Avatar Associates Testimony October 28, 2009

"Default Nation: Are 401(k) Target Date Funds Missing the Mark?"

Good afternoon, Senator Kohl, Ranking Member Corker, and Members of the Committee. Thank you for inviting me to appear before you today.

I am Michael Case Smith, Senior Vice President for Institutional Strategies and Target Date Portfolio Manager with Avatar Associates. Avatar, founded in 1970, is an investment management firm that specializes in asset allocation and uses ETFs, in which we have no economic interest, as the underlying investments for strategies offered to 401(k) and profit sharing retirement plans. Avatar customizes its products to meet client objectives, using a process that employs quantitative, top-down, macro-economic models that are proprietary to Avatar. These models are refined qualitatively by Avatar's seasoned research and portfolio team with the result that each fund is managed to suit a particular level of risk ranging from conservative to aggressive. As an un-conflicted investment manager, Avatar willingly accepts responsibility as a 'fiduciary' within the meaning of Section 3(21) of ERISA.

The Committee is aware of our efforts to seek clarification from the Department of Labor on whether the fund of mutual funds structure used by retirement plans creates a scenario where the underlying funds become plan assets under ERISA and subject to the fiduciary standards of ERISA.

Today, I would like to offer my views on a topic of critical importance to the retirement income security of Americans, namely the ever-increasing use of default investment alternatives, such as target date investment funds, not only in the absence of participant investment direction, but also as an affirmative choice by millions of Americans who lack the experience, confidence and/or time to exercise direct control over the investment of assets in their pension plan accounts. This has resulted in a heavy reliance on target date investment funds that are generally structured using a fund of funds approach.

I would like to briefly repeat an observation I made at the recent Securities and Exchange Commission/Department of Labor hearings on target date funds, namely, that Avatar believes a participant's retirement date is like no other date. It is when the participant ceases to contribute to his 401(k) plan account, when the employer ceases to contribute and when he begins to withdraw funds. We believe the closer the retirement date, the more conservative the investment allocations should be. Other investment organizations effectively minimize the importance of the retirement date and argue that because the participant is expected, on average, to live many more years, a much more aggressive investment allocation is called for. Unfortunately, the last few years of market experience have exposed this approach as very risky, particularly for those nearing retirement. I hope that the law moves toward requiring more clear and simple disclosure of which investment philosophy is being used in the management of the target date fund.

I would now like to turn to the question at hand: We believe many target date funds have embedded conflicts of interest. Some mutual fund companies create a “fund of funds” that invests in shares of other mutual funds that are funds of the same mutual fund family.

Technically, a mutual fund is a separate corporation registered under the Investment Company Act of 1940 with its own board of directors that is charged with protecting the interests of the fund’s shareholders. In practice, however, the adviser to the mutual fund that manages its assets tends to dominate the fund’s board of directors. The adviser may collect management fees, not only from the underlying funds, but also from the fund of funds itself, resulting in a tiering of fees. These fees reduce investment returns, and, thus, are ultimately paid for by the fund's shareholders.

Importantly, in a fund of funds, the adviser determines the mix of underlying mutual funds, each of which has its own fee structure, and in so doing may directly or indirectly affect its own compensation.

A fund of funds offers opportunities for an adviser to enhance its profits by engaging in self-dealing. The goals of the fund adviser, as opposed to the best interest of plan participants, may be furthered by including new funds in the mix of underlying funds, thereby providing the new funds with start-up capital. A fund of funds could also serve as a means to direct: (i) assets to those funds that are unable to attract investment on their own because of poor performance or other issues, and (ii) investments toward funds with a higher fee structure such as equities compared to bonds.

Now is the opportune moment for Congress to clarify that conflicts in the allocation process are prohibited. A conflict of interest, which may result in the skewing of plan asset allocations to allocations that are more profitable or beneficial for the adviser or fund family than is reasonable, prudent or comparatively efficient is not currently regulated or even required to be disclosed. This raises a number of issues under ERISA. But for the Department of Labor's interpretation that the assets underlying a tiered mutual fund do not constitute plan assets, the embedded conflict regarding asset allocation in a fund of funds would constitute a prohibited transaction under ERISA.

Avatar believes that the statutory provisions that address whether the underlying assets of mutual funds are plan assets are not particularly clear. Section 3(21) of ERISA provides that a plan's investment in a mutual fund "shall not by itself cause such investment company [i.e., mutual fund] or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest" for purposes of ERISA. In addition, Section 401(b)(1) of ERISA provides that if a plan invests in a mutual fund, the plan's assets shall not "solely by reason of such investment, be deemed to include any assets of such investment company." The wording "shall not by itself" and "solely by reason of" begs the question that the exception applicable to the underlying assets of mutual funds, that is, to the underlying funds in a fund of funds, is not absolute. We at Avatar suggest that this exception to ERISA's remedial scheme was not meant to apply to tiered asset allocation mutual funds where the adviser does the allocation, because such an investment structure either did not exist at the time of ERISA's passage or, if it existed at that time, was virtually unheard of and therefore not contemplated by Congress. Further, the legislative history concerning the relevant statutory provisions, which indicates that the underpinning for this exception was premised on the applicability of protections against self-interested transactions that are part of the Investment Company Act, supports the conclusion that no relief should be provided from the self-dealing that is inherent in tiered mutual fund asset allocations.

Now is the perfect opportunity for Congress to clarify that such conflicts are prohibited, and, in that way, protect plan participants and our nation's private pension system.

In conclusion, given the demand for default investment alternatives, such as target date funds, it is important to ensure the integrity of such investment offerings. One practical way of doing so would be to adopt the protections in the exemption for investment advice contained in the Pension Protection Act of 2006 to reduce and disclose conflicts of interest. For example, a mutual fund adviser of a tiered asset allocation mutual fund could be required either to: (i) use algorithms of an independent third party for asset allocation, or (ii) at least have its own algorithms certified by an independent person as not biased, and then have the actual asset allocation audited to ensure that allocations are made consistently with the independent or certified algorithms. While some may say this could result in additional, unnecessary cost, this position is not credible given the billions of dollars recently lost as a result of the over concentration in equities which could have been caused by conflicted asset allocation.

The goal is to encourage and support a robust and equitable target date fund market by having the asset allocation determined in an un-conflicted manner -- this would lead to a win-win situation for all: less fiduciary exposure for plan sponsors, better rates of return and more reasonable administrative fees for plan participants, more satisfied clients for mutual fund families, and amore robust pension system for all of America.

I thank you for your time and consideration and would be happy to answer questions.