

# THE ASPPA Journal

ASPPA's Quarterly Journal for Actuaries, Consultants, Administrators and Other Retirement Plan Professionals

## Chart a Path to Target Date Fund Selection with a Fiduciary Process

by Glenn A. Dial

Since last year's market downturn, when many investors close to retirement experienced steep losses, target date funds have come under scrutiny, leading many decision-makers to question their selection.

Amid the controversy, one key theme has emerged: the importance of an effective fiduciary process that allows decision-makers to identify the target date funds that are appropriately aligned with the goals and needs of the plan, as well as the behavior of the plan's participants.

**T**o evaluate target date funds properly, decision makers should connect the plan's goals and objectives to the appropriate target date philosophy.

Using a process to properly assess different target date fund "philosophies"—particularly the funds' underlying asset classes and exposure to equities near retirement—is necessary because sponsors have significant views on appropriate levels of risk that they're willing to take with their program, as well as a preferred level of diversification. If target date fund selection is not appropriately aligned with these views, sponsors may unintentionally expose participants to higher than necessary levels of risk that can affect eventual outcomes—a point clearly demonstrated during the most recent market downturn.

### What are Target Date Funds?

Target date funds include a target retirement date that represents the approximate point in time 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 date. The principal value of the fund(s) is not guaranteed at any time, including at the target date.



### Target Date Selection: No "Apples to Apples" Comparison

Evaluating the differences among target date fund strategies, however, can be challenging for decision-makers. Target date funds have different "philosophies." Unlike traditional funds, which fall into categories according to market cap or style (large, mid and small cap, value, core and growth), target date strategies are actually asset allocation strategies that cannot be categorized within a Morningstar style box.

*Sponsors can help participants achieve retirement savings goals by comparing fund glide paths and determining the appropriate level of risk exposure for participants as they approach retirement.*

Even the industry's previous efforts to categorize or "name" these funds according to date—2010 Funds, as an example—may have been confusing for many decision-makers; among the entire category of 2010 strategies, the underlying asset allocation strategies and level of equity exposure can vary dramatically.

### A Fiduciary Process Ensures Appropriate Selection

The author recommends a documented process that can help fiduciaries effectively evaluate the most appropriate funds for their plans and their participants.

#### Defining plan goals and participant needs.

Start by determining the plan's objective in relation to participants' account balances; is it to minimize downside risk and the effects of market volatility at retirement, or to maximize participants' savings through their lifetimes? This decision will determine the level of equity allocation in the five to ten-year periods prior to retirement—a critical factor to achieving projected outcomes.

#### Analyzing participants' behaviors and workplace demographics.

Participants' savings and investment behavior—including the frequency with which they take loans, the amount of their contributions and levels of their withdrawals—can also impact the volatility their investments experience. Does the plan consist of participants' with ideal savings behaviors, or those with erratic or less than ideal behaviors when it comes to saving and investing? This determination will influence whether the appropriate philosophy should be to focus on managing the downside risk of the investment selection, or on maximizing upside return potential. These are two extremes, but ultimately there will be a bias in either direction.

#### Defining the plan's approach to participants' risk tolerance.

Glide paths can differ widely among funds, even in the crucial five to ten-year period leading up to target retirement date; the level of equity among the 45 or so 2010 mutual funds varies anywhere from 20% to 65%. Sponsors can help participants achieve retirement savings goals by comparing fund glide paths and determining the appropriate level of risk exposure for participants as they approach retirement.

#### Determining the role, and appropriate level of diversification.

Sponsors will need to understand the trade-offs between maximizing returns versus managing volatility—particularly during the five to ten-year period prior to retirement—by considering solutions that may be effective at achieving comparable returns while minimizing excess volatility approaching participants' retirement. Depending on their goals, they will need to assess their preferences for a more limited approach to diversification—or a desire to access a broader opportunity set that incorporates extended and alternative asset classes in an attempt to generate appropriate risk-adjusted returns.

#### Analyzing and comparing specific fund families.

Having narrowed the number of target date funds to a smaller list that is more closely aligned with the particular needs and goals of the plan and its participants, the plan's fiduciaries can then engage in the traditional quantitative and qualitative investment analysis. By comparing target date funds whose approaches most closely align with their preferences, fiduciaries are better prepared to select a particular suite of target date funds.

#### Evaluation Tools Can Provide a Framework for Target Date Fund Selection

Advisors can play key roles in helping their plan sponsor-clients evaluate the appropriate target date funds and fulfill fiduciary obligations with tools that provide an evaluation framework to guide sponsors through the process of assessing and documenting their plans' goals and objectives and determining which target date funds are best aligned with those views.

Ideally, the most effective tools consist of an evaluation framework that includes dialogue and questions designed to help decision makers assess plan goals, participants' behaviors and preferences on risk and diversification. Based on their answers to these questions, sponsors are guided to the appropriate target date types. One such methodology uses a "compass" consisting of four quadrants corresponding to different target date types. Once they are "plotted" within one of the four quadrants, sponsors can compare the appropriate funds and narrow their selection to those funds most closely aligned with plan goals.

Recognizing that plan sponsors have varying views on their plan's goals, objectives and participant dynamics, target date evaluation tools should be designed to provide decision makers with an objective framework and view of the target




date mutual fund universe to help them identify funds that best align with their needs. For example, when using the “compass method,” plan sponsors who place themselves in the northwest quadrant of the compass will find themselves sharing a similar philosophy to those target date funds falling in the northwest quadrant. In contrast to the other quadrants, which have either or both higher equity exposure at retirement and less diversification, funds in the northwest quadrant of the compass are designed to manage downside risk at the point of retirement (*i.e.*, manage to retirement) and employ broader diversification with the goal of potentially increasing risk-adjusted returns—usually through diversification to extended asset classes. The funds in the northwest quadrant of the compass also align closely with the behavior of more than 80% of participants who begin lump sum withdrawals from their savings plans when they retire.<sup>1</sup>

### Rely on a Process to Help Ensure Optimal Outcomes

Up until now, many decision-makers have focused on making target date selection decisions based on quantitative factors such as the performance and fees of funds on the recordkeepers’ platform. Yet, last year’s market downturn emphasized the importance of going beyond those factors to a more holistic approach—including a fiduciary process and evaluation framework—that takes into account the goals and objectives of the plan, specifically its approach to risk and asset class diversification. This process can help ensure the appropriate selection of target date funds and may

also help ensure optimal numbers of participants cross the retirement “finish line.”

If decision-makers fail to utilize a fiduciary process and appropriate evaluation framework to express the plan’s and participants’ views, sponsors may continue to expose participants to significant losses, particularly at the crucial point when they need these assets the most—the five to ten-year period leading to retirement. 



*Glenn A. Dial is vice president at J.P. Morgan Asset Management, which provides the Target Date Compass tool for evaluation of target date funds. Glenn is a member in the firm’s Investment Only-Defined Contribution (IODC) distribution channel.*

*An employee since 2006, Glenn covers sales management responsibilities for IODC wholesalers. Before joining the firm, Glenn held senior management positions with Merrill Lynch, Ceridian and ADP. He has been in the retirement plan industry since 1989 and speaks extensively at national retirement plan venues such as ASPPA, SPARK, Pension and Investments and Center for Due Diligence. Glenn holds an Accredited Investment Fiduciary (AIF) designation from the Center for Fiduciary Studies, a PLANSPONSOR Retirement Professional (PRP) from PLANSPONSOR Institute and FINRA Series 7, 26 and 63 licenses. ([glenn.a.dial@jpmorgan.com](mailto:glenn.a.dial@jpmorgan.com))*

**IRS Circular 230 Disclosure:** JPMorgan Chase & Co. and its affiliates do not provide tax advice. Accordingly, any discussion of US tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with JPMorgan Chase & Co. of any of the matters addressed herein or for the purpose of avoiding US tax-related penalties.



<sup>1</sup> Source: DSG study, Capturing and Retaining Rollover Assets at the Retirement Inflection Point, July 2008