Target date funds: Low fee does not equal low risk

Three reasons passive target date funds aren't automatically the safer choice for DC plan fiduciaries

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Passive target date funds (TDFs) continue to be a popular choice for many defined contribution (DC) plans, a choice often driven by the generally lower fees associated with these types of portfolios. It intuitively may feel like "lower cost" naturally translates into a more prudent option for plan participants. However, the reality is that this may not always be the case, particularly for a complex age-based, multi-asset-class solution such as a TDF, which entails many moving parts that collectively help determine long-term investment outcome potential.

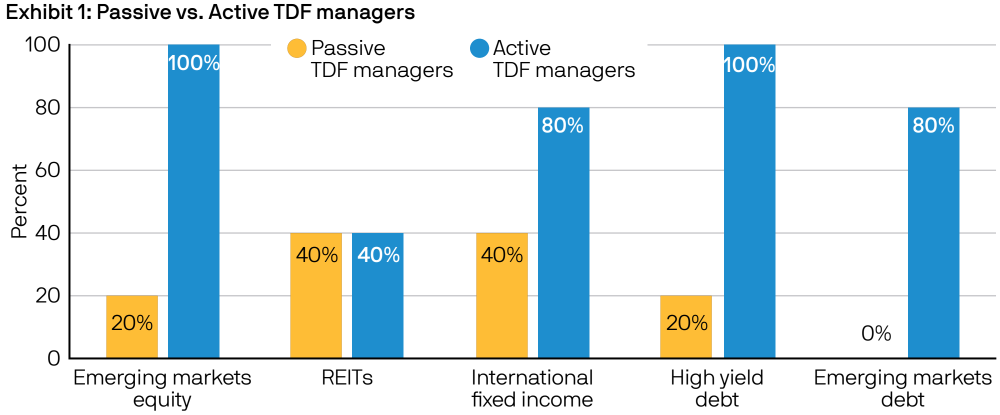
Further, the term "passive TDF" is a bit of a misnomer. *All* TDFs are actively managed strategies when it comes to the most significant determinants of participant experience, such as manager decisions around the level of asset class diversification, glide path design, underlying investment strategy selection and portfolio construction. "Passive" only refers to the underlying strategies used to populate these TDFs' glide paths.

By limiting underlying investments to lower cost index funds, these TDFs typically are less expensive compared with portfolios that include actively managed underlying strategies or a blend of active and passive investments. However, this also can back them into potentially limiting diversification and glide path decisions that may lower participant outcome potential.

For example, there is a range of asset classes—from high yield bonds to real estate, to name a few—that have proven to be difficult or more expensive to replicate as passive strategies but which historically have been extremely additive to long-term performance outcomes from both enhanced alpha and effective risk reduction perspectives. Therefore, passive target date fund strategies tend to exclude these asset classes, as they are more difficult to replicate in an efficient manner (**Exhibit 1**).

Most passive players are less diversified

Exhibit 1: Passive vs. Active TDF managers



Source: Morningstar; data as of December 31, 2022. Active managers defined as those with 75%+ actively managed underlying funds; passive managers defined as those with 75%+ passively managed underlying funds. Top five largest active/passive target date fund series as measured by AUM.

Taking these types of considerations into account, plan fiduciaries should not be lured into a false sense of security that simply selecting a passive TDF automatically lowers their fiduciary risk, nor is it always the better choice for plan participants. Below are three reasons.

1. A new market cycle is emerging

The 10 years prior to 2022 were particularly well suited to passive TDFs. These strategies tend to focus on traditional equities as their primary return engines, particularly large cap securities, which generally delivered historically impressive returns across that period, buoyed by zero to negative interest rate policies around the world.

However, 2022 saw that cycle begin to change, as rates began to normalize. Broad stock indices suffered their worst declines in years. J.P. Morgan's Long-Term Capital Market Assumptions now forecast asset returns to move close to their long-term equilibrium looking ahead. This type of investment climate typically can place greater importance on correlation diversification to expand return potential and strengthen risk-adjusted performance.

In addition, indexing in fixed income is different from that in equities. While the S&P 500 Index captures more than 80% of the U.S. stock market, bond indices are less reflective of the markets they seek to emulate. The Bloomberg US Aggregate Bond Index captures only 49% of the U.S. bond market. It also is highly concentrated in U.S. Treasuries and agency mortgage-backed securities, which represent nearly 70% of its underlying assets (**Exhibit 2**). The index's rule-based construction, designed in the 1980s, excludes many investment grade securities that are now often part of modern, well-diversified portfolios, including certain agency mortgage securities, most asset-backed securities and approximately 40% of all corporate bonds. As a result, relying only on the index for a TDF's investment grade fixed income exposure may potentially result in notable opportunity costs and elevated volatility exposures, especially in more challenging investment environments.

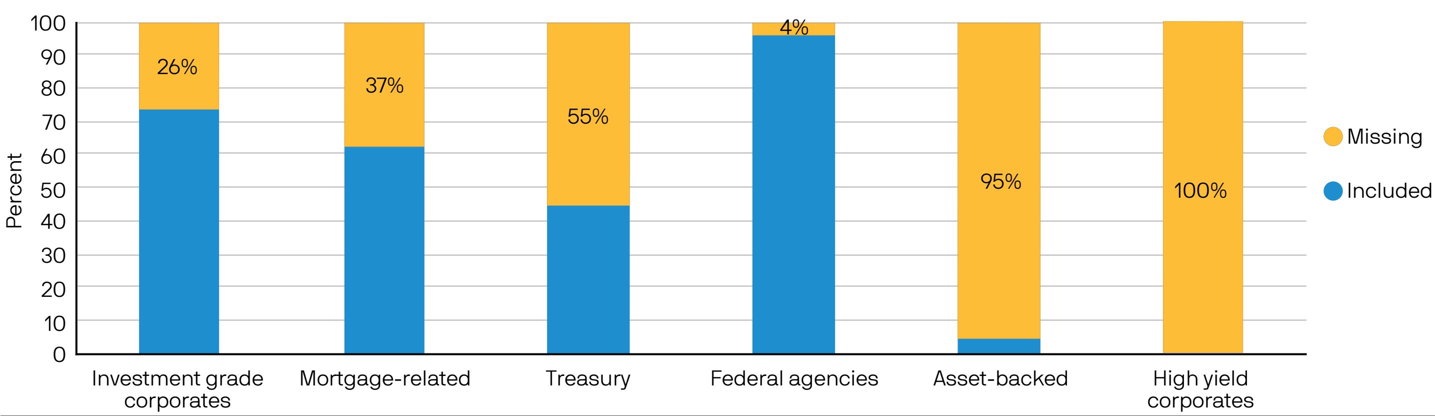
With these factors in mind, passive TDFs may be at an inherent disadvantage in the new market cycle ahead, given their usually lower levels of asset class diversification and heavier reliance on broad market returns. Consider the vastly different experiences participants may have had in the generally rising equity period between 2009 and 2019 vs. the volatile performance of 2008, 2020 and 2022, or the extreme peaks and troughs that ultimately led, in essence, to flat market returns between 2001 and 2008. From a fiduciary perspective, the key is to look for a carefully designed TDF strategy that is positioned to navigate—consistently and effectively—the broadest range of market cycles possible.

2. The DC litigation landscape is evolving

Lawsuits against DC plan sponsors are nothing new. In the past, most have tended to focus on excessive fees. Plan sponsors have been more inclined generally to settle rather than spend the time and resources to see a case through court. That is starting to change. Plan sponsors have been increasingly successful in these court challenges.

Indexed core bond strategies may miss more than 50% of the overall market

Exhibit 2: U.S. core bond market and portion captured by Bloomberg US Aggregate Bond Index



Source: Bloomberg, J.P. Morgan Asset Management; data as of December 31, 2021; data represents Bloomberg US Aggregate Bond Index.

The majority of suits now involve TDFs, and plan sponsors are more frequently choosing to defend themselves in court. In addition, performance, as well as the potential for performance, is beginning to emerge as a theme.

Recent cases emphasized performance over fees:

Lower fee vs. higher returns

Plaintiffs in 11 lawsuits against various plan sponsors all using the same passive TDF for a qualified default investment alternative (QDIA) are arguing that the plan sponsors focused on low fees in strategy selection without considering the funds' ability to generate returns (cases still pending).

Focus on longer-term returns

An appellate court decision in another case confirmed that TDF returns should be viewed in the context of long-term performance and outcome potential. The court rejected plaintiffs' claim that recent underperformance of the plan's active TDF series relative to passive options indicated imprudent strategy selection and monitoring. According to the decision, "merely pointing to another investment that has performed better in a five-year snapshot of the lifespan of a fund that is supposed to grow for fifty years does not suffice to plausibly plead an imprudent decision—largely a process-based inquiry—that breaches a fiduciary duty."

This ruling highlights the importance of looking deeper into investment performance beyond recent one-, three- and five-year returns when evaluating an investment strategy. This is especially true when considering a multi-asset-class solution that is designed to deliver participants to safer retirement outcomes over a career-spanning investment horizon, which is likely to experience a broad range of market and economic cycles and potential investor savings and withdrawal patterns.

3. The best fiduciary protection is a well-defined selection and review process

When it comes to prudent TDF selection, it's not just about price—it's about process. The Department of Labor's eight tips for TDF evaluation continue to offer important guidance for plan fiduciaries:

1. Establish a process for comparing and selecting TDFs.
2. Establish a process for the periodic review of selected TDFs.
3. Understand the fund's investments: the allocation to different asset classes and individual investments, and how these will change over time.
4. Review the fund's fees and investment expenses.
5. Inquire about whether a custom or nonproprietary TDF would be a better fit for your plan.
6. Develop effective employee communications.
7. Take advantage of available sources of information to evaluate the TDF and recommendations you received regarding the TDF selection.
8. Document the process.

Fees, of course, offer a straightforward, easily quantifiable comparison factor, whereas the other guidance factors are more qualitative in nature. However, focusing on fees to dominate the evaluation process does not eliminate the other evaluation standards. Rather, it may risk leading to selection decisions that might not fully integrate investment suitability and fiduciary responsibilities based on the plan's goals and participant needs.

Conclusion

While simply choosing a lower cost, passive TDF may seem like the easy choice, it does not lower a plan's fiduciary risk on its own. It also does not eliminate plan fiduciaries' due diligence and monitoring requirements.

Focus on long-term results

- **Fees are an important consideration but far from the only one:** More important criteria include glide path design, the rationale for selecting specific asset classes and underlying investment strategies, and how these decisions position the overall strategy to perform in various market cycles.
- **Consider investment value as well as cost:** Evaluate TDF fees in the context of a strategy's net returns over the long term, as well as in shorter-term market environments, especially during challenging periods. Does the cost justify the investment value?

- **It's not just about returns—it's about outcomes:** Consider how the TDF is likely to affect participants' investment experience. Is it designed to help position as many as possible for retirement success, across a wide range of investment scenarios?

Also, what is the process for deciding to use actively or passively managed strategies across the various asset classes available in the plan? Is it the same for both the investment menu lineup and the qualified default investment alternative (QDIA)? How does this process align with how plan fiduciaries may be managing defined benefit plan or endowment assets? If there are notable differences, why?

And lastly, remember that the passive/active decision is no longer an either/or choice. Many TDF providers are now integrating components of both into their underlying investment strategies, typically using passive investments for asset classes that are easier to index, to help manage fees, while also including potentially additive actively managed investments for those that are not. What remains most important is to select a TDF that is well aligned with your plan's objectives and demographics.

Next steps

For more information, please contact your J.P. Morgan Client Advisor.

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