# Managing Defined Contribution Plan Investment Policy Statements

An article by

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Fred Reish is a partner in the Employee Benefits & Executive Compensation Practice Group of Drinker Biddle & Reath LLP. The firm has been compensated by J.P. Morgan Asset Management for providing its insights regarding the topic of investment policy statements.

# Investment policy statements

**While the Employee Retirement Income Security Act** (ERISA) does not explicitly require that retirement plan fiduciaries (for example, committee members) adopt an investment policy statement (IPS), there are important reasons to do so.

- First, ERISA's provisions do require that fiduciaries make investment policy decisions. For example, what investment categories will be included in a defined contribution (DC) line-up? How will the investments be chosen for each of those categories? How will they be monitored and, if necessary, how will investments be removed and replaced? Who will make those decisions? And that is just a partial list of the policy decisions for plan committees.
- Second, the Department of Labor says that fiduciaries need to retain the documents supporting their decisions. What criteria did the committee apply to selecting and monitoring a plan's investments? What information was reviewed to make the decisions?

Also, it's good risk management to document the process that will be followed to make those decisions. In other words, it's a good idea to document the investment policy decisions ... to have an investment policy "statement." The IPS supports a committee in making consistent decisions, year after year, in a thoughtful and prudent manner ... as a roadmap for fiduciary compliance.

To provide the greatest value, an IPS should be constructed in a thoughtful and skillful manner and should be implemented diligently. (Remember that the prudent man rule requires that committee members act with the "care, skill, prudence and diligence" of a person who is knowledgeable about investing.)

The skillful construction of an IPS involves a number of considerations. For example, ERISA's investment provisions require that fiduciaries apply prevailing investment industry practices. That would include, for example, considering both qualitative and quantitative factors when selecting, monitoring and removing an investment. A knowledgeable investment consultant or advisor can provide invaluable assistance by identifying and explaining those factors.

The implementation of the IPS requires diligence by the committees—in meeting and applying the criteria to the investment options offered to the participants. For example, a material change of a portfolio manager requires that a committee consider the impact of the change on the investment, determine whether that change could adversely impact the quality of the investment and evaluate its potential consequences for the participants.

**CHECKLIST**

*We have also included a checklist for fiduciaries on page 5 to help ensure the right criteria is being considered when creating and monitoring an IPS.*

**KEEP IN MIND ...**

*Once an IPS is created and in place, it is the plan sponsor's responsibility to adhere to it. An ongoing monitoring process is key to a successful IPS. If something changes to make the IPS no longer relevant, it must be revised. Ensure the actual IPS has the most prudent guidelines for the participants.*

**Fiduciaries of DC plans are** legally required to prudently select and monitor their plans' investments. (Since most plans are overseen by plan committees, this article refers to a plan's fiduciaries as committees and committee members.) While a plan's investments may be mutual funds, collective trusts or separate accounts, the process for prudent selection and monitoring has the same focus ... the individuals and organizations that make the investment decisions—the "portfolio managers."

This article discusses the monitoring process and, more specifically, the changes in the investment strategy as well as portfolio management that would warrant placing an investment on a "watch list," possibly resulting in the removal of that investment if the watch list investigation is not satisfactory.

By the way, a watch list is not an ERISA requirement; instead, it is derived from the investment industry. But ERISA generally requires that fiduciaries follow "prevailing investment industry practices" when making investment decisions. So, at the least, it is good risk management to include a watch list or monitoring provision in the committee's investment process and in the IPS.

A committee's investment process should include information and advice that enables the committee to identify those circumstances that, for one reason or another, raise questions in the minds of the committee members. Once a committee identifies a material issue, the investment is placed on the watch list for further investigation ... or, in other words, to be watched.

**KEEP IN MIND ...**

*Investigation is the better description; the committee has a duty to investigate the circumstances that raised the issue and to determine whether the investment continues to be a prudent choice for the plan's participants. Watching is not enough.*

## QUESTIONS TO CONSIDER WHEN MOVING AN INVESTMENT TO THE WATCH LIST

There are a number of issues that can raise important questions ... questions that are material enough to warrant more attention than ordinary monitoring or, stated differently, important enough to place the investment on the watch list. Among the most critical are:

- The portfolio manager and the investment firm were initially selected for a reason. Has that changed? Was the investment firm or portfolio manager selected for its reputation? Has something changed such that the initial reason for selection may no longer be valid?
- Has the individual portfolio manager (or a lead portfolio manager of a team) left the firm? Obviously, the greater the influence of the departed manager over the investment strategy or investment selection, the greater the potential impact of the departure.
- Has there been significant change or turnover in the investment firm's staff ... and particularly among the analysts and portfolio managers? While the individual portfolio manager may be the face of the organization, a successful investment program is dependent on its analysts and support team. Departures and turnover can adversely affect the firm's investment process.

- Have there been substantial outflows from the investment? Material changes to the amounts invested—and particularly outflows—can be disruptive to the portfolio manager's investment process and may result in the liquidations of investments at inopportune times. Those events may adversely affect the investment results for the participants.
- Are there regulatory investigations of the investment firm? An examination by a regulator, such as the Securities and Exchange Commission, may or may not reflect any wrongdoing. But, until the outcome is known, there is some risk. Also, the investment firm will need to devote resources to the examination, which may be a distraction from the portfolio management.

## PLACING A INVESTMENT ON THE WATCH LIST

There are two fundamental lines of analysis when monitoring investment options. Those are "quantitative" and "qualitative." Quantitative refers to the numbers. Qualitative refers to the quality of the portfolio manager(s) and of the investment firm.

### Quantitative

Examples of changes that can be quantified are:

- Material underperformance as compared to a benchmark.
- Style drift when, for example, the average market capitalization of the holdings changes from large companies to small companies, or the average price to earnings ratios change from low to high—from "value" to "growth."

### Qualitative

Examples of qualitative changes are:

- The loss of the individual portfolio manager or a key individual on a team of managers or significant turnover in the firm's staff (and particularly among the analysts).
- Change in the portfolio manager's process or philosophy; these can significantly shift the focus and return expectations of the investment.

Because of the importance of qualitative factors, the balance of this article focuses on qualitative changes at the investment firm.

**KEEP IN MIND ...**

*In evaluating quantitative issues, though, the inquiry is often whether a qualitative change has occurred that caused the quantitative anomaly. For example, if an investment has underperformed its benchmark, was that due to a change in investment process or a period of underperformance by a proven portfolio manager with a history of success? The former is usually a matter of great concern, while the latter is not.*

## THE WATCH LIST IS ONLY THE BEGINNING

Putting an investment on a plan's watch list is only the beginning of a prudent process.

Once an investment is on that list, the committee needs to:

- "Watch" (that is, to investigate) and make a decision about whether to retain the investment—and remove it from the watch list—or
- "Fire" the investment manager (by removing the investment option and replacing it with another in which the committee members have more confidence).

### How does that decision get made?

The simple answer is for the committee to engage in a prudent process for that purpose. The more detailed answer is for the committee to investigate the issue that raised the concern by gathering the information that a prudent, or knowledgeable, investor would want to review in order to make the decision. As a practical matter, most committees will probably want to have their investment consultant or advisor handle the investigation ... and then report to the committee.

Two key elements of a prudent process are:

- Gather and evaluate the "right," or relevant, information
- Consult with a qualified investment consultant or advisor

The financial advisor should be helpful with both determining what information is relevant and how to properly evaluate that information. (For this purpose, the relevant information is the information that a knowledgeable investor, with responsibility for other people's money, would need to do the evaluation.)

### What kind of qualitative information could suggest the replacement of an investment option?

The answer depends on the particular area of concern. For example, if the precipitating event is a government investigation, it depends on the subject matter of the investigation, the potential impact of the examination on the organization and, of course, the outcome.

If it is the departure of an individual "lead" portfolio manager, the question is whether the committee has enough confidence in the replacement portfolio manager(s) to have selected him initially. On the other hand, where the decisions are made by a team of portfolio managers, the departure of a single team member may not raise concerns.

Some considerations are:

- Has the new portfolio manager(s) overseen a fund invested in a similar style? If so, what is the portfolio manager's track record?
- Is there some unique aspect to the investment vehicle, for example, its strategy or size? If so, what is the replacement portfolio manager's experience with funds of that style or size?

Those are just some examples.

**KEEP IN MIND ...**

*The decision is whether the investment option continues to be a prudent selection for the plan's participants. In making that decision, committee members should consider a conservative approach.*

*For example, if significant changes have occurred at the investment firm, and there is some risk to the participants leaving the investment with that firm, the committee should consider whether there is a material benefit to the participants of continuing to offer that investment.*

## THE FINAL ANALYSIS

In the final analysis, the question is whether the information produced by the investigation enables the committee members to have a high degree of confidence that, going forward, the participants' investments are in the right hands. Perhaps the best way to do that is to compare the watch-listed investment with other highly considered similar investments.

In that way, committee members can evaluate both the qualitative factors, such as a portfolio manager's experience, and quantitative factors, such as performance history with the type of investment.

Keep in mind that the real issue is that the committee has entrusted the participants' money to the investment manager. If, after an investigation of any changes, the committee members no longer have confidence that the investment option is a prudent choice, the committee should consider removing the investment option and replacing it with a proven investment firm. Some key points to consider are:

- What is the nature of the change at the investment firm? People? Process? Performance?
- How material is the change at the investment firm?
- What is the long-term track record of the key portfolio manager or management team in that style of investing?
- If the issue is performance, what was the cause of the underperformance ... and can it be fixed?
- If a portfolio management change has occurred, was the investment process unique ... and is the key person behind that process still with the investment firm?
- Were there other unique or unusual aspects of the investment strategy or portfolio manager that were/could be impacted by the change?
- Is the organization stable or has it experienced turnover in important positions?

Remember, the committee's fiduciary responsibility is to provide the participants with a prudent line-up of investment choices. In doing that job, the committee should avoid unnecessary risk in the monitoring process.

## CONCLUSION

In summary—from a legal perspective, when material changes occur at an investment firm, the most important step is for the committee to engage in a process to evaluate all aspects of the investment option. For the process to be prudent, the committee determines which information is relevant to the decision—and gathers and analyzes that information. The final step is to make a "reasoned," or reasonable, decision based on the information reviewed. Without engaging in that process, it will be difficult to show that the committee has fulfilled its fiduciary responsibilities.

# Investment Policy Statement
# Checklist for Fiduciaries

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*The checklist below is designed to help ensure that plan sponsors are creating and monitoring their investment policy statement with the right considerations.*

## ☐ EVALUATE DEMOGRAPHICS

An investment policy statement should reflect the committee's decisions about the investment structure that is appropriate for its covered participants (the "demographics").

## ☐ SELECT INVESTMENT CATEGORIES

Once the demographics of the covered participants are considered, the committee should select the types of asset classes and investment styles (i.e., "investment categories") consistent with the analysis of the demographics.

## ☐ DEFINE INVESTMENT SELECTION CRITERIA

The next step is to choose the qualitative and quantitative criteria to be used for the selection and monitoring of the investment options to be used for each of the investment categories.

## ☐ APPLY CRITERIA

Then, those criteria are applied to choose the most appropriate investment option for each of the investment categories.

## ☐ MONITOR

After the selection, committees have an ongoing duty to regularly monitor the investment options to ensure that they continue to be prudent and suitable choices for the plan and the participants. If the committee is concerned about changes at an investment firm, it should more closely investigate the change ... and if the committee is no longer confident that the investment firm is a prudent choice, the committee should remove and replace the investment option.

# About the author

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Fred Reish is a partner in the Drinker Biddle & Reath Employee Benefits & Executive Compensation Practice Group and Chair of the Financial Services ERISA Team. He has specialized in employee benefits law since 1973 and works with both private and public sector plans and fiduciaries; represents plans, employers and fiduciaries before the IRS and the DOL; consults with banks, trust companies, insurance companies and mutual fund management companies on 401(k) investment products and issues related to plan investments; and represents broker-dealers and registered investment advisers on compliance issues. Fred serves as a consultant and expert witness for ERISA litigation.

Fred received a J.D. from the University of Arizona James E. Rogers College of Law and a B.S. from Arizona State University.

## Professional recognition and awards

Fred has received a number of awards for his contributions to benefits education, communication and service, including:

- In 2011, selection by *PLANADVISER* magazine as one of the 5 Legends of the retirement industry and with retirement advisors
- The 2009 American Society of Pension Professionals & Actuaries (ASPPA)/Morningstar 401(k) Leadership Award for directly and positively influencing the ability of Americans to build successful retirements
- Selection by *PLANSPONSOR* magazine as one of the 15 Legends in the development of retirement plans
- Recognition by *401kWire* as the 401(k) Industry's Most Influential Person for 2007 (and has, for every year of that survey, been in the top 10)
- The IRS Director's Award and the IRS Commissioner's Award for his contributions to employee benefits education
- The 2006 Lifetime Achievement Award from *PLANSPONSOR* magazine
- The 2006 Lifetime Achievement Award from *Institutional Investor* for his contributions to the benefits community
- The 2004 Eidson Founder's Award from ASPPA for his significant contributions to that organization and to the benefits community

On behalf of ASPPA, he has co-authored amicus curiae briefs with the Supreme Court of the United States in the case of *Patterson v. Shumate* and with the Tax Court in the case of *Citrus Valley Estates v. Commissioner of Internal Revenue Service*.

## Publications

Fred has written four books and more than 350 articles. He authors a monthly column on 401(k) fiduciary responsibility for *PLANSPONSOR* magazine.

As an experienced lawyer on benefits matters, Fred is frequently quoted by both professional and public publications, including *The Wall Street Journal, Fortune, Forbes, Inc., CFO Magazine, New York Times, Washington Post, Los Angeles Times, USA Today, Institutional Investor, PLANSPONSOR* and *Pensions & Investments*.

## Speaking engagements

Fred is a nationally known speaker on fiduciary responsibility. He has spoken at the annual conferences of the American Bar Association, the American Society of Pension Professionals and Actuaries, the Western Pension and Benefits Conference, the Enrolled Actuaries Conference and the International Foundation of Employee Benefit Plans.

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