

Request to Participate in Target Date Joint Hearing, File Number 4-582

June 2, 2009

Sent Via Internet

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Target Date Fund Joint Hearing
Room N-5655, U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

To whom it may concern:

Avatar Associates respectfully submits to its request to participate in June 18th hearing to determine if additional guidance would be helpful in the management of target date funds.

Our firm hopes to provide meaningfully different insights into two of the areas of interest the Department of Labor and Securities Exchange Commission, as noted in the May 21, 2009 Federal Register; namely, how Target Date Fund (“TDF”) managers determine and change allocations, and how managers select and monitor underlying investments.

We believe the Agencies will benefit from our testimony because **our philosophy, methodology, and math are fundamentally different from the consensus in the Target Date community** - where Monte Carlo simulations and Modern Portfolio Theory were used to justify large exposures to equities in 2010 funds and other TDFs. In contrast to the standard approach, the Avatar glidepath is based on Commitment Driven Investing and adds a tactical overlay to further reduce or increase risk, as warranted. The results, last year, for our 2010 fund included:

- A baseline **allocation to equities of 20% that was tactically reduced to 13%** as the markets came under pressure.
- A **2008 return of -2.6%** vs. the category average return of -22.5% (*Source: Morningstar*)
- A management fee of 25 basis points (*exclusive of ETF and trust fees, which add an additional average cost of .30bps*)
- QDIA portfolios constructed with **non-proprietary Exchange Traded Funds** to lower fees, improve transparency, and remove conflicts of interest and the ability of Avatar to self-deal

The following is an outline of the topics we wish to discuss, indicating the intended time allocated to each:

1. About Avatar (One Minute)

- a. Avatar is a tactical asset allocator, founded in 1970, with approximately \$1 billion under management. Actively allocated QDIAs are available to participants in collective trusts.
- b. The firm recently requested that the Department of Labor clarify the fiduciary status of proprietary lifecycle mutual funds.
- c. Avatar professionals were involved in Department of Labor’s Prohibited Transaction Exemption issued to TCW and Advisory Opinion issued to SunAmerica, both describing how a party in interest can provide investment advice and discretionary portfolio management to plan participants by eliminating conflicts of interest.

2. An Alternative Glidepath (Three Minutes)

- a. The Monte Carlo simulators that are typically used in glidepath design are based on the assumption that the asset value is known at the present and the goal is to manage the future value. For an investor with a financial commitment to fund retirement, the challenge is exactly the opposite. Future values – the commitment – is known, and the challenge is to determine how much to invest and how allocate the assets.

- b. We solve for the series of future portfolio selections using Nash equilibrium game theory and stochastic present values of all cash flows associated with the retirement funding goal. Cohort data are based on national averages or plan demographics for customized QDIA projects.
- c. The result is a glidepath that mathematically serves the investor's best interests, defined as providing the highest income replacement ratio that can be achieved for a given level of contributions and risk path.

3. An Alternative Point-In-Time Allocation Methodology (One Minute)

- a. Modern Portfolio Theory uses mean revision to 'average-away' the kind of events we saw in 2008.
- b. In contrast, Avatar's quantitative process is focused on event risks at 'the tails' of a bell curve.
- c. We infer valuations based on behavioral observations and monetary models perfected over forty years.
- d. To avoid event risk, point in time allocations on the glidepath are actively managed. Avatar shifts participant balances in a 20% range above and below the TDF glidepath. Tactical tilts are made 8-12 tilts times per year.

4. Selection and Monitoring of Underlying Investments (Two Minutes)

- a. When hired as an ERISA 3(38) investment manager, Avatar acknowledges its fiduciary responsibilities in writing. Therefore, the first criterion used in selecting underlying investments is to ensure there are no real or potential conflicts of interest.
- b. As tactical beta managers, we have identified Exchange Traded Funds as the best vehicle to construct TDFs.
- c. We use ETFs because they have effective asset class tracking, low fees relative to mutual funds, and because Avatar has no economic interest as they are non-proprietary to Avatar and offer no revenue-sharing.

5. Conclusion (Two Minutes)

Most Target Date Funds use Modern Portfolio Theory to 'average-out' the kind of events we saw in 2008. Avatar feels that the risk of such events occurring at retirement, just as contributions stop and retirement spending begins, far outweigh MPT justifications for high equity exposure at retirement. We therefore believe that additional guidance from the Agencies is warranted to reduce the equity exposure of TDFs in the years prior to the target date disclosed to plan sponsors, participants, and their beneficiaries.

We appreciate your consideration in our request and welcome any interim questions.

Regards,

Michael Case Smith
Senior Vice President,
Target Date Portfolio Manager
msmith@avatar-associates.com
212/624-1903