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From Capital Group

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**Is Passive  
Truly the Safer  
Fiduciary Choice  
for TDFs?**

# Why Passive May Not Be the “Safe” Choice

## Active/Passive in the Target Date Fund Selection Process

- 1 Passive management does not automatically provide inherent fiduciary protection**
- 2 Select active management may lead to better participant outcomes**
- 3 Factors to consider when selecting target date funds**

# Passive Does Not Automatically Provide Fiduciary Protection

Fees are not the only consideration in the selection of a TDF provider

“An unfortunate misconception’ exists among defined contribution (DC) plan fiduciaries that low cost is equivalent to low risk from either a market or a fiduciary perspective, says Jessica Sclafani, associate director at Cerulli ...

‘What is unique to the DC industry is that demand for passive strategies is being driven by the misunderstanding of many plan fiduciaries that choosing passive is a way to offload or mitigate their fiduciary liability.’”

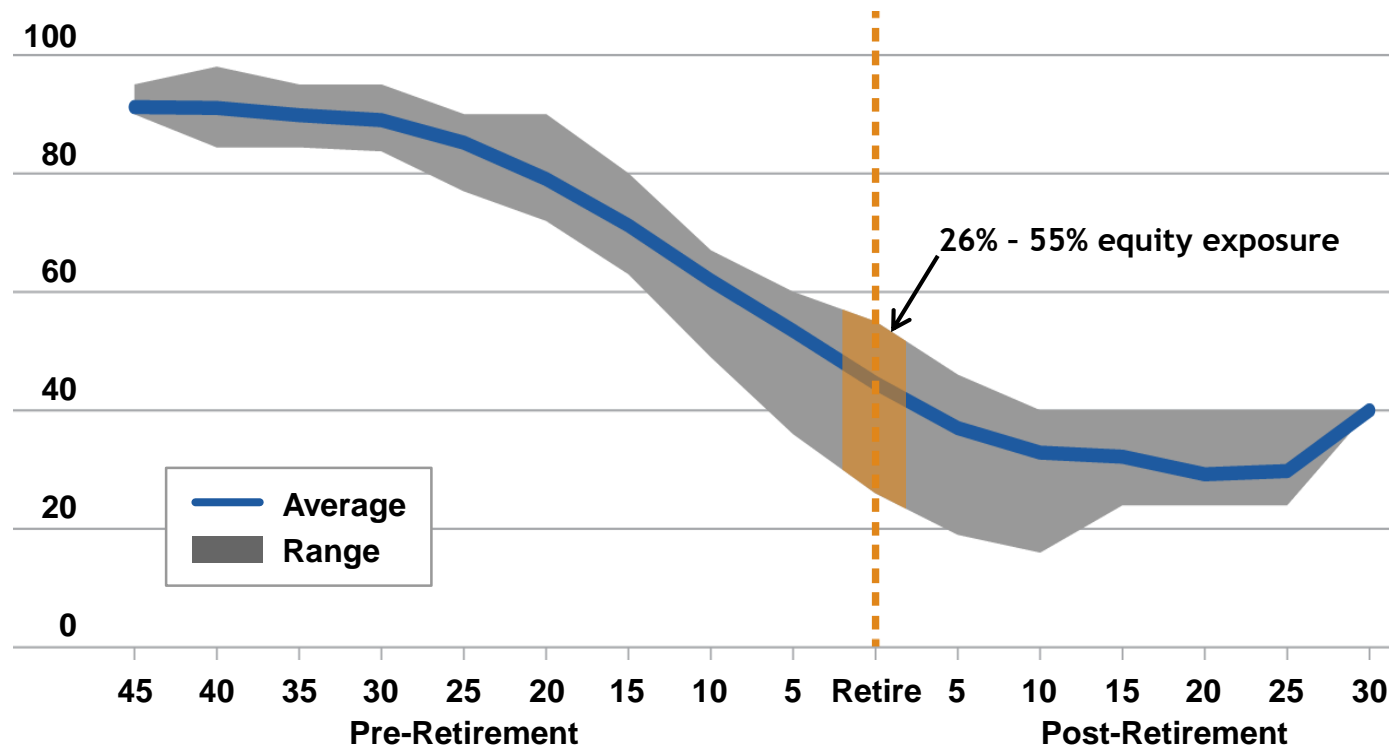
— **PLANSPONSOR** magazine, October 2, 2015

# No Target Date Fund Is Completely Passive

## Glide Path Is an Active Allocation Decision

### Equity Exposure Can Vary Widely in Passive TDFs

Percentage of assets in equity (as of 12/31/14)

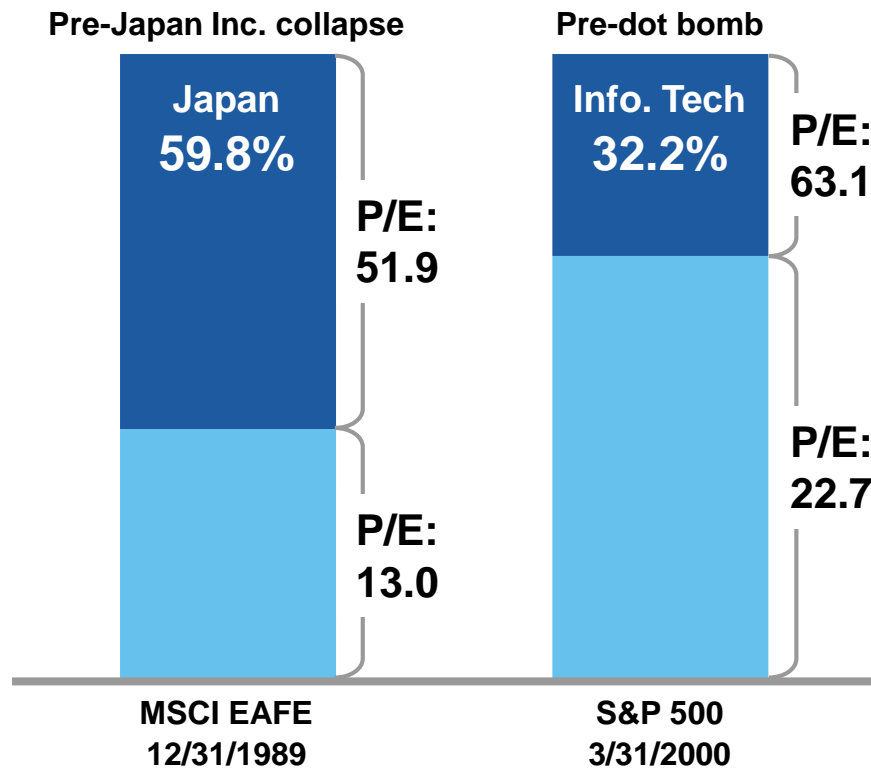


Source: Capital Group, based on Morningstar data. Based on the eight target date series that have a three-year history and no more than 20% of assets actively managed.

# Passive Funds Based on Indexes Can Become Imbalanced

## Active Equity Funds Can Help Mitigate the Risk of Asset Bubbles

**Benchmarks can be skewed toward riskier sectors**  
Geographic and sector weightings of major indexes



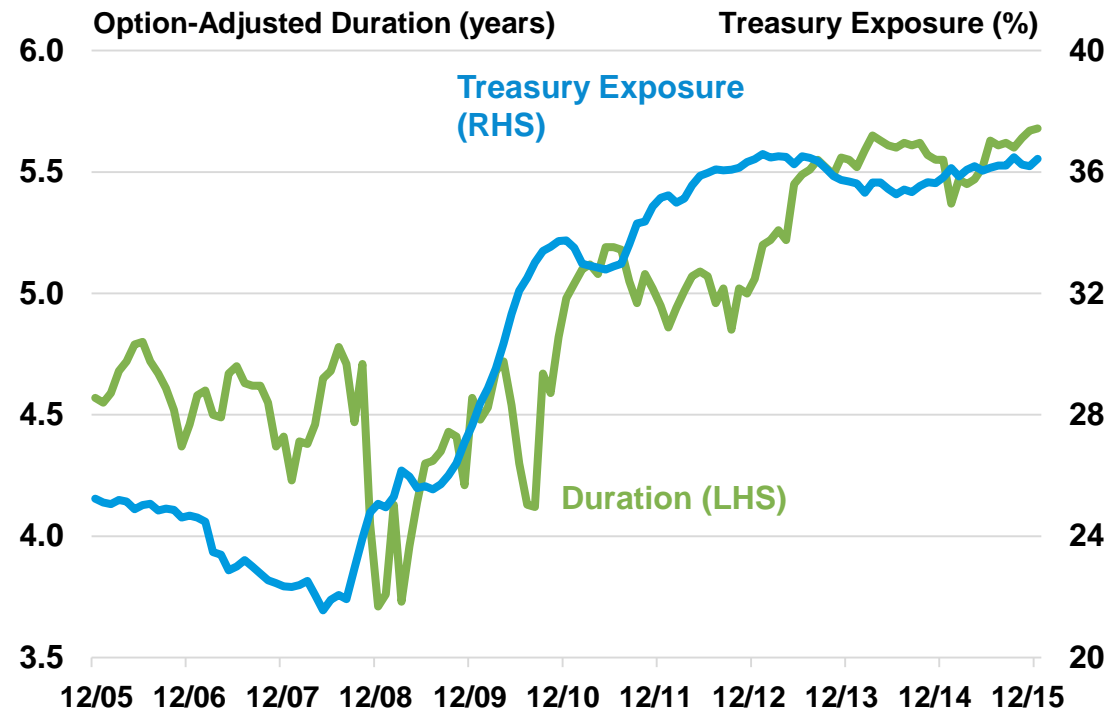
“Cap-weighted index funds by definition have maximum exposure to the most overheated parts of the markets at their absolute peaks.”

— *Morningstar Advisor*, October 5, 2015

# Passive Bond Exposures May Come With Hidden Risks

## Most Passive Bond Fund Managers Can't Adjust with the Market

Duration and U.S. Treasury Exposure of Barclay's U.S. Aggregate Index



The share of the Barclays U.S. Aggregate Index in U.S. Treasuries increased from 25.2% at the end of 2005 to 36.4% in December 2015.

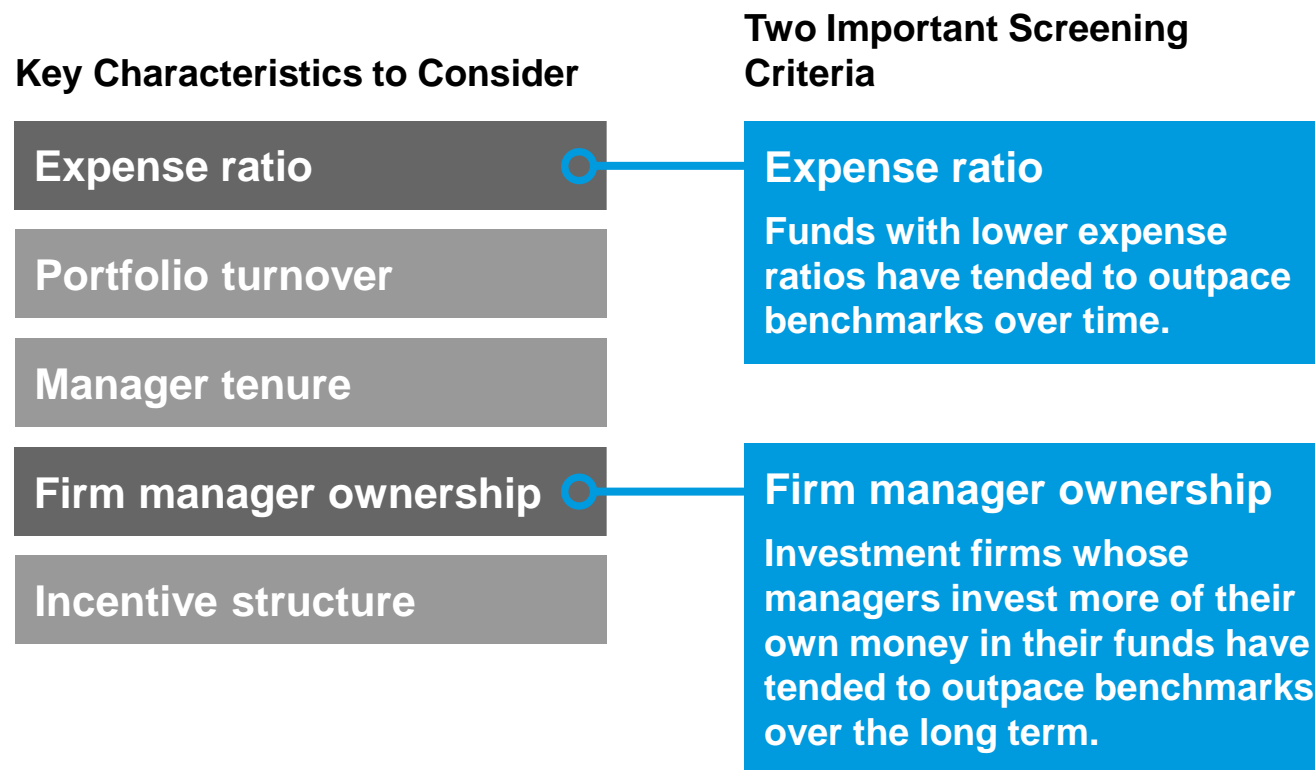
# Questions to Ask About Passive Bond Funds for TDF

## Active Bond Funds Can Potentially Take Index-Differing Positions

- 1 How does the series seek to replicate bond indexes?
- 2 What are the rules of the index?
- 3 What are the index's exposures and how have they changed?
- 4 Which asset classes do the passive bond funds include?

# Two Screens May Help Identify Strong Active Equity

## Two Criteria Made a Meaningful Difference



Source: 2015 Morningstar U.S. Mutual Fund Industry Stewardship Survey, June 26, 2015

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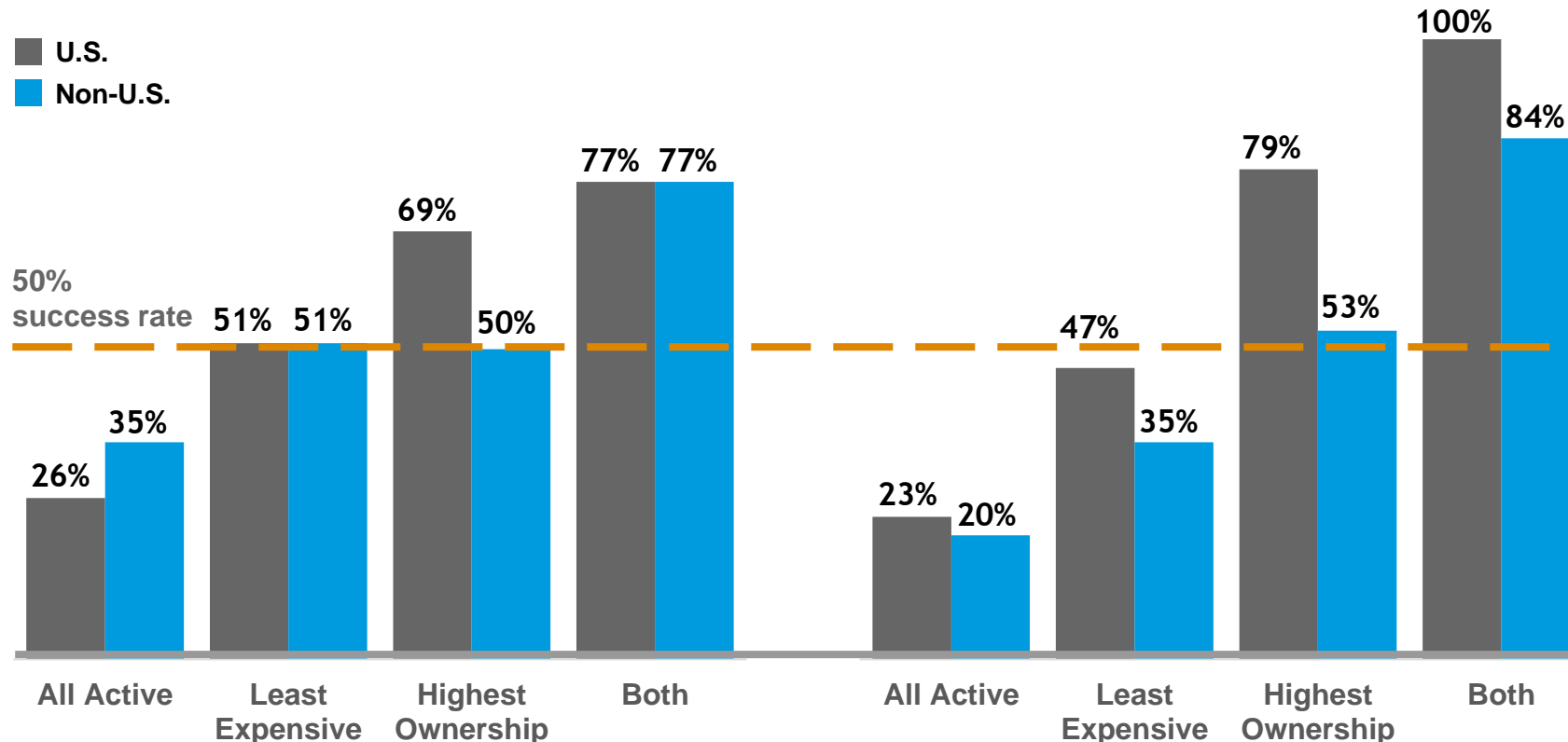


# Active Equity Funds Meeting Two Criteria Have Beaten Indexes

## Percentage of Rolling Periods in Which Large-Cap Funds Outpaced Indexes, Net of Fees

Over rolling 5-year periods

Over rolling 10-year periods



Source: Capital Group, based on Morningstar data. Based on monthly returns from January 1995 to December 2014. U.S. funds are those in the Morningstar Large Value, Large Blend and Large Growth categories. U.S. index is S&P 500. International funds are those in the Morningstar Foreign Large Value, Foreign Large Blend and Foreign Large Growth categories. International index is MSCI ACWI ex USA. The indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index. All distributions are reinvested.

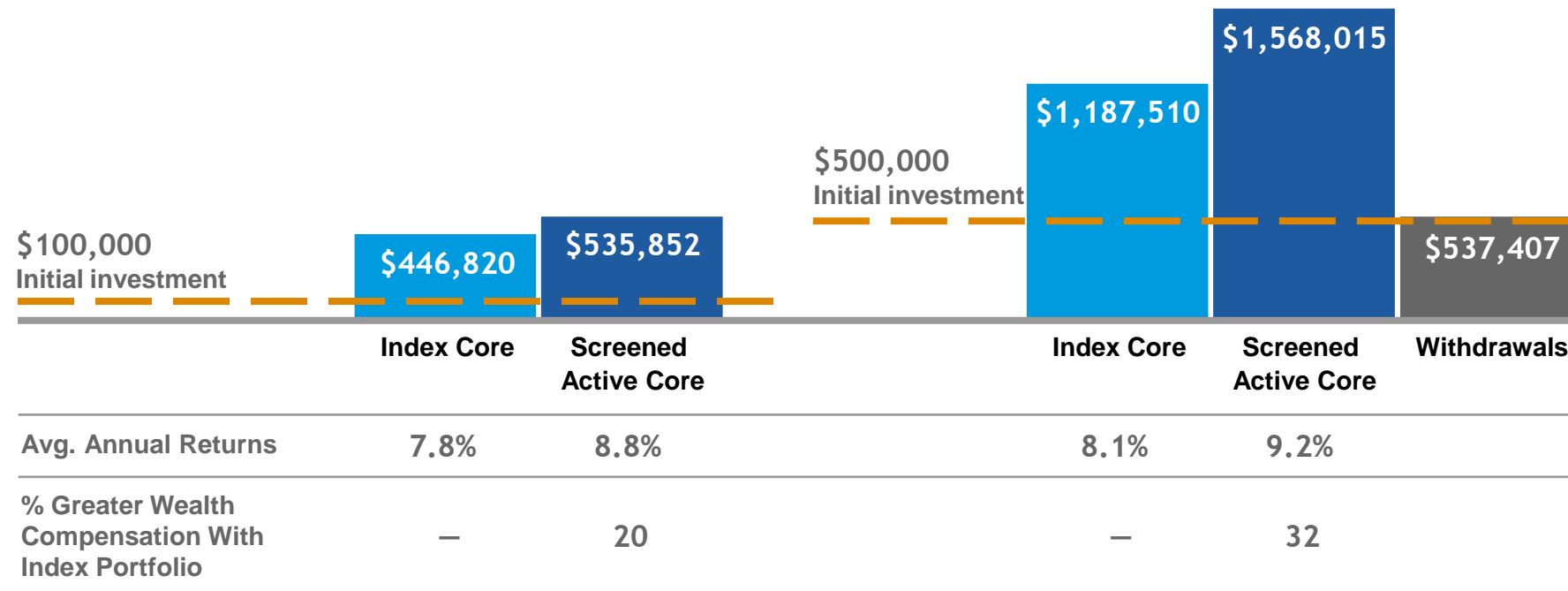
# High Ownership and Low Fees Generated Greater Ending Wealth

## Screened Funds Delivered Greater Wealth in Accumulation and Distribution

### Returns of a Hypothetical 50% U.S. Large Cap/50% Non-U.S. Large Cap Portfolio

Accumulation phase: age 45 to 65

Retirement income phase: age 65 to 85



Source: Capital Group, based on Morningstar data. Hypothetical results are based on monthly returns at net asset value of portfolios from January 1995 to December 2014. Results reflecting a sales charge would have been lower. The index blend portfolio consists of 50% S&P 500 Index and 50% MSCI All Country World Index ex USA. Past results are not predictive of results in future periods. Portfolios were rebalanced monthly. The indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index. Ending values for the 20 years ended December 31, 2014.

# Five Questions When Evaluating Target Date Funds

Questions	Considerations
1 How is the glide path constructed?	<b>All target date funds make active glide path decisions.</b>
2 What are the needs of participants?	<b>Pursuit of above-average returns may help participants reach accumulation goals.</b>
3 What underlying funds are used in the series?	<b>Active, unlike passive, touches all major asset classes.</b>
4 What types of risk does the target date series exhibit?	<b>Active has the flexibility to manage many market risks.</b>
5 How much do participants pay for the funds?	<b>Value received, not fees alone, is what is important.</b>

# Is Passive Truly the Safer Fiduciary Choice for TDFs?

## What We've Learned

- 1 Passive does not have inherently greater fiduciary protection**
- 2 When selecting TDFs, sponsors should evaluate a range of criteria, not just fees**
- 3 Active funds may provide better participant outcomes**

# Next Steps

- 1 **Look in your plans where passive might not be the best fit**
- 2 **Discuss options with plan sponsors**
- 3 **Suggest alternatives based on plan demographics**
- 4 **Hone your own TDF evaluation skills**
- 5 **Contact your American Funds representative**

**Thank you.**

## Important Information

**Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.**

**Statements attributed to an individual represent the opinions of that individual as of the date published and do not necessarily reflect the opinions of Capital Group or its affiliates. This information is intended to highlight issues and not to be comprehensive or to provide advice.**

# Important Information

The database built to represent the universe of both large-cap domestic and large-cap foreign funds drew from Morningstar's U.S. Open-End Large Value, Large Blend and Large Growth U.S. and Foreign categories, with live and dead funds combined. For live funds, only the oldest share class was used. For dead funds with multiple share classes, the median monthly returns were used. If a sales charge had been deducted, results would have been lower. For fee-related illustrations that include dead funds with multiple share classes, the median expense ratios were used. We searched Morningstar's database for large-cap actively managed funds that were in both the lowest quartile ranked by expense ratio and the highest quartile ranked by manager ownership at the firm level. Past results are not predictive of results in future periods.



# Important Information

Least expensive quartile was calculated using annual report net expense ratio (NER) for all observed Morningstar categories for the 20-year period indicated. For funds with missing expense ratios, gaps between two available data points were filled in using linear interpolation. Highest manager ownership quartile was calculated using weighted averages of Morningstar screens of manager holdings at the firm level. Each fund was assigned the weighted average of its firm manager holding. Funds without values were excluded from the quartile rankings. The combination of least expensive NER and highest manager ownership quartiles (the screened active core) was the result of a cross-section of the two screens. Only those funds with both the lowest expense ratios and the highest manager ownership were included. Investors who wish to identify funds that ranked in the top quartile by manager ownership can rely on the following rule of thumb: The top quartile of funds ranked by manager ownership roughly corresponded with firms that had 55% or more assets in the fund family complex in which at least one fund manager had invested a minimum of \$1 million.

# Important Information

MSCI All Country World ex USA Index is designed to measure results of more than 40 developed and emerging equity markets, excluding the United States. Standard and Poor's 500 Composite Index is a market capitalization-weighted index based on the average weighted results of 500 widely held common stocks.

The market indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index. Past results are not predictive of results in future periods.



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