneficiaries in a participant-directed plan a narrative explanation of how the target date fund's asset allocation will change over time, and the point in time when it will reach its most conservative position; a graph of how the fund's asset allocation will change over time; and if a fund refers to a particular date, an explanation of the relevance of the date.

While regulations over the advertising and marketing of target date funds are much needed, they come too little too late for participants who lost the bulk of their retirement savings in the last bear market. Target date funds gave older participants a false sense of security. Participants assumed that the target date funds were more secure as the date came closer, but they had more exposure to equity than any participant could have ever thought. It was certainly not the mutual fund industry's finest hour.

While most financial advisors are still using target date funds for their 401(k) plan sponsor clients' fund lineups, I am still very wary of them. Until the SEC and DOL finalize rules to clear up their false and deceptive advertising, history can repeat itself.

THE ROSENBAUM LAW FIRM P.C.

Copyright, 2011. The Rosenbaum Law Firm P.C. All rights reserved.
Attorney Advertising. Prior results do not guarantee similar outcome.

The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com
Follow us on Twitter @rosenbaumlaw