DOL's Fiduciary Rule Rehabilitates Target Date Funds

- Target Date Fund fiduciaries have been behaving badly, despite their good intentions.
- The DOL Fiduciary Rule Goes into effect June 9, 2017, despite expectations of a cancellation.
- Most believe the Rule is for the retail investor, but it will also help target date fund beneficiaries immensely.

The road to hell is paved with good intentions. Bernard of Clairvaux, French abbot

The Best Interest Standard of DOL's Fiduciary Rule will benefit target date fund (TDF) participants immensely. The Standard is an ethical principle that will have legal teeth when the Fiduciary Rule goes into effect on June 9, 2017. "Best Interest" is akin to the fiduciary "Duty of Care" that obligates fiduciaries to do the best they can and to do no harm. It's like our duty to care for our children.

In this article we identify four specific applications of the Standard to current TDF fiduciary practices. Fiduciaries have been behaving badly, despite their good intentions. Currently at $1.5 trillion and growing rapidly, TDFs are a big deal, and with big deals come big responsibilities. After all, TDFs are still in their formative years, effectively launching in 2006 with the passage of the Pension Protection Act. The Hippocratic Oath of TDFs should be "First, lose no beneficiary's money."

Current TDF Fiduciary Practices

As a practical matter, the applicable legal requirements for TDFs are currently fulfilled with "procedural prudence," namely acting as other experts act in a similar capacity. In fact, as you'll see in this article, TDF fiduciaries rely on procedural prudence and the safe harbor protection of TDFs as Qualified Default Investment Alternatives (QDIAs). This is not sound ethical practice since it does not protect beneficiaries. It didn't protect in 2008, and risk has increased since. **Procedural prudence, as currently practiced in TDFs, is not in the best interests of beneficiaries.**

When DOL's Fiduciary Rule goes into effect, fiduciaries may be surprised by an aspect of fiduciary law that holds them to a higher standard called substantive prudence, which is doing what is best. A Best Interest Standard demands substantive prudence.

Best Interests of Beneficiaries

There are four specific areas where TDF fiduciaries serve the best interests of beneficiaries.

<u>Serving Best Interests</u>

(1) Try to select the best
(2) Protect, especially near the target date
(3) Avoid excessive fees
(4) Be wary of gimmicks

(1) <u>Selecting the best</u>

Fiduciaries currently believe they are protected by two safe harbors in their selection of TDFs:

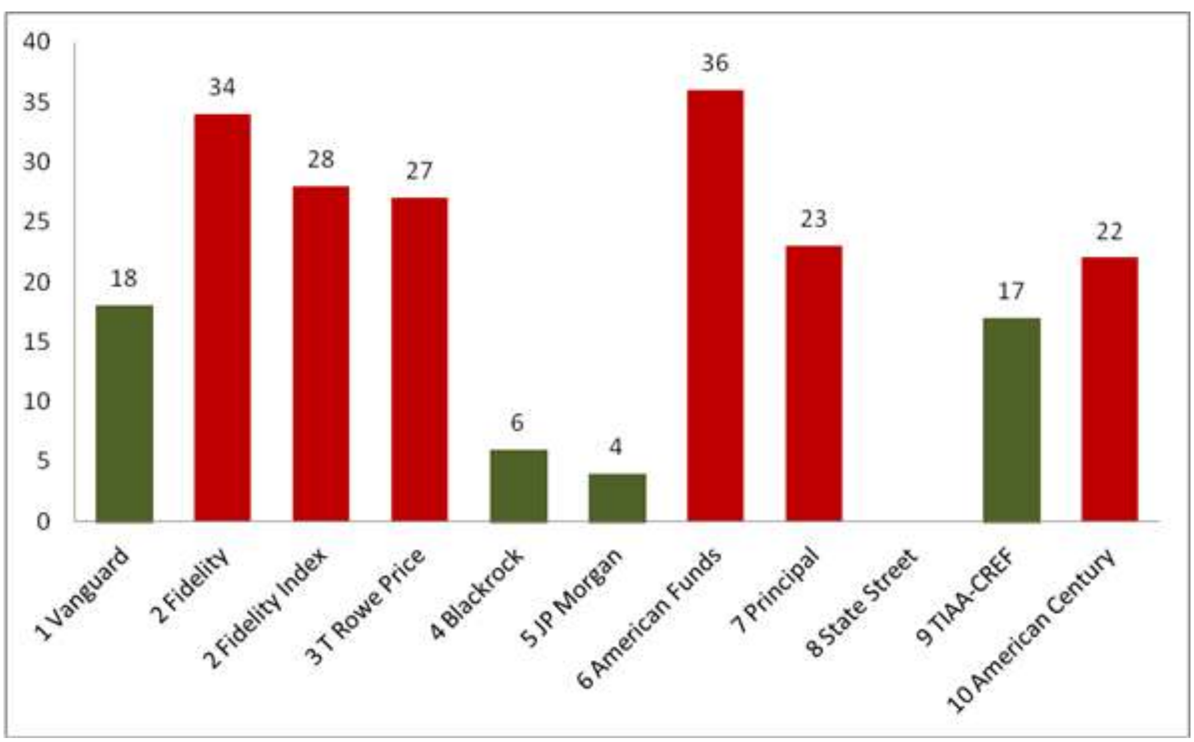
1. Properly structured TDFs are Qualified Default Investment Alternatives (QDIAs) under the Pension Protection Act of 2006.

2. Choosing one of the most popular TDF providers is procedurally prudent. Fidelity, T. Rowe Price and Vanguard manage 65% of the blossoming TDF market primarily because they are the largest bundled service providers.

These beliefs fall in the "empty head but good heart" wishful thinking category. They are neither prudent nor ethical because little effort has been made to find the best. Rather, bundled service providers are chosen out of laziness, convenience and familiarity. Vanguard, Fidelity and T. Rowe Price are fine firms, but their target date funds are not the best for everyone.

Under a Best Interest Standard fiduciaries will shop for prudence because it is best for beneficiaries, especially for doing no harm. This will improve the current situation for beneficiaries. The current data shows that the top 10 TDF managers are not the most prudent. In the following graph we show the [Prudence Ranking]() for the Top 10. We've ranked the 41 largest mutual fund TDFs. A low rank is good – 1 is the best. As you can see, only 4 of the top 10 are above median in prudence, with a rank below 21. (We don't have data for State Street). There are many more prudent TDFs that are not currently popular. Prudence is not currently popular.

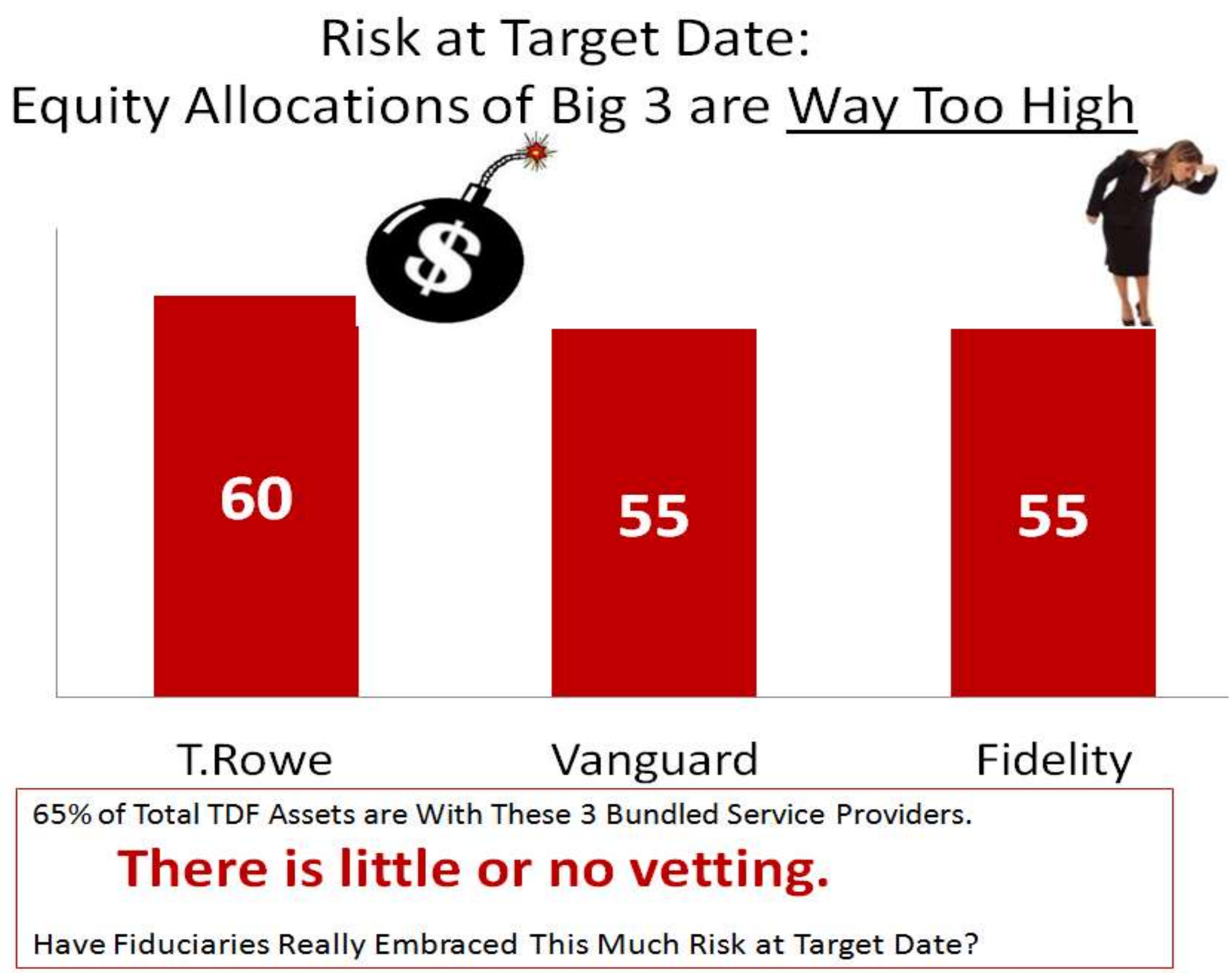
Prudence Rankings (out of 41) of Top 10



(2) <u>Protect, especially near the target date</u>

In 2008, 2010 TDFs lost more than 30% and there was a public outcry to never let such losses happen again, especially to those in or near retirement. It was a shocking wake-up call. Beneficiary lifestyles were devastated while at the same time fiduciaries were not only unscathed, they were unphased, choosing to increase risk in the years that followed. Rather than correcting 2008's problem TDFs have become riskier because (1) U.S. equity allocations have increased in order to compete in the performance horserace and (2) bonds have become very risky because of Quantitative Easing.

Equity allocations of the Big 3 at the target date remain at least as high as they were in 2008, and most other TDFs have similar ending allocations.



Just because fiduciaries got away with large losses in 2008 doesn't mean excessive risk is right or that fiduciaries will continue to get away with it. The basic ethical dilemma here is that TDFs are being sold, not bought, and what is being sold is not safe. You can't blame the fund companies because they are not fiduciaries; they're vendors whose business is selling profitable products.

Under a Best Interest Standard fiduciaries will opt for little or no risk at the target date because it is best for beneficiaries, especially to do no harm. Since most participants either withdraw their assets or purchase an annuity when they retire, the duration of TDF assets should more closely approximate the participant's retirement date. In other words, allocations at the target date should be very safe, mostly in short term bonds. Prior to the Pension Protection Act's declaration of QDIAs, the common practice was to default participants into cash or stable value. This may have been too conservative for younger employees, but it was just about right for those nearing retirement.

(3) Avoid excessive fees

Books were written and TV shows were aired about the excessive fees in 401(k) plans, but nothing changed until lawsuits were won. As reported by the 401(k) HelpCenter, the list of litigants is long and includes Insperity, Allergen, TIAA, JP Morgan, Wells Fargo, Oracle, T. Rowe Price, Aon Hewitt, Edward Jones …

When it comes to fees, a Best Interest Standard already exists thanks to lawsuits. Fiduciary interests are aligned with beneficiary best interests. So now fund companies are racing to the bottom on fees because fiduciaries fear lawsuits. Lawsuits are the stick that changed this unethical behavior. It's a shame that ethical behavior requires successful lawsuits, but that has been the history of such matters.

(4) Be wary of gimmicks

Not surprisingly, opportunists have entered the TDF game, including:

- custom funds
- market timing
- ESG funds.

Encouraged by the DOL's 2013 Tips, some vendors are selling custom target date funds as a means to match workforce demographics. These one-size-fits-all glide paths cannot match a diverse group of employees. The best "custom" fund matches the one demographic that all defaulted participants have in common, namely a lack of financial sophistication. In other words, safety first is the way to match the one demographic that can actually be matched.

Another gimmick is market timing, modifying the glide path in response to a vendor's crystal ball predictions. The implied promise is that these providers will get out of the way of the next 2008. Time will tell of course, but history suggests that this is a very tough call. A more reliable course of action is to use a glide path that always protects near the target date.

The most recent gimmick is ESG (Environmental, Social, Governance) Funds, intended to make the investor feel good. Since TDFs are chosen by fiduciaries rather than participants, the good feeling is targeted to fiduciaries.

Under a Best Interest Standard fiduciaries will focus on more important matters like selecting the best and controlling risk at the target date.

Bottom line

Target date funds should be bought, not sold. With $1.5 trillion in TDFs, the stakes are much higher today than they were in 2008 when TDFs were $150 billion, which is only 10% of the current assets.

Incentives modify behavior and come as carrots and sticks. Ethical decisions that protect employees are the carrots. Fiduciaries can feel proud for doing the right thing. Ethics did not motivate fiduciaries to seek low fees. Sticks, namely successful lawsuits, got the job done, and so it will be with the passage of the DOL Fiduciary Rule and its enforceable Best Interest mandate.

TDF beneficiaries need and deserve the Best Interest Standard.

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