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Retirement Plan Investments: A Conversation with an Investment Services Professional

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Mary Giganti interviews Howard Essner, Managing Director and Executive Committee Member of Ancora, located in Cleveland, Ohio

Q What are the key duties of a trustee regarding retirement plan investments?

A The trustee or investment committee's duty can be divided into categories: (1) the construction of the investment menu and (2) the duty to monitor.

Q What is the process to construct the investment menu?

A The financial advisor will review with the trustee what types of funds and the investment options that will be in the plan. There is very little guidance from the U.S. Department of Labor (DOL) on what plan investments must include. The DOL requires that retirement plans construct a portfolio to meet participants' risk profiles; and generally offer a broad range of funds to meet that risk profile. Our general approach is simplicity. Studies show that too many choices create confusion and inaction.

Q What is the construction of a general investment menu?

A Following the rule of simplicity for participants, we start with target date funds or risk-based fund model portfolios. The key is to develop what is the appropriate target date and risk-based. This analysis is quite in-depth. We generally have five of these funds. Then you blend passively managed index funds and actively managed funds of U.S. stocks. We typically hit the four corners of the style box for actively managed funds and use index funds for the blend style. The style box is the nine square grid to represent investment styles. It classifies investments by market capitalization (large, mid and small) on the vertical axis and growth, blend and value on the horizontal axis. The four corners would be: large growth, large value, small growth and small value. We then add a few international funds (active and passive), a few bond funds and a stable option. From there, depending on the employee demographics and trustee's preferences, you can add additional funds such as technology, fixed income or other specialty areas. This process and the decisions reached should be documented.

Q Is the documentation to which you are referring the investment policy statement?

A No, the investment policy statement comes later. First, you need to document the steps taken to construct the portfolio, the rationale for you decisions, and methodology used to identify and evaluate the funds that went into the portfolio. Some of this information will make its way into the investment policy statement.

An investment policy statement is a description of how funds are evaluated, the asset classes included, and when and if to offer specialty funds. It documents the process of creating the investment menu, the selection of the investments, the on-going review process, and criteria of when to watch and replace various investment options. Investment advisors can assist creating the investment policy statement. Every retirement plan should have an investment policy statement.

Q How often should a trustee review investments and its investment policy statement?

A Plan investments and the investment policy statement should be regularly reviewed, at least on an annual basis. Our preference is quarterly or semi-annually.

Q What should the review entail?

A There is no "right" system to use to evaluate investments; there are many systems that a financial advisor could use. The key for the trustee is to have a well-documented process to evaluate and review the investments, and follow that process. For example, the documented process might identify the criteria that may put a particular fund on a "watch list" and may require the replacement of the fund if it remains on that list for three quarters or more.

The investment policy statement and the periodic reviews, documented with meeting minutes and items reviewed, will assist the trustee to build a fiduciary file for the investment selection. We had clients go through DOL audits with no issue on the investment selection because they had a documented process and could demonstrate, through documentation, that they followed the process.

Q Why should a plan with participant direction of investment have an investment policy statement?

A As noted above, the investment policy statement is the written documentation of the investment options offered to the participants. The participants choose among the investment options offered. The trustee maintains responsibility (and liability) for the types of investments offered. The trustee should document the investment options offered, and the process to review the on-going options and when to change the options.

You can appreciate that a formal process is rather common among plans with a large amount of assets and a large number of plan participants. Nevertheless, even small plans should have a formal process and regular reviews.

Q What type of financial/investment understanding should a trustee have?

A In most of our plans, we act as a 3(21) advisor, and the trustee takes responsibility for accepting or rejecting our recommendations. The financial advisor should review the investments, measurements, and performance and report those to the trustee. The trustee should understand the overall structure and over-arching approach. The trustee should understand what they are looking at and why the investment advisor is making the recommendation (*i.e.*, stay with particular investments or make changes). It is reasonable for the trustee to rely on the financial advisor for their expertise to understand the various investment measurements and performance.

Q Could you quickly explain the difference between a 3(21) advisor and a 3(18) advisor?

A A 3(21) fiduciary is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

A 3(38) fiduciary is a fiduciary who (i) has the power to manage, acquire, or dispose of any asset of a plan, (ii) is a registered investment manager, and (iii) has acknowledged in writing that he is a fiduciary with respect to the plan. Generally, there is a greater transfer of fiduciary liability to a 3(38) fiduciary.

Q What type of financial/investment education should participants receive regarding the retirement plan investments?

A Participants should understand asset allocation and risk tolerance. Target date funds and risk-based funds are a good starting point for participants. They involve a broad-based allocation of assets and address asset allocation and risk tolerance.

Q How often do you meet with participants?

A Most plan sponsors have an annual meeting with the participants. These meetings are usually group meetings, with an opportunity for one-on-one discussions. These annual meetings can be part of benefit fairs, broader-based education days and financial wellness days. These meeting documents (notices, handouts, powerpoints, etc.) should also be part of the fiduciary file. The participants also have the investment advisor's information so that they can schedule a one-on-one meeting outside of the meeting day. Participants can also call at any time with questions.

Q What communications should be made during a market downturn or regarding volatility?

A Education before a downturn is key. In a downturn or in a volatile market, it is important to remind participants about diversification and asset allocation. You should also review staying invested for the long-term horizon of retirement and dollar cost averaging.

Q What are some of the common characteristics you see in a retirement plan that has good participation and involved participants?

A There are several I see. First, the owners and management of the plan sponsor are engaged in the plan, and the employees see that engagement. The plan sponsor communicates the importance of the retirement plan, what the plan sponsor is doing and what is the participant's responsibility regarding retirement planning. The plan sponsor makes a financial commitment to the participants, through a matching contribution, safe harbor contribution, or other profit sharing contribution, and communicates that commitment to the participants, including any vesting schedule attached to those contributions. The plan sponsor will also emphasize that this is one piece of overall financial wellness, and will also have a broader financial wellness program.

Thank you Howard; we appreciate you sharing your insights with us.