Post-Modern Asset Management: The Credit Crisis and Beyond

Target Date Investing

by Anne Lester

J.P.Morgan
Asset Management

Target Date Investing

:: **ANNE LESTER**

IMPACT OF CREDIT CRISIS ON TARGET DATE FUNDS 2008 is memorable for many reasons—the credit crisis, failures of financial services firms, and plunges in asset values among them—but DC plan sponsors and participants are also very conscious of a milestone of another sort: this was the year that the first baby boomer became eligible to collect Social Security.

2008 also capped several years of well-received innovations to DC plan structure, including participant auto-enrollment, contribution auto-escalation, and the designation of Qualified Default Investment Alternatives (QDIAs) such as balanced funds, managed accounts, and target date funds (TDFs).

TDFs are investments that change with the investor's age. They start with an aggressive mix of stocks and bonds, and gradually transition, or glide, to a more conservative asset allocation as the investor approaches retirement. While all TDFs share this general goal of lowering expected volatility as retirement approaches, each TDF manager has developed its own glide path, incorporating higher or lower levels of asset class diversification and higher or lower levels of equity along the glide path.

A major point of difference in TDF approaches is the choice of an end point to the glide path. Most TDF managers assume participants will remain in the TDF beyond the age of retirement, so they continue to reduce volatility after retirement and, consequently, have a relatively high level of equities at the assumed retirement age of 65. Others assume that participants will take their money from the plan at or before the point of retirement, perhaps annuitizing some or all of their balance, and consequently have a fixed allocation after the age of 65 with a lower level of risk.

The very broad differences in approaches are illustrated in Figure 1 on the next page, with asset class diversification ranging from 4 to 12 asset classes, and the percent of equity at retirement ranging from 20% to 70%.

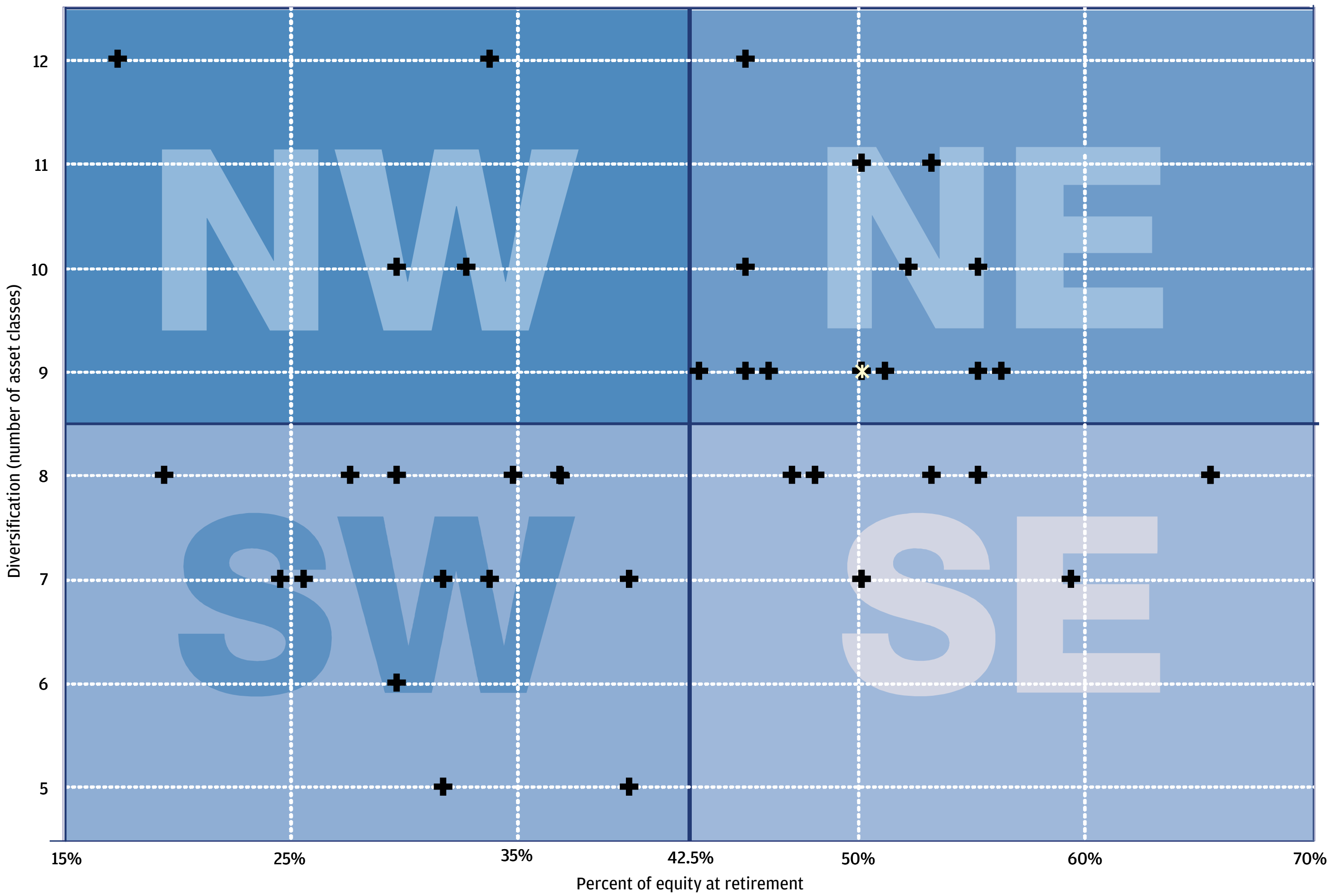
The increasing adoption of TDFs, focus on baby boomer retirement, and dreadful market returns in 2008 have resulted in a number of pointed questions from the media and legislators regarding the effectiveness and appropriateness of TDFs for those approaching retirement. Indeed, the Lipper 2010 Target Date universe (the fund recommended for workers in their 60s who are approaching retirement in or near 2010), had fund returns ranging from -3.61 to -41.84% in 2008. We believe that this wide dispersion in returns, resulting from the large differences in asset class allocation, may force a debate about whether there should be greater consensus around appropriate asset mixes and levels of risk for TDFs targeted to those approaching retirement. Not surprisingly, the strategies which focused on lower volatility at the point of retirement were at the upper end of the performance range for the period.

ARE TARGET DATE FUNDS BROKEN? The basic question—are TDFs broken—may best be asked in two different ways. The first is, "Did investors in 2010 TDFs do better or worse than they would have if they had NOT invested in a TDF?" The second is a more difficult question. "Are TDFs living up to the expectations that plan sponsors and participants had for them?"

We believe that, for the majority of employees in their 50s and 60s, TDFs did a much better job of protecting retirement savings from the brunt of the bear market than participants would have done on their own. An analysis of over 100,000 DC participants on J. P. Morgan's Retirement Plan Services recordkeeping platform who did not have access to TDFs in their plan shows that workers in their 60s had a fairly high allocation to equities on September 30, 2008, just as the dramatic decline in equities was beginning. See Figure 2 on the following page.

The average participant return in this cohort was -32.1%, which is near the bottom quartile of the Lipper universe of 2010 returns. Most TDFs, regardless of their diversification and volatility approach, did better than the average 62-64 year-old investor on their own.

FIGURE 1: TARGET DATE FUNDS—AND THEIR RESULTS—VARY GREATLY



Source: Powered by Lipper, a Thomson Reuters Company. The fund companies displayed in the chart above appear based upon advisor request. Percentage of equity exposure at age 65: Strategic allocation to non-fixed income asset classes at target date, typically age 65. Asset class diversification: Determined by exposure, across each company's suite of target date funds, to 12 separate asset classes as reported to Lipper through asset allocation, capitalization, credit quality, sector, region and country data as well as underlying fund categorization. The 12 asset classes include: Large Cap Equity, Mid Cap Equity, Small Cap Equity, Developed International Equity, Emerging Markets Equity, REITs, Commodities, U.S. Fixed Income, High Yield, TIPS/Inflation, International Fixed Income and Emerging Markets Debt. Please see the Target Date Navigator Methodology booklet for additional information.

Examples like this help to underscore one of the main challenges of fiduciary decision-making—undertaking decisions that are in the best interests of the majority of participants, while recognizing the potential impacts on all participants. We believe that plan sponsors must focus on selecting a QDIA that will provide the best outcome for the majority of participants in the plan, not necessarily the best outcome for every individual investor in the plan.

The second question—are TDFs meeting participant expectations—strikes at the heart of one of the greatest risks in defaulting participants into any investment solution, namely the unspoken assumption that the plan sponsor's choice of default will necessarily allow the worker to achieve retirement income security. Indeed, the Pension Protection Act of 2006 specifically directed the Department of Labor to outline requirements for QDIAs precisely for this reason—the fear that participants would

FIGURE 2: PARTICIPANT SELF-ALLOCATION RESULTS

Age	Average Balance	Equity	Bonds	Cash	Balanced
	9/30/2008	9/30/2008	9/30/2008	9/30/2008	9/30/2008
23	$2,310	70%	7%	2%	22%
28	$10,370	71%	8%	2%	19%
33	$24,935	72%	9%	4%	15%
38	$42,715	72%	10%	5%	13%
43	$63,171	72%	11%	6%	11%
48	$89,992	69%	13%	7%	11%
53	$121,588	66%	16%	8%	10%
58	$156,164	62%	19%	9%	10%
63	$191,.685	58%	23%	11%	8%
65	$198,391	58%	23%	11%	8%

Source: J.P. Morgan Asset Management
The above information is shown for illustrative purposes only. Past performance is not indicative of future results.
Notes: Participant allocations were averaged and then normalized for each average age shown. Participant data is representative of a large plan that has in excess of 100,000 employees, for which J.P. Morgan Retirement Plan Services is the administrator.

be unable to retire because prior default choices (stable value and money market funds) generated insufficient returns to provide for retirement security.

Managing the important tradeoff between protecting principal in stable value and money market funds and generating higher returns in target date funds or other QDIAs is the subject of much debate right now. But often overlooked in the debate about the appropriate level of risk and return in default funds is the crucial role that the savings rate plays. Essentially, the greater the certainty of outcome (and therefore the less risk taken in the equity market), the higher the savings which are required to reach the same expected outcome (because the assumed returns are lower than those from the equity market). We calculate that if DC participants wanted a more certain outcome (investing in stable value), they would have to approximately double their savings rate to generate the same expected outcome than if they invested in a 60/40 balanced fund. And we also know that participants, on average, currently save barely enough to generate income replacement of 40% from their 401(k) savings if they have invested their assets in a typical TDF glide path with relatively high levels of risk for much of the time.[1] The other option, now much discussed, is the need to work past the age of 65.

We believe that the debate about appropriate levels of risk in default funds must also incorporate a discussion of savings. The Defined Contribution plan is merely one component of providing for retirement. The other parts are personal savings, social security and the defined benefit plan (if any). Plan sponsors and service providers must all do a better job of helping individuals understand all components of providing for retirement and articulating the tradeoff between lower risk and the need for higher savings.

DIVERSIFICATION: DID IT HELP OR HURT IN 2008? One of the many unpleasant lessons learned or relearned, in 2008 was that correlations increase with volatility, and many of the assets that TDF managers and other institutional investors included in their portfolios actually underperformed the very asset classes they were supposed to protect investors from. For example,

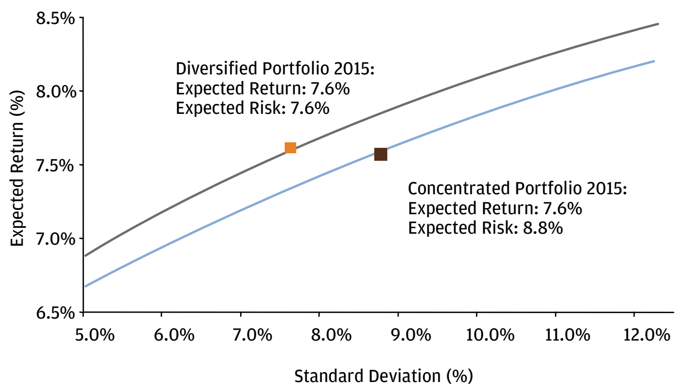
[1] *Ready! Fire! Aim?*, J.P. Morgan Asset Management, October 2007

U.S. small cap equities, international equities, emerging market equities, and REITs all underperformed the S&P 500, and so the more diversification a manager had into these “diversifying” asset classes, the worse the performance. Bond sectors behaved the same way, with high yield, emerging market debt, and TIPS underperforming the Barclays Capital Aggregate index.
So did all TDFs with more diversification do worse than those, typically index funds, with less? Somewhat surprisingly, the answer is no. Diversification moves out the efficient frontier, allowing a manager or sponsor to choose between a portfolio with higher expected returns and the same amount of expected risk, or to choose a portfolio with the same expected return and lower risk than they would have been able to achieve in an undiversified portfolio (See Figure 3). In 2008, managers who chose to use diversification to lower risk did relatively well, especially compared to those who used diversification to try to increase returns.

Put another way, managers who diversified out of ***equities*** and into diversifying assets like high yield, emerging market debt and direct real estate did better than managers with higher equity weightings, but those that diversified out of ***fixed income*** into these same asset classes typically suffered larger losses, as Figure 4 illustrates.

In addition, many plan sponsors are asking whether active management makes sense in TDFs, given the higher fees and greater risk of under-performance. We believe that plan sponsors should first and foremost determine which glide path makes most sense for their participants, and then determine how best to implement that glide path—with active strategies, passive strategies, or some combination of both. Of course in some asset classes like Real Estate, High Yield, and Emerging Markets Debt and Equity, it may be difficult to build index strategies. In others, plan sponsors will have to decide on a case by case basis how much active management they want to maximize net-of-fee risk adjusted returns.

FIGURE 3: DIVERSIFIED AND CONCENTRATED PORTFOLIO EFFICIENT FRONTIER ANALYSIS



- Concentrated Frontier includes:
  - Domestic large and small cap equities
  - International & emerging markets equity
  - U.S. Fixed Income
- Diversified Frontier also includes:
  - U.S. REITs
  - High Yield Fixed Income
  - Emerging Markets Debt
  - Direct Real Estate

Source: J.P. Morgan Capital Market Assumptions. The assumptions are presented for illustrative purposes only. They must not be used, or relied upon, to make investment decisions. The assumptions are not meant to be a representation of, nor should they be interpreted as J.P. Morgan investment recommendations. Allocations, assumptions, and expected returns are not meant to represent any J.P. Morgan portfolio. Please note all information shown is based on assumptions, therefore, exclusive reliance on these assumptions is incomplete and not advised. The assumptions should not be relied upon as a recommendation to invest in any particular asset class. The individual asset class assumptions are not a promise of future performance. Note that these asset class assumptions are passive only; they do not consider the impact of active management.

WHAT CHANGES CAN WE ANTICIPATE GOING FORWARD? To date, there have been relatively few changes in either participant or plan sponsor behavior. Participants, with the exception of those closest to retirement, have continued to make steady contributions into TDFs. We, and other TDF managers, have observed very small withdrawals from funds intended for those closest to retirement (2010, 2015, and to a lesser extent 2020) but we do not know if these withdrawals are due to participants’ decision to move to less risky asset classes overall or whether they have retired or otherwise separated from their plans. Participants appear to be staying the course, perhaps because they are observing the investment outcomes in TDFs and deciding that they still believe that these funds do a better job than the participants could do by themselves.

FIGURE 4: INDEX RETURNS AS OF DECEMBER 31, 2008

Traditional Asset Classes	1 Year	Extended Asset Classes	1 Year
S&P 500	-37.00%	MSCI REIT	-37.97%
Frank Russell 2000	-33.79%	GPR 250 Global ex. U.S.	-50.32%
MSCI EAFE	-43.38%	MSCI EM Free	-53.18%
Barclays Capital Aggregate	5.24%	Barclays Capital Corporate High Yield	-26.16%
Ibbotson U.S. Treasury Bills	1.69%	J. P. Morgan EMBI Global	-10.91%
		Barclays Capital U.S. TIPS	-2.35%
		NCREIF	-6.46%

Source: J. P. Morgan Asset Management. Index returns are shown for the one year period ending December 31, 2008.

In dozens of conversations over the past six months, plan sponsors, too, continue to say that they believe that the changes they have made to their plans over the past few years, such as participant auto-enrollment, contribution auto-escalation, and the designation of QDIAs, should improve results for their participants. We observe greater interest from plan sponsors in understanding exactly how their TDF relates to their overall plan design and objectives, and we hope that one of the results of this very difficult market cycle will be a renewed focus on understanding the consequences of asset allocation choices made by TDF managers. All TDFs are not created equal and different funds will be a better match for different plan sponsors.

To date, TDF managers themselves seem to be making very few changes to their asset allocation glide paths. We believe that managers are reviewing and testing their asset allocation models to see if fundamental assumptions about asset class returns and volatility would drive a different glide path. In the interim, they likely have decided to keep intact their overall weightings to risk assets. However, an important question for the industry would be whether it can find a more efficient way to protect the funds closest to their retirement date against continued negative risk. We will certainly be pursuing this topic in our formal research going forward.

Likewise, we believe that many plan sponsors may be questioning whether the glide path represented by their TDF choice produces their desired risk-adjusted returns. If many plan sponsors are re-assessing their DB asset allocations with a renewed focus on downside risk management, we think it is likely that this should extend to TDFs offered in a DC plan lineup. TDFs using an institutional approach to asset allocation and diversification will, we think, emerge as strategies that will stand up to the rigors and stresses of challenging markets going forward.

:: ANNE LESTER

MANAGING DIRECTOR, is a senior portfolio manager in the Global Multi-Asset Group ("GMAG"), based in New York. Since joining the GMAG in 2000, Anne has been responsible for the firm's defined contribution asset allocation products including the SmartRetirement target-date funds. She is also the portfolio manager for a number of defined benefit plans. An employee since 1992, previously Anne was a fixed income and currency trader and portfolio manager in the Milan office. Anne was awarded a Fulbright Scholarship in 1990 and spent over a year in Tokyo, working for a member of the Japanese Parliament. Prior to that, she worked for the Senate Governmental Affairs Committee. Anne obtained an AB in Politics from Princeton University and an MA in International Economics and Japan studies from the Johns Hopkins University School for Advanced International Studies.

:: CS VENKATAKRISHNAN

MANAGING DIRECTOR, is the head of product management for U.S. Fixed Income. An employee since 1994, Venkat has held positions managing investment functions, product development and research. From 2007-2008 he was Chief Investment Officer for New York Fixed Income. Prior to that role, he was head of New York Fixed Income, responsible for the development and growth of the product line, macro process and research and technology. Venkat was also previously head of Quantitative Research, responsible for research, analytics development, risk management and performance attribution. Venkat holds S.B., S.M. and PhD. degrees from the Massachusetts Institute of Technology.

This essay is part of a compendium of 15 individual articles produced by investment professionals at J.P. Morgan Asset Management. Our purpose was to inform individual and institutional investors on the lessons of the credit crisis with thoughts on the likely consequences for investment management. For a copy of the complete paper, please contact your J.P. Morgan representative, or visit our website at jpmorgan.com/insight.

ABOUT J.P. MORGAN ASSET MANAGEMENT

For more than a century, institutional investors have turned to J.P. Morgan Asset Management to skillfully manage their investment assets. This legacy of trusted partnership has been built on a promise to put client interests ahead of our own, to generate original insight, and to translate that insight into results.

Today, our advice, insight and intellectual capital drive a growing array of innovative strategies that span U.S., international and global opportunities in equity, fixed income, real assets, private equity, hedge funds, infrastructure and asset allocation.

The publication was edited, designed and produced by the institutional asset management marketing department at J.P. Morgan Asset Management.