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General Comment

Performance Benchmarks for Asset Allocation Funds: Section 318

By Chris Tobe, CFA, CAIA

The Adoption of “reasonable” simplistic benchmarks in balanced funds could result in higher fees, higher risks, and less transparency for retirement participants if applied poorly.

Since target dates are 50% of all 401(k) assets, the individual components ie Equity, fixed allocation, demand the same level of transparency as individual stand alone options. Transparency to underlying target date funds especially poorly state regulated CIT's that contain annuities, private equity etc is essential See Attached for full comment

Attachments

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Performance Benchmarks for Asset Allocation Funds: Section 318

By Chris Tobe, CFA, CAIA

The Adoption of “reasonable” simplistic benchmarks in balanced funds could result in higher fees, higher risks, and less transparency for retirement participants if applied poorly.

Since target dates are 50% of all 401(k) assets, the individual components ie Equity, fixed allocation, demand the same level of transparency as individual stand alone options. ⁱ

The lowest fee, most transparent funds and best performing in the long run balanced funds, in certain periods can look to underperform 1,3,5 year benchmarks, and a year later with a change in markets can be a top performer. For example Blackrock target funds at end of 2021 was a poor performer and sued, but by 2022 was back as a top performer because of their under allocation to US equities. Vanguard and Fidelity are appearing to underperform now because of a higher allocation to international. ⁱⁱ If International takes off they could be top performers next year.

I believe Target Date Funds were created to sustain higher fees. The least transparent Target Date Funds are those that are not SEC registered mutual funds. Many are in poorly state regulated annuities either in whole or in part. Many are in poorly state regulated Collective Investment Trusts (CIT)s Many CIT’s can hide private equity or annuities and their many hidden fees and risks. Many, if not most, CIT based Target Date Funds and all annuity TDF’s are a fiduciary breach based on the higher risks alone, not to mention the excessive fees. ⁱⁱⁱ

There is a general assumption that CIT’s are regulated by the Federal Government Office of Comptroller of the Currency (OCC). Some CIT’s are regulated by the OCC while many others are regulated by one of 50 state bank regulators. This allows CITs to choose their own state

regulator who may have the laxest oversight.^{iv} While the SEC mutual fund regulations are not perfect, they do control for a lot of risks and provide a good amount of transparency

One non mutual fund fund the Prudential Day One Target Date funds provide this disclosure to plans:

Unlike mutual funds, the Day One Funds, as insurance company separate accounts or collective investment trusts, are exempt from Securities and Exchange Commission registration under both the Securities Act of 1933 and the Investment Company Act of 1940 but are subject to oversight by state banking or insurance regulators, as applicable. Therefore, investors are generally not entitled to the protections of the federal securities laws.^v

Another fund Principal provides this disclosure:

The CITs are not mutual funds and are not registered with the Securities and Exchange Commission, the State of Oregon, or any other regulatory body.

The Collective Trust and the Funds intend to qualify for the exclusion from the definition of an "investment company" under the 1940 Act provided for by Section 3(c)(11) of the 1940 Act. The Section 3(c)(11) exclusion is available for collective investment funds maintained by a bank consisting solely of assets of certain employee benefit plans. Accordingly, Participating Trusts will not have the benefit of the protections afforded by the 1940 Act (which, among other things, requires investment companies to have governing boards of directors with a majority of disinterested directors and regulates the relationship between the adviser and the investment company). The offering of units of the Funds (each, a "Unit") has not been registered under the U.S. securities laws or the laws of any applicable jurisdiction. Therefore, Participating Trusts will not have the benefit of the protections afforded by the Securities and Exchange Commission ("SEC") under the Securities Act of 1933 (the "1933 Act") (which, among other things, requires specified disclosure in connection with the offering of securities). Neither the SEC nor any state securities commission has approved or disapproved of the Units or determined if this document is accurate or complete. Any representation to the contrary is a criminal offense

How can any fiduciary subject to Federal ERISA laws use for its main investment options target date funds that go out of their way to avoid Federal oversight?

Toxic Assets

A major reason to avoid SEC oversight is to put in investments which are not allowed in SEC registered mutual funds because of risk. The other reason is to load up on assets with hidden fees which will not be disclosed under the current weak regulation.

Private equity, along with other illiquid contract investments like hedge funds, private debt, real estate is a potential fiduciary time bomb for plans and their participants. In target date funds

even a small allocation to a Target Date Fund, with the excessive risk, lack of outperformance and excessive fees seem to make it a fiduciary risk.^{vi}

A disclosure from Principal Target Date CIT:

A differentiating aspect.....is exposure to alternatives (hedge fund strategies).^{iv]} Given the managers approach to asset allocation (more equities and alternatives).... Exposure to nontraditional (commodities, natural resources, and real estate) and alternative (hedge fund strategies) asset classes is a differentiating aspect from a style perspective relative to the peer group

Principal LifeTime Hybrid CITs may invest in various types of investments including Principal Funds, Inc. institutional class shares, Principal Life Insurance Company Separate Accounts and other collective investment trusts and mutual funds. The risks associated with derivative investments include ...that there may be no liquid secondary market, Investing in real estate securities, subjects the Fund to the risks associated with the real estate market (which are similar to the risks associated with direct ownership in real estate), including declines in real estate values, loss due to casualty or condemnation, property taxes, interest, rate changes, increased expenses, cash flow of underlying real estate assets, regulatory changes (including zoning, land use and rents) and environmental problems, as well as to the risks related to the management skill and creditworthiness of the issuer.

Like high-risk hedge funds Prudential, Principal and others have the contractual right to put up gates and restrict liquidity if they are downgraded or in danger of default. They can refuse to give the plan/participant their money at any time which would be illegal in a SEC registered mutual fund

Annuities

I spent 7 years at Transamerica making insurance annuity 401k products Anytime an insurance company puts something in an annuity form, they take ownership of the underlying securities put it on their balance sheet and squeeze out another 150 bps or more in spread fees. Anytime something is put in an insurance company Separate Account, same thing they take ownership and lock in a spread.

These annuities do not have SEC mutual fund oversight, and the plan does not own the underlying SEC registered securities, the insurance company does. I make the argument that any annuity is a fiduciary breach.^{vii}

Prudential Day One Funds may be offered as: (i) insurance company separate accounts available under group variable annuity contracts issued by Prudential Retirement Insurance and Annuity Company (PRIAC),

Sub-Advised Investment Options include Separate Accounts available through a group annuity contract with Principal Life Insurance Co.

Fees

Target Date Funds are so opaque that the actual fees and profits are hard to pin down. I estimate that many could approach 200 basis points or more.

Principal Target dates have 13 underlying funds 5 insurance company separate accounts (annuities), 4 CIT's, 4 proprietary mutual funds, for a total of 25 share classes.

The disclosed fees are even way above most providers, so any plan using these is not trying to minimize fees, in many cases there is a so-called consultant receiving a huge undisclosed insurance commission.

One of my favorite disclosures:

The ultimate decision as to whether a Principal LifeTime Hybrid CIT is an appropriate investment option for a plan and whether a target date fund can serve as a QDIA belongs to the appropriate retirement plan fiduciaries.

This target date fund shifts any fiduciary liability off of itself and onto in most cases a clueless plan sponsor.

<https://www.plansponsor.com/dol-opens-public-comment-on-secure-2-0-provisions/>

ⁱ <https://commonsense401kproject.com/2022/06/07/toxic-target-date-case-study-of-the-worst-of-the-worst/>

ⁱⁱ <https://www.barrons.com/advisor/articles/vanguard-fidelitys-target-date-funds-underperform-balanced-options-morningstar-d639f9e5>

ⁱⁱⁱ <https://commonsense401kproject.com/2022/04/30/problems-with-target-date-funds/>

^{iv} <https://commonsense401kproject.com/2022/02/22/cits-collective-investment-trusts-in-401k-the-good-and-the-bad/>

^v <https://www.prudential.com/advisors/investments/day-one-target-date-funds/cit-funds>

^{vi} <https://commonsense401kproject.com/2022/02/15/private-equity-in-401k-plans-a-ticking-time-bomb/>

^{vii} <https://commonsense401kproject.com/2022/05/11/annuities-are-a-fiduciary-breach/>