Target date funds: Translating Department of Labor guidance into action

IN BRIEF

- In February 2013, the U.S. Department of Labor (DOL) issued eight tips to help plan fiduciaries with target date fund (TDF) selection.
- Plan sponsors can use this guidance to help determine the most prudent TDF actions in the context of their specific plan goals and participant needs.
- J.P. Morgan offers an array of practical, product-agnostic TDF education and evaluation resources to help plan sponsors apply these guidelines to their TDF strategy selection and review process.

IN FEBRUARY 2013, THE DOL ISSUED TIPS FOR ERISA PLAN FIDUCIARIES on TDF selection. Under the safe harbor and automatic enrollment legislation introduced by the Pension Protection Act of 2006, TDFs have become by far the most popular qualified default investment alternative (QDIA) for defined contribution (DC) plans. Consequently, the number of fund families offering target date funds has expanded from 19 in 2005 to more than 40 today. When you consider that many fund families offer multiple series to choose from, the universe grows dramatically larger.

This growth in product choice offers plan sponsors the flexibility to select the most appropriate type of TDF for their particular plan needs. The wide range of different investment manager approaches to asset allocation, portfolio construction and glide path end date, however, all have significant implications for each TDF’s specific risk/reward characteristics and expected potential retirement outcomes. This can result in dramatically different individual participant investment experiences, depending on which TDF the plan decides to offer.

Given this degree of complexity and broad variance in fundamental TDF design, the DOL guidance provides welcome insight into strategy evaluation and selection.

1 Strategic Insight; as of February 2017.
Reviewing the DOL’s TDF tips for plan fiduciaries

▶ Establish a process for comparing and selecting TDFs

**Summary**
- Engage in an objective process that obtains information to evaluate the prudence of any plan investment option
- Review TDF information such as performance, fees and expenses
- Consider how a TDF’s characteristics align with participant traits, such as ages, likely retirement dates, defined benefit plan participation, salary levels, turnover rates, contribution rates and withdrawal patterns

**How this might apply to your plan**
- A starting point for this process is to determine what the plan hopes to achieve with its TDF.
- Outline the specifics about how the plan expects to accomplish these goals
- Understand how these objectives link to the critical components of TDF design and resulting retirement outcomes
- Recognize that failing to define the plan’s goals creates the risk of selecting a TDF that may not be designed to deliver expected results or that potentially backs participants into outcomes or consequences they may not expect

**ACTION:** Evaluate how the TDF aligns with your plan’s goals.

▶ Establish a process for the periodic review of selected TDFs

**Summary**
- Review plan investment options periodically to ensure that they should continue to be offered
- Consider any significant changes in the TDF, such as management team, investment strategy or ability to perform
- Evaluate if the plan’s TDF goals have changed

**How this might apply to your plan**
- Some changes that require periodic monitoring are easy to identify; others are more subtle but equally important to long-term investment success.
- Review participant population shifts or plan design changes that may warrant a new TDF approach
- Consider how cyclical and secular market changes may affect a TDF’s returns
- Evaluate if the TDF is constructed to weather shifting market cycles as well as participant life changes

**ACTION:** Consistently evaluate the TDF’s team, strategy and performance, and periodically review if these continue to align with your plan’s goals.

▶ Understand the fund’s investments: The allocation to different asset classes (stocks, bonds, cash), individual investments, and how these will change over time

**Summary**
- Read the TDF’s prospectus or offering materials
- Understand the principal strategies and risks of the TDF and any underlying asset classes and investments that it may hold
- Evaluate the TDF’s glide path and if it reaches its most conservative asset allocation at or after its target date
- Review how the TDF’s exposure to more volatile assets after its target date aligns with participant withdrawal patterns

**How this might apply to your plan**
- A TDF’s asset allocation and glide path are likely to be the most critical components of long-term performance.
- Understand the factors that shape TDF investment characteristics and outcome potential
- Review asset class diversification and glide path end date, particularly in terms of equity exposure and expected returns and volatility
- Analyze asset allocation and glide path first, then consider fees and underlying funds

**ACTION:** Evaluate if the TDF’s asset allocation and glide path align with your plan’s goals, including any potential benefits, limitations and risks.
Review the fund’s fees and investment expenses

Summary

- Consider variations in TDF costs, both in amount and type; even small differences can have a serious impact on reducing long-term retirement savings
- Understand overall costs, including fees and expenses, for both the TDF and the underlying funds, as well as any sales loads
- Ask what services and expenses make up the difference if the expense ratios of the individual component funds are substantially less than the overall TDF
- Evaluate if these costs are justified in terms of improved performance

How this might apply to your plan

Prudent TDF cost and risk decisions should be made in the context of what the plan hopes to achieve.

- Understand overall costs and fee transparency at four general levels:
  1. underlying fund fees (also called acquired fund fees)
  2. glide path management fees
  3. administrative costs
  4. shareholder service fees
- Analyze cost/benefits to identify if an added expense offers significant value
- Ensure performance comparisons are net of all fees

ACTION: Evaluate all TDF costs and determine if these fees and expenses provide appropriate value based on your plan’s goals.

Inquire about whether a custom or non-proprietary TDF would be a better fit for your plan

Summary

- Consider if a custom TDF provides benefits by incorporating the plan’s existing core funds into the TDF
- Evaluate diversification advantages of non-proprietary TDFs that include component funds that are managed by fund managers other than the TDF provider
- Weigh cost and administrative tasks involved in creating a custom or non-proprietary TDF against these potential benefits

How this might apply to your plan

Developing a custom TDF solution may seem to be an intuitively smart choice, but managing underlying strategy risk is ultimately about effective due diligence, regardless of whether the TDF manager is researching third-party or proprietary strategies.

- Understand the full responsibilities and potential benefits and challenges of a custom TDF
- Evaluate if the broader number of investment manager brands in the TDF actually translates into less risk and/or higher returns on a consistent basis
- Keep in mind that investment provider diversification is not required
- Consider important factors that may make the due diligence process of a custom series of TDFs more difficult (e.g., individual compliance and operational reviews for each third-party provider, in addition to investment reviews)
- Remember that successful portfolio construction is more nuanced than simply identifying top-performing funds; it requires knowledge of each strategy’s additive benefits as it interacts with other TDF holdings

ACTION: Ask the TDF provider whether it offers custom or non-proprietary TDFs and if it can provide insights to help you determine if either of these options makes sense for your plan.
Develop effective employee communications

**Summary**

- Plan for employees to receive appropriate information about TDFs in general, the use of TDFs as a retirement investment option and the plan’s specific TDF offering
- Outline TDF basics to employees
- Distribute disclosures required by law, including greater detail about plan and investment option fees and expenses, as well as risk considerations

**How this might apply to your plan**

Many employees simply do not read plan communications. Strategies that overcome this challenge can help participants set realistic goals and determine if they are suited for the TDF.

- Work with a TDF provider that understands participant behaviors and real-world retirement plan usage
- Evaluate how participants learn and invest when developing communications
- Consider how communications may work with other strategies to help drive constructive behavior

**ACTION:** Evaluate the TDF provider’s direct experience with participants in addition to its investment management.

Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection

**Summary**

- Benefit from commercially available sources of information and services to assist in the decision-making and review process

**How this might apply to your plan**

Systematically including objective analysis can help ensure that the TDF continues to be an appropriate choice.

- Select from a number of third-party services that research and evaluate the TDF marketplace
- Include value-added programs and services offered by many TDF providers that may also be useful in your analysis

**ACTION:** Utilize a wide range of services to help strengthen your TDF review process.

Document the process

**Summary**

- Document the selection and review process
- Detail how decisions about individual investment options are reached

**How this might apply to your plan**

Carefully documenting the plan’s evaluation criteria is critical to addressing investment suitability and fiduciary responsibilities.

- Document key areas such as individual duties, plan goals, risk/reward profile, investment policy statement, due diligence, costs and ongoing monitoring efforts
- Incorporate ongoing educational programs to keep the investment committee informed about evolving TDF considerations
- Periodically review your plan’s evaluation criteria

**ACTION:** Detail your evaluation process and any education efforts that can help you make more informed TDF decisions.
TARGET DATE FUNDS

Deciding which TDF is right for your plan

J.P. Morgan offers plan fiduciaries and their advisors access to industry-leading TDF education and evaluation resources. For more information about these programs and services, please contact your J.P. Morgan representative or visit www.jpmorganfunds.com/ri.

Target Date Compass™
This is an industry-leading target date fund evaluation tool that provides a process for evaluating and selecting target date funds. The program:
• Provides objective and unbiased analysis that can be easily incorporated into investment policy statements
• Helps plan sponsors document their decision-making process around QDIA choices
• Helps plan sponsors meet their fiduciary obligations
• Facilitates important discussions about plan objectives, risk tolerance, demographics and anticipated participant behaviors

Custom or off-the-shelf target date strategies?
This paper looks into key considerations that plan sponsors should be thinking about when deciding whether a custom or off-the-shelf TDF is the better fit for their plan. It includes key resources for evaluating custom strategies, including:
• a list of legal considerations
• a checklist to help determine if a custom strategy is right for a plan
• questions to ask a provider

Ready! Fire! Aim? research series*
This ongoing research looks into participant behavior patterns and how different TDF designs may stand up to the stresses of real-life DC plan saving and investing. The research analyzes:
• How cash flow volatility and market volatility interact to help, and hinder, retirement funding success
• Saving and investment patterns of approximately 2.2 million participants from more than 400 DC plans
• Potential outcomes of four common TDF designs, based on real-world participant usage trends and actual funds in the marketplace

Off balance: The unintended consequences of prioritizing one risk in a target date fund*
This research focuses on analyzing the risks inherent in managing portfolios for an extended time frame, specifically focused on evaluating the risk management approaches utilized by different target date funds, all of which have a 40+ year time horizon. The research analyzes:
• Risk/reward trade-offs that come when a target date fund manager focuses on one specific risk rather than managing risks dynamically
• Differences in glide path design that may enhance or detract from expected retirement outcomes
• Potential outcomes of common TDF designs, based on risk management approaches and actual funds in the marketplace

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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.

Target Date Compass U.S. Patents No. 8,255,308; 8,386,361 and patent(s) pending.

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