Target Date Funds the Next Retirement Dilemma

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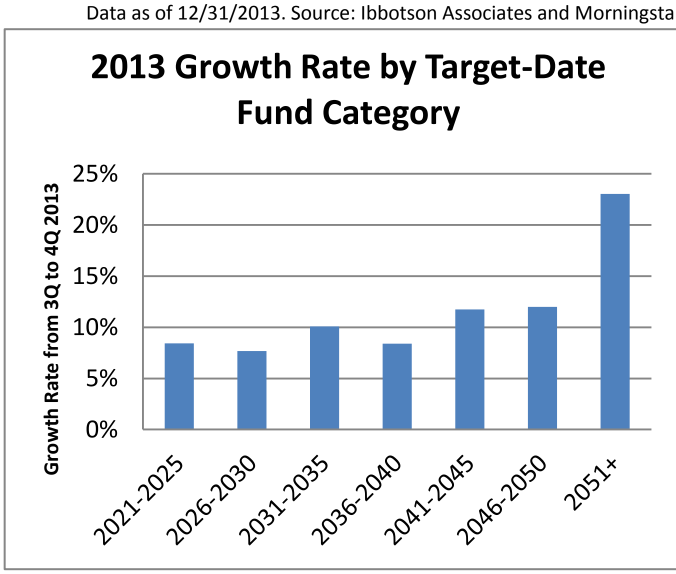
Target Date Funds are headed to become the next retirement controversy as the young workers of today begin to reach middle age and realize the huge investment misstep they have made by investing virtually all their retirement savings in one investment called Target Date Funds (TDFs). This impending dilemma is not much different than the excessive company stock purchases that occurred in the 1970's-thru the Enron and Worldcom bankruptcies when employees suffered great losses of virtually all their retirement savings. ("Beware of Investing"). The point is too much of one type of investment can cause issues when employees depend on only one type of investment for their livelihood in retirement. Wise investing has shown that a single investment will likely need consistent rebalancing and allocation adjustments considering all the market and economic changes that will affect it.

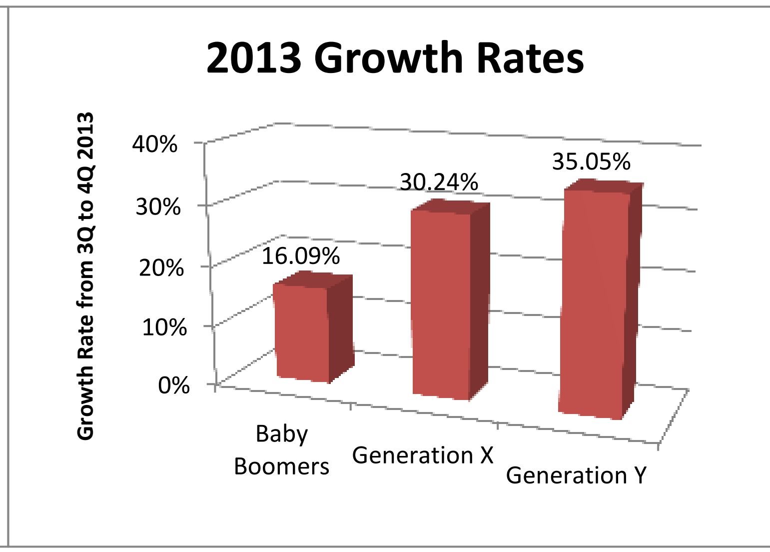
It is important for the investing public to understand what is really happening behind the scenes in most all of the Target Date Fund (TDF) providers. This is compiled from research our firm conducted as a fiduciary consultant which assists about 100,000 public sector employees, in Michigan. The research was compelling enough to share the information with the investors in hopes to pass along some alarming news and information about TDFs.

Target Date Funds (TDFs) are gaining massive momentum in the 21st century with $1 Trillion expected invested in them by 2020. The TDFs gained popularity when the Pension Protection Act of 2006 named them Qualified Default Investment Alternatives (QDIAs) for ERISA plans. Therefore many retirement plan trustees have hired 401(k) investment firms who offer TDFs. A question is would trustees actually allow TDFs as choices if they understood what was actually happening inside these investments? Remember trustees of ERISA retirement plans are personally liable for Investment Fiduciary Liability of the plan. When investing directly in TDFs the TDF Company does not accept Investment Fiduciary Liability for ERISA plans because they can't and they won't. TDF managers are brokerage firms or mutual fund companies. They are not independent from the TDFs since they created them or trade them on their platform. Therefore these firms will not accept ERISA section 3(38) Investment Fiduciary Liability for a retirement plan. This means the trustees of the plans offering TDFs are personally liable for the outcomes of the TDF offerings.

A current trend exists where many large companies and institutions only offer TDFs as choices for new employees enrolling for the first time in their retirement plan. Hence many of the young workers are only getting the choice of a TDF upon entry into their retirement plan. Notice in the charts below, the younger workers have the highest growth rate of deposits investing into TDFs.

Data as of 12/31/2013. Source: Ibbotson Associates and Morningstar Direct [SM]





The problem is once these young employees select the TDF most are continuing on for years and even decades only investing in the TDF they selected upon enrollment. Our firm meets weekly with prospective clients for investment advising only to discover they have invested in a TDF for years and cannot understand why they do not have enough to retire. This research discloses why this is the case and why it is likely to cause the forthcoming investors dilemma.

The Race to Offer TDFs: All the national custodians and mutual fund companies jumped on the venue by offering TDFs when the Pension Protection Act of 2006 allowed them to offer TDFs as Qualified Default Investment Alternatives (QDIA). Today three mutual funds companies dominate with over 76% of all the TDF investments which are Fidelity, Vanguard, and T. Rowe Price, with the remaining mutual fund companies (see chart below) following up the leaders with the remaining 24%.

Source: Morningstar Fund Research "Net Assets, Organic Growth, and Market Share of Largest Target-Date Firms"

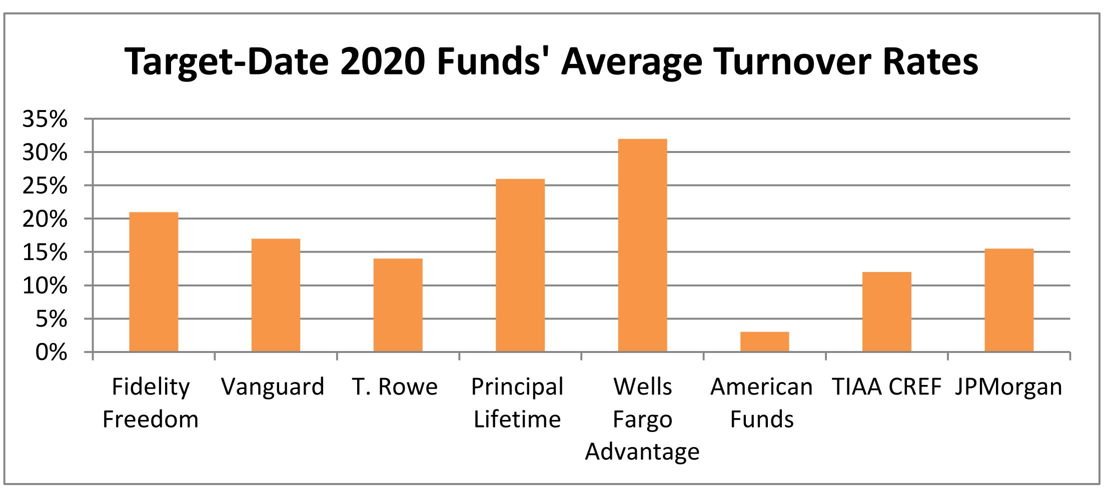
Net Assets and Market Share %		
Fund Company	**Total Net Assets 2012**	**Market Share %**
Fidelity Investments	157,189,545,090	32.42
Vanguard	124,359,813,721	25.65
T. Rowe Price	80,234,687,672	16.55
Principal Funds	21,025,958,178	4.34
Wells Fargo Advantage	13,819,325,436	2.85
American Funds	13,268,889,133	2.74
TIAA-CREF Mutual Funds	12,692,934,184	2.62
John Hancock	9,794,158,343	2.02
JPMorgan	9,363,576,945	1.93
American Century Investments	6,569,258,606	1.35
ING Retirement Funds	5,371,784,439	1.11
BlackRock	4,802,718,407	0.99
State Farm	4,483,105,319	0.92
Great-West Funds	3,694,002,620	0.76
USAA	3,049,771,709	0.63
Vantagepoint Funds	2,526,624,573	0.52
Schwab Funds	1,825,302,181	0.38
AllianceBernstein	1,307,476,516	0.27
MassMutual	1,252,465,476	0.26
Nationwide	1,141,465,476	0.24
GuideStone Funds	1,137,905,806	0.23
MFS	830,665,329	0.17
Russell	806,955,252	0.17
Hartford Mutual Funds	697,766,477	0.14
DWS Investments	557,788,767	0.11
PIMCO	530,065,904	0.11

Manning & Napier	494,994,385	0.10
MainStay	360,331,663	0.07
Invesco	335,042,807	0.07
Putnam	229,133,559	0.05
Franklin Templeton Investment Funds	205,574,322	0.04
Allianz Funds	167,020,920	0.03

Investors Vision of TDFs: The investors have a rosy view of TDFs because they think if they select the year they want to retire they will be successful and sail into retirement with no worries. Some even think they can't lose their savings and their investments are guaranteed to be sufficient by the end year of the TDF. (Weiss and Pilotte 2-3)

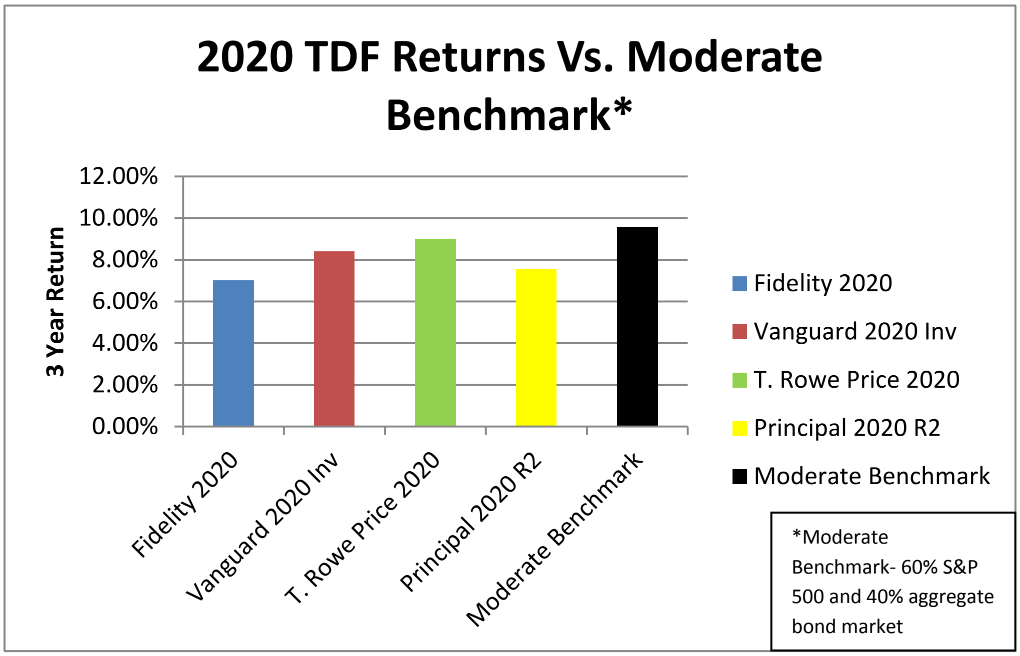
Cheap and Easy: You get what you pay for, in the case of TDFs that are touted as cheap and easy. Think about everything you have ever been passionate about and worked hard for, was it cheap and easy? Probably not, your college education, career success, raising children, or building a company all of which took relentless and tireless hours to produce the outcome of success. Investments are the same, they need continuous review, portfolio nurturing by implementing dynamic reallocations after careful fundamental review of the economic drivers of the market. Research found that most TDFs prospectuses did not even mention reallocation of the portfolio or rebalancing on a continuous basis and if it was mentioned it was yearly. TDFs are not rebalancing often enough to keep up with the changing market conditions. Simply put both investors and TDF managers have a "Set it and Forget it" mentality which will likely not sufficiently perform for investors over time. Note the low turnover ratio by target-date funds (Morningstar Glossary "Turnover") 20-30% indicates a buy and hold strategy.

Source: fi360 Toolkit, MarketWatch.com



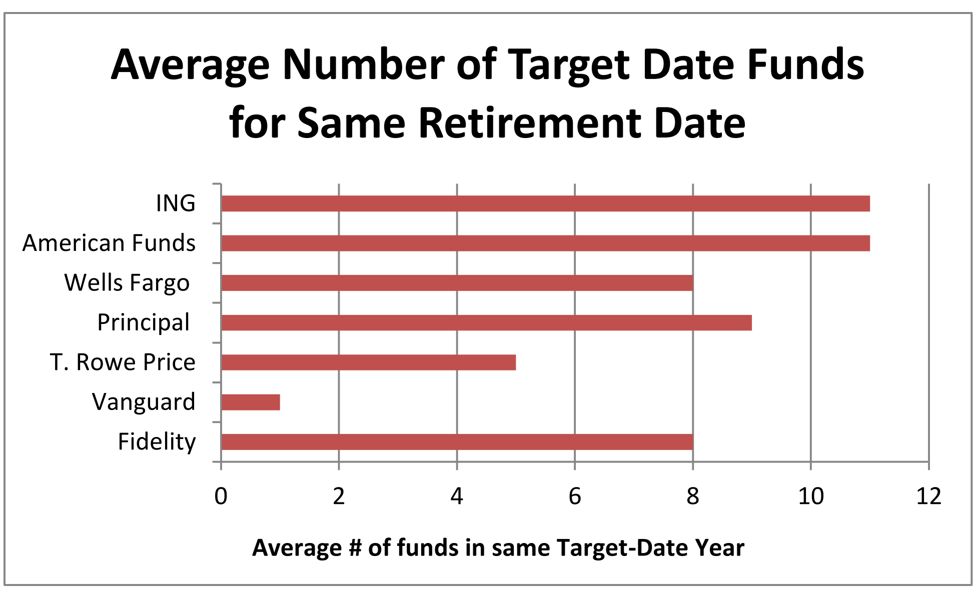
Most TDFs just set a standard allocation and it does not matter that the bond market is losing value, due to interest rates rising; they stay the course in intermediate and long bonds because the TDF mutual fund is a long term investment. One of our conclusions was that TDFs are non-committal on if they are watching the economy and changing the investments based on the current market environment. Ultimately their returns are showing it.

Source: Morningstar Inc.



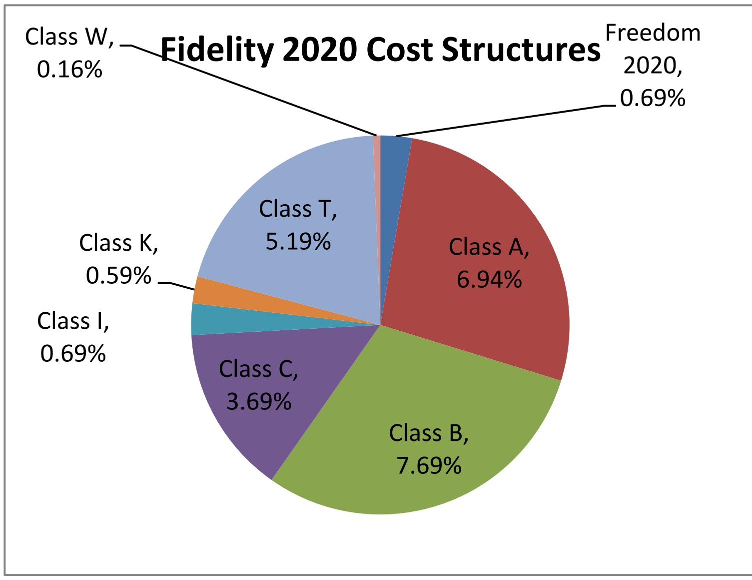
<u>TDFs Have a Flavor for Every Palate</u>: Our research has found within most mutual fund families there are numerous layers of the same year of TDF. A mutual fund manager will have eight or more TDFs for 2020.

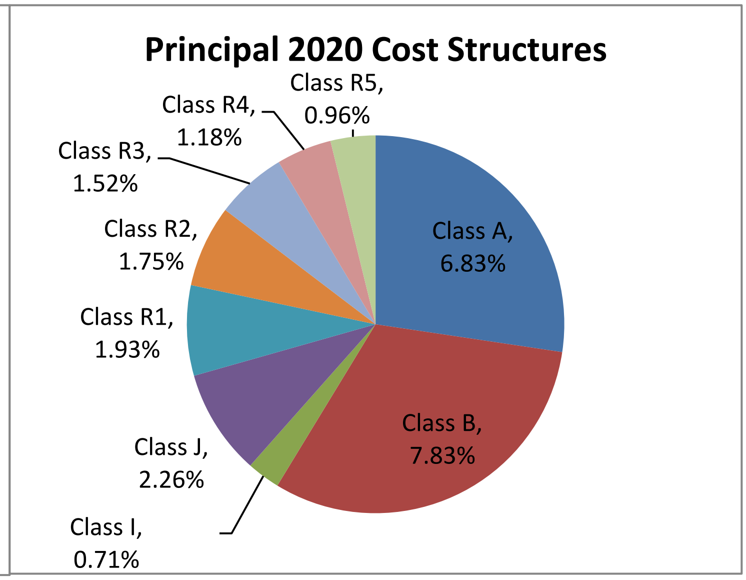
Source: fi360 Toolkit



What this means, for example, is the TDF 2020 will have every cost structure imaginable so that commissioned based and fee-based registered representatives can sell these share classes to the investors and get paid from the TDF. See below, two TDF providers with the palate of share classes for the year 2020 and the cost structures associated with each share class. These cost structures include: front loads, deferred loads, internal expense ratios, and 12b-1 fees.

Source: Morningstar Inc., Marketwatch.com





This proliferation of the TDFs share classes has caused many of the TDFs to lag in performance as compared to their benchmarks. Some of this lagging performance is caused from more expensive cost structures and the remainder of it is caused from how the TDF is actually invested behind the scenes. We do not believe the general investor really knows this is happening inside the TDFs and how they are actually being invested.

<u>Subpar Investments Within the TDF Allocation</u>: Our research has found that most TDF providers are investing their TDF offerings with subpar investments that the general investor would not invest in directly. By hiding them inside the TDF the mutual fund company can have money flows into funds that otherwise would not get invested money from the general investor. Most TDF providers are using only their own funds to create the TDF so the investor only gets as good at that company has to offer. In the case of ING they have 98 ING TDFs, but instead of selling their own ING TDFs they have hired State Street Global Advisors (SSgA) to

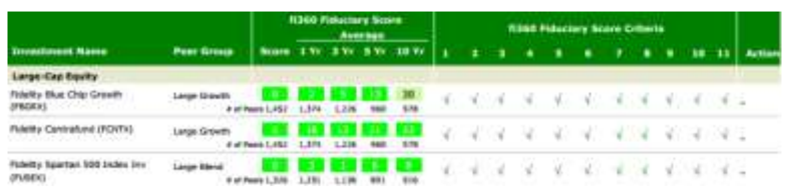
manage the ING TDF offerings in separately managed funds so the investors cannot see or know what they are actually invested in. The SSgA separately managed TDFs do not have prospectuses and no way of knowing what they are invested in, a "black hole" in a sense.

Fidelity

Taking a look at the Fidelity Freedom 2020 portfolio composition, fi360 reveals that over half of the holdings have little to no history and are sub-par in comparison to Fidelity's other fund choices. Of the various Freedom funds, 10 of the 11 are on Watch.
Source: fi360

Fidelity Freedom 2020 Portfolio Holdings

Highlighted below are a few of Fidelity's flagship funds, ironically falling in the same peer group as the failing funds in the current portfolio. Why isn't Fidelity investing their TDFs in these well-established funds?



Investment Name	Peer Group	fi360 Fiduciary Score Average: Score	1 Yr	3 Yr	5 Yr	10 Yr	1	2	3	4	5	6	7	8	9	10	11	Action
Large-Cap Equity																		
Fidelity Blue Chip Growth (FBGRX)	Large Growth	[illegible]	[illegible]	[illegible]	[illegible]	30	√	√	√	√	√	√	√	√	√	√	√	-
	# of Peers	1,452	1,374	1,226	980	578												
Fidelity Contrafund (FCNTX)	Large Growth	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	√	√	√	√	√	√	√	√	√	√	√	-
	# of Peers	1,452	1,374	1,226	980	578												
Fidelity Spartan 500 Index Inv (FUSEX)	Large Blend	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	√	√	√	√	√	√	√	√	√	√	√	-
	# of Peers	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]												

Source: fi360

Vanguard

One alarming note when observing Vanguard's selection of Target-Date funds report is the failure of Manager Tenure. The future performance of these funds is reliant on the success of all new managers. Additionally, Vanguard is using sub-par picks for some of their TDF portfolio holdings.

T. Rowe Price

Source: fi360

T. Rowe Price has exhibited robust performance during 2013 in all of the underlying equity funds, giving their TDF 2020 a presentable appearance. However, upon examination of the red X's, nine of the funds have a failing 1 year return. Additionally, another instance of sub-par picking presents itself. The failing score on the first page of the report, World Stock, T.Rowe used its fund, T Rowe Price Real Assets, which got a score of 90 and failed in 5 of the 11 criteria categories, including 1 yr, 3 yr, and 5 yr returns. Now turning attention to all of the funds T. Rowe has in the World Stock peer group, better alternatives appear, namely T. Rowe Price Global Stock.

Principal

Principal maintains a wide range of share classes for each of their Target-Date (Lifetime) categories. Notably, each R1 TDF

Source: fi360

is on watch and half of them are failing in their 1 yr, 3 yr, and 5 year returns.

Investment Name	Peer Group	Score	1 Yr	3 Yr	5 Yr	10 Yr	1	2	3	4	5	6	7	8	9	10	11
Allocation																	
Principal LifeTime 2020 B ([illegible])	Target Date 2016-2020 # of Peers	32 / 185	66 / 168	75 / 128	79 / 77	-	√	√	√	N/A	N/A	X	X	X	√	√	√
Principal LifeTime 2020 R1 ([illegible])	Target Date 2016-2020 # of Peers	42 / 185	57 / 168	67 / 128	71 / 77	-	√	√	√	N/A	N/A	X	X	X	√	√	√
Principal LifeTime 2020 R2 ([illegible])	Target Date 2016-2020 # of Peers	42 / 185	58 / 168	64 / 128	70 / 77	48 / 17	√	√	√	N/A	N/A	X	X	X	√	√	√
Principal LifeTime 2020 R3 ([illegible])	Target Date 2016-2020 # of Peers	42 / 185	33 / 168	41 / 128	48 / 77	25 / 17	√	√	√	N/A	N/A	X	X	X	√	√	√
Principal LifeTime 2020 A ([illegible])	Target Date 2016-2020 # of Peers	[illegible] / 185	[illegible] / 168	37 / 128	48 / 77	-	√	√	√	N/A	N/A	√	X	X	√	√	√
Principal LifeTime 2020 I ([illegible])	Target Date 2016-2020 # of Peers	[illegible] / 185	[illegible] / 168	36 / 128	48 / 77	32 / 17	√	√	√	N/A	N/A	√	X	X	√	√	√
Principal LifeTime 2020 R4 ([illegible])	Target Date 2016-2020 # of Peers	[illegible] / 185	[illegible] / 168	37 / 128	45 / 77	32 / 17	√	√	√	N/A	N/A	√	X	X	√	√	√
Principal LifeTime 2020 R5 ([illegible])	Target Date 2016-2020 # of Peers	[illegible] / 185	[illegible] / 168	31 / 128	48 / 77	28 / 17	√	√	√	N/A	N/A	√	X	X	√	√	√
Principal LifeTime 2020 Inst ([illegible])	Target Date 2016-2020 # of Peers	[illegible] / 185	[illegible] / 168	[illegible] / 128	36 / 77	[illegible] / 17	√	√	√	N/A	N/A	√	X	√	√	√	√

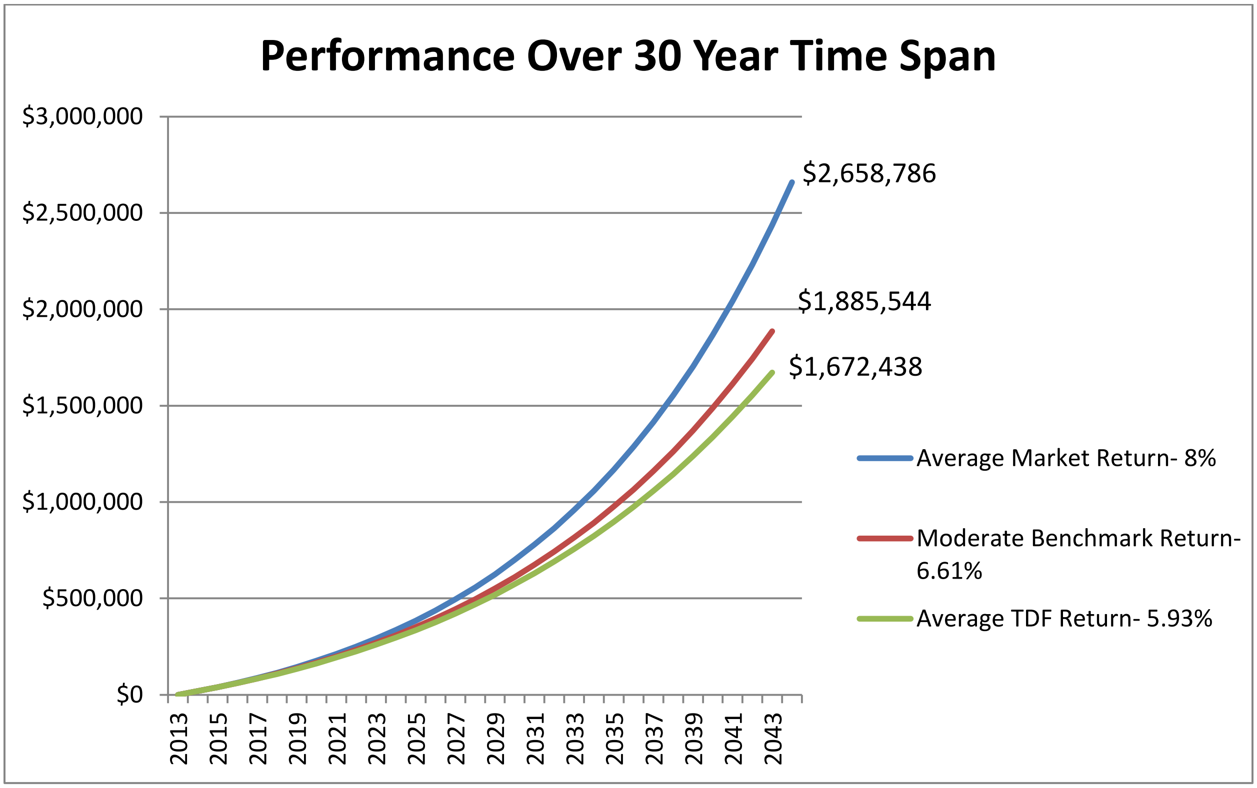
In the second report, the various share classes of the 2020 date are shown. As illustrated, the chosen share class has a drastic effect on performance. It must also be noted that Principal used sub-par funds, most notably in the Conservative Allocation and Large Cap peer groups.

<u>TDFs Lagging Rates of Return: </u>We also have studied the ROR (rate of returns) of TDFs versus the market benchmark and have found the TDFs seem to generally be lagging the market. This is likely caused by the TDF manager utilizing subpar mutual funds inside the TDF and not reallocating the TDF when the market environment calls for it to change. We researched numerous of the large TDF providers and have assembled a summary of the findings by each provider. You will note in the case of all our examples each mutual fund provider had many other choices at their shop but chose to invest the TDF in either the new fund with no history or an established fund with sub-par rankings and returns. If the investors knew there were better choices for investment they would likely not choose the TDF investments. Note the fi360 Fiduciary Score Cards for numerous TDF providers and the red X's noting performance below the 50th percentile.

Next a scenario, assuming a Generation Y investor, took the 10 year average return of the top four TDF managers for their 2020 no-load funds, which had a return average of 5.93% from 1/31/2004-1/31/2014. The four TDFs had an average return of 5.93% as compared to the Moderate benchmark of 6.61% giving a shortfall average of (.68%). This same scenario compared to the market average, as Janet Bodnar from Kiplinger.com assumes on the long term, of 8% would produce a shortfall of (2.07%). See graphs below of data supporting our results.

Name	Ticker	1 Yr Return	3 Yr Return	5 Yr Return	10 Yr Return	3 Yr Alpha	Average Net Expense Ratio	Morningstar Rank	Inception	Total Net Assets	Fee	Returns as of:
		Average Annual Returns										
Fidelity 2020	FFFDX	9.49%	7.01%	11.41%	4.78%	-0.91%	0.69%	45	10/17/1996	13.17 Billion	No Load	1/31/2014
Vanguard 2020 Inv	VTWNX	10.93%	8.41%	13.80%	6.59%	-1.12%	0.16%	15	6/7/2006	24.1 Billion	No Load	1/31/2014
T. Rowe Price 2020	TRRBX	12.01%	9.00%	15.86%	7.16%	-1.95%	0.68%	3	9/30/2002	15.82 Billion	No Load	1/31/2014
Principal 2020 R2	PTBNX	9.70%	7.57%	14.21%	5.19%	-3.03%	1.45%	28	3/1/2001	6.59 Billion	No Load	1/31/2014
Average		10.53%	8.00%	13.82%	5.93%							
Average Shortfalls		-2.40%	-1.58%	-0.11%	-0.68%							
Moderate Benchmark		12.93%	9.58%	13.93%	6.61%							1/31/2014

*All data as of 1/31/2014
Moderate Benchmark 60% Equity(S&P500, Russell 2000, iShares MSCI EAFE) , 40% Bond (Barclays US Aggregate Bond)

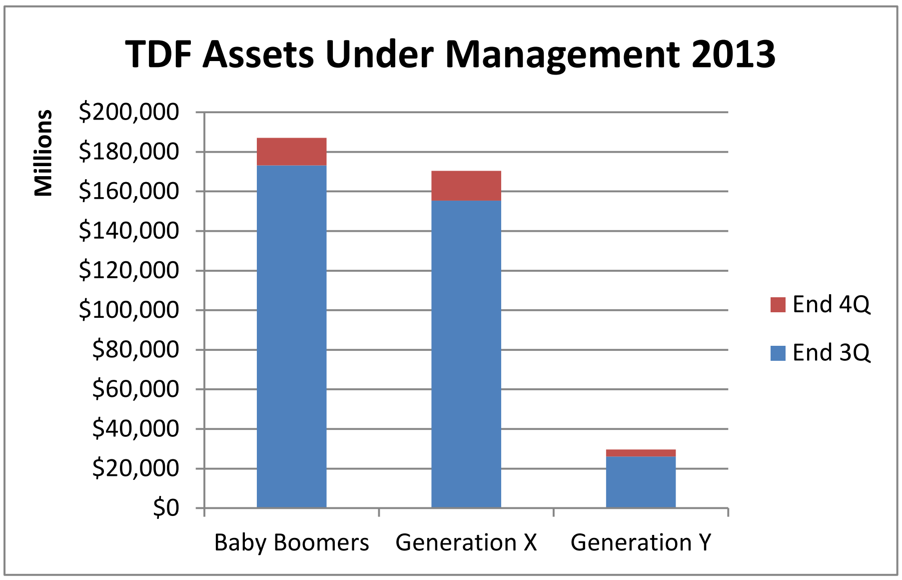


Taking these shortfalls and projecting it over a typical retirement savings for 30 years of contributing the IRS maximum in a retirement plan would likely produce a shortage ranging from ($238,500) up to ($860,700). Would this upset a retiree to think they incurred a shortfall of this size in less returns due to TDF investing?

Inexperienced Investors Choose TDFs: Another alarming trend is young investors, Generation X, Y and Z, are signing up for TDFs because it is easy and they don't need to take the time to understand investments. The Baby Boomers actually have the most $ money invested in TDFs currently, as shown in the graph below. However the young investors are catching up quickly and will likely surpass this statistic very soon given the trends of money flow and the time value of money.

This is really alarming considering the fact TDFs do not have a great track record to date when compared to the benchmarks and other diversified portfolios. These young investors will likely stay in these TDFs for many years, as the Baby Boomers have. The harm will really be bore by these young investors, when they wake up in their 40's, and realize they have invested the bulk of their working life in a TDF which has lagged in return performance for practically their whole career.

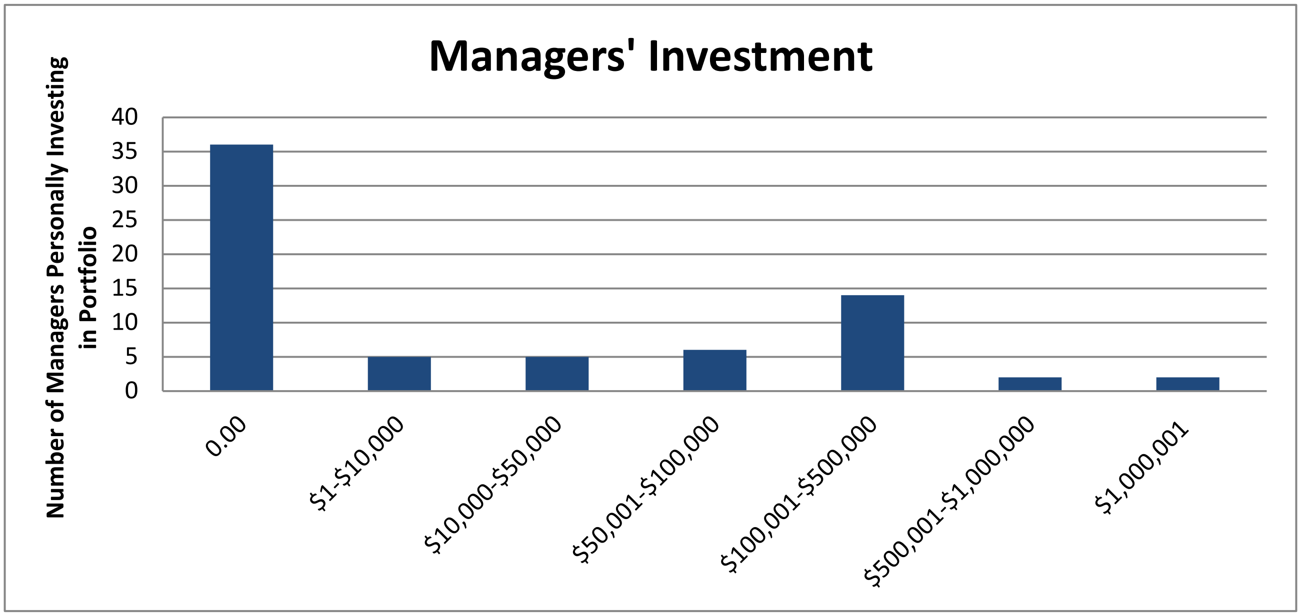
Data as of 2013. Source: Ibbotson Associates Inc.



	Estimated Target Retirement Date
Baby Boomers	2020-2030
Generation X	2030-2045
Generation Y	2045-2065

<u>TDF Managers Even Choose Other Investments for Their Own $</u>: About half of the TDF mutual fund managers, 36 out of 70, do not invest their own money in the TDF they are managing. They obviously don't believe in their own cooking. The investors should be alerted when the person choosing the investments for the TDF won't even invest in it. This should send red flags up immediately. Notice the overwhelming number of managers with $0 invested in their own TDF.

Source: Morningstar Fund Research “Target-Date Series Managers’ Ownership of Series’ Fund Shares”



Company Fiduciaries and Trustees Should be Concerned: The facts surrounding TDFs are beginning to compile a frightening evidential case that should be making trustees, company fiduciaries, and even our politicians in Washington shutter as to the size of the dilemma that is coming by allowing TDFs to be offered and handled so carelessly for our investors. There are large public education facilities, Fortune 500 companies, and public state employees all being forced by their employers into the TDFs, based on the employees retirement date, for their investments as the default investment for auto enrollment. These organizations are touting the TDF as being offered as a choice for “free” from a transaction cost standpoint. Only if the employee reads the fine print do they realize there other decent investments offered in the plan, but these “will cost something extra” if you choose them.

Erisa law section 3(38) won’t be accepted by TDF providers because they know they can’t accept this liability. Therefore trustees and fiduciaries will be personally liable for TDF results.

TDF Conclusions: A retirement dilemma is likely coming. If TDFs are not governed and monitored to set guidelines for these investments then the investors will continue to suffer with mediocre investment results. The trustees and fiduciaries of retirement plans need to seek professional consulting help when choosing and analyzing TDF funds. Additionally, trustees and fiduciaries need to realize they are personally liable for the results of any investment inside their retirement plans according to the ERISA law section 3(38). Direct TDF investments assume no Investment Fiduciary Liability for the reasons stated within this report. The general investor will likely be harmed by lagging returns in Target Date Funds for decades, and they need to seek professional advice and education on how to properly invest for their future. TDFs need to be evaluated among all opportunities for retirement investors as compared to all other investment opportunities relative to market conditions. TDFs should not be assumed, based on a Target Date, that they are the best investment for a future retiree over the long haul.

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