A review of how Target Date Compass® can assist in evaluating and selecting target date funds

I. Introduction

After an initial surge in popularity following the passage of the Pension Protection Act of 2006 (PPA), target date funds (TDFs) remain the preeminent default investment vehicle in most defined contribution plans today. In today's market, plan fiduciaries have numerous TDF options to choose from. However, given the number of options, comparing TDFs has become more challenging, as there are wide differences among TDFs with respect to investment style, strategy, fees and risk—even among funds with the same target date.

As the marketplace for TDFs continues to evolve, plan fiduciaries should ensure that they are both aware of and acting in accordance with their fiduciary obligations with respect to TDF selection (see **"What the QDIA 'safe harbor' is—and isn't,"** below). TDF selection may present significant challenges for plan fiduciaries beyond those that accompany traditional investment products. First, given the dynamic nature of TDFs (i.e., their evolving asset allocation), understanding the particular needs and circumstances of plan participants is especially important when considering whether a TDF is appropriate. Second, in view of the evolving TDF marketplace, collecting and analyzing sufficient information to understand the features of different TDF offerings—particularly the distinctions among seemingly comparable TDFs with similar target dates—are becoming increasingly important for plan fiduciaries.

J.P. Morgan's Target Date Compass tool is designed to assist plan fiduciaries with meeting the increasing challenges of TDF due diligence. Originally launched in 2008, Target Date Compass is regularly refined and improved to address changes in both the TDF marketplace and the regulatory landscape. Based on Groom Law Group's review of the tool, Target Date Compass is designed to address most of the TDF selection factors described in 2013 guidance issued by the Department of Labor (DOL), *Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries* (the DOL Tips). To date, the DOL Tips remain the most specific guidance issued with respect to TDF selection.

Authors

Erin K. Cho
Principal,
Groom Law Group

David N. Levine
Principal,
Groom Law Group

Arsalan Malik
Associate,
Groom Law Group

What the QDIA "Safe Harbor" is—and isn't

For many years, a key appeal of TDFs to plan fiduciaries has been the ability to reduce fiduciary risk with respect to default investments. In this regard, under the PPA and DOL regulations, plan fiduciaries are protected by a "safe harbor" for investment losses associated with defaulting participants into qualified default investment alternatives (QDIAs).

While the QDIA safe harbor is certainly an important consideration, **plan fiduciaries should not misunderstand the safe harbor as being more than what it is**. In this regard, the safe harbor only provides protection for the important yet limited act of placing participants into a default investment; **plan fiduciaries remain responsible for the prudent selection and periodic review of TDFs, as they are with any other investment type.**

II. Target Date Compass as a tool to assist plan fiduciaries

The Employee Retirement Income Security Act of 1974, as amended (ERISA), imposes various duties on plan fiduciaries with respect to managing the investments of employee benefit plans. As explained in more detail in **"Fiduciary responsibility under ERISA,"** right, ERISA imposes a duty of prudence on plan fiduciaries, which focuses on plan fiduciary conduct and the process that is employed to make investment decisions rather than on investment results. However, although prudence is an inherently factual question, there is no exact formula for what constitutes a prudent process for investment selection. That said, in the DOL Tips, the DOL articulated eight considerations that fiduciaries should take into account when evaluating and selecting TDFs.[1]

Specifically, plan fiduciaries should:

- Establish a process for comparing and selecting TDFs.
- Establish a process for the periodic review of selected TDFs.
- Understand the fund's investments—the allocation in different asset classes (stocks, bonds, cash) and individual investments—and how these will change over time.
- Review the fund's fees and investment expenses.
- Inquire about whether a custom or non-proprietary target date fund would be a better fit for the plan.
- Develop effective employee communications.
- Take advantage of available sources of information to evaluate the TDF and suggestions received regarding the TDF selection.
- Document the process.

Target Date Compass provides a holistic process for plan fiduciaries to evaluate and select TDFs, and helps plan fiduciaries meet six of the eight considerations described in the DOL Tips. This begins with completing an objective questionnaire—one developed with the assistance of a third-party research firm—to gain an understanding of the particular needs and circumstances of plan participants. Through the questionnaire, Target Date Compass helps plan fiduciaries:

- Define plan investment objectives and facilitate conversations to better understand plan participant behaviors.
- Identify the appropriate diversification needs and risk tolerance for plan participants.
- Identify the Target Date Type that best matches plan goals and needs of the plan (see **"The Compass Quadrant Map"**).

Fiduciary responsibility under ERISA

ERISA imposes several duties on plan fiduciaries, including the duty of prudence, which requires that fiduciaries act solely in the interest of participants and beneficiaries "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." ERISA § 404(a)(1)(B).

One element of this duty is substantive prudence, which requires that fiduciaries give "appropriate consideration" to the facts and circumstances relating to a particular investment. "Appropriate consideration" includes, among other things, a determination as to whether the investment is "reasonably designed" to further the purposes of a plan in view of the associated risks of loss and opportunities for gain. 29 C.F.R. § 2550.404a-1(b)(2).

ERISA's prudence standard also requires procedural prudence, which is an objective standard that focuses on the process employed by a fiduciary to arrive at an investment decision, rather than on investment results. The DOL has recognized that this is an "inherently factual question" that requires consideration of "all the facts and circumstances of the individual situation." U.S. Department of Labor Advisory Opinion 98-04A (May 28, 1998).

Courts have similarly found that the focus is "on a fiduciary's conduct in arriving at an investment decision, not on its results, and... whether a fiduciary employed the appropriate methods to investigate and determine the merits of a particular investment."[2]

Moreover, no single factor is dispositive for satisfying the prudence standard.[3]

Target Date Compass considers all registered target date mutual funds, as well as collective investment trust (CIT) suites on the market that are available for purchase by qualified retirement plans, and is not restricted to just J.P. Morgan or affiliated products. Based on the information provided in the questionnaire and funds selected for evaluation by the plan fiduciary or investment professional, Target Date Compass generates the Target Date Compass Analysis Report, which provides a detailed comparative analysis of the TDFs selected as potentially appropriate for the plan.

As noted above, Target Date Compass is designed to address six of the eight considerations[4] described in the DOL Tips, thus helping demonstrate a prudent process in accordance with the requirements of ERISA. In this regard, the table on the following page describes how Target Date Compass addresses the guidance.

The Compass Quadrant Map is at the heart of Target Date Compass. The map classifies funds with similar investment orientations into four Target Date Type quadrants, using two important characteristics: level of equity exposure at the target date and level of asset class diversification. Determining a plan's Target Date Type begins with the questionnaire.

How Target Date Compass addresses the DOL Tips

DOL Tip	What it means	How Target Date Compass helps
Establish a process for comparing and selecting TDFs.	Plan fiduciaries should have a process for understanding the characteristics of plan participants (e.g., ages and retirement dates), and for obtaining and comparing information for different TDFs (e.g., prospectus information, performance/returns and investment fees and expenses).	• The Target Date Compass questionnaire helps facilitate important discussions about plan objectives, risk tolerance, demographics and participant behaviors. • Based on the information provided in the questionnaire, Target Date Compass determines which Target Date Type best matches the goals and needs of the plan. • The Target Date Compass Analysis Report provides a detailed comparative analysis of the TDFs that may match the plan's Target Date Type. • This report helps fiduciaries understand the distinctions among the TDF options that could be appropriate for the plan.
Establish a process for the periodic review of selected TDFs.	Plan fiduciaries should periodically review TDFs (e.g., for performance, changes in management or strategy) in order to ensure that they remain appropriate for plan participants.	• The Target Date Compass questionnaire can be used on an ongoing basis to continue important discussions about plan objectives, risk tolerance, demographics and participant behaviors. • Target Date Compass is updated quarterly with performance and other metrics to provide information needed to periodically review TDFs.
Understand the fund's investments—the allocation in different asset classes (stocks, bonds, cash) and individual investments—and how these will change over time.	Plan fiduciaries should understand a TDF's investment strategies, risks and underlying investment holdings, as well as its glide path and expected timing for allocation shifts.	• The Target Date Compass Analysis Report provides comprehensive comparative information on TDFs, including: — Tables describing the underlying asset classes and fund structure — Charts depicting glide path shape and slope
Review the fund's fees and investment expenses.	Plan fiduciaries should understand the fees and expenses associated with a TDF, including the fees for underlying investments and any special fees (e.g., for rebalancing), as well as the impact of fees and expenses on long-term retirement savings.	• The Target Date Compass Analysis Report provides comparative information on the net and gross expense ratios of different TDFs. • All performance comparisons are net of fees, including: — Historical growth (in dollar amounts) — Charts describing historical risk and return metrics, as well as comparative rankings
Take advantage of available sources of information to evaluate the TDF and suggestions received regarding the TDF selection.	Plan fiduciaries should consult the "increasing number of commercially available sources for information and services" available to assist in decision making regarding TDFs.	• Target Date Compass utilizes independent, third-party fund information from Morningstar.[5] • The questionnaire was developed with the assistance of a third-party research firm and can help gain an understanding of the particular needs and circumstances of plan participants.
Document the process.	Plan fiduciaries should also document their processes for selecting and reviewing TDFs.	• The Target Date Compass Analysis Report, which provides a detailed comparative analysis of different TDFs, can be valuable for documenting TDF due diligence. • The questionnaire can also be a valuable part of documenting due diligence.

III. Takeaway

ERISA requires that plan fiduciary decision making be informed by a process that considers all relevant facts and information. While prudence is an inherently factual question, the DOL has articulated certain considerations that should guide TDF evaluation and selection. Target Date Compass is designed to help plan fiduciaries take these considerations into account when making decisions regarding TDFs. Although the tool does not select a TDF for a plan (which will remain the responsibility of plan fiduciaries), it can help plan fiduciaries align their decision making with the DOL Tips, and therefore can provide a valuable framework to significantly enhance the processes used by plan fiduciaries to evaluate and select TDFs.

PLEASE NOTE: Erin K. Cho,* David N. Levine and A. Arsalan Malik are attorneys with the Groom Law Group, a law firm focused exclusively on retirement, health and benefits. They were compensated by J.P. Morgan Asset Management to provide their views regarding Target Date Compass. This publication is provided for educational and informational purposes only, and does not contain legal advice and does not analyze the underlying investment evaluation process. The information should in no way be taken as an indication of future legal results. Accordingly, you should not act on any information provided without consulting legal counsel.

** Erin K. Cho was a principal with Groom Law Group from 2016 to 2021.*

SOURCES:

[1] *The DOL Tips are available online at https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf.*

[2] *In re Unisys Sav. Plan Litig*., 74 F.3d 420, 434 (3d Cir. 1996); see also *Pension Ben. Guar. Corp. ex rel. St. Vincent Catholic Med. Centers Ret. Plan v. Morgan Stanley Inv. Mgt. Inc.,* 712 F.3d 705, 716 (2d Cir. 2013) (the duty of prudence is an objective standard that focuses on the methods employed by the fiduciary); DiFelice v. U.S. Airways, Inc., 497 F.3d 410, 418-20 (4th Cir. 2007) (noting that prudence requires examining the thoroughness of a fiduciary's investigation and that "a court must ask whether the fiduciary engaged in a reasoned decision-making process"); *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983) (noting that ERISA's prudence requirement focuses on "the fiduciary's independent investigation of the merits of a particular investment, rather than on an evaluation of the merits alone").

[3] *Cf. Hecker v. Deere & Co.*, 556 F.3d 575, 586 (7th Cir. 2009) (noting that fiduciaries are not required to "scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems)").

[4] Target Date Compass does not analyze whether a "custom" TDF is a better fit for a plan, and also does not include a feature for participant communications.

[5] Although Target Date Compass is a tool for following this DOL Tip, it is not intended to provide a comprehensive collection of sources for purposes of TDF evaluation.

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