

Fiduciary Best Practices

The term “fiduciary” is derived from the Latin term for “faith” or “trust”. Fiduciaries have important responsibilities and are held to standards of conduct because they are given the power to act on behalf of another in situations that require great trust and faith. Many of PEI’s clients are bound by the fiduciary standards stated under ERISA for qualified plans or UPMIFA for endowments and foundations.

ERISA defines “fiduciary” not in terms of an official title but rather in functional terms of control and authority over plan assets. As stated in the “Prudent Man Rule,” found in Section 404(a)(1)(B) under ERISA, fiduciaries must carry out his/her duties “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.”

Similar to ERISA, the fiduciary duties specified under UPMIFA include the duty of care, the duty to minimize costs, the duty to investigate, and the duty of loyalty. Additionally, UPMIFA requires that:

- Investment decisions be made in regards to the entire portfolio;
- Investments be diversified, and;
- If investment duties are delegated to a third party, the committee must prudently select and monitor the third party.

The list below highlights a number of broad fiduciary best practices:

1. Document, document, document. Meetings of the fiduciaries should be conducted regularly and the decision-making process should be documented and maintained in a central, secure file.
2. Maintain a well-drafted Investment Policy Statement that builds the framework for a thoughtful fiduciary process.
3. Identify, understand, and monitor fees. These fees include all direct investment fees and administrative charges. They also include any indirect, third-party fees including any reimbursements.
4. Have an attorney review documents, to ensure compliance with all regulatory and legislative provisions defined by the IRS, DOL, PBGC, and/or SEC. This will also, ensure processes conform to written plan documents.
5. Consider appointing an expert, independent consultant to support each step of the prudent process.

Consider incorporating these best practices into your current processes to help meet your fiduciary duties outlined by specific statutes and regulations.

In This Issue

Articles & Commentary

Fiduciary Best Practices

Fee Benchmarking – One Size Doesn’t Fit All

Conducting an Advisor Check

Asset Class Insider: Core versus Core Plus

Guaranteed Minimum Withdrawal Benefit

Three Tier Lineups for DC Plans

News

Client Update

What’s New at PEI?

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Fee Benchmarking – One Size Doesn't Fit All

Fee disclosure has been a popular topic over the past several years, but it has taken on renewed interest in the wake of the DOL's new 408(b)(2) and participant fee regulations. PEI has been at the forefront of appropriate fee benchmarking. Rather than rely on survey data or broad benchmarks, PEI believes that each client's fee structure should be customized based on the services it receives from its vendors.

The first step in the fee benchmarking process is to develop a Request for Information (RFI). This process can identify appropriate vendors that fit into a client's service and cost model. To do so, PEI completes a thorough analysis of each client's needs. Key areas of focus include funding, administration, general communication strategy, and custody. When done properly this process, helps clients accurately benchmarking fees and experience cost savings when warranted by the analysis. With new disclosure regulations on the horizon, one should consider conducting a fee benchmarking study if one has not been done in several years. As a best practice, a fee benchmarking study should be conducted every three to five years or sooner if there is a significant change in asset levels.



Conducting an Advisor Check

How do you know if your current or potential investment consultant is free of conflicts of interest? A fiduciary should be confident that any professionals working with them are only doing so in the best interest of their investment portfolios. Disclosure laws make all legal documentation filed by an investment consultant available to the public. Fiduciaries should use these tools to ensure their consultants have no conflicts of interest.

A conflicted advisor can have an extremely negative effect on the success of your plan. The Government Accountability Office released its Defined Benefit Pension Report which stated “pension plans using consultants with undisclosed conflicts of interest earned returns an average of 1.3% less”.¹

So, what can you do to make sure the investment advice your plan is receiving is free of conflict? Below are a few helpful tips.

- Visit www.advisorinfo.sec.gov and search the firm name under “Investment Advisor Firm”. Pay special attention to Item 5 (Compensation Arrangements) and Item 8 (Interest in Transactions & Discretion) of Part 1A. Also review ADV Form Part II. A review of these forms should provide disclosure on possible conflicts of interest.
- Also, when reviewing the Form ADV, pay close attention to the CRD numbers provided in Schedule A of key firm personnel. Searching on an individual's CRD number may uncover undisclosed broker/dealer relationships of certain key firm personnel that may not be disclosed on a firm's Form ADV.
- You can also search for individuals on www.finra.org/Investors/ToolsCalculators/BrokerCheck. Any registered representative will have a FINRA registration number which allows them to buy and sell securities. The FINRA website will also provide any past or on-going litigation against the firm or employee.
- Lastly, the use of a simple search engine such as Google or Yahoo can uncover information about the firm or its employees.

Being well-informed and aware of the business relationship you have is one of your best fiduciary protections. Taking the few minutes to maximize your knowledge can provide the long-term security and success of your investment portfolios.

1. GAO, “Conflicts of Interest Involving High Risk of Terminated Plans Pose Enforcement Challenges,” Defined Benefit Pension Report (June 2007), p. 15. <http://www.gao.gov/new.items/d0721.pdf>

Client Update

We want your feedback! Keep an eye out for a **client satisfaction survey** via email. Please take a few moments to respond to the survey. We appreciate your time and effort.

Asset Class Insider: Core versus Core Plus Fixed Income

Even though investment managers may invest in the same broad asset class (equities, bonds, real estate, etc.), the strategies employed by these managers vary widely. This portion of *The Prudent Press* will explore these differences at a high level. In the inaugural section, the distinctions between “core” and “core plus” fixed income strategies are highlighted.

Core fixed income strategies typically involve domestic investment grade securities, such as those comprising the Barclays Aggregate Bond Index. These include US corporate securities and government bonds as well as securitized sectors (asset-backed, commercial- and residential mortgage-backed).

Core plus fixed income adds non-core assets such as high-yield bonds, non-U.S. fixed income and emerging market debt. These asset classes can provide broader market exposure and additional opportunities to add value to a fixed income program. A major advantage of core plus fixed income is the ability to access non-traditional fixed income sectors, which may offer diversification and expected return premiums. Also, while many of these non-core assets are often volatile when in isolation, they can contribute to a broader opportunity set and reduced overall volatility in the context of a diversified portfolio.

Guaranteed Minimum Withdrawal Benefit

Traditionally, the focus on DC plans has been on the accumulation phase. However, as baby boomers begin to retire and in the aftermath of the 2008 market downturn, new attention is being placed on the “de-accumulation” phase as retirees begin to drawdown on their savings. The industry has been developing a number of new products for this purpose. One of these new products is an annuity product offering a Guaranteed Minimum Withdrawal Benefit (GMWB). The product is designed to give participants protection from downside market risk.

Within DC plans the Guaranteed Minimum Withdrawal Benefit trend has been to combine a lifetime guaranteed wrapper with mutual funds. For example, 10 years prior to retirement a participant may choose to direct all or a portion of their account balance to a GMWB product. For an additional asset based fee, the participant is then guaranteed annual lifetime retirement income beginning at age 65 equal to a percentage of the amount invested in the GMWB, typically 3% to 5%. For example, a participant could direct \$100,000 of assets into such a fund in exchange for a promised minimum payout of \$3,000 a year. During the lifetime of the product, the guaranteed benefit base may be reset upward if the market value of the portfolio exceeds the benefit base. When the participant dies, any amount of market value remaining in the product will be paid to their estate. If the market value of the assets are fully depleted prior to this, income payments will continue to be paid for the life time of the participant, but not to the estate.



These products have been gaining in popularity yet many plan sponsors and recordkeepers have found it challenging to offer these products due to unique features including the calculation of income benefits and distribution election processes that add to the recordkeeping complexity of DC plans.

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Additionally, while a GMWB is a great tool for reducing market risk during periods of market turmoil, it does not alone address the risk of outliving one’s retirement income stream. New providers are beginning to offer additional assistance to record keepers in this area as this product matures. For example, insurance companies have become savvier by offering GMWB products with a life time benefit for an additional cost. PEI will continue to monitor these product trends.

Three Tier Lineups for DC Plans

PEI is an advocate of a Three Tier Investment Lineup for DC Plans. The three tiers are:

- 1) Target Date Funds;
- 2) Passive investment options, and;
- 3) Active investment options. Structuring an investment lineup in such a manner allows participants to choose from a variety of options and investment strategies.

PEI has approached the development of the fund lineup with the objective of providing participants with multiple paths to achieve a diversified portfolio. Each tier, by itself, can be used to construct a fully diversified portfolio, or tiers can be combined to provide participants with the ability to combine active management with low cost passive solutions. In addition to providing multiple options for participants, this lineup is designed to capitalize on different behaviors exhibited by participants when considering an investment strategy.

The primary objective of the assets within a DC plan is to fund the retirement of the participants. The most significant drivers influencing the ability to reach this objective are the participant's savings rate, the asset allocation strategy chosen, and the amount of time available to accumulate the necessary assets. Although a plan sponsor has very little control over a participant's savings rate or the amount of time available for the participants to save, they can, through careful plan construction, influence the ability of the participant to develop a proper asset allocation strategy.

Portfolio construction begins with the concept of diversification; selecting multiple asset classes with widely varying characteristics and highly uncorrelated return profiles. Different combinations of these asset classes can be used to construct portfolios with varying risk and return characteristics. Each additional asset class has the potential to provide an additional diversification benefit. However, it is important to weigh the unintended consequences of adding too many asset classes.

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These unintended consequences can be better explained by considering participant behavior. One unintended consequence comes from the fact that participants often form a bias towards the status quo. In the absence of guidance, participants may choose a “do nothing” approach to investing. This bias tends to increase as the number of investment choices also increases.

Participants can be overwhelmed by the number of alternative fund choices and in extreme cases choose to not invest at all. In other cases, a participant that has a basic understanding of the concept of diversification may tend to spread their assets over multiple asset classes. However, lacking an understanding of all of the investment alternatives, the participant may choose to spread their assets evenly over all of the investment choices. Depending on the structure of the lineup, this will lead to portfolios that are either too conservative or too aggressive for the participant's stage of life.

What's New at PEI?

The PEI Team

Joe Mattei joined PEI as a Senior Consultant based in Dallas, TX. He is a 20 year veteran of the retirement industry, covering a wide spectrum of roles including Employee Education Consultant, Implementation Manager, Client Consultant, and Vice President.

Brooke May joined PEI as Marketing Manager, a new position at the firm. Her role is to improve PEI's brand recognition and help grow the firm's national presence.

PEI also welcomed two new investment analysts in December 2010, Ryan Stuart and Jack Menke. PEI has over 20 analysts whereas 95% of firms employ less than 12 full-time associates according to research from Ann Schleck & Company.

PEI Out and About

David Hudak, Senior Consultant was named to the ASPPA GAC IRS Subcommittee. The purpose of the IRS subcommittee is to monitor the audit and enforcement activities of the IRS and to analyze formal, informal and proposed guidance issued by the IRS and Treasury.

Fred Stewart, Senior Consultant, will serve as a moderator during the 2011 P&I East Coast DC Conference.

Three Tier Lineups for DC Plans - cont.

Another unintended consequence that often arises from the lineup chosen by the plan sponsor is the endorsement effect. The endorsement effect refers to the misconception by plan participants that the plan sponsor is endorsing the investment choices as good investments for them. This is of particular concern when adding a new asset class to the lineup. In most cases, the plan sponsor added the asset class in order to provide an additional level of diversification for the participant with the expectation that the participant will invest no more than an appropriate amount towards that asset class. However, what often happens is that participants will view the new investment as a “hot issue” and will “load up” on this asset class and purchase an amount that is inconsistent with proper diversification.

Other behavior trends that a plan sponsor should be cognizant of relate to loss adverse investors and spontaneous investors. Specifically, myopic loss aversion is the tendency to view the volatility of investments in very short term time increments, despite the fact that participants have a very long term investment time horizon. This tendency to view investment risk only in the short term often leads to investors avoiding equity investments and gravitating towards low risk stable value investments. The long-term, low absolute return of these investments is often detrimental to the ability of participants to accumulate enough wealth to retire. On the other side are the spontaneous investors. Spontaneous investors tend to ignore short-term volatility and focus purely on short-term gains, specifically short term historical gains. These investors will tend to overweight the latest “hot” investments without any consideration for the risk associated with these investments. This often leads to a repeating cycle of purchasing investments when they are high and selling investments when they are low, leading to poor long term portfolio performance.

Underpinning our success has been our core philosophy:

do everything in the best interest of the client.

By being true to this tenet, we hope to continue to grow as a firm and serve our clients.

Portfolio Evaluations, Inc. (PEI) is an independent, institutional investment consulting firm. Started in 1992, PEI has been established as the benchmark for conflict-free analysis and expert advice.

For further information on how PEI can help you achieve your goals, please contact Brooke May at 973.538.4347.

This newsletter has been prepared exclusively for informational purposes. Every effort has been made to provide accurate and authoritative information in regards to the subject matter in this newsletter; however, accuracy and completeness cannot be guaranteed and is now warranted as such. Numerous sources were used in compiling the data for this newsletter. PEI does not assume responsibility for the accuracy or completeness of such information. The information contained in this newsletter is provided with the understanding that PEI is not engaged in rendering legal, accounting, or actuarial advice. If such advice is required, the services of a competent professional of this kind should be sought. The information contained in this newsletter does not constitute the recommendation of any advisement advisor or their services nor does PEI assume responsibility for the conduct of any investment manager.

About PEI

PEI serves a wide range of clients including corporations, government, Taft-Hartley, foundations & endowments, and board designated.

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