

Choosing target date funds

A suitability assessment

February 2020

SOME DEFINED CONTRIBUTION (DC) PLAN SPONSORS, INTENT ON PRUDENTLY SELECTING THE MOST APPROPRIATE TARGET DATE FUND (TDF) FOR THEIR PARTICIPANTS, MAY BE IGNORING SOME TDF CHARACTERISTICS THAT ARE CRUCIAL TO THIS ALL-IMPORTANT FIDUCIARY DECISION.

The choice of a TDF—especially one that will serve as the plan’s qualified default investment alternative (QDIA)—has the potential to shape participants’ retirement outcomes in a way no single asset class investment decision ever could. TDFs can simplify individual investment decisions and, when carefully matched with participant profiles and behaviors, help more participants experience a secure retirement.

The popularity and growth of target date funds have been a major positive development for plans and participants. However, our *2019 DC Plan Sponsor Survey* findings suggest there is room for continuing education on the importance of understanding and evaluating TDF strategies.¹ Our research has shown that a sizable number of plan sponsors lack a strong understanding of the methodology used to construct the TDFs in their plans. Performance and fees continue to dominate how plan sponsors evaluate TDFs, while important factors such as demographics and glide path structure still lag.

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The absence of standard performance benchmarks, coupled with the wide and varied landscape of target date funds, makes comparing the performance of TDFs challenging. We believe that fiduciaries who focus on short-term performance and fees without considering a TDF’s strategic design and how that interacts with participants’ real-world behaviors may be missing the mark. Furthermore, they may be opening themselves up to an allegation that they are not acting in the best interest of their plan participants. This is of particular concern because class-action law firms that have sued DC plan fiduciaries on behalf of plan participants are lately zeroing in on TDFs, investigating TDF construction and looking for dissatisfied participants to serve as lead plaintiffs against their plan sponsors. When a TDF is selected as the QDIA, the stakes are even higher.

The choice of a TDF should be influenced by a range of participant characteristics and behaviors, as well as plan sponsors’ objectives for the plan and their investment philosophies. We encourage plan sponsors and their advisors/consultants to think carefully about the list of considerations provided here and to document the decision-making process leading to their TDF choices.

¹ *The Power of Being Proactive—2019 Defined Contribution Plan Sponsor Survey Findings*, J.P. Morgan Asset Management, July 2019.

FRAMING THE DECISION: MAXIMIZING VALUE FOR COST

Clearly, cost matters when choosing a TDF as a plan's QDIA, but if the plan sponsor is to meet the fiduciary standard of acting "solely in the interest of participants and beneficiaries," cost cannot stand alone. Choosing a TDF requires a robust framework that takes into account how TDFs mitigate risk and serve participants' retirement investing needs, with fees considered in that broader context. It's not about minimizing cost; it's about maximizing value for cost. Many courts have embraced this principle. For example, in dismissing a lawsuit where participants alleged that fiduciaries breached their duties under ERISA by not selecting less expensive investment funds, the court said, "Fiduciaries have latitude to value investment features other than price (and indeed are required to do so)."² Or, as an appellate court noted, "Nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems)."³

The U.S. Department of Labor (DOL), in publishing its *Tips for ERISA Plan Fiduciaries*, recognized the multiple dimensions that must be considered in selecting TDFs for 401(k) and similar plans.⁴ The DOL encourages plan fiduciaries, not only to examine performance and fees, but also to understand the TDF's investment strategy, its glide path and the age at which it reaches its most conservative allocation. These factors will often drive much of the fund's performance relative to peers. The DOL also emphasizes the importance of assessing how well a TDF's design aligns with DC plan objectives; the employer's defined benefit (DB) plan, where relevant; and the characteristics of eligible employees, such as age, likely retirement dates, salary levels, contribution rates and withdrawal patterns.

ASSESSING TDF SUITABILITY FOR DC PARTICIPANTS STARTS WITH DC PARTICIPANTS

Selecting the most suitable TDF for DC participants starts with an understanding of participants' saving and investing behaviors and needs. In fact, this understanding can also play

a fundamental role in shaping the plan sponsor's objectives for the plan's participants.

Is the goal to help as many participants as possible reach an acceptable income replacement threshold at retirement? This outcome implies a focus on minimizing downside risk while trying to deliver more predictable participant outcomes—i.e., narrowing the dispersion of outcomes by reducing the risk of significant losses at the end of the glide path, though potentially reducing the upside extremes as well. The other option is to focus on maximizing returns, and therefore account balances, at the point of retirement or beyond, which may present the risk of losses along and at the end of the glide path. Losses at the end of someone's savings life cycle could negatively impact their ability to retire when and/or as planned.

How should participant characteristics influence TDF selection? In the end, it comes down to identifying the TDF and glide path design the plan sponsor believes will most effectively manage the risks and returns of DC assets for participants over time, given the goal for the plan.

Plan sponsors and their advisors should consider the following questions and work with the plan recordkeeper to obtain participant data that can help them better understand the employee population and its retirement investment needs.

When do participants generally retire ... or start withdrawing their assets?

In reality, it is more important to focus on when participants start withdrawing assets than on when they retire. Based on our most recent *Ready! Fire! Aim?* research, just 28% of participants remain in the plan three years after retirement. Around 10% of participants withdraw, on average, 55% of assets starting at and after the age of 59.5.⁵ Research from our Chase spending data further supports this notion—on average, rolling one-year spending in retiree households peaked at the point of retirement, and, in fact, spending increases persisted in 35% of households for at least one of the first three years after retirement. Participants are not only withdrawing funds, they are spending them.⁶

² *White v. Chevron Corp.*, No. 16-0793, (N.D. Cal. August 16, 2016).

³ *Hecker v. Deere & Co.*, 556 F.3d 575 (7th Cir. 2009).

⁴ *Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries*, U.S. Department of Labor Employee Benefits Security Administration, February 2013.

⁵ Anne Lester and Daniel Oldroyd, *Ready! Fire! Aim? 2018*, J.P. Morgan Asset Management, February 2019.

⁶ Aggregated and de-identified Chase credit card and debit card (excluding some co-branded cards), electronic payment, ATM withdrawal and check transactions from October 2012–December 2016. Outliers in each asset group were excluded (0.1% of top spenders in each spending category). Information that would have allowed identification of specific customers was removed prior to each analysis.

These common patterns put participants' retirement outcomes at considerable risk in the years just before and after retirement. Should a market drawdown occur at this stage, those forced or inclined to withdraw and spend could be liquidating assets at significant losses that will not be recouped. This makes understanding the relationship between participants' behavior in the years around retirement and the risk level of different TDFs near retirement a critical consideration.

How diverse are participants in their drawdown of DC account balances in retirement?

It's important to remember, of course, that no one is average.⁷ But different participant behaviors may or may not point to different types of TDF glide path strategies.

Participants who tend to make larger than average withdrawals to finance essential expenditures in and around the initial retirement years, and those who rely to a large extent on DC plan benefits to support them throughout retirement, may be best served by a TDF glide path that reaches its lowest market risk level at or near retirement. Exposure to market risk will then be lowest at the point where the potential impact of a downturn is the greatest.

A glide path that reaches its lowest level of risk at or near retirement is also likely to be appropriate for participants who begin taking regular withdrawals as they enter retirement. Their balances and, hence, exposure to the risks of a downturn are at or near a peak at their retirement date. In retirement, while their willingness to take on risk may decline, their *capacity* to take on risk generally increases, at roughly the same pace, given the decline in their balances (see "Why retirement shouldn't mean decline," J.P. Morgan Asset Management, 2018). This argues for a flat glide path in retirement.

On the other hand, if most participants tend to defer withdrawal of their TDF assets beyond the fund's target date (perhaps until they are subject to required minimum distributions) and then gradually withdraw balances, a TDF that meets its risk allocation minimum beyond the years surrounding retirement could be more appropriate. Although this approach can potentially provide higher returns, it does introduce a higher level of risk in

the crucial years leading up to retirement and may be better suited for those who are less reliant on their DC balances to finance essential expenditures in retirement. Additionally, it is important to assess the level of risk across the trajectory of the glide path after the retirement date as it continues to decline.

One strong probability for all plan participants is that their account balances will be highest at or near retirement. This likelihood has implications for risk-taking, given the potentially devastating result of sequence of return risk.

Do participants generally exhibit "good behavior" in terms of contributions and withdrawals while employed?

When it comes to contributions, plan sponsors should actively encourage their participants to save. Target date funds cannot effectively compensate for inadequate contributions. Our *Ready! Fire! Aim?* research shows that, in general, participants aren't saving enough, with contributions reaching, on average, just 7% of their income in the years leading up to retirement. Additionally, participants who are automatically enrolled and don't take any further action remain at an even lower average contribution rate of 3%. What's more, our research indicates that participants begin withdrawing funds in the form of loans and hardship withdrawals beginning in their 40s, with 19% borrowing, on average, 20% of their account balances.⁸ For some, this pattern is repeated several times before they leave the plan or retire. It's important to take these factors into consideration when determining what glide path might be right for the participant base. If participants are saving adequately, the plan may be able to take on more risk to enhance balances or get more participants to retirement with a given level of risk and volatility.

What do salary levels and their distribution look like for the participant base?

Lower salaried employees have less income to replace. Social Security may provide a significant proportion of that replacement income. At the same time, this population may be reliant on both their DC plan savings and Social Security to

⁷ "No one is average: Why averages can mislead in retirement plans—and how to move beyond them," Retirement Insights, J.P. Morgan Asset Management, June 2017.

⁸ Anne Lester and Daniel Oldroyd, *Ready! Fire! Aim? 2018*, J.P. Morgan Asset Management, February 2019.

cover very basic needs in retirement. They may also have fewer alternative sources of replacement income. On balance, this would suggest that a strategy that reduces risk at or near retirement to a level commensurate with the goal of minimizing the risk of loss could be appropriate. That same strategy may not be a fit for a higher salaried contingent within the participant base. In evaluating TDF options, plan sponsors must be clear on the primary objective and focus of their plan. One way to think about that is to consider what type of strategy is likely to benefit the most participants in the plan.

CHOOSING THE TDF—ALIGNING WITH PLAN SPONSOR INVESTMENT POLICIES AND PHILOSOPHIES

Careful consideration of the above participant characteristics together with the plan sponsor's overarching plan objectives can help narrow potential TDF choices to a generalized TDF style.

Most plan sponsors would agree that achieving a higher level of returns (net of fees) over the long term with a given level of risk is desirable. A number of additional fund characteristics—level of diversification, the asset classes included, the degree to which the fund is actively managed and the quality of that management—have the potential to improve the return-risk trade-off, but may also increase costs.

How these characteristics factor into TDF selection might be influenced by the investment policy statement (e.g., are there restrictions on certain asset classes?) and plan sponsors' investment views and philosophies (e.g., do plan sponsors believe there is an advantage to taking an actively managed approach and/or providing managers with the flexibility to shift allocations at the margin when short-term market opportunities or risks present themselves?).

Advisors and consultants have an increasing array of analytical tools available to help plan sponsors assess and compare these TDF characteristics and make objective, informed target date fund decisions. But when using these tools, advisors should understand the factors the tools take into account. If they only consider performance and fees, advisors may need to gather additional information to help plan fiduciaries choose the most appropriate target date funds for their participants.

FURTHER CONSIDERATIONS

Even a well-managed TDF closely aligned with plan objectives and participant needs does not guarantee that retirement outcomes will be maximized. Also critical: getting participants into the plan and its TDF, motivating positive contribution behavior and ensuring the TDF option is understood and used appropriately by participants. Automatic design elements and strong participant communication programs can complement the selected TDF strategy, potentially helping to improve retirement outcomes.

CONCLUSION

Fiduciaries who focus on short-term performance and fees without considering a TDF's strategic design, and how that interacts with participants' real-world behaviors, may be missing the mark. There are many tools and resources available to help plan sponsors and their advisors evaluate target date funds. It is important to understand and use a combination of these tools, together with critical participant data, when assessing TDF suitability. A comprehensive, balanced look at all these considerations is essential in selecting the target date fund that is likely to help the most participants successfully cross the retirement finish line.

Finally, plan sponsors should carefully document their decision-making process and rationale for choosing a target date fund. TDF choices should be monitored and revisited over time to ensure continued alignment with overall plan objectives, participant profiles and developments in the areas of portfolio construction and glide path design.

CONSIDERATIONS FOR SELECTING AN APPROPRIATE TARGET DATE FUND

1 KNOW PARTICIPANT CHARACTERISTICS AND BEHAVIORS.

(Work with Human Resources and your recordkeeper to obtain relevant information)

When/how do participants tend to withdraw plan account balances?

Significantly, prior to and around retirement \longleftrightarrow Gradually, beginning at or after retirement

What are participant salary levels?

Low \longleftrightarrow High

Tight distribution \longleftrightarrow Wide distribution

How would you characterize loans/hardship withdrawals during the employment life cycle?

Infrequent, small \longleftrightarrow Frequent, large

Where are employee contributions relative to the level required to reach threshold income replacement?

Below \longleftrightarrow At or above

2 ESTABLISH THE PRIMARY OBJECTIVE OF YOUR RETIREMENT PLAN. FOR EXAMPLE, ARE YOU AIMING TO ...

... **maximize the number of participants** reaching income replacement threshold at retirement?

\longleftrightarrow

... **maximize participants' balances** at the point of retirement or beyond?

3 DETERMINE (GIVEN THE ABOVE) THE SUITABLE TYPES OF TDFs AND A PRELIMINARY LIST OF CONTENDERS. IN ADDITION:

- **UNDERSTAND** how the glide path is designed to manage the risk of losses at or near retirement.
- **CONSIDER** the strategy's overall return-risk profile and glide path trajectory.

4 ASSESS CONSISTENCY OF POTENTIAL TDF STRATEGY CHOICES WITH THE INVESTMENT POLICY STATEMENT AND PLAN SPONSOR INVESTMENT PHILOSOPHIES. FOR EXAMPLE, DOES THE PLAN SPONSOR BELIEVE ...

... **broad portfolio diversification can improve participant outcomes?**

Agree \longleftrightarrow Disagree

... **active management can improve participant outcomes?**

Agree \longleftrightarrow Disagree

... **allocation to extended asset classes can improve participant outcomes?**

Agree: Use traditional *and* extended asset classes \longleftrightarrow Disagree: Use only traditional asset classes
(e.g., high yield, emerging market equity, commodities) *(e.g., stocks and bonds)*

... **actively shifting asset allocations at the margin to take advantage of short-term market opportunities can improve participant outcomes?**

Agree \longleftrightarrow Disagree

5 CONDUCT THOROUGH DUE DILIGENCE ON LIST OF FINAL TDF CONTENDERS.

Work with advisors/consultants and specialized evaluation tools to assess performance, fees and value for cost

6

DOCUMENT THE DECISION PROCESS; MONITOR AND REVISIT TDF SELECTION.

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