A PRUDENT PROCESS FOR CREATING A RETIREMENT PLAN INVESTMENT MENU

TruePlan℠
Benefit and Retirement Advisors

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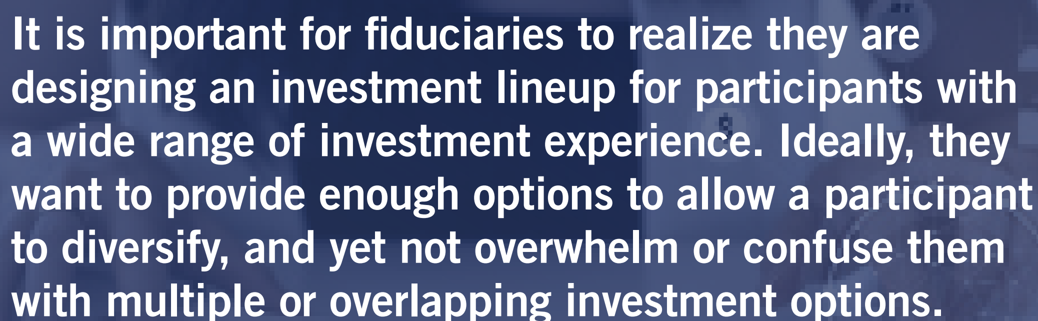

It is important for fiduciaries to realize they are designing an investment lineup for participants with a wide range of investment experience. Ideally, they want to provide enough options to allow a participant to diversify, and yet not overwhelm or confuse them with multiple or overlapping investment options.

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INTRODUCTION

A retirement plan's overarching goals are to help participants accumulate wealth during their years of employment and to provide them with income during their retirement. With the decline of defined benefit plans, more emphasis is being placed on the employee's responsibility to save. Providing employees with a defined contribution plan featuring best-in-class investment options will increase the probability of their retirement readiness. Establishing a prudent investment process that is both documented and consistently applied is an appropriate focus for plan fiduciaries.

The menu of investment options available in retirement plans has evolved over the years from fixed to variable annuities, to mutual funds, to the introduction of target date funds and in larger retirement plans, the use of separate accounts and collective investment trusts. The challenge for fiduciaries is to successfully navigate the options available and build an optimal investment menu. Here are the four key steps necessary to build an optimal retirement plan lineup:

Step 1 | Investment Policy Statement

Step 2 | Investment Menu Structure

Step 3 | Investment Categories (Asset Classes)

Step 4 | Investment Selection Process

It is important for fiduciaries to realize they are designing an investment lineup for participants with a wide range of investment experience. Ideally, they want to provide enough options to allow a participant to diversify, and yet not overwhelm or confuse them with multiple or overlapping investment options. Ease of use is an important component of a successful retirement plan lineup. Since plan fiduciaries may be exposed to personal liability, it is prudent that they have a process in place for the selection and monitoring of investment options.

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STEP 1: INVESTMENT POLICY STATEMENT

Plan fiduciaries should have an established framework on which they can defend their investment decisions should they ever be challenged. The process should begin with the construction of the plan's Investment Policy Statement. Although not required by the Employee Retirement Income Security Act, drafting an IPS is a fiduciary best practice. The IPS serves as a policy guide that can offer an objective course of action to be followed when emotional or instinctive responses might otherwise motivate less prudent action.

The IPS should be written to allow fiduciaries latitude to use their best judgment based upon a given set of circumstances. Rigid investment policies that are not followed could be used against fiduciaries in a court of law. It is a fiduciary best practice to review a plan's IPS at least once every two years or pursuant to significant regulatory changes.

STANDARD ITEMS APPEARING IN AN INVESTMENT POLICY STATEMENT

1. Identification of the retirement plan name, participants and fiduciaries
2. For fiduciary-directed investment portfolios, a statement of asset allocation policy and rebalancing guidelines
3. A description of the process and/or criteria to be used in choosing and monitoring the plan's investments, including TDFs, passive investments and the Qualified Default Investment Alternative
4. Listing of approved asset classes, with a relevant industry benchmark index for each
5. A statement of purpose for the IPS
6. Identification of the replacement process or watch list for managers who no longer meet the selection/retention criteria
7. Identification of the service providers with roles, responsibilities and deliverables to fiduciaries (e.g., the plan advisor, recordkeeper, administrator, custodian, directed trustee and actuary)
8. Statement of frequency of investment performance reviews and general communications procedures for service providers

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STEP 2: INVESTMENT MENU STRUCTURE

The investment menu structure is just as important as the investment options themselves. The structure should be built after the plan's demographics and participant investment experience are considered. What may be appropriate for one plan may not be suitable for another. For example, it may not be appropriate to include a self-directed brokerage window if participants are predominantly novice investors. The ideal structure will properly direct participant behavior and ultimately impact their retirement outcomes in a positive manner.

Participant behavior	Investment type
Do it for me	Target date fund/risk-based funds
Do it with me	Diverse investment options employees can use to build their own portfolio
Do it myself	Self-directed brokerage window allowing access to investments outside the plan's menu

If built properly, the menu structure will help guide participants toward the path most suitable to their investor profile. It will allow participants to make choices based on an assessment of their risk tolerance, time horizon, investment experience and comfort level with managing their portfolio.

STEP 3: INVESTMENT CATEGORIES (ASSET CLASSES)

The next step is the selection of the specific investment options that will be available to plan participants. There are numerous investment vehicles to choose from: group annuities, Collective Investment Trusts, exchange-traded funds and mutual funds. Traditionally, mutual funds are employed due to a favorable combination of low cost, performance transparency, trading efficiencies and availability across most retirement plan record-keeping platforms.

An optimal retirement plan lineup will use enough investment options to provide breadth of choice, but not so many as to confuse participants. Ideally, an optimal retirement plan lineup should incorporate no more than 16 to 18 diverse investment options. If a target date series is used, it would count as one. The inclusion of certain investment categories and options should be based upon an understanding of the plan's demographics and investment knowledge of the participant base. The following chart depicts the optimal investment options by asset class that could be considered. Not every retirement plan lineup will incorporate all of these.

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Money market/ stable value	Bond	Target date
Stable value	Inflation protected bond fund Investment grade bond fund High-yield bond fund Global bond fund	Target date portfolio

Foreign equity
International fund Emerging markets fund

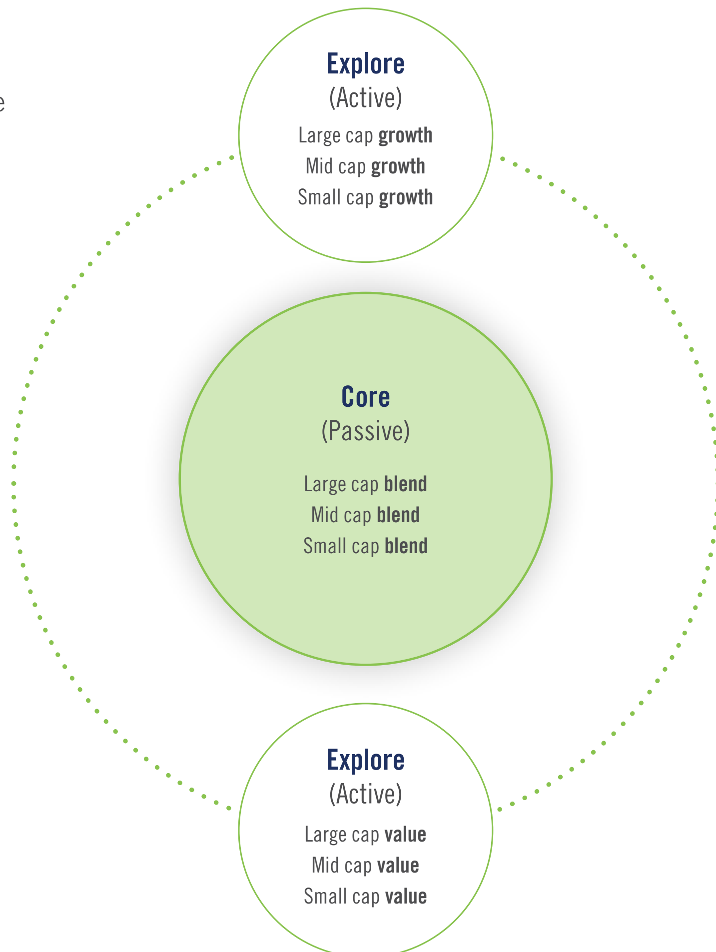
Specialty/other
Real estate Sector fund

Balanced/asset allocation
Balanced fund

U.S. EQUITY

An optimal investment menu should provide participants with both low-cost, index and actively managed options, especially in light of the retirement industry's focus on fee transparency. An optimal lineup would at least offer passive index funds in the U.S. equity blend style boxes across the three market capitalizations and complement those with actively managed growth and/or value options. This will provide a "core and explore" design.

"Core" refers to the low-cost indexing strategy designed to give a participant broad exposure to the market and "explore" allows a participant to invest with an active manager attempting to outperform the market. Participants may favor one investment philosophy over the other or choose to use both.



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FOREIGN EQUITY

An optimal investment menu will offer exposure to both international and emerging market equity so participants can globally diversify their equity holdings and improve risk-adjusted returns over time. Typically, international equities and/or economies do not move in tandem with domestic equities or the U.S. economy. Incorporating investment options that are not highly correlated with one another is an important component of building an optimal portfolio and should be reflected in the investment menu.

Whether due to fear, lack of knowledge or a sense of patriotism, many participants have shied away from international investing. In the chart below, while international equity markets have lagged U.S. markets in recent years, the two asset classes have traded leadership over the long term.

THOUGH RELATIVE PERFORMANCE HAS FAVORED U.S. EQUITY MARKETS IN RECENT YEARS...

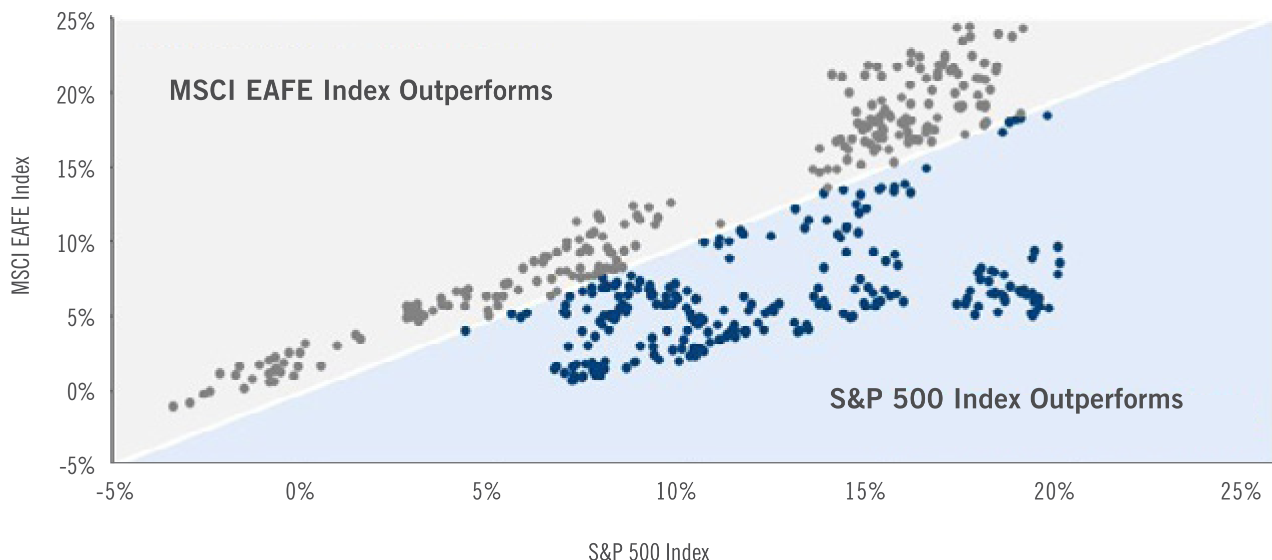
10-year Annualized Return

Source: FactSet as of 9/30/2020

...THE LONG-TERM PAINTS A DIFFERENT PICTURE...

U.S. and Non-U.S. Equity Markets Have Traded Leadership over the Long Term

Rolling 10-year returns; period ended Jan. 31, 1980 through Dec. 31, 2019



Source: FactSet. **Past performance does not guarantee future results, which may vary**. Diversification does not guarantee investment returns and does not eliminate the risk of loss.

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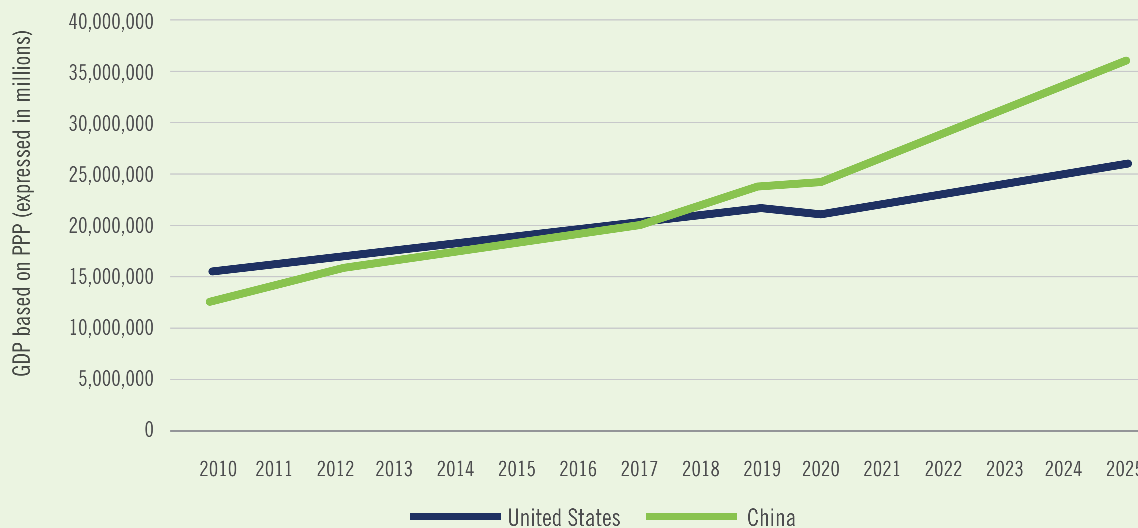
There are many investment opportunities abroad that can provide participants with an opportunity to diversify and, perhaps surprisingly, reduce portfolio risk, not introduce it. Traditionally, some investors have felt that investing in mutual funds that include multinationals (corporations that have facilities and assets in at least one country in addition to the domicile country) provides adequate international exposure. However, most multinationals (Coca Cola, Nike, McDonalds, etc.) only provide investors with mega-cap and large-cap exposure. They do not provide exposure to international mid-cap, small-cap or emerging market equity.

Moreover, despite the historical world dominance of the U.S. economy, our future growth prospects are not as strong as some emerging economies. According to the International Monetary Fund, the global economic power shift away from the established advanced economies in North America, Western Europe and Japan will continue in the coming decades. China has actually overtaken the U.S. to become the largest economy in purchasing power parity terms. The PPP exchange rate is the rate at which the currency of one country would have to be converted into that of another country to buy the same amount of goods and services in each country.

ESTIMATED (2010-2019) AND PROJECTED (2020-2025) GDP BASED ON THE PURCHASING POWER PARITY METHODOLOGY



Source: International Monetary Fund and HANYS Benefit Services *(now TruePlan Benefit and Retirement Advisors)*, October 2020

Additionally, the Centre for Economics and Business Research expects the value of China's economy when measured in dollars to exceed that of the U.S. by 2028. The firm also forecasts that India will become the world's third largest economy by 2035.

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Emerging market equity exposure can be obtained by offering a designated emerging markets fund or by using an international fund that allocates to emerging market equity. Fiduciaries can make this decision based upon an evaluation of their participant's investment experience. The additional levels of risk (currency and political) inherent in emerging markets, require careful evaluation by fiduciaries.

SPECIALTY/OTHER

Depending on the asset classes identified within the IPS, fiduciaries may opt to include other or specialty asset classes like real estate, sector funds and/or socially responsible funds (also referred to as environmental social governance funds, or ESG).

Real estate is an asset class that merits consideration for most plans, as it has historically had low correlation with both equities and fixed income. This provides an additional layer of diversification that can minimize long-term volatility.

Having appropriate ESG investment options in plan lineups could encourage participation among millennials and other employees who want to support businesses that use sound social and environmental procedures and employ constructive workplace practices. Plan participants, especially those in nonprofit settings, may want a connection between their values and their financial goals, which can be advanced by the availability of ESG options in a plan's investment menu. Ultimately, these investment types still need to meet and adhere to the standards outlined in the plan's IPS, and any additional risk characteristics should be evaluated closely.

FIXED INCOME

Diverse fixed income choices are equally important, especially if plan demographics indicate an older or more conservative participant base. A stable value or cash- equivalent option that can offer a competitive interest rate for participants nearing retirement and is more focused on capital preservation should be complemented with a "core" investment grade bond fund designed to offer broad fixed income exposure.

Fiduciaries should be aware that the choices they make for the conservative options within their plan lineups are just as vulnerable to scrutiny as the more aggressive, equity-oriented choices. This has been affirmed by the lawsuits filed against Anthem, Inc. and Chevron Corp. Both plan sponsors were sued for their decision to

ANTHEM, INC. AND CHEVRON CORP. LAWSUITS

Plan sponsors were sued for not offering the lowest cost share class available in a money market fund and for failing to offer a stable value fund in lieu of a money market fund.

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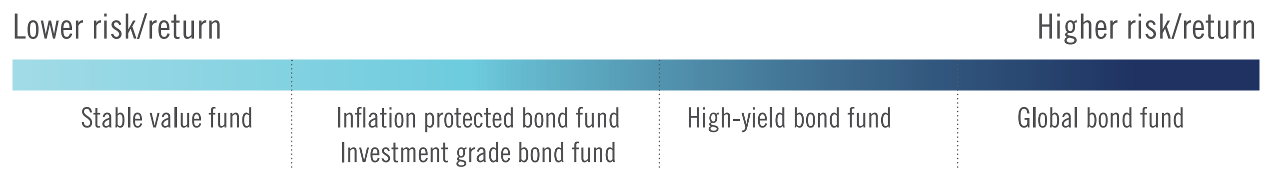
offer a Vanguard money market fund in lieu of a stable value fund. The Chevron complaint alleged that the "microscopically small return" of the Vanguard money market fund cost Chevron workers more than $130 million in retirement savings. While the case against Chevron was dismissed, Anthem ended up settling.

Most participants building their own portfolios will look to invest some percentage in an investment grade bond fund in order to offset the higher risk inherent in equities. An inflation-protected bond fund provides participants nearing retirement with a hedge against inflation.



As participants plan for retirement, their investment goals shift from wealth accumulation to capital preservation and current income. Inflation erodes purchasing power and inflation risk affects retirees more than it does participants not relying on their portfolio for income. Ultimately, participants want to ensure their portfolios will be designed to meet their lifetime income needs. Lastly, riskier high yield or global bond funds might also be used to provide participants with the ability to further diversify their fixed income holdings. These categories are not without risk and can behave more like equities. Effective participant education should be provided to present the risks associated with both high-yield (junk bonds) and global bond funds.

QDIA DECISION: TARGET DATE FUNDS/BALANCED FUNDS

The Pension Protection Act of 2006 encouraged employers to adopt automatic enrollment features for their participant-directed plans by providing a new type of fiduciary liability relief for default investments, or Qualified Default Investment Alternatives. A QDIA is used when a participant fails to make his or her own election. An investment must have specific qualifications to be considered a QDIA. Importantly, a QDIA's asset allocation strategy need only take into account participant age and does not need to consider an individual participant's risk tolerance or other investment assets. The three general categories that may be used for a QDIA are life-cycle or TDFs, balanced funds or managed accounts. Target retirement date funds have overwhelmingly become the favored QDIA choice among fiduciaries. The data on the following chart show that TDFs represented 35.1% of QDIA assets in 2006, and have more than doubled through 2019 to 87.3%.

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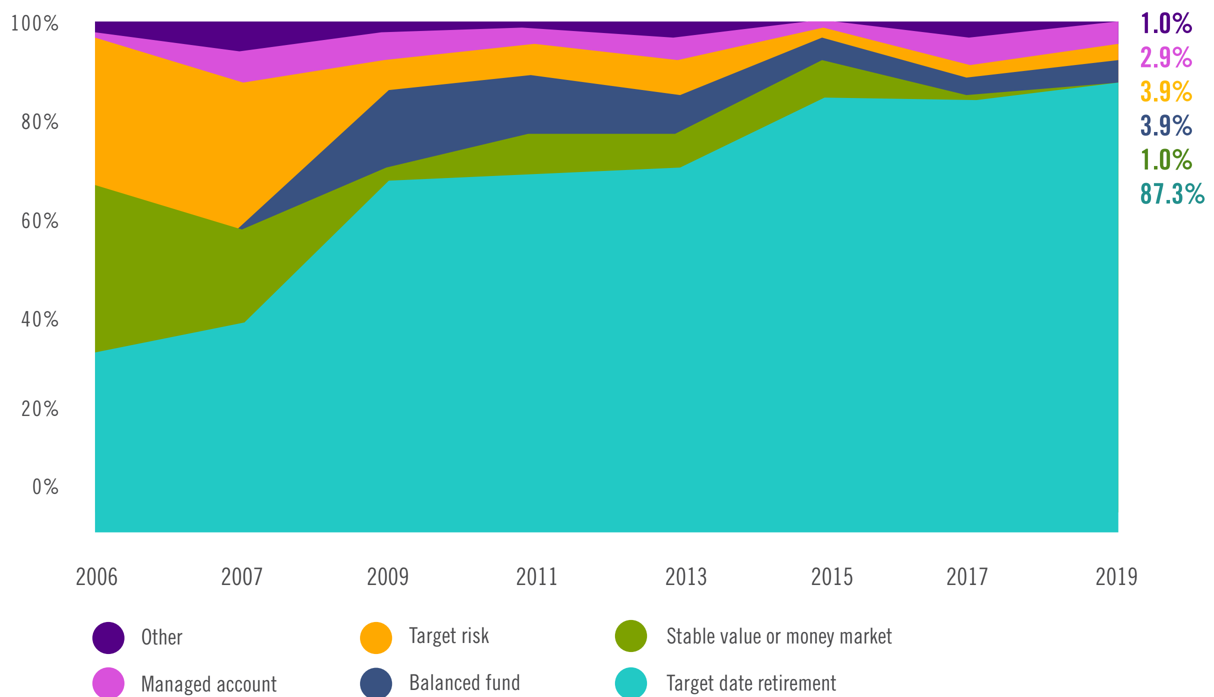
CURRENT DEFAULT INVESTMENT ALTERNATIVE FOR NON-PARTICIPANT DIRECTED MONIES



Source: Callan Institute, 2019

While target date strategies have garnered an increasingly significant proportion of retirement assets since they were approved as QDIAs by PPA, there may be value in offering a balanced fund within the lineup as well. A balanced fund will provide exposure to both stocks and bonds, and typically offers a static 60% stock/40% bond allocation. This investment option might appeal to participants who are not comfortable with a TDF and want allocation to both stocks and bonds within one vehicle.

GUIDELINES FOR SELECTING AND MONITORING TARGET DATE FUNDS

In 2013, the U.S. Department of Labor's Employee Benefits Security Administration issued tips intended to help plan sponsors select and monitor TDFs in their investment lineups. It is incumbent on plan fiduciaries to establish a process or fiduciary best practice for comparing and selecting target date strategies, especially when they serve as the plan's QDIA. Fiduciaries should implement a process to perform periodic reviews to have a clear understanding of the investments and how they will change over time, and to compare the funds' fees.

Target date funds automatically adjust their asset mixes to become more conservative as investors approach retirement age. This shift in the asset allocation over time is called the TDF's glide path. Some TDFs' glide paths are managed "to" retirement, while others are managed "through" retirement.

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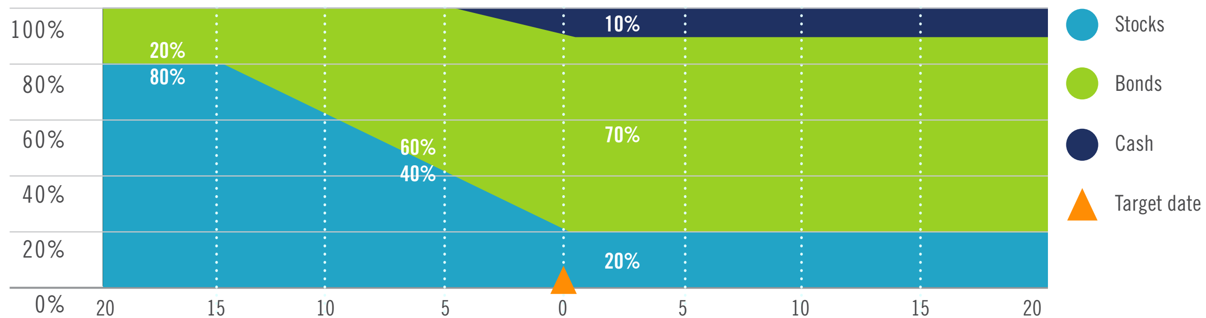
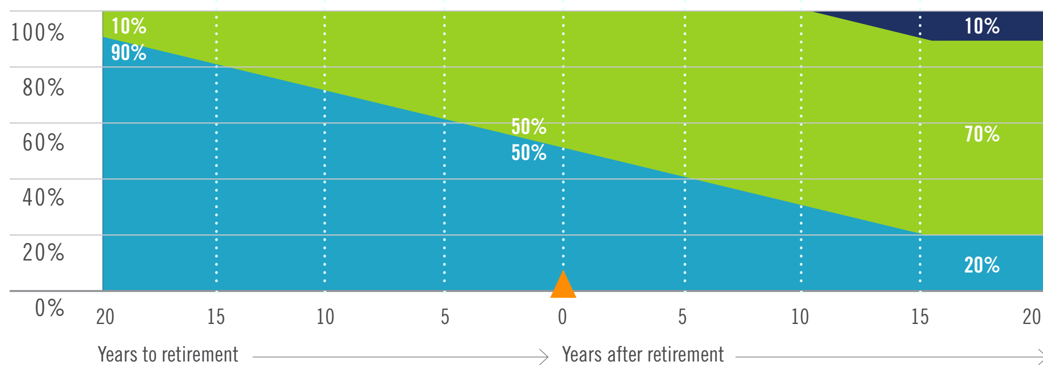
RISK LEVEL AT RETIREMENT

Comparison of "to" versus "through" funds

To retirement



Through retirement



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A "to" approach reduces the equity exposure over time to its most conservative point at the target date. A "through" approach continues to manage the asset allocation beyond the target date and will eventually reach its "landing point," or most conservative allocation, years later.

Another consideration is whether the underlying funds use active management or follow a passive strategy. Passive funds will have lower expense ratios than active, but may lag in tactical flexibility. Active strategies may provide increased breadth of choice in the asset classes that are offered and a broader choice of non-traditional asset classes, such as commodities and real estate investment trusts. Non-traditional asset classes might not be appropriate as stand-alone options in a participant-directed defined contribution plan; an active TDF portfolio manager can better allocate assets among these non-traditional asset classes and capitalize on tactical tilts.

Some firms such as T. Rowe Price include a blend of both active and passive underlying funds. All TDFs employ an active approach in the construction of their asset allocation glide paths. Overall, TDFs should be dynamic and flexible enough to change with market conditions. The following table provides an example of some of the inputs and the scope of tactical decisions made within TDFs.

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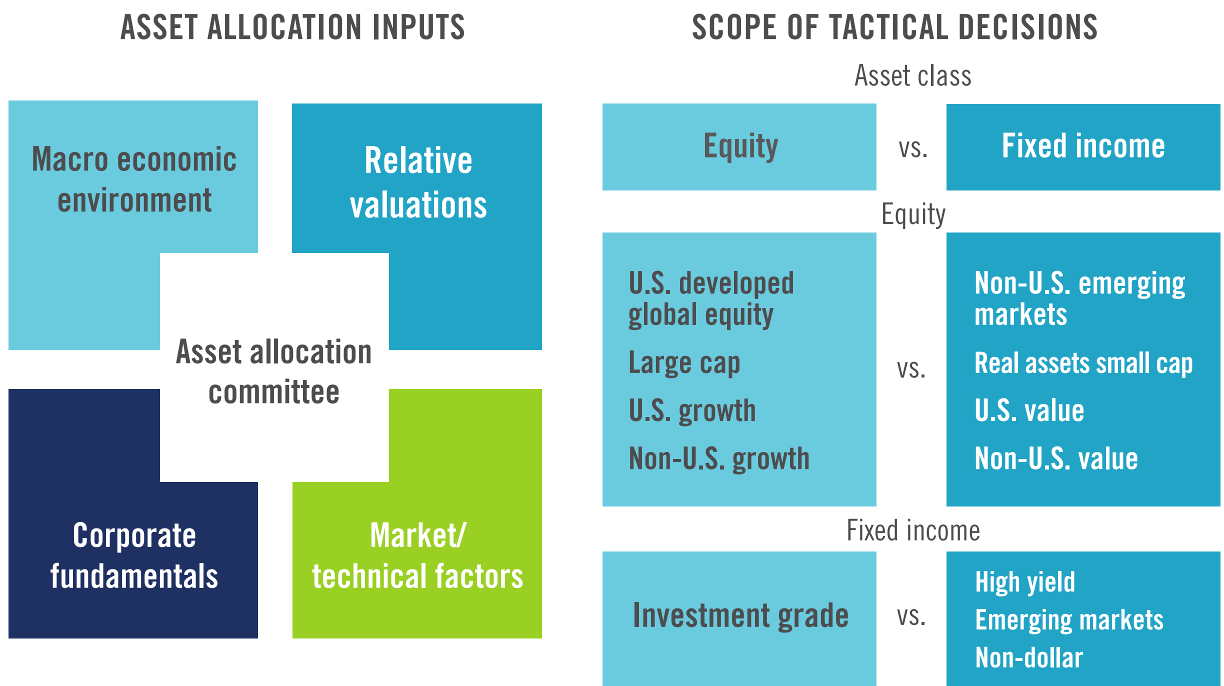

PROPRIETARY OR CUSTOM TARGET DATE FUNDS

TDFs are characterized as either proprietary or custom. The U.S. Department of Labor recommends that plan sponsors evaluate the feasibility and potential merits of a custom target date solution. Custom TDFs are typically offered in separate account or collective trust vehicles. These vehicles are not registered as investment companies under the Investment Company Act of 1940 and therefore are precluded from use in 403(b) plans. Proprietary TDFs are defined as pre-packaged investments that usually are comprised of underlying mutual funds of a single investment firm. Therefore, it can be challenging to ensure "best-in-class" managers are offered across the underlying funds within the proprietary TDF.

Morningstar, Inc., a leading investment analysis firm, considers it a best practice for target date managers to continually assess the stand-alone merit of each underlying fund used within their target-date series. Custom TDFs are created by the retirement plan sponsor, who ultimately becomes responsible for choosing the asset classes, underlying mutual funds and the retirement savings "glide path."

Plan sponsors who choose to implement custom TDFs generally do so in an attempt to realize investment economies of scale. One way to reduce investment expenses is to negotiate a low-cost separate account structure with an investment manager. The other main reason plan fiduciaries may implement a custom TDF is to better address the unique demographic profile of their participants. For example, a plan sponsor might consider custom TDFs when their plan has an earlier than "normal"

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retirement age of 65 or 67, or offers a defined benefit plan alongside the defined contribution plan. In both examples, participants may benefit from a glide path that is more aggressive than that offered by a proprietary TDF.

Plan sponsors who create custom TDFs face significant challenges:

1. **Substantial target date resources and investment expertise are required** to make prudent decisions about asset classes, asset allocation and glide path management. Sponsors who do not have such internal expertise must hire investment professionals.
2. **Complex administration** and demanding participant reporting requirements. All participant educational materials, disclosures and performance calculations must be customized.
3. Need for **strong, consistent oversight** of underlying investments.
4. Recordkeeping platforms **may not be able to accommodate** custom TDFs.
5. It becomes **difficult to implement tactical asset allocation** (short term over weights and under weights of asset classes).

Because of these challenges, custom TDFs are more often found in “Mega Plans” ($500 million+), as these plans have greater internal resources and expertise to take on the added complexity of customization and they can realize economies of scale.

A truly custom strategy utilizing open architecture (best-in-class mutual funds from multiple companies) will likely be complicated and expensive to implement. Therefore, plan sponsors with a unique demographic participant profile should attempt to find a good fit among the 50+ proprietary TDF providers before attempting to create a custom solution. Some retirement planning experts argue that identifying an “average” participant demographic is elusive for most plans and the only way to factor in an individual’s unique circumstances would be to customize a glide path at the participant level, not the plan level. A custom glide path at the participant level is currently available through managed accounts for an additional fee.

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STEP 4: INVESTMENT SELECTION PROCESS

Once the investment categories are identified, the individual investment selection process begins. There are many investment options that will fulfill the criteria that are outlined in a plan's IPS. A thorough, consistent and well-documented process of fund selection should be used to build an optimal investment lineup. Selection criteria should be based upon quantitative and qualitative measures, including level of risk, fees, fund stewardship and performance monitoring.

LEVEL OF RISK

Although a fund might meet the risk metrics outlined in the plan's IPS, further qualitative and quantitative review may uncover that the fund is investing in riskier security types, is not diversified or adheres to an investment process that raises concerns about repeatable performance. An investment option that delivers performance with less volatility, captures performance in a strong bull market and protects on the downside should be favored. It is important to keep the risk tolerance of the average participant in mind when choosing investment options within a retirement plan lineup. Fiduciaries should consider the current state of the markets when assessing manager risk. For example, when evaluating top-ranking managers in the midst of a lengthy bull market, it would be prudent to avoid managers with a short performance record since it would not allow evaluation of their performance in a bear market.

FEES

Fees are a necessary criterion for consideration. Unlike performance, which always varies, fees are somewhat static and predictable. For index funds, the goal should be to identify a reputable firm with the lowest possible fees and low tracking error (variation) versus the stated index. For actively managed funds, management fees vary across the asset classes.

This is an area where fiduciaries can compare the fees associated with specific fund types (asset classes) more closely and identify active managers that deliver performance for a reasonable fee. Recent fee disclosure rules and the risks of litigation require that fiduciaries ensure fees are reasonable.

FIRM/FUND FAMILY STEWARDSHIP

Firm and/or fund family stewardship falls under the general qualitative review that fiduciaries should incorporate in their selection process. It is imperative that fiduciaries conduct an objective analysis on a fund and/or fund family to assess if the firm's interests are aligned with shareholder interests, and ensure there are no regulatory issues. Fiduciaries should also choose firms and funds that are well

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established and well managed. An analysis should be made of the firm's resources and capabilities. Does the firm demonstrate indicators of success and stability? Will the firm still be in business in five years? This becomes especially important for small cap funds. If selected, there should be assurances the fund can effectively manage the asset inflows. Overall, confidence can be instilled when fiduciaries choose fund families that are established in the industry and recognized by participants.

ONGOING PERFORMANCE MONITORING

The process does not end once a fund is chosen. This was affirmed in the *Tibble v. Edison International* Supreme Court decision. Quantitative metrics outlined in the plan's IPS should be reviewed by fiduciaries on an ongoing basis. Performance reporting is an important component of the quantitative monitoring and ensures fiduciaries are documenting the process. Fiduciaries should consider placing a fund on a "Watch List" if it fails to meet the metrics outlined in a plan's IPS over a period of time and is not showing signs of improvement. When a manager is placed under review or is on a "Watch List," heightened monitoring should be performed. A "Watch List" status should only be considered temporary. Ideally, an assessment of a manager should be made and it should either be removed from the "Watch List" or be replaced. When appropriate, recommendations for fund additions, deletions or replacements should be made based upon the plan's previously established criteria.

TIBBLE VS. EDISON INTERNATIONAL

In May 2015, the court found that plan fiduciaries have an ongoing duty to monitor investments and remove imprudent offerings from the plan lineup.

The qualitative review process is also continuous. Fiduciaries should monitor changes in qualitative criteria, including firm ownership, key personnel changes or adverse litigation/regulatory issues. Fiduciaries should be aware of an organizational change at a firm, such as a portfolio manager change. If a key portfolio manager is leaving, the fund should be reassessed based upon the track record and reputation of the incoming manager. Another reason that a manager replacement might be considered is when the fund demonstrates a significant shift in investment style. This "style drift" can undermine the plan's optimal investment menu design. For instance, when a small-cap manager "drifts" into the mid-cap segment of the market, it creates both a gap and a potential redundancy in the lineup. Avoiding fund overlap and not having deficiencies in the investment lineup are equally important in maintaining an optimal fund menu.

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CONCLUSION

Constructing an optimal retirement plan lineup is an important fiduciary responsibility. There are many factors for fiduciaries to consider, particularly when designing an investment lineup for participants with a wide range of investment experience. ERISA §404(a)(1)(B) sets forth the “prudent man” rule guiding fiduciaries to act:

> **...with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.**

If fiduciaries do not possess the required level of investment expertise, they may hire a plan advisor to help them meet this standard. Due to the complexities involved, employing the expertise of a plan advisor to institute a process and develop fiduciary best practices can ensure that prudent, defensible choices are made. However, this does not eliminate potential fiduciary liability, as the fiduciaries must closely monitor the services of the plan advisor.

HANYS Benefit Services has outlined a four-step process for constructing an optimal investment menu that fosters ERISA compliance and provides desirable investment choices for plan participants. After all, the adoption of an appropriate menu structure coupled with the strategic use of specific investment options will ultimately guide participant choices and directly impact their retirement outcomes.

If you have any questions about this paper or would like to talk to a trusted advisor, please get in touch by calling 800.388.1963 or emailing trueplan@trueplanadvisors.com.

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