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Highlights

Highlights of GAO-11-118, a report to the congressional requesters

Why GAO Did This Study

To promote the adoption of appropriate default investments by retirement plans that automatically enroll workers, in 2007 the Department of Labor (DOL) identified three qualified default investment alternatives. One of these options—target date funds (TDF)—has emerged as by far the most popular default investment. TDFs are designed to provide an age-appropriate asset allocation for plan participants over time.

Because of recent concerns about significant losses in and differences in the performance of some TDFs, GAO was asked address the following questions: (1) To what extent do the investment compositions of TDFs vary; (2) what is known about the performance of TDFs; (3) how do plan sponsors select and monitor TDFs that are chosen as the plan's default investment, and what steps do they take to communicate information on these funds to their participants; and (4) what steps have DOL and the Securities and Exchange Commission (SEC) taken to ensure that plan sponsors appropriately select and use TDFs? To answer these questions, GAO reviewed available reports and data, and interviewed TDF managers, plan sponsors, relevant federal officials, and others.

What GAO Recommends

GAO recommends that DOL take actions to assist plan sponsors in selecting TDFs to best suit their employees, and to ensure that plan participants have access to essential information about TDFs. DOL raised a number of issues with our recommendations, and we amended one of them in response to their comments.

View GAO-11-118 or key components.
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DEFINED CONTRIBUTION PLANS

Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants

What GAO Found

Target date funds vary considerably in asset structures and in other ways, largely as a result of the different objectives and investment philosophies of fund managers. In the years approaching the retirement date, for example, some TDFs have a relatively low equity allocation—35 percent or less—so that plan participants will be insulated from excessive losses near retirement. Other TDFs have an equity allocation of 60 percent or more in the belief that relatively high equity returns will help ensure that retirees do not deplete savings in old age. TDFs also vary considerably in other respects, such as in the use of alternative assets and complex investment techniques. In addition, allocations are based in part on assumptions about plan participant actions—such as contribution rates and how plan participants will manage 401(k) assets upon retirement—which may differ from the actions of many participants. These investment differences and differences between assumed and actual participant behavior may have significant implications for the retirement security of plan participants invested in TDFs.

Recent TDF performance has varied considerably, and while studies show that many investors will obtain significantly positive returns over the long term, a small percentage of investors may have poor or negative returns. Between 2005 and 2009 annualized TDF returns for the largest funds with 5 years of returns ranged from +28 percent to -31 percent. Although TDFs do not have a long history, studies modeling the potential long-term performance of TDFs show that TDFs investment returns may vary greatly. For example, while one study found that the mean rate of return for all individual participants was +4.3 percent, some participant groups could experience significantly lower returns. These studies also found that different ratios of investments affect the range of TDF investment returns and offer various trade-offs.

While some plan sponsors conduct robust TDF selection and monitoring processes, other plan sponsors face challenges in doing so. Plan sponsors and industry experts identified several key considerations in selecting and monitoring TDFs, such as the demographics of participants and the expertise of the plan sponsor. Some plan sponsors may face several challenges in evaluating TDFs, such as having limited resources to conduct a thorough selection process, or lacking a benchmark to meaningfully measure performance. Although plan sponsors may use various media in an effort to inform participants about funds offered through the plan, some plan sponsors and others noted that participants typically understand little about TDFs.

DOL and SEC have taken important steps to improve TDF disclosures, participant education, and guidance for plan sponsors and participants. For example, both agencies have proposed regulations aimed at helping to ensure that investors and participants are aware of the possibility of investment losses and have clear information about TDF asset allocations. However, we found that DOL could take additional steps to better promote more careful and thorough plan sponsor selection of TDFs as default investments, and help plan participants understand the relevance of TDF assumptions about contributions and withdrawals.