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# Retirement Report

NEWS AND UPDATES FOR PLAN SPONSORS AND FIDUCIARIES OF DEFINED CONTRIBUTION PLANS

## Index Funds – More Than Meets the Eye

The largest misconception about index funds is that their only distinguishing feature is their fees. It's not uncommon to hear, "index funds are just holding the stocks or bonds in the index, so we don't need to pay attention to them." This assumption, however, is an oversimplification. Many investors don't realize that all index funds are not created equally.

A key difference between indexes and index funds is that index funds are exactly that – funds. Index funds manage obstacles that indexes themselves don't face. The largest is that funds actually must transact in securities whereas indexes do not.

As an example, when Standard and Poor's recently added Facebook (FB) to the S&P 500 Index to replace Teradyne (TER), S&P simply recalculated the index values based on the closing prices of the securities on the effective date. Index **funds** that track the S&P 500, however, had to sell out of their positions in TER and purchase FB, PLUS rebalance the weightings of any remaining securities that were impacted by the change. Trading in these securities exposed the funds to transaction costs such as commissions and market impact. Additionally, funds face the risk that their realized trade prices on the securities may be different than the values used to calculate the index, creating a difference in performance. In this example, the impact of these factors is generally small.

Where the impact is more meaningful is in areas such as fixed income and international equities where liquidity in the securities tends to be significantly lower, there are more securities in the indexes, and changes are more frequent. The Barclays Aggregate Index, for example, has over 8,500 securities in it, with many of them not trading every day. In addition, the index rebalances on a monthly basis, so managers tracking this index must constantly adjust the fund.

Index funds must also efficiently manage flows in and out of the funds, dividends and interest payments, mergers, tax

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# Enter the Dragon

*"Be like water making its way through cracks. Do not be assertive, but adjust to the object, and you shall find a way around or through it." – Bruce Lee*

Bruce Lee is a kung fu movie icon and is considered a pioneer of American martial arts. In real life, he preached the principles of having a complete set of skills in order to be successful. In the movies, he used his all-encompassing expertise of the martial arts to win legendary battles and foil his foes. While you may never have need for his martial arts prowess, you can apply his philosophies to your retirement plan and have the expertise required for your impending showdown with the Department of Labor (DOL) or Internal Revenue Service (IRS).

Not that a DOL or IRS investigation or audit is going to be a battle. Well, perhaps, but it really needn't be.

Now this isn't to say that on occasion you may not happen across a combative investigator. Maybe he/she was cut off by an angry driver exiting the freeway on the way to your office, maybe his/her 3-year old spilled coffee all over his/her suit. Maybe it is something in your 5500 or in your response to the request for documents that struck the investigator poorly. The investigator is not "out to get" you. Investigators are not Mr. Han, the villain in Lee's *Enter the Dragon*. Rather, they are "out to" find the truth and to make certain you are running your plan properly. They are attempting to ensure that your participants are being treated appropriately, something that should be an existing concern of yours.

At this point, it should be apparent why Bruce Lee was quoted at the beginning of this article. Lee's martial arts philosophy, Jeet Kune Do, preached that one must be ever evolving and to make use of the most effective tools available. It's not in your best interest to "go into battle" with an investigator without that philosophy. You will likely lose that battle. Like Bruce Lee, your role is to keep calm, organized and responsive. You should *be like water*. You should *adjust* to what the investigator is requesting or arguing. In all likelihood, the investigator is looking for a reasonable answer or solution to put to rest any apparent or alleged issues.

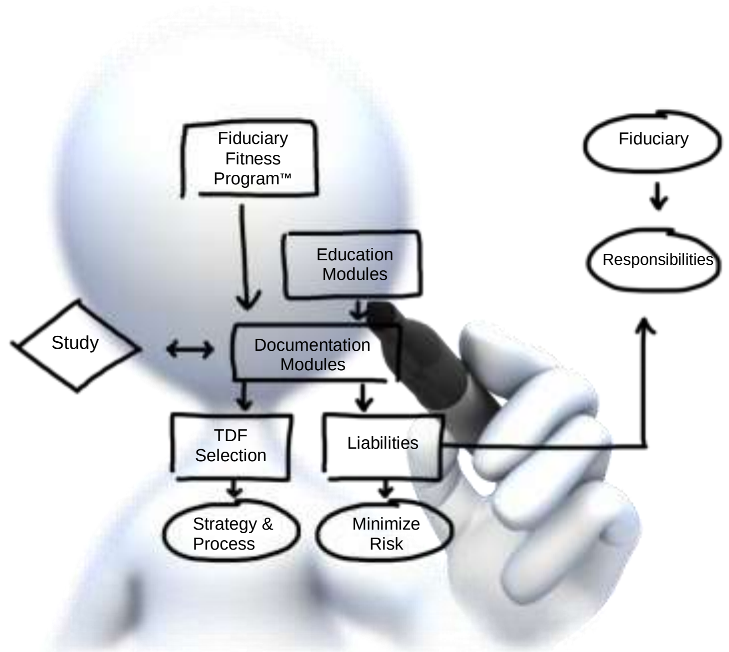
Like you, investigators have different areas of expertise. They've come from different walks of life. Each has a different professional experience that allows him/her to focus on different areas of a plan's compliance. Historically, the DOL's Employee Benefits Security Administration (EBSA) investigators requested a copy of a plan's investment policy statement (IPS) and that represented the sum total of their inquiry into the plan's investment menu and processes. Rare, if ever, did the investigator even read the IPS, much less raise issue with it. But more recently there has been an influx of EBSA investigators that are former RIAs. They are specially suited to explore your investment processes, including selection and ongoing monitoring.

The truth is that most of your work prepping for an audit should already be done prior to receiving an investigation request letter. If you have been diligently working your way through the Fiduciary Fitness Program (FFP) (that means **BOTH** education *AND* documentation modules), you should be largely prepared for a regulatory inquiry. If and when an investigator comes calling, you should turn to the FFP Modules that will inevitably be responsive to the request letter, or to the proper service provider for proper documentation.

If you have completed, or are diligently working your way through the FFP, the investigation should flow smoothly. In the absence of any unusual compliance issues, the investigation will likely wrap quickly. If you keep calm, focused and responsive (*like water*) the investigator will recognize that you take your responsibilities seriously and won't have any red flags distracting him/her. Remember – "*adjust to the object, and you shall find a way around or through it*."

# Fiduciary Training

An article by the Plan Sponsor Counsel of America came as a bit of a surprise to many plan sponsors. It read, "During several recent audits, plan sponsors were surprised to hear the DOL auditor ask for documentation that the members of the Fiduciary Committee received fiduciary training over the past year." (The article is entitled, *DOL Auditors Seek Proof of Fiduciary Training*.)




The article discusses challenges that plan sponsors face in accessing the appropriate fiduciary training. In the article, the DOL responds to this issue as follows: "Staff believes that there may be worthwhile and suitable fiduciary training programs available. Where the department has required training as part of its settlements, the fiduciaries are able to identify such programs."

Further, when asked if there is now a predisposition to add a formal (fiduciary) training program, the DOL responded, "We support anything that helps plan fiduciaries more effectively manage their plan in the best interest of the participants."

When you think about it, how can a fiduciary act in concert with ERISA guidelines for behavior if they are not sufficiently trained in what that behavior should be. Remember, fiduciaries are held to the highest standard of due diligence under ERISA's "prudent expert" rule.

Plan sponsors have varying levels of understanding of their roles and responsibilities as fiduciaries. We have made certain that our plan sponsor clients are well informed about their fiduciary status. Out of this concern, and the realization that this topic would continue to become increasingly important for our clients, we developed the Fiduciary Fitness Program. Today this program provides fiduciary education, and also serves as a self audit of fiduciary behavior and documents all major aspects of fiduciary activity.

If you have questions about your fiduciary responsibilities, or would like more information about the Fiduciary Fitness Program, please contact your Plan Consultant today.

## Are Your Written QDRO Procedures in Place?

A QDRO, or a Qualified Domestic Relations Order, is a court mandate to divide the assets of a retirement account among divorcing spouses. While there are probably few QDROs that will need to be processed by your plan over its lifetime, it's still important to confirm that you are in QDRO compliance. ERISA Section 206(d)(3)(G)(ii) requires that a plan have written QDRO procedures in place and that the QDRO procedures are sent to the participant and each alternate payee upon receipt of a domestic relations order. Every plan sponsor should confirm that such written procedures exist and further, should easily be able to furnish the document upon request (by an IRS or DOL auditor for example). Contact your Plan Consultant to help you with this important task.

# Index Funds

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consequences and securities lending – all challenges that the underlying indexes do not face.

Fortunately, most index managers are adept at keeping their funds in-line with their benchmarks, so the impact of these factors on fund performance is generally small – small, but important. Just like active funds, evaluating index funds requires careful analysis beyond fees and should also include performance and risk. The index fund metrics in the Scorecard System™ incorporate all of these, providing a complete picture of the factors that produce the most effective index funds.

*About the Author, Solomon Stewart, CFA*

As a Plan Consultant for 401(k) Advisors, Solomon is responsible for conducting investment due diligence reviews for optimal plan performance, while ensuring ongoing fiduciary best practices in plan design and operations. He came to 401(k) Advisors with a diverse background in the investment industry and brings with him over seven years of experience. Solomon has worked in both investment and client service roles, and most recently worked for BlackRock's iShares ETF group as a strategist focused on fixed income markets. Solomon holds the Chartered Financial Analyst (CFA) designation, an MS in Financial Analysis and Investment Management from St. Mary's College of California and a BS in Finance from the University of Arizona. Solomon and his wife live in San Clemente, California where they enjoy spending time at the beach and engaging in a variety of ocean-related activities.

## COMMUNICATION CORNER: Are you on track to enjoy life post-employment?

This month's employee memo is titled, "Are you on track to enjoy life post-employment? This memo addresses several factors during different retirement phases (10 years, five years, three years and one year before retirement as well as during retirement) and provides tips for participants to best prepare for retirement.

As a reminder, we post each monthly participant memo online via the Fiduciary Briefcase™ (fiduciarybriefcase.com) and it is also available in Spanish.

Call or email your Plan Consultant if you have questions or need assistance.