Target date fund manager selection matters

IN BRIEF

Manager selection is one of three critical levers utilized in constructing J.P. Morgan's SmartRetirement target date funds. With equity volatility continuing, now is the time to ensure your target date fund managers have the ability to navigate through a variety of market environments and effectively balance maximizing returns for younger participants who have longer time horizons and, at the same time, reducing downside risk for those participants who are closer to retirement.

Since the depths of the financial crisis a decade ago, low interest rates in the U.S. and accommodative central banks across the globe have been supportive of risk assets, with U.S. equities up more than 400% and high yield fixed income up over 200% on a cumulative basis.[1]

Target date fund (TDF) managers who maintained a tilt towards risk assets during this period benefited as well. The challenge now is how to continue generating returns as we enter the late cycle of this decade-old bull market. And, in particular, how to maximize returns for younger participants who have longer time horizons, while mitigating drawdown risk for those participants who are closer to retirement.

Underlying manager selection is now more critical than ever

Unlike many TDF managers, at J.P. Morgan we utilize three levers to generate investment results:

1. **Glide path construction** – strategic asset allocation that changes throughout a participant's life – is driven by J.P. Morgan's Long-Term Capital Market Assumptions and participant behavior research, resulting in a globally diversified asset allocation for each retirement vintage.
2. **Manager selection** involves choosing the underlying investment strategies for each asset class, leveraging the firm's broad investment platform of more than 500 managers across all asset classes, including equity, fixed income and alternatives
3. **Tactical asset allocation** allows us to navigate through different market environments by adjusting allocations between and within asset classes, over- or underweighting positions relative to our strategic glide path allocations.

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[1] Source: Bloomberg; data from 3/9/09 - 5/31/19. US equity markets as measured by the S&P 500 Index and high yield as measured by the Bloomberg Barclays US Corporate High Yield Bond Index.

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Selection of a TDF's underlying managers becomes even more critical today, as it is important to consider their structural biases and ability to navigate characteristics of a late cycle market environment, including declining corporate profit margins, widening credit spreads, a flattening yield curve and rising volatility. All of these factors can have a significant impact on a participant's TDF investment as volatility increases, particularly for participants at or near retirement who can least afford a drawdown in their savings.

Active managers have the ability to manage around these challenges, but the method each manager utilizes will be unique to each particular strategy. Therefore, understanding an underlying manager's structural tilts, tendencies and flexibility can provide an indication of how they might perform in certain market environments and allow us to optimize the combination of managers at each phase of the glide path to provide the greatest portfolio utility – essentially meaning we seek to maximize the expected portfolio return based on a given level of risk.

J.P. Morgan's manager research and selection process

With J.P. Morgan's global investment platform of approximately 500 strategies across all asset classes, the investment teams have access to a broad range of managers.

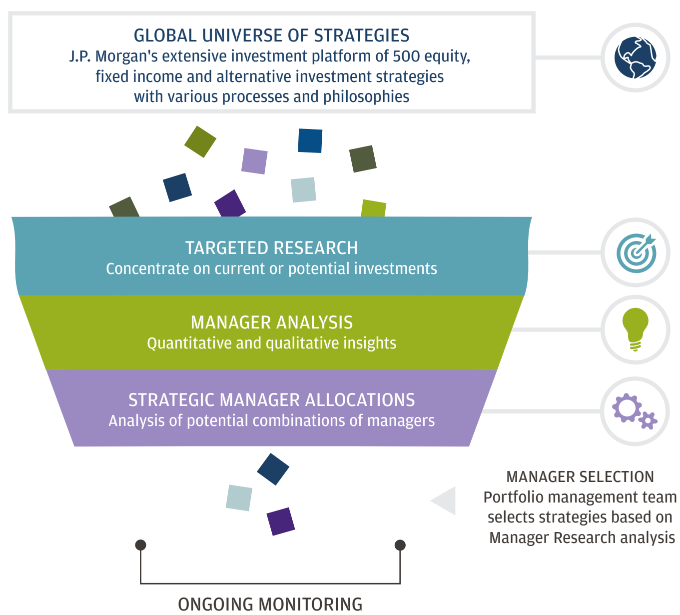
Within the Multi-Asset Solutions team, we have a separate, independent Manager Research function that serves as an essential resource to portfolio managers, acting as a consultative partner. The Manager Research team consists of six dedicated professionals with traditional and alternative investment experience across asset classes, investment disciplines and multi-asset portfolio management.

The process begins with the portfolio managers discussing details about the portfolio objective or desired investment outcome with the Manager Research team. When evaluating underlying managers, the Manager Research team assesses investment philosophies, objectives, processes and performance to help gauge potential alpha generation. Within each asset class, the team differentiates each strategy by identifying its structural tilts and biases. The Manager Research team then provides the portfolio managers with relevant analysis of potential strategies for portfolio inclusion.

The portfolio managers leverage these insights to determine whether there is a compelling fit for a strategy within a multi-asset portfolio and, for TDF portfolios specifically, where along the glide path a manager might add the most value. For example, the portfolio manager may choose to utilize a higher return-generating strategy at the beginning of the glide path (where there is a longer time horizon) and, conversely, a more conservative equity manager at the end of the glide path. How an underlying manager fits within the overall portfolio is extremely important and includes confidence in the strategy's representation of the asset class and contribution to portfolio diversification as well as return and volatility expectations.

Once an underlying manager is added to the portfolio, the Manager Research team continues to evaluate and monitor it, along with many other strategies. The Manager Research team holds meetings on a regular basis where portfolio managers are welcome to attend to gain critical insights that inform the portfolio construction process.

Portfolio managers and the Manager Research team work together in partnership to ensure strategies are designed to contribute to the portfolio objective or desired outcome.



Graphic for illustrative purposes only.

Using active vs. passive managers

Our SmartRetirement TDF strategies have always incorporated some level of active management for two primary reasons:

- A well-diversified portfolio may lead to strong risk-adjusted returns. And, in order to obtain the diversification necessary to achieve those returns, the SmartRetirement strategies invest in extended fixed income sectors — such as high yield and emerging markets debt — which typically cannot be indexed efficiently and where we can add more value through active management.
- Active management of underlying strategies can help us generate more efficient risk-adjusted returns which have the potential to both mitigate volatility on the downside and lead to better income replacement outcomes. Although passive strategies offer lower-cost exposure to equity and fixed income markets, they are designed — by construction — to, at best, keep pace with market indices rather than outperform them.

This being said, there is a place for passive management and we may choose to index some asset classes for a number of reasons, including to:

- reduce portfolio tracking error and/or volatility
- implement tactical asset allocation views in a more efficient way
- manage liquidity and cash flows
- better align with the overall objective of the portfolios, as we have done in our SmartRetirement Blend series

We have the flexibility to use passive management for fee efficiency or within asset classes where we seek the desired beta exposure without the additional tracking error. For example, in the SmartRetirement Blend series, we choose to leverage passive strategies in certain asset classes, such as U.S. equities, simply because they cover more efficient markets, making it easier and more cost effective to replicate the index.

By contrast, fixed income markets are less efficient and the indices cannot be replicated entirely, as there are over 9,000 securities in the Bloomberg Barclays US Aggregate Bond Index. In addition, active managers with defensive characteristics can be employed at the end of the glide path to help navigate turbulent markets.

Common triggers for changes to underlying strategies

An anticipated shift to a late cycle market environment may trigger an end-to-end review of the entire line-up of underlying managers. We re-evaluate portfolio utility, structural biases and performance expectations in the context of an expected shift in the market cycle. In addition, we consider the role of each strategy throughout the glide path. For example, we introduce strategies with lower volatility characteristics 10 years before the end of the glide path because our research indicates that participant directed cash flows become more volatile during this time period.

With equity volatility continuing, now is a perfect time to ensure your target date fund managers have the ability to navigate through a variety of market environments and effectively balance maximizing returns for younger participants who have longer time horizons and, at the same time, reducing downside risk for those participants who are closer to retirement.

FOR MORE INFORMATION

Contact your J.P. Morgan representative

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RISK SUMMARY

TARGET DATE FUNDS. Target date funds are funds with the target date being the approximate date when investors plan to start withdrawing their money. Generally, the asset allocation of each fund will change on an annual basis with the asset allocation becoming more conservative as the fund nears the target retirement date. The principal value of the fund(s) is not guaranteed at any time, including at the target date.

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