US Securities and Exchange Commission and Department of Labor

Hearing on Target Date Funds and Similar Investment Options

Re: File Number 4-582

Requests to Participate in Joint Hearing Examining Target Date Funds

From

Randal McGathey, Needham, MA

COMMENTS:

I believe that target date funds are extremely valuable investment products, and that they can deliver needed value in the form of a reasonable risk/return that systematically adjusts the asset allocation over time in order to be appropriate in the context of the investors position in their “retirement life cycle.” However that belief is based on the products being properly designed, clearly and understandably disclosed and efficiently delivered.

There are opportunities for competitive improvement on all three of those dimensions (design, disclosure and delivery) but it is the disclosure dimension about which I want to comment. As noted by members of this hearing and in the industry press, the use of the target date itself as a product descriptor is currently at least insufficient, and - in practice - potentially misleading. The target date itself does not convey the investment strategy and horizon of the target date fund. There needs to be more information provided in the product name in order for one product to be differentiable from other products with the same target date but with significant differences. Without this information and its disclosure there will remain significant risk of mistaken product selection, resulting in incorrect expectations and undesired investment outcomes, even though the outcome may have be reasonably predicted based on the products design and intended use.

To be clear, I reiterate that I am a strong supporter of Target Date Funds, and am urging that the SEC and DOL to direct that these issues be properly addressed in order to retain and increase the value that target date funds can deliver to retirement investors. My concern is (please pardon the worn metaphor) that we not throw out the baby with the bath water, even though the bath water may have been particularly noxious recently.

Disclosure is a problem. In response, I suggest that a framework is needed by which to more completely and consistently organize and describe target date funds. This framework would support standard disclosure and comparative analysis of investment risk and performance from one target date fund to the next.

Earlier this year, I prepared and made public a paper that suggests one such a framework. That paper is attached.

The principal point of the paper is that there are two materially different types of target date funds. The most obvious and consequential difference is their time horizon. They both use the Target Date as the product name, but these type has substantially different investment horizons. These differing investment horizons lead to very different asset allocations at the same points in time (relative to the target date) along their respective glide paths. We have recently seen and experienced the consequent effect. Both product types may be appropriate if properly employed, but they are very different. The problem is that they have the same name, and I suggest that they be clearly differentiated . For my comments, will refer to them as “Accumulation Phase Only” (or Accumulation) Type, and “Full Life Cycle” Type.

The Accumulation type Target Date Fund manages the glide path to its minimum risk level ***by or before*** the Target Date. This Type is strategically deferential to the premise that the time just prior to, during and following the Target Date (generally presumed to be the retirement date) is the period of time during which an investment loss has the greatest negative effect on the retirement investor. This type also “expects” that the investor will make a separate decision as to how the retirement assets should be redeployed and managed throughout the post retirement “distribution” phase of the retirement life cycle.

The Full Life Cycle Type Fund expects that the investor will remain invested in that target date fund throughout their life, all the way to its conclusion, or the exhaustion of the assets. The Target Date Fund therefore manages the glide path to its minimum risk at a point that is chronologically ***after*** the Target Date, thereby incorporating the “distribution phase” into the product, and designing the glide path with that in mind. The purpose of pushing the minimum risk point later, into the distribution phase, is to retain greater equity exposure longer in order to increase investment income. However, the counterpoint is greater risk later in the cycle.

Either “Type” may be an appropriate selection if done so knowingly. However, either could deliver undesired outcomes if expectations were based on the other product type.

A consequence of the fact that this fundamental difference is generally unnamed and unrecognized is that the different types can be and are compared to each other. In cases that Full Life Cycle type funds are compared to Accumulation Types, they almost assuredly will to be determined to be more aggressive (as measured by their equity allocation) and perhaps to an extent that seems unreasonable. However, it is important to first consider their different respective investment horizons, i.e. what “type” of target date fund was it. Full Life Cycle funds will, by their essential design, have greater equity allocation later into the glide path, but that is not necessarily greater aggression, it is a different strategy - a different product type. This distinction is important. After organizing the products into their respective cohorts, by type, then one can begin to come to better understanding of the range of aggressiveness within those cohorts, or types. Again, If the distinction is not made, the differences are exaggerated and the conclusions are misleading

My concern is that these exaggerated differences and misleading conclusions could lead to greater than due criticism of the product, and result in remediating action that actually takes value away from the public.

I do not presume that I the right particular framework, but I do suggest that there are important distinctions that are not yet well named and disclosed, but that should be.

All this is said in defense of Target Date Funds. For most people, who are not investment professionals, a product that automatically manages the investment strategy according to accepted investment management tenets is very likely to lead to more and more consistent positive outcomes than leaving the selection and execution of the investment strategy to the retirees themselves. My comments are intended to support the “survival” of Target Date Funds, which will require important improvements, notably in their description and disclosure, as described in this testimony.

Thank you.

Submitted Friday June 5, 2009

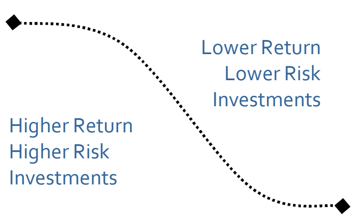
Attached: Target Date Funds: A Framework for Disclosure and Analysis, by Randal McGathey

A White Paper

Target Date Funds
A Framework for Disclosure & Analysis

by Randal McGathey

GLIDE PATH



TARGET DATE FUND MILESTONES

- TD = Target Date
- MR = Point of inflection at which the risk profile first turns down from the maximum.
- NR = Point of inflection at which the minimum risk profile is first touched.

Introduction

Target Date Funds are specialized investment products that are frequently used for retirement savings. They are multi-asset class balanced funds, including equity, fixed income and often real estate, commodities and other asset classes in order to achieve a well diversified portfolio. However, target date funds have a particular characteristic that differentiates them from other balanced funds: they include a feature by which the allocation across the asset classes systematically shifts over time in a prescribed way. That systematic shift is governed relative to a milestone in order to optimize the likelihood of a positive outcome for the investor. That milestone, or Target Date, is typically the date of the investor's retirement, and the particular prescribed course of that systematic shift for any particular target date fund is referred to as its *Glide Path*.

While all target date funds have this broad objective and operative characteristic in common, that does not mean that they are all the same or even comparable. For that reason, there is opportunity for misunderstanding of the product by the investor, and therefore, the potential for incorrect product selection and expectations. This opportunity for error arises from at least three factors. This paper offers a framework by which to name and define those factors, and which in turn may be used to differentiate and organize target date funds into comparable cohorts for analysis and comparison. That same differentiating framework can be used to label target date funds, in order to prevent misunderstanding and reduce the potential for incorrect product selection.

Target Date Fund Families

Target Date Fund providers produce products in "families" with the family comprised of multiple "vintages." The vintages arise from the fact that investors with different requirements will require funds with different target dates, i.e. people of different ages and with different retirement dates. The glide path is designed relative to the target date milestone, and therefore can be executed relative to any specific calendar date as the "Target Date." The design of the glide path is the same from vintage to vintage, but each vintage will be in a different position along the glide path, relative to its respective target date.

Target date funds are typically offered in 5 or 10 year incremental vintages, and are named based on their respective target date, e.g. 2010, 2015, 2020, 2025, 2030, 2035, 2040, 2045, 2050, 2055, 2060. Past dated vintages may be maintained, or some families roll past dated vintages into a "current fund" which is a fund that is determined to be at the most conservative allocation that is appropriate in the context of a retirement investment product.

The date expressed in the name of the Target Date Fund, i.e. the vintage, is understood to be the date of retirement for the investor. For example, the 2020 fund is intended for individuals whose retirement date is closer to 2020 than any other vintage offered by the family.

The Glide Path

There is a fundamental premise that underlies all target date funds and that is the notion of the "Glide Path." A glide path is an investment strategy that specifies a progressively changing asset allocation over time in the context of a milestone in time: the target date. The two simultaneous objectives of the glide path are to (1) maximize the investment return while (2) managing the investment risk to the appropriate level, expressly in the - context of the target date milestone. -

Glide paths usually begin with a relatively high allocation to higher return and correspondingly higher risk assets. That allocation may remain unchanged for some period of time, but at a determined milestone, the glide path will begin to shift the allocation away from higher return/higher risk assets toward lower return/lower risk assets. This strategy (glide path) presumes that the investor has a higher tolerance for risk during the earlier years of the glide path's timeline but that tolerance diminishes over time in relation to a specified milestone.

There is a broad inherent challenge in assessing the relative and comparative performance of target date funds. That challenge is due to the substantial differences among their glide paths. Different target date funds begin the shift from higher to lower risk allocations at different points in time relative to the target date, and likewise they end that shift at different relative points on the timeline, resulting in differing glide path shapes and durations, and posing substantial challenges to comparative analysis.

Glide Path Milestones

The milestone at which the glide path begins to shift downward from the maximum risk allocation is referred to in this paper as MR (maximum risk) and the point at which it stops shifting down, having first reached the point of minimum risk in the glide path, is referred to as nR (minimum risk.)

The placement on the timeline of the minimum risk milestone (nR) is set in relation to the Target Date (TD), and its position in the glide path can be expressed in that way as well, e.g. "nR=TD – 5," or "nR is positioned 5 years prior to TD." This relative position is a critical factor in the essential nature and expected performance of every target date fund. This is the first factor to be addressed in the framework, and provides the most fundamental distinction among target date funds. A brief statement about the "Retirement Savings and Investing Life Cycle" will provide context for that distinction.

The Retirement Savings and Investing Life Cycle

The overall "Life-Cycle" of an individual's activities related to their retirement can be divided into phases: the accumulation phase and the income distribution phase. The *accumulation phase* is the time during which the individual is working and earning income for that work. Some of that income is saved and invested expressly for the purpose of providing income later in life, during retirement. The *income distribution phase* is the period of time after the individual stops working and during which the individual is reliant on income arising from the assets that were saved and invested during the accumulation phase.

INVESTOR LIFECYCLE MILESTONES

C = CONTRIBUTIONS BEGIN
R = RETIREMENT DATE
S = CONTRIBUTIONS END
DI = RETIREMENT INCOME DISTRIBUTIONS BEGINS
EX= ASSETS ARE EXHAUSTED (DISTRIBUTIONS ARE NO LONGER POSSIBLE)

Target Date Fund "Types"

For the purpose of this paper there are 2 types of target date funds:

1. - Asset Accumulation Cycle Type. This product **type** is designed to be used during the accumulation phase of the retirement life cycle. It "expects" the investor to implement a separate investment strategy for the income distribution phase of the Retirement Savings Life Cycle.
2. - Full Life Cycle Type. This product **type** expects the investor to leave the entire pool of accumulated assets in the target date fund throughout the entire Retirement Savings Life Cycle, including both the accumulation and income distribution phases.

Asset Accumulation Type
Certain target date funds intend to manage the assets only during the accumulation phase of the retirement savings lifecycle, and "expect" that the investor will make a separate decision as to how the assets should be deployed and managed during the income distribution phase.

An essential characteristic of this type of target date fund is to ensure that the accumulated value is reliably deliverable at the target date. Therefore, the investment strategy expressly minimizes the possibility for loss during the period in time immediately preceding the target date, thereby protecting the value for subsequent redeployment to a separate discreet strategy for retirement income distribution. This type of target date fund provides the flexibility (requirement) for the investor to select any one or combination of several retirement income approaches, including income distribution investment products, per se, (e.g. fixed income products) broad market exposure products, and/or - insurance/annuity/guaranteed income products. This flexibility enables the investor to - develop a comprehensive income distribution strategy in consideration of any/all other - assets and income sources, and in the context of their own individual longevity risk and - lifestyle considerations. THE DOWNSIDE ➔ If the investor believes that the TDF is a full life - cycle type, they may actually have less market exposure (and therefore lower expected - investment return) than they expect/desire. -

The period of time the target date, notably coined "the red zone" by Prudential, can be considered to span some number of years prior to TD and some number of years after TD, during which a loss has the greatest negative effect on the investor. Accumulation type products are explicitly designed in the context of this consideration.

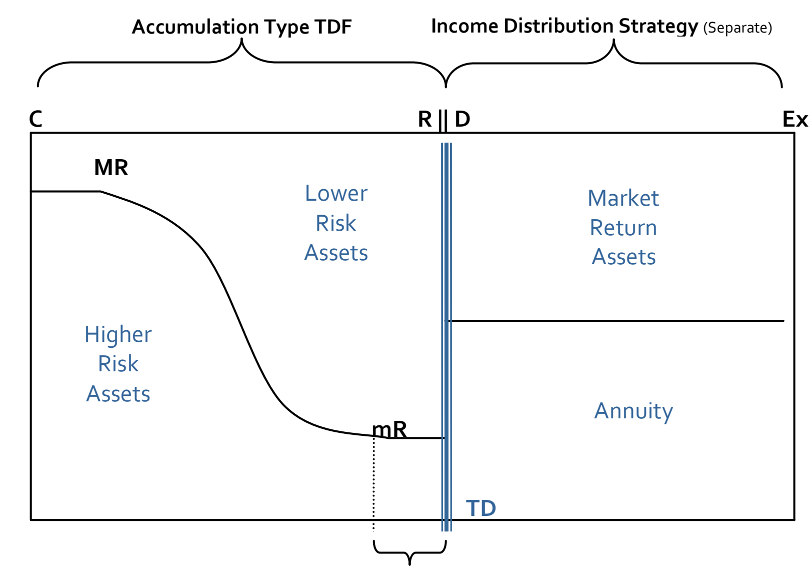


Figure 1

Figure 1 depicts an Accumulation Type target date fund. The glide path reaches nR prior to TD, with the intent of protecting the principal value from loss as the target date approaches, based on the expectation that the funds will be re-deployed in a separate "post target date" income distribution strategy, which is depicted in Figure 1 as a combination of

Annuity and Market Exposure Assets.

For any TDF in which nR precedes TD, the value of the delta (Δ) between TD and nR is - negative, -n. That value is referred to in this paper as the "risk delta." Therefore, by - convention, any TDF whose risk delta is a negative value, is an Accumulation type. -

Full Lifecycle Type
Full Life Cycle type target date funds intend to manage the assets throughout the entire retirement savings lifecycle, including *both* the accumulation and income distribution phases. In this case, the glide path is designed as a single comprehensive investment strategy that spans both phases of the lifecycle. The attendant expected benefits are: (1) elimination of the need to choose and implement a separate income distribution program, and (2) the additional income that arises from the longer exposure to the higher return assets, which is the distinctive characteristic of this TDF type.

In this TDF type, nR is not reached until **after** the TD. The objective of this strategic choice to generate greater accumulated investment growth by remaining exposed to the higher potential return assets longer.

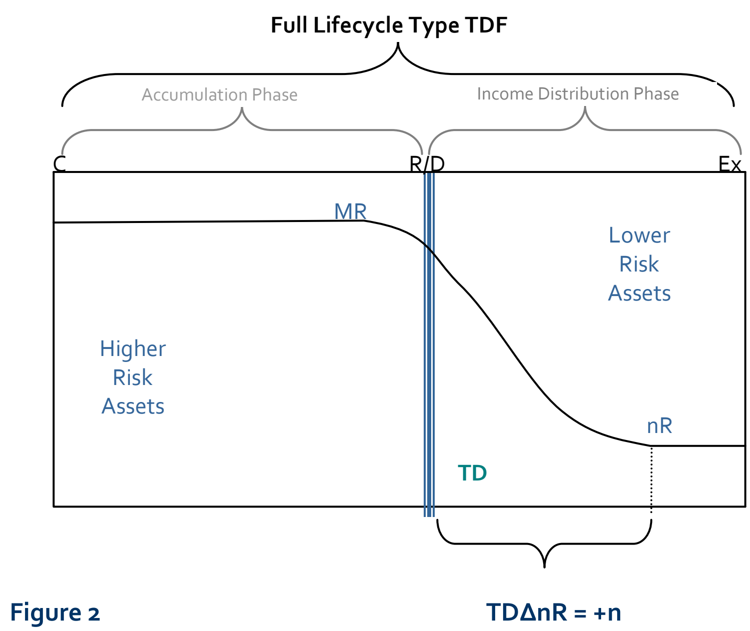


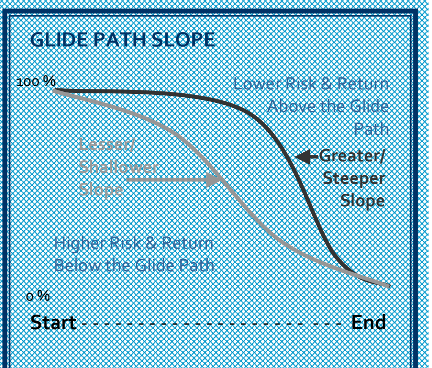
Figure 2

In the case of Full Life Cycle products, The distance between TD and nR, or the risk delta, is a positive value. Figure 2 depicts a full life cycle type product. Note that the risk delta is positive, and that exposure to the higher risk assets extends past TD. Conversely from the Accumulation type, the risk delta for a Full Life Cycle type will always be a positive value. By convention, TDFs with risk delta of zero are determined to be Accumulation types.

As noted, an important characteristic of Full Life Cycle type TDFs is that they remain exposed to the higher risk/higher return assets longer. This includes, by definition, the point at which the glide path crosses the Target Date and beyond. This is intended to be, and *can be* a rewarding strategy. THE DOWNSIDE ➔ If the investor has the expectation that the product was an accumulation type, and intends or *unexpectedly needs* to sell out of the target date fund at target date, or even after target date but prior to reaching nR, AND if the market is down at that point, the strategy can have undesirable consequence. (Investment performance in 2008 is the epitome of this point.)

Risk Delta as a Metric
As discussed, the placement of nR relative to TD determines the TDF product type: Accumulation or Full Life Cycle, and then the distance from TD to nR expresses the degree of risk of the respective type of product. For an Accumulation fund, the larger the absolute value of the Risk Delta, the lesser the opportunity for market gain, but the smaller the impact of a market downturn near TD. For a Full Life Cycle fund, the larger the absolute value of the Risk Delta, the higher the opportunity for market gain (in an up market,) but the greater the opportunity for negative impact of a market downturn.

The Slope of the Glide Path
The placement in time of the maximum risk milestone (MR) is set in relation to nR, based on the number of years that the strategy allows for the systematic "de-risking" of the fund. The steepness of the rate of descent, or shifting from the higher to lower risk assets impacts the magnitude of outcomes and likelihood of achieving the expected outcome, or in more direct terms, how many investors will not get as good an outcome as they expected.



The slope of the glide path is a function of the duration in time between MR and nR relative to the difference in risk allocation between MR and nR. The motivation for shorter time duration and therefore a steeper slope is to maximize the potential return by remaining invested in the higher risk assets longer by delaying MR, and then "plunging" to nR in a shorter amount of time. The mitigating consideration is that if a market downturn occurs during the shorter duration between MR and nR, there is less opportunity for recovery. The result of a steeper slope is (i) more numerous and or (ii) more extreme positive outcomes, but the converse is true in that there will be 9i) more numerous and/or (ii) extreme negative outcomes as well, with necessarily fewer "normal" outcomes. Said more simply, the greater gain for some comes at the greater loss for others.

Aggression
With all other factors normalized, some target date funds are fundamentally more aggressive in their investment strategy than others, with the measure of that aggression being greater allocation to assets with higher risk and returns.

This Aggression analysis can well be done, but only after having appropriately organized - the products into cohorts based on Type, Risk Delta, and Slope. -

The Glide Path is an investment strategy.
The Glide Path is an investment strategy that is specified and calibrated in 3 dimensions: 1. risk delta, 2. slope, and 3. aggression.

Target Date Fund Analysis and Comparison
As with all investment products, there is a critical need for analysis of target date funds. There remains a need for a broadly recognized and accepted analytical framework for target date funds.

That notwithstanding, much good work has been done in designing and applying target - date indexes, which have been developed and employed as benchmarks for relative and - comparative analysis. In addition, series of indexes have been developed in order to -

recognize and assist in sorting the products into cohorts based principally on aggression. This allows comparative analysis within those aggression cohorts. Nevertheless, comparison of the absolute performance of a TDF with risk delta of -5 with another TDF with a risk delta of +10, is of disputable value since it is a comparison of clearly dissimilar products, and may result in misleading conclusions. As already noted, performance evaluation should be in the context the comparable glide paths, as determined by TDF type, risk deltas, slopes and aggression.

All that notwithstanding, it is increasingly critical for a broadly accepted framework to emerge by which to describe and organize target date funds, and therefore to be able to analyze and compare them.

Conclusion

It is too commonly, and too simply believed all Target Date Funds are essentially the same and comparable. They are not. In fact, there are at least two materially different types of target date funds, 1. Accumulation and 2. Full Life Cycle funds, and there are measurable further distinctions within each of those 2 types. The distinctions include the risk delta, glide path slope and aggression, all of which are deliberate investment strategy decisions that have predictable effects on the product's performance. By naming, defining and using these distinctions to organize the products, transparency and disclosure are provided, and when those factors are used as an analytical framework, meaningful relative and comparative measurement of their investment performance is possible.

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