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Written Testimony to the

U.S. Department of Labor
and
Securities and Exchange Commission
Joint Hearing
on
Target Date Funds and Similar Investment Options

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Introduction

My name is Richard Dunne and I am the founder of QDIA.com a service to help 401(k) plan sponsors increase retirement security, reduce fiduciary risk and eliminate excessive cost using ERISA Qualified Default Investment Alternatives.

I appreciate this opportunity to present my comments, which I hope will stimulate constructive ideas for improving the quality of target date funds and similar investment options.

A simple analysis of performance data for 62 target date funds with a target date at or before 2010 shows that in the 6-month period from June to November of last year, the median fund incurred a cumulative loss of 23% and the worst performing fund lost 43% of its assets. Even allowing for difficult market conditions the severity of these losses reflect serious flaws in the construction and management of target date funds. The fact that US workers were exposed to, or in many cases automatically defaulted to invest in such flawed products also suggests serious deficiencies in the understanding, selection and monitoring of these funds by plan fiduciaries.

My comments today focus on three areas where additional steps could be taken to improve the performance, safety and value of target date funds and similar investments. These measures would also enable fiduciaries to more effectively fulfill their legal and ethical obligations and reward service providers who develop better solutions. The proposed measures are:

- *Improving fiduciary transparency* by identifying plan fiduciaries and disclosing basic professional information equivalent to what mutual funds currently disclose in respect of their directors, officers and portfolio managers;

- *Improving decision-making processes* by encouraging voluntary disclosure by plan sponsors of a written investment policy statement for target date funds and other qualified default investment alternatives, combined with guidance from the agencies in the form of a model decision-making process that could be adapted and incorporated into such a statement.; and

- *Improving performance and risk monitoring* by providing additional information concerning glide path construction and facilitating the development of standard liability indexes to monitor progress towards achieving retirement income security.

Improving Fiduciary Transparency

Individual plan participants lack both the technical knowledge and the economic power to negotiate with service providers and enforce quality standards. Consequently, the retirement security of millions of U.S. workers depends almost entirely on how well those responsible for administering and managing plan assets represent and protect their participants' interests, consistent with their duty of loyalty and care.

It seems obvious that if we want to improve the evaluation, selection and monitoring of target date funds we first need to be able to identify what resources are currently being applied to these tasks and how they are being used.

Any member of the public can consult a mutual fund's prospectus or statement of additional information and find out important basic information about the people responsible for the fund's governance, management and operations. While ERISA requires the designation in writing of at least one "named fiduciary", to the best of my knowledge plan participants have no single source where they can identify and learn basic information about all of the key individuals responsible for safeguarding their retirement investments.

It is often unclear among the many parties managing plan assets as to who is a fiduciary and the nature of their fiduciary obligations. For example, if named fiduciaries allocate responsibilities among themselves then, subject to certain conditions and exceptions, the range of acts or omissions for which they remain liable is limited. Some corporate executives within the plan sponsoring organization self-identify as fiduciaries but are not 'named fiduciaries'. Others sometimes discover as a result of litigation procedures that because of their actions or responsibilities they are deemed to be a "functional" fiduciary even though they were never formally designated as such. Some plan sponsors consider their external investment consultants to be fiduciaries but do not receive from them a formal acknowledgement to this effect. Many investment consultants do formally accept fiduciary responsibility and as a result some plan sponsors believe, perhaps incorrectly, that this relieves them of all fiduciary responsibility.

While most attention is usually focused on ERISA fiduciaries it is important to remember that the independent directors of mutual funds also have important fiduciary responsibilities to their shareholders under the Investment Company Act of 1940.

I am not a lawyer and am therefore subject to correction but I believe, for example, that independent directors are required every year to review and formally determine whether they will renew the fund's investment advisory agreement. If used effectively this is possibly the single most powerful sanction that any fiduciary has at their disposal to compel adequate disclosure, enforce quality standards and secure value for money on behalf of all investors in the target date fund.

Given the growing importance of target date funds to the retirement security of U.S. workers, it seems particularly vital that the interests of their independent directors should be strongly and directly aligned with those of investors. Unfortunately, based on preliminary findings from research that is currently being undertaken by QDIA.com it would seem that many independent directors, while technically not "interested parties" as defined by the Investment Act of 1940, are exposed to particularly dangerous conflicts of interest because of the level, source and structure of their remuneration. This concern is particularly acute in respect of 'captive' target date funds that allocate their entire capital to multiple underlying funds, all managed by the same mutual fund complex. In the light of what my analysis reveals as obvious deficiencies in how some target date funds were designed, managed and marketed it will be instructive to observe what action independent directors of these target date funds take during the next annual investment advisory contract review cycle.

I recommend that every retirement plan should be required to disclose basic information in respect of each fiduciary to the plan, equivalent to what mutual funds currently provide on their trustees, officers and portfolio managers. This would include name, age, job title, current employer, professional qualifications and affiliations, most recent five year employment history, a description of their fiduciary duties in respect of the plan and the number of other plans in respect of which they serve in a fiduciary capacity.

The benefits of this disclosure would be (a) to help every fiduciary manage their own risk exposures by clarifying the distribution of fiduciary responsibilities both within the plan sponsor organization and among its service providers, (b) to facilitate earlier identification of potential problems by helping fiduciaries to better understand and focus more clearly on their respective duties, and (c) to promote optimal staffing levels by providing accurate benchmark profiles of the number, experience level and competing demands on the time of people assigned to taking care of plan assets by different categories of sponsoring organization.

Improving Decision-Making Processes

Retirement plan fiduciaries are routinely expected to make complex decisions involving competing and sometimes conflicting demands, multiple options, limited resources and uncertain outcomes. The way in which decisions are made critically affects the quality of results achieved. ERISA wisely reflects this by focusing on the quality of decision processes when determining whether or not a fiduciary has acted prudently. However, based on my experience over the past ten years, I find that the decision-making procedures used by many fiduciaries have not evolved to keep pace with the increasing complexity of the choices they are required to make. Indeed, the severe losses incurred in target date funds are a clear symptom of this fundamental problem, which is weakening the entire retirement system.

Many plan sponsors embraced first generation target date funds without carefully considering key issues such as:

- the appropriateness of proposed glide path design, including pre-retirement capital accumulation, post-retirement income security, longevity risk and rebalancing policies over the life of the fund;

- whether the underlying portfolios were properly constructed and adequately diversified;

- the opportunity costs of using captive underlying funds; or

- the most appropriate way to evaluate comparative performance and risk.

These are all issues that are now being examined as a result of the losses already incurred by plan participants but without better decision-making tools there is no reason to believe that future decisions will be any more successful.

Although conceptually simple the design of target date funds raises complicated issues that have resulted in a wide variety of different product offerings to achieve the same basic objective. No single product can simultaneously be best on every decision criterion so inevitably the plan sponsor must decide a series of tradeoffs.

Most decision methods used by plan sponsors and their advisors today focus on a single measurement at a time and do a poor job of balancing multiple selection criteria. Very often decision makers use some combination of simplified screening or scoring methods to reduce the number of decision variables to a level where they can intuitively identify their preferred choice. The choice is then justified by emphasizing particular criteria in which the selected candidate is particularly strong. In cases where selection criteria are vaguely expressed or not well understood the choice can be heavily influenced by brand resulting in a fund selection that is determined by market share rather than suitability.

In the extreme this choice could be heavily influenced by branding criteria, where a particular choice of investment funds would represent a 'safe' selection which the fiduciary might believe sufficiently satisfies a range of otherwise opaque or vaguely expressed and not well understood criteria.

Such methods suffer from serious deficiencies. Screening fails to reflect the relative importance of different criteria and fails to take into account the degree of performance difference on each criterion. The value of many scoring systems is severely limited because of the way in which scores are assigned. Using a flawed methodology might actually be dangerous rather than helpful. It can create the superficial impression of being systematic when in reality it fails to meet minimum requirements for validity and effectiveness.

Deficiencies in investment decision-making are not confined to plan sponsors but extend down the supply chain into the heart of fund management companies. However, when asked about the quality of investor due diligence a number of leading money managers responded that although investors come armed with a long list of "industry standard" questions, these rarely probe deeply enough to identify specific strengths or weaknesses in the manager's infrastructure or processes. Until investors implement manager selection processes that effectively differentiate between different quality levels, censure poor standards and reward good ones, there is little incentive for the managers themselves to take the initiative.

In 1998, almost 15 years after the enactment of ERISA, two leading pension experts observed that "it is not yet routine for [governing fiduciaries] to authorize a procedural audit, questioning whether prudent processes have not only been established, but are also being carried out."[1] Unfortunately, this statement is still true ten years later. Most fiduciaries are so busy dealing with day-to-day operational issues they rarely have time to consider the effectiveness of their decision-making processes. Furthermore, while the pension industry is overflowing with investment and legal experts it severely lacks expertise in decision process management. Perhaps therefore it is not surprising that on the rare occasions that pension governors do review decision-making procedures, the focus is usually on meeting legal and regulatory requirements, rather than improving the quality of the decisions they are making.

Many plan sponsors, pension consultants and fund managers continue using traditional methods despite their known weaknesses because they think the only alternative is to embrace unfamiliar solutions that might prove even more dangerous. Even when logic recommends a new approach the potential unknowns place it too far outside most comfort zones.

Fortunately, there is a viable solution to this impasse. The challenges of deciding complex issues involving multiple decision-making criteria are not unique to the investment industry. Multi Criteria Decision Making (MCDM) methods have been the subject of academic research and used successfully for decades in a myriad of challenging situations[2]. By looking beyond our own industry borders we can draw on a wealth of global standards, proven methods and practical experience to help us tailor an effective solution.

Most of the leading decision management methods are unknown to pension fiduciaries and fund managers, even though each has at least a 30-year global pedigree. Techniques such as the Analytic Hierarchy Process, Adaptive Conjoint Analysis or Rasch Measurement Scales can also sound very daunting to a newcomer. However, these methods are conceptually easy to understand and they have each been implemented in software programs that have been designed to be intuitively easy for non-experts to use. Moreover, these practical, operational tools have been extensively proven in real-world

[1] Ambachtsheer, Keith P. and D. Don Ezra, "Pension Fund Excellence – Creating Value for Stakeholders" (John Wiley & Sons, Inc: New York, 1998), Chapter 4, pp. 36.

[2] See Wallenius, Jyrki, Dyer, James S. et al. "Multiple Criteria Decision Making, Multi-attribute Utility Theory: Recent Accomplishments and What Lies Ahead", July 2007, accessed by author on http://www.sal.tkk.fi/Opinnot/Mat-2.4194/TDDA/Dyer_July2007rev5.pdf.

use, including the commitment of multiple billions of dollars in capital investment projects.

It takes a very rare combination of integrity, insight and initiative for a plan sponsor to independently seek out and implement better solutions. Fortunately such leaders do exist, which is how the system slowly evolves towards better solutions. I believe however that solving fundamental problems of poor decision-making is sufficiently important and urgent that it needs the kind of catalytic effect that can best be achieved through direct support from regulatory agencies.

I therefore recommend that the Department initiate a program specifically to help plan fiduciaries improve the quality of their decision making processes. While such a program might eventually address all plan assets, initially focusing on the decision-making methods used to either select a third-party offering (including target date funds and similar investments) or construct a customized solution would simplify the task, while providing a sufficiently important example on which to build experience.

This program might be pursued by encouraging voluntary disclosure by plan sponsors of a written investment policy statement for target date funds and other qualified default investment alternatives, combined with guidance from the agencies in the form of a model decision-making process that could be adapted and incorporated into such a statement.

The goal would be to eventually have plan assets managed using decision-making processes that meet the following standards:

- every step in the process should link either to another step or to the final decision and the description of each step must be sufficiently specific that at all times a decision-maker can know exactly what to do next. This enables the use of software-assisted implementation, which reduces both cost and the possibility of error;

- the process should articulate its goals, define a set of standards in respect of each goal that differentiates between absolute requirements and relative preferences and identify specific attributes that would be used to determine success at meeting those standards. This establishes the vital link between the eventual decision and the original purpose of the exercise;

- the process should incorporate a method to integrate quantitative and qualitative attributes and decide the appropriate tradeoffs among different quality or performance levels of each attribute to produce a discrete ranking for every individual investment alternative. This ensures that all relevant information can be taken into account when making a decision.

One way to test the achievement of the above standards is that given only a description of the decision-making process, a record of previous decisions and access to information on the investment alternatives, an unrelated third party should be able to correctly forecast which of two investments would be preferred by the previous decision maker. This validates the consistency of the final decision.

I acknowledge that this level of detailed design and disclosure is far ahead of standard practices today. Consequently plan sponsors would need a reasonable time to review and where necessary amend their decision-making processes to meet the standards outlined above. However, if a plan sponsor were to use any of the three major decision-making methods I previously mentioned, the ready availability of professional guidance and software tools would make the task of design, disclosure and implementation relatively easy. Many of the Fortune 500 companies use Multiple Criteria Decision Making tools and methods to help them manage their businesses more successfully so in the case of many larger plan sponsors some expert support should already be available internally. The availability of one or more decision-making process templates should further reduce the cost and accelerate the adoption of better approaches.

It is important to note that even though a large number of plan sponsors and managers might rely on the same generic decision methods mentioned above, we could still expect significant variation in the attributes they select, the relative importance they attribute to each attribute and the value they place on different quality levels. Therefore, far from imposing a single standard solution on all decision makers the widespread adoption of more advanced decision methods would enable greater diversity based on clearer differentiation among the requirements and preferences of different plans. The experience of other industries demonstrates that the availability of such information would significantly help vendors reach better-informed decisions regarding investment in new product and service development. This leads to a virtuous circle in which selected funds are more closely aligned with the particular needs of each plan.

Many plan sponsors are reluctant to produce a written investment policy statement because they fear that such a document might provide ammunition for a lawsuit against them if they fail to implement it precisely. Given that many standard investment policy statements are imprecise and incomplete and therefore open to multiple interpretations, this might not be an unfounded fear. The standards I am proposing however are explicitly designed to address this concern by eliminating ambiguity through a process design that is complete and consistent. Indeed I would go so far as to suggest that it would be difficult to sustain a claim of imprudence against any fiduciary who implements the type of decision-making process which I have been describing.

In addition to potentially reducing individual fiduciary risk, a general benefit of this proposed disclosure is that it would provide the necessary impetus for the entire retirement industry to upgrade its decision-making methods and tools, without requiring any individual plan sponsor to risk taking a solitary leadership position. In addition, any decision-making process that meets the standard would inherently permit a better understanding of the relationship between the selected attributes, relative importance and quality values on the one hand and the investment choices on the other. Indeed, the Analytic Hierarchy Process specifically incorporates the ability to study the impact on the final choice of changing any of the decision parameters. These insights should help both individual decision makers and the industry as a whole to more easily repeat past success and to identify opportunities for further improvement. Finally, implementation of a comprehensive decision-making process focuses particular attention on the quality of the attributes used to profile and compare investment alternatives, the final topic to which I will now turn.

Improving Performance and Risk Monitoring

The principal value proposition marketed by target date funds is that their investment portfolios are professionally managed to maintain diversification while reducing risk over their lifetime. Therefore, in order to effectively evaluate and monitor target date funds it is important to be able to measure the quality of their diversification and the level of their risk exposures. Both of these factors are primarily determined by the composition and shape of a fund’s glide path, which reflect policy allocations of capital over time.

Current public disclosure by target date funds is insufficient to accurately assess either the potential risks and returns of their policy allocations or the extent to which funds are actually implementing their own allocation policies. I therefore suggest that target date funds need to disclose at least the following information:

- their definition of the asset classes or investment categories used to construct each glide path;
- the methodology used to determine capital allocations to the defined allocation categories;
- the current policy allocations resulting from such methodology;
- the rules under which capital allocations are rebalanced; and
- the date following which no further policy changes would be made to capital allocations.

This information should be sufficiently detailed to permit a person reasonably knowledgeable in investment analysis to correctly determine the allocation category to which any candidate investment would be assigned under the policy and to accurately forecast the policy allocation to each category for any date in the future, in both cases using only the information contained in the policy statement or other publicly available documents.

This level of disclosure would permit a plan fiduciary to analyze the quality of diversification, assess the fund manager's asset allocation skills and confirm that the fund is not taking on excessive market risk, all of which are basic requirements for prudently managing the target date investments.

Finally, I think it is important to carefully consider the use of indexes in evaluating target date fund performance. A number of companies are offering competing target date index products and each perhaps is hoping to become the dominate reference benchmark. Passive index based funds can offer lower cost investment options but plan sponsors should be wary about simply assuming that benchmark construction methods used in stock or bond markets are automatically the best solutions for target date funds.

Target date fund indexes are constructed using a variety of methods. The first is a customized benchmark for each individual target date fund consisting of a blend of generic market indexes in the same proportions as the target date fund's policy glide path. The second method faithfully represents the average performance of actively managed target date funds that are actually available in the market. The third method essentially implements the index designer's subjective view of an optimal asset allocation policy.

The first method permits the estimation of tracking error and information ratios relative to the policy glide path while each of the other two methods offers the potential for lower-cost investment options in the form of index-tracking funds. However, in my opinion all three fail to address a critical difference between target date funds and other mutual fund products. The primary purpose of a target date investment is to accumulate sufficient capital to fund a post-retirement lifetime income stream. In my opinion therefore, the most relevant index against which to measure asset accumulation would be one that measures the percentage change in the cost of funding this known retirement liability.

This is not a new idea but I think that nobody has yet taken on the task of designing and publishing such an index. Perhaps the difficulty lies in how to commercialize such an index. Typically the designer of an asset-based index earns revenue through license fees from multiple fund managers who replicate the index by buying all or a subset of the components. A liability index does not fit this standard business model because it is more difficult to imagine how a fund manager might construct an investible fund to replicate the index. If no commercial provider emerges, public policy might be well served by either the Department or the Commission facilitating the development of standard liability indexes to monitor progress towards achieving retirement income security.

Conclusion

QDIA.com is founded on the belief that plan sponsors can implement better, safer and cheaper QDIA solution by combining the power of 'open-source' collaboration and multi-criteria decision-making methods. Our mission is to provide plan sponsors with the training, tools and support services they need to realize the benefits of such a combination.

Target Date Funds started out as a good idea but in the early products speed to market took precedence over careful design and plan participants have paid the price for those mistakes. The proposals presented in this submission address serious structural weaknesses in the way plan sponsors evaluate, select and monitor plan investments, including target date funds and similar investments. Regulators play a crucial role and are already providing strong leadership in relation to target date funds. Plan sponsors, their advisors and fund managers must also make the effort necessary to deliver investment products that will help, not hinder, plan participants in achieving the retirement income security they deserve.

Thank you.