

Pay Close Attention to So-Called “Default” Investments

One of the provisions of the Pension Protection Act of 2006 was to allow companies to automatically enroll their employees in their companies’ 401(k) plans, but it wasn’t until last October that companies got guidance on the categories of investments they had to choose for their workers’ contributions.

The decision contained a controversial provision. The Labor Department decided to prohibit stable-value funds or guaranteed investment contracts (GICs) from the choices, because many experts find them too conservative for younger investors.

Instead, companies can now offer balanced mutual funds among their QDIAs (Qualified Default Investment Alternatives) as well as target and lifecycle funds. Balanced funds create an assortment of investments that fit the group of employees as a whole, while target or lifecycle funds contain specific mixtures of investments targeted to an investor’s age or retirement date.

What’s also important to know is that employers won’t be liable for employees’ money lost while invested in a QDIA, but they’ll be responsible for doing the due diligence to select the investments, for monitoring the investments’ performance and for deciding whether to keep or jettison those investments.

So does that mean that you can comfortably rely on default investments for your entire retirement strategy? No.

Target investments specifically have become very popular. Money has been gushing into these funds, according to the Investment Company Institute. By yearend 2006, this particular category of funds held \$114.3 billion in assets, up from only \$12.3 billion in 2001. Why the demand? In part such funds have been positioned as “no-brainer” investments for individuals without the time, inclination or knowledge to choose investments for themselves. 401(k) plan architect Ted Benna was quoted earlier this year as saying that within 5-10 years, more than 75 percent of 401(k) plan assets could be invested in target funds.

A trained financial expert such as a Certified Financial Planner™ professional can help individuals meet specific goals in retirement that aren’t addressed by these one-size-fits-all plans. For instance, some critics say life-expectancy issues are not adequately addressed in target-date plans, and they definitely don’t address scenarios in which you plan to work in retirement or spend your assets in unconventional ways. Also, some critics offer that many people may underfund such plans without realizing the correct amounts they should invest to meet their goal. A planner’s job is to help advise individuals on an ongoing basis about meeting such goals.

That said, how should you evaluate a target-date fund? Here are some questions you should ask:

Do you know how much money you’ll need to retire? This is one of the questions you should start with based on your age and the vision of retirement you have. It is one thing to invest in a fund that promises consistent growth until your retirement date, but what if you need

more growth? What if there are specific tax and spending issues that might interfere with putting the right amount of money into such funds each year? This is why individual advice makes sense. A mutual fund can't ask you what your goals are, nor can it make sure you're investing enough.

How did your employer select the funds it's offering? Obviously, most employers want to make the right fund choices for employees, but just because they're offering target funds doesn't mean they're offering the right target funds for you and your needs. Keep in mind that most fund choices offered to companies are heavily marketed and might not be the cheapest or most efficient investment choices out there. Always check the Morningstar rating of any fund your 401(k) invests in.

What if you leave your job and take your 401(k) with you? What happens to your targeted investment plan then? Obviously you'll roll over these assets into another tax-advantaged retirement plan, but what will happen to your annual retirement savings strategy at that point? Always ask.

What are you paying for a targeted fund? Granted, the investment choices are being made for you, but what are you paying for those choices? Often, these funds are constructed based on a fund-of-funds structure that layers a fee on top of the fees incurred by the individual funds. Always understand the fee structure of any fund you invest in.

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