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Retirement Report

NEWS AND UPDATES FOR PLAN SPONSORS AND FIDUCIARIES OF DEFINED CONTRIBUTION PLANS

Target Date Fund Analysis

Though extremely useful, target date funds (TDFs) have always presented challenges in the retirement plan space. They are a series of funds that gradually grow more conservative, exhibiting lower volatility, over time. The year in the fund name is typically the date in which the participant is expected to retire (at age 65). Despite their relatively short existence, target date funds are the most widely used investment in defined contribution plans today. They are offered in over 70% of defined contribution plans with tremendous potential for growth in asset accumulation. These professionally managed portfolios have simplified asset allocation, **yet they are also the most widely misunderstood**, by the plan sponsor (many of whom believe that they are all similar), the participant (whose understanding is “all over the map”), and by novice advisors (who may not have access to the information or analytics necessary to properly evaluate these funds).

We believe that there is potential substantial fiduciary liability exposure in this area, particularly when the next market downturn arrives. This may be a focus of litigation, particularly now that the Department of Labor has spoken to plan sponsor expectations in monitoring and selecting TDFs. Despite the similarity in names (i.e. Retirement 2010 or Target 2010), TDFs exhibit a varying array of approaches and characteristics. For example, in 2008 and 2009, “2010” dated funds experienced losses ranging from -9 to -41 percent. A variance of 32%!

Selecting and monitoring TDFs is a process with many critical underpinnings. The first step is determining the appropriate fit. Should a conservative TDF series be implemented (which exhibits a low exposure to equities near retirement), an aggressive series (higher exposure to equities near retirement), or something in between (moderate TDF series)? When determining suitability at a plan level, it is important to collectively work through a series of questions that can be answered by the plan sponsor with the help of the advisor and recordkeeper. Combining the plan sponsor’s knowledge of the participant base with the statistics provided by the recordkeeper, the appropriate TDF can be selected. It is imperative to first find the right fit for the client before actually evaluating the funds. Note that the principal value of the fund(s) is not guaranteed at any time, including at the target date.

The core underlying components of a mutual fund are crucial to prospective investors, far beyond past returns. It is important to understand the people, process, and philosophy. From there, look at actual numbers to explain why or how a manager was able to achieve returns. TDFs present a conundrum, so much so that they are gaining attention from the DOL. Selection and monitoring strategies vary greatly. Be sure to create an apples to apples comparison between the funds. Since all “2010” funds (for example) are not created equal, it is more appropriate to compare funds based on their level of risk, regardless of the year stated in the fund name.

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Are You On the Right Glide Path?

While the term "glide path" may still be defined by Merriam-Webster as "the proper path of descent for an aircraft preparing to land", those of us in the retirement planning world know it as the path that TDFs take to gradually reduce their equity exposure at and throughout retirement. While aircrafts may have a proper path of descent (as defined by the term), TDFs seem to be all over the board in terms of their glide paths (some are very conservative while others can be pretty aggressive). TDF glide paths vary due to the different assumptions investment managers make regarding life expectancy, accumulated retirement assets, contribution rates, and rates of return.

One size does not fit all, meaning that there is neither a "best" nor a "right" glide path. Since we all have our own unique retirement objectives and glide paths, it is a challenge to select one glide path (product) for a retirement plan. Plan sponsors need to understand the assumptions made for the glide path (product) in their plan to determine if those assumptions are appropriate for their plan participants as a collective whole. The decision requires a good understanding of the plan's demographics. For example, some glide paths glide to a lower equity exposure *at* retirement (typically age 65) while others glide to a lower equity exposure *through* retirement (typically age 85-90). A plan containing participants with well funded participant accounts and participants who typically leave the plan at retirement may be better off with a glide path that glides to a lower equity exposure *at* retirement. So, while it is nice to know that the glide path (to some extent) can be addressed at the plan level, how can participants, as individuals, be sure that they are on the right "glide path"?

For participants, the decision when selecting a TDF from an already pre-determined glide path or set of funds (like a "2030", "2040", "2050", etc.) may be just as complex as it is for plan sponsors selecting the glide path (or, set of funds). While the selected glide path may be appropriate for most plan participants, there may, and will, be cases where the glide path's assumptions don't perfectly match up with participant assumptions. Understanding the assumptions behind the investment strategy may ultimately help a participant decide whether to go with a "2030" fund or the "2040" fund. While participants may not have much input into the particular glide path for the fund options within the plan, with the proper education, they do have the opportunity to fine tune where on the glide path they want to be. Just as a pilot needs to understand how the aircraft works in order to achieve a safe landing, participants and plan sponsors need to have a good understanding of how these funds (and their glide paths) work, so that their glide path to retirement can be a smooth one.

New DOL Guidance on Target Date Funds

The broad variety of different target date fund (TDF) designs can result in dramatically different individual participant investment experiences, depending on which type of strategy a plan decides to offer. Given this complexity, in February 2013, the U.S. Department of Labor issued tips on TDF selection that provide welcome insight into TDF evaluation.

The eight starting points shown below will help plan fiduciaries and their advisors begin translating these recommendations into action.

1. Establish a TDF evaluation process.
    - Outline what the plan hopes to achieve with its TDF and the specifics about how it expects to accomplish these goals
    - Understand how these objectives link to the critical components of TDF design and resulting retirement outcomes
2. Establish a process for periodic TDF review.
    - Evaluate overall TDF consistency, as well as any participant population shifts that may warrant a new approach

- Consider how cyclical and secular market shifts may affect a TDF's returns and if the strategy is built to weather market and participant life changes

3. Understand the TDF's investments: the allocation in different asset classes, individual investments and how these will change over time.
   - Understand the factors that shape TDF investment characteristics and potential outcomes
   - Review asset class diversification and glide path end date, particularly in terms of equity exposure and expected returns and volatility
4. Review the TDF's fees and investment expenses.
   - Understand all costs and fee transparency
   - Analyze cost/benefits to identify if an added expense offers significant value
5. Consider if a custom or non-proprietary TDF makes sense for your plan.
   - Evaluate the potential benefits and challenges of a custom TDF
   - 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)
6. Develop effective employee communications.
   - Focus on how participants learn and invest when developing communications and work with a TDF provider that understands real-world behaviors and retirement plan usage
   - Consider how communications may work with other strategies to help drive constructive behavior
7. Take advantage of available TDF information sources.
   - 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
8. Document the process.
   - Detail the plan's evaluation criteria
   - Incorporate ongoing educational programs to keep the investment committee informed about evolving TDF considerations

This article was originally published in J.P. Morgan's *JOURNEY* Summer 2013 edition. Follow this link to access the complete e-magazine of *Journey* or go to www.jpmorganfunds.com/journey.

Socially Responsible funds – Think Green? No. Think Red!

It was a few years ago that the Department of Labor issued guidance reaffirming their position that the goal for investments in ERISA plans (such as 401(k)s and 403(b)s) must be to design investment menus to allow participants to attempt to maximize returns and not for any factor other than the economic interest of the plan. The guidance specifically addressed funds meeting environmental (green) criteria known as socially conscience or socially responsible funds. "The plan's fiduciaries may not simply consider investments solely in green companies. They must consider all investments that meet the plan's prudent financial criteria." This means that there should be no special consideration given to any investment due to its social agenda. The same selection and monitoring process that is utilized for the core investments in the plan's menu must be applied to socially responsible funds. More from the DOL guidance, "…fiduciary consideration of noneconomic factors should be rare and, when considered, should be documented in a manner that demonstrates compliance with ERISA's rigorous fiduciary standards." Furthermore the

DOL indicated that "fiduciaries who rely on factors outside the economic interests of the plan in making investment choices and subsequently find their decision challenged will rarely be able to demonstrate compliance with ERISA absent a written record demonstrating that a contemporaneous economic analysis showed that the investment alternatives were of equal value." In other words, the fact that a fund is socially responsible is not a reason to offer it in a retirement plan. Always use quantitative and qualitative analysis to determine the appropriateness of investments in your plan.

If you have questions or would like more information on this topic please contact your 401(k) Advisors plan consultant or email help@401kadvisors.com.

COMMUNICATION CORNER: Single Most Important Decision

This month's sample employee memo is Part One of a six part series in which we answer the most common questions we receive from participants. In Part One we answer: What is the single most important decision I can make as a retirement plan participant?

As a reminder, we post each monthly participant memo online via the Fiduciary Briefcase™ (401kadvisors.com) in both English and Spanish versions.

Call or email your Plan Consultant if you have questions or need assistance.