

Retirement Report

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

The Fed Steps Back-Will Active Equity Funds Step Up?



In October, the Federal Reserve (the Fed), will wrap up its asset purchase program whereby it monthly purchased billions of dollars of bonds in the open market. The Fed believes enough recovery in key economic measures has occurred and the strength of the U.S. economy now warrants winding down these asset purchases. In addition to the end of bond buying, the Fed also stated that it expects to begin raising the Fed funds' rate at some point in 2015. This key interest rate measure—what financial institutions that maintain deposits at the Fed can charge one another when they borrow and lend overnight—has effectively stayed near zero since the depths of the credit market crisis in late 2008. These current Fed actions create a “normalization” of Fed policy and will likely create a “normalization” of the asset markets.

Since the beginning of the Fed's monetary policy in 2009, we have seen strong bond markets and a highly correlated and liquidity-driven stock market, in which stocks have delivered strong absolute returns, best described as a rising tide that has lifted all ships. Despite respectable returns by active fund managers, relative to their benchmark, less than one-quarter of these managers have outperformed over this five-year period.

History has shown a pattern of performance leadership shifts between active and passive strategies. In a more volatile market, where stock selection can play a key role in outperformance, active managers can truly add value. However, amidst the sea of liquidity provided by the Fed, we have seen very little volatility in the market (as seen most recently by seven straight quarters of positive returns for the S&P 500), and active management has therefore been less of a factor.

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Ten Years Later: Scorecard Retrospective



The year was 2003. Investment due diligence reports totaling over 100 pages per recordkeeper were the standard. The assumption was that these exhaustive investment due diligence reports would lead to clear decisions regarding analyzed investment strategies. Instead, these large reports increasingly made investment decision making a random process. Sometimes, trendy statistics were used. At other times, a certain chart was preferred. Rarely was the same time period selected. Many times, the statistic or time period chosen was dependent on the story the consultant was trying to tell. Over time, it became clear that consultants favored different charts and graphs leading to different conclusions even when using the same data set. Plan sponsors also had their favorite statistics, favoring mostly peer group ranking charts.

The random process made it difficult to know whether a plan sponsor would choose one investment strategy over another. Nothing was ever clear cut, not even the starting point. It became a case-by-case, or rather, consultant-by-consultant basis. When it was time for a plan sponsor's investment decision, anything went.

ERISA's standard of care definition made clear that fiduciaries would be held to a very high standard. Institutional money managers were accustomed to this high standard. Few aspects, if any, of the investment process were random. Therefore, it was frustrating that retirement plan fiduciaries were not only random but also reckless with their investment due diligence approach. This approach certainly was not the intent of ERISA's standard of care. Since 1974, ERISA had been evolving.

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Allowable Plan Expenses: Can the Plan Pay?

The payment of expenses by an ERISA plan (401(k), defined benefit plan, money purchase plan, etc.) out of plan assets is subject to ERISA's fiduciary rules. The "exclusive benefit rule" requires a plan's assets be used exclusively for providing benefits. ERISA also imposes upon fiduciaries the duty to defray reasonable expenses of plan administration. General principles of allowable expenses include the following:

- The expenses must be necessary for the administration of the plan.
- The plan's document and trust agreement must permit use of plan assets for payment of expenses.
- The expenses must be reasonable and incurred primarily for the benefit of participants/beneficiaries.
- The expense cannot be the result of a transaction that is a prohibited transaction under ERISA, or it must qualify under an exemption from the prohibited transaction rules.

In light of today's plan fee environment, it is incumbent upon fiduciaries to request full disclosure of fees and expenses, how they breakdown with services provided, as well as a request for full explanation of who will be the recipient of fees. Ultimately the ability to pay expenses from a plan trust is a facts and circumstances determination that needs to be made by plan fiduciaries. Because it is possible that the DOL may challenge such determinations it is important that fiduciaries consult ERISA counsel prior to paying questionable expenses from a plan trust and document the decision and reasoning. For more information on this topic contact your plan consultant.

ERISA Fidelity Bond versus Fiduciary Liability Insurance

Plan sponsors often ask, “Is an ERISA fidelity bond the same thing as fiduciary liability insurance?” The answer is no, they are not the same. The two insure different people and have different requirements under the terms of ERISA.

An ERISA fidelity bond is required under ERISA Sec. 412. Its purpose is to protect the plan, and therefore the participants. It does this by ensuring that every fiduciary of an employee benefit plan, and every person who handles funds or other property of the plan, be bonded. This protects the plan from risk of loss due to fraud or dishonesty on the part of the bonded individuals. The amount of the fidelity bond is 10% of the plan assets (with a \$1,000 minimum) and is capped at \$500,000 (or \$1,000,000 for plans with company stock).

Fiduciary liability insurance protects the fiduciaries (not the plan or participants) from a breach of their fiduciary responsibilities with respect to the plan. Remember that fiduciaries may be held personally liable for losses incurred by a plan as a result of their fiduciary failures. Unlike a fidelity bond, fiduciary liability insurance is not required under ERISA. The Department of Labor may ask whether the plan fiduciaries have insurance in the event of an investigation. It’s important that fiduciary liability insurance explicitly covers “ERISA” claims. Review of any policy, including E&O policies, should look for language that may void the coverage in the event a plan has ever been out of compliance (something virtually all plans experience at some point in their existence).

The Fed Steps Back

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Although it is possible this advance continues in the straight-upward direction, going forward we will likely witness a market cycle consisting of a more normal pattern of both up and down quarters for the equity market because of the Fed ending its asset purchase program. The normal pattern for the equity market over its history and over the long term has resulted in healthy returns in full market cycles. Returning to a normal market environment should result in more rewarding relative performance prospects of active equity managers and the plan participants who utilize active stock funds in their investment lineup.

About the Author, Daniel Kallus, CFA, CIC



Daniel Kallus, CFA, CIC uses his vast experience in the equity portfolio management industry to bring best-in-class investment due diligence consulting to plan sponsor clients. As a CFA charterholder, Daniel has a highly technical perspective that allows him to effectively communicate the finer aspects of a retirement plan’s investment lineup. Daniel is a CFA charterholder and is a member of the CFA Institute and the Houston Society of Financial Analysts. He is also a Chartered Investment Counselor. Daniel received a BBA summa cum laude in finance from the University of Houston in 1993 and an MBA from the University of Houston in 1997.

Scorecard Retrospective

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While the evolution came slowly, it did eventually come to fruition, specifically with ERISA’s “prudent man rule.” This rule mandates advisors to make investment decisions in the same manner required of a “prudent person.” A prudent person, however, did not necessarily connote one skilled in investments, and therefore over time this rule evolved into the “prudent expert rule.” This rule clearly indicates that prudent investment experts, not just prudent people, should make investment decisions. Similar to investment managers who had well-defined standards and criteria for managing money, retirement plan fiduciaries required similar elevated standards for their process. At the same time, procedural prudence became just as important as adhering to well-defined investment standards and criteria. A new “gold standard” for retirement plan fiduciaries emerged. Expectations for a “prudent expert” were being set and clarified.

The new standard, however, only caused more frustration as retirement plan fiduciaries still seemingly failed to grasp its meaning. There had to be an alternative to the production of 100-page reports that would likely not meet the standards of ERISA.

Similar to investment managers' practice, the better way to conduct investment due diligence was to organize it around a process. To do this, an evaluation system of relevant criteria was needed. This system would set the process and allow fiduciaries to follow some procedural prudence, incorporating the same institutional criteria that investment managers utilized instead of the simple peer group rankings used in the retail environment. Such a process would remove the randomness of consultant-to-consultant review and would lay the groundwork for the establishment of a formal process.

Shortly after mid-2003, the Scorecard System™ was created. The Scorecard™ was designed to incorporate the essential ingredients in identifying manager skill. It set a process, but a process itself is not the final answer for fiduciaries. Such a system, similar to those used on the investment management side, must be back-tested before inception and consistently evaluated while in use to gauge whether it adds value. The Scorecard has its own back study, where actual results are tested to quantify if the score (the quantitative investment due diligence) provides a meaningful result.

While the Scorecard System has many imitators, the retail-based systems from which many of these imitators are derived fail to capture the value of the institutional metrics utilized by the Scorecard System because comparing a fund to its peer group, the most common retail scoring method, lacks a forward-looking component.

In creating the Scorecard, the questions were simple. Could retirement plan fiduciaries operate in the same manner as investment professionals? Should a similar level of investment expertise exist in the process? Fiduciaries needed it, and the "prudent expert rule" demanded it. The answer was the Scorecard System.

Cognizant of ERISA, the Scorecard System allows fiduciaries to follow a better and more efficient approach to their investment decision making. Through the back studies conducted, the Scorecard System's value can be quantified as a selection tool and for ongoing monitoring.

What started as frustration with 100-page portfolio analytic reports led to something new and revolutionary—the Scorecard System now in its tenth year.

COMMUNICATION CORNER: What Type of Investor Are You?

This month's employee memo is titled: Conservative or Aggressive? It is a quiz participants can take to find out what kind of investor they are.

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.

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