Independent Directors Council

Promoting Excellence in Fund Governance

Board Oversight of Target Retirement Date Funds

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Introduction

Target retirement date funds—also called lifecycle funds—are an important innovation in retirement savings. They provide an efficient way for a shareholder to invest in a mix of asset classes through a single fund that both rebalances its asset allocation periodically and becomes more conservative over time. Target date funds have grown significantly over the past decade; at the end of February 2010, approximately $263 billion was invested in these funds. Target date funds recently have been a focus of the media and policymakers. In part, this focus is due to the market events of 2008 and early 2009, during which many target date fund investors (like many other market participants) saw significant losses in their accounts.

Target date funds operate under the same regulatory framework as other registered funds. They are overseen by a board of directors that has a fiduciary duty to the fund and promotes the interests of fund shareholders. In addition, they are managed by a fund adviser that also has a fiduciary duty.

The Independent Directors Council (IDC) has prepared this document to assist target date fund directors in performing their oversight responsibilities. It includes practical guidance in the form of potential questions to ask advisers in areas that may be of particular interest in the target date fund context. While the document is designed to assist fund directors, it should help to further educate others about the important role of directors in overseeing these funds. The Investment Company Institute (ICI) has developed a useful resource page about target date funds, and this document builds upon those materials, particularly the Frequently Asked Questions About Target Retirement Date Funds, which includes definitions and explanations about the purpose and operation of these funds.

Target Retirement Date Funds

Target date funds are designed to offer a convenient way to invest for a person expecting to retire near a particular date. A target date fund pursues a long-term investment strategy, using a mix of asset classes (or asset allocation) that the fund adviser adjusts to become more conservative over time. The funds are designed to help investors avoid some of the more common investment mistakes, such as lack of diversification and failure to periodically rebalance. The primary features of these funds include: diversification across asset classes (e.g., domestic and international equity, fixed income, cash) and sub-asset classes (e.g., value and growth, developed and emerging markets, investment grade and high yield debt); avoiding extreme asset allocations; automatic rebalancing to maintain target asset allocation; and automatic adjustment for a changing risk profile as an investor nears retirement.

Oversight by Fund Directors

Directors oversee the management and operations of target date funds under the same regulatory framework as other registered funds. The Investment Company Act of 1940 imposes significant responsibilities on fund directors in addition to the duties of loyalty and care to which they are typically bound under state law. Independent directors, in particular, serve an important role on behalf of the fund's shareholders: they serve as "independent watchdogs" and monitor potential conflicts of interest between the fund and its adviser.

Throughout the year, mutual fund boards, including those of target date funds, are engaged in a variety of oversight activities. They meet regularly, request and review numerous reports relating to fund matters (including investment performance and the compliance function), and engage in discussions with the adviser, counsel, and others. They must annually review and approve the contract with the fund's adviser and the adviser's fees—a rigorous process that can take months, if not an entire year. Directors continuously assess the quality of the services provided by the adviser and other service providers. Should any of those services need improvement, directors can and do require them to provide appropriate additional resources to resolve the issue. (For more information about fund directors' role and responsibilities, please see Frequently Asked Questions About Mutual Fund Directors.)

Potential Areas of Inquiry by Fund Boards

Board oversight practices (such as types of reports reviewed, topics discussed with the adviser, and questions asked) vary depending upon a number of different factors, including governance practices, previous familiarity with the target date fund, the number of funds overseen, and whether proprietary funds serve as underlying funds. Below is a list of topics and questions that a board might consider in connection with its oversight of target date funds. These are not intended to reflect best practices or to be a model for boards to follow. Rather, they are meant to assist boards in considering the types of information they might seek and discuss with the adviser. Many boards may already be addressing these topics in discussions with their fund's adviser, while others may determine that they are not applicable or helpful given the facts and circumstances of their particular fund.

Oversight of Portfolio Performance

A principal activity of a fund is investment management, and a fund board oversees the performance of the fund's portfolio as part of its overall oversight responsibilities. Factors influencing a target date fund's performance include portfolio construction issues such as: the glide path and diversification across different investment sectors; long-term and tactical asset allocation strategies; and the performance of the underlying funds (most target date funds have a "fund of funds" structure). Thus, board oversight may include reviews of reports and discussions regarding these and other performance-related matters.

Oversight of a fund's performance typically also includes consideration of the fund's performance relative to its peers and to benchmark indexes. For target date funds, comparative peer group data may be more limited because of different approaches taken by target date funds with respect to glide paths and the relevance of the "target date" in the fund name, among other factors. Boards may seek to understand these "ingredients" of the fund and how they may differ from those of the funds in the peer group when considering the target date fund's performance.

The board also may consider any limitations associated with the performance benchmarks that are used. As a "fund of funds," the target date fund's benchmark index might be a custom index composed of a set of indexes to reflect the underlying funds, weighted by their relative value in the fund. Some funds might use a target date index provided by a third party.

Questions boards might ask in this context include:

- What is the fund's glide path?
  - How was the glide path determined?
  - What happens to the glide path after the target date? How did the adviser consider the trade-off between investors' investment risk, inflation risk, and longevity risk?
  - In developing the glide path, what were the assumptions about investors' withdrawal intentions at and after the target date? What has been the actual experience of investor withdrawals?
  - How does the glide path (and related risk-return trade-off) compare to those of other funds with the same target date in the name?
  - Is there a process for periodically reviewing the assumptions that influenced the determination of the glide path and making adjustments?
  - Does the adviser have the flexibility to actively adjust asset allocation along the glide path to take into account market conditions? If so, who is responsible for that process, how frequently might adjustments be made, and what are the criteria and limits for making adjustments? How are the adjustments communicated to investors?
- What is the process for selecting the underlying funds available to the target date fund and allocating assets to particular underlying funds?
  - Why were particular funds selected over other funds in the same asset class?
  - Is each of the underlying funds an appropriate investment for the target date fund (e.g., is there a clearly defined role for each of the underlying funds)?
  - Is any particular underlying fund more critical than the others to the performance of the target date fund?
  - If proprietary funds are used, explain the advantages of using them over non-proprietary funds. Were proprietary funds created specifically for the target date fund?
  - Is there a sufficient "bench" of available funds in a particular asset class or sector (such as fixed income) that can be used if a selected underlying fund must be replaced for performance or other reasons?
- At what frequency is the fund rebalanced with respect to the glide path and allocation to specific asset sectors and underlying

funds?

- Who is responsible for rebalancing the fund (and allocating assets to specific underlying funds), and what is the person's seniority within the organization?
- If allocations change significantly at rebalancing, why is that?
- What is the process for addressing poor performance of an underlying fund?
- What influence does the target date fund manager have when addressing performance issues with an underlying fund?
- What criteria are used to determine whether to replace an underlying fund?
- Specific explanation should be provided if there may be other incentives for allocating assets to the underlying fund, such as an affiliated fund that is otherwise losing assets.

Approval of Advisory Contract and Advisory Fees

A target date fund board—including a majority of the board's independent directors—reviews and approves the contract with the fund's adviser as well as the advisory fees following the same Section 15(c) processes it follows for other funds. Because target date funds typically are a "fund of funds," the board generally will consider the fees of the underlying funds when reviewing the target date fund adviser's fees during the contract renewal process. And, as they do for other funds, boards may consider comparative fee and performance information of fund peers. As noted above, such peer group data may be more limited for target date funds. Questions boards may consider asking on these subjects include:

- What are the quality and array of services the target date fund adviser provides for its fees? How do those services differ from those provided by the underlying funds?
- What reports or other information would enable the board to confirm that there is no duplication of fees being paid to the target date fund adviser and the underlying fund?
- Are there differences between the target date fund and peer group funds that may impact the quality of the comparative data being presented?

Disclosure and Distribution

The board oversees the process by which fund disclosure is prepared and updated (and may be liable under the federal securities laws for material misstatements or omissions in the fund's registration statement, including its prospectus). As part of their oversight of this process, fund directors might inquire about the disclosure provided with respect to key pieces of information that an ICI working group determined can help enhance understanding of target date funds. (Please see Principles to Enhance Understanding of Target Date Funds.) With the working group's principles as a backdrop, directors might ask the following questions:

- What disclosure is provided regarding:
  - The relevance of the "target date" in the fund's name, including what happens on and after the target date;
  - The fund's assumptions about the investor's withdrawal intentions at and after the target date (e.g., whether it is designed for an investor who plans to withdraw his or her money at the target date or gradually after the target date);
  - The age group for whom the fund is designed;
  - The glide path, including asset allocation (in appropriate broad asset classes) at both the target date and at the point at which the glide path is expected to reach its most conservative asset allocation;
  - Whether the fund manager has the flexibility to deviate from the glide path (and the applicable parameters); and
  - The risks associated with a target date fund, such as investment risk (the risk of loss, including losses near, at, or after the target date), inflation risk, and longevity risk (that there is no guarantee the fund will provide adequate income at and through the investor's retirement)?
- If the word "conservative" or another term that implies safety is used in the registration statement, is it clear what the concept means?
- To whom are the funds being marketed (e.g., are they primarily part of retirement plan platforms and, if so, what types of platforms)? Are they being marketed to individuals through IRAs?
- What is the process for ensuring that the marketing materials and website content are consistent with the fund's registration statement?

Nothing contained in this paper is intended to serve as legal advice. Each investment company board should seek the advice of counsel for issues relating to its individual circumstances.