

#### A HANDBOOK FOR INVESTMENT FIDUCIARIES

Persons who have the legal responsibility for managing someone else's money.

Investment Committees of Retirement Plans, Foundations, and Endowments
Investment Advisors, Consultants, Private Bankers, Financial Planners
Trustees of Private Trusts

#### PRUDENT INVESTMENT PRACTICES

#### A HANDBOOK FOR INVESTMENT FIDUCIARIES

#### Written by the Foundation for Fiduciary Studies

Donald B Trone J Richard Lynch Mark A Rickloff Andrew T Frommeyer

#### **Board of Directors**

Bill Allbright, Esq., CPA Susan Davis Rich Koppes, Esq. Charles Lowenhaupt, Esq. Eugene Maloney, Esq. Don Phillips Bert Schaeffer, Esq.

Frank Sortino, Ph.D Donald B Trone Mary Lou Wattman

Legal Review by Reish Luftman McDaniel & Reicher

C. Frederick Reish, Esq. \ Bruce L. Ashton, Esq.

Copyright © 2002. Foundation for Fiduciary Studies. All rights reserved.

The format, process, practices, and procedures of this handbook are PROPRIETARY.

No portions of this handbook may be reproduced without the permission of the

Foundation for Fiduciary Studies, Pittsburgh, PA (412) 390-5077.

TABLE OF CONTENTS	PAGE
Introduction	4
BENEFITS OF THE PRACTICES	8
PRACTICES MATRIX	9
<b>Practice No. 1.1</b> Investments are managed in accordance with applicable documents, and written investment policy statements	e laws, trust 12
Practice No. 1.2 Fiduciaries are aware of their duties and responsibilities	15
Practice No. 1.3 Fiduciaries and parties in interest are not involved in se	elf-dealing 17
<b>Practice No. 1.4</b> Service agreements and contracts are in writing, and do provisions that conflict with fiduciary standards of care	not contain 19
<b>Practice No. 1.5</b> There is documentation to show timing and distribution flows, and the payment of liabilities	of cash 20
<b>Practice No. 1.6</b> Assets are within the jurisdiction of U.S. courts, and are from theft and embezzlement	e protected 21
Introduction to Practice Nos. 2.1 - 2.5	22
Practice No. 2.1 A risk level has been identified	25
Practice No. 2.2 An expected, modeled return to meet investment object been identified	ives has 27
Practice No. 2.3 An investment time horizon has been identified	28
Practice No. 2.4 Selected asset classes are consistent with the identified and time horizon	risk, return, 30
Practice No. 2.5 The number of asset classes is consistent with portfolio	size 32
INTRODUCTION TO PRACTICE NOS. 3.1 - 3.7	35
Practice No. 3.1 There is detail to implement a specific investment strate	egy <b>36</b>
<b>Practice No. 3.2</b> The investment policy statement defines the duties and responsibilities of all parties involved	38
<b>Practice No. 3.3</b> The investment policy statement defines diversification rebalancing guidelines	and <b>39</b>

TABLE OF CONTENTS CONTINUED	PAGE
<b>Practice No. 3.4</b> The investment policy statement defines due diligence criteria for selecting investment options	41
<b>Practice No. 3.5</b> The investment policy statement defines monitoring criteria for investment options and service vendors	42
<b>Practice No. 3.6</b> Investment policy statement defines procedures for controlling and accounting for investment expenses	43
<b>Practice No. 3.7</b> Investment policy statement defines appropriately structured, socially responsible investment strategies (when applicable)	44
Introduction to Practice Nos. 4.1 - 4.4	46
<b>Practice No. 4.1</b> The investment strategy is implemented in compliance with the required level of prudence	47
<b>Practice No. 4.2</b> Fiduciary is following applicable "Safe Harbor" provisions (when elected)	53
Practice No. 4.3 Investment vehicles are appropriate for the portfolio size	55
<b>Practice No. 4.4</b> A due diligence process is followed in selecting service providers, including the custodian	61
Introduction to Practice Nos. 5.1 - 5.5	62
Practice No. 5.1 Periodic performance reports compare the performance of money managers against appropriate index, peer group, and IPS objectives	63
Practice No. 5.2 Periodic reviews are made of qualitative and/or organizational changes to money managers	66
Practice No. 5.3 Control procedures are in place to periodically review a money manager's policies for best execution, soft dollars, and proxy voting	67
Practice No. 5.4 Pees for investment management are consistent with agreements and with the law	70
Practice No. 5.5 "Finders fees," 12b-1 fees, or other forms of compensation that have been paid for asset placement are appropriately applied, utilized, and documented	72
Conclusion	73
ENCLOSURE 1: SAMPLE INVESTMENT POLICY STATEMENT	74
ENCLOSURE 2: GLOSSARY OF TERMS	89

#### PRUDENT INVESTMENT PRACTICES

#### INTRODUCTION

The primary purpose of this handbook is to outline the *Practices* that define a prudent process for investment fiduciaries. It is intended to be a reference guide for knowledgeable investment decision makers, as opposed to a *How to* manual for persons who are not familiar with basic investment management procedures.

The term *fiduciary* is inclusive of the more than five million people who have the legal responsibility for managing someone else's money including members of investment committees of retirement plans, foundations, and endowments; trustees of private trusts; and investment advisors. Fiduciary status is determined by facts and circumstances, but generally is defined as a person who:

- 1. Manages property for the benefit of another;
- 2. Exercises discretionary authority or control over assets; and/or
- 3. Acts in a professional capacity of trust, and renders comprehensive and continuous investment advice.

#### PRIMARY DUTY OF THE FIDUCIARY

To *manage* a prudent investment process, without which the components of an investment plan cannot be defined, implemented, or evaluated. Statutes, case law, and regulatory opinion letters dealing with investment fiduciary responsibility further reinforce this important concept.

#### **Illustration Introduction 1**

Fiduciaries have the most important, yet most misunderstood role in the investment process: to manage the investment practices, without which the other components of the investment plan can be neither defined, implemented, or evaluated. Statutes, case law, and regulatory opinion letters dealing with fiduciary status further reinforce this important concept.

#### **Introduction (continued)**

The legal and practical scrutiny a fiduciary undergoes is tremendous, and it comes from multiple directions and for various reasons. It is likely that complaints and/or lawsuits alleging fiduciary misconduct will increase. Although some of these allegations may be entirely justified, most can be avoided by following the investment *Practices* outlined in this handbook. Fiduciary liability is not determined by investment performance, but rather on whether prudent investment *practices* were followed. *It's not whether you win or lose, it's how you play the game.* 

A fiduciary demonstrates prudence by the process through which investment decisions were managed, rather than by showing that investment products and techniques were chosen because they were labeled as "prudent." No investments are imprudent on their face. It is the way in which they are used, and how decisions as to their use are made, that will be examined to determine whether the prudence standard has been met. Even the most aggressive and unconventional investment can meet that standard if arrived at through a sound process, while the most conservative and traditional one may not measure up if a sound process is lacking.

On a more positive note, the *Practices* also make good investment sense. Superior investment returns result from developing a prudent investment process, and then sticking to it. The *Practices* can provide the foundation and framework for such an investment process, and help to keep fiduciaries from making *ad hoc* investment decisions influenced by emotions, market noise, press-appointed investment gurus, and/or product peddlers.

This handbook covers twenty-seven *Practices* that define a prudent investment management process from beginning to end. Each *Practice* is followed by citations to the legislation, case law, and/or regulatory opinion letters that serve as the basis for the *Practice*. A second handbook has been published, *Legal Memorandums for Prudent Investment Practices*, which provides a much more detailed explanation and legal opinion on the citations for each of the twenty-seven *Practices*. [The legal memorandums were prepared by the law firm of **Reish Luftman McDaniel & Reicher**. To purchase a copy, contact the **Foundation for Fiduciary Studies** (412) 390-5080.]

The legislative basis for each of the twenty-seven *Practices* include:

ERISA - Employee Retirement Income Securities Act (impacts qualified retirement plans).

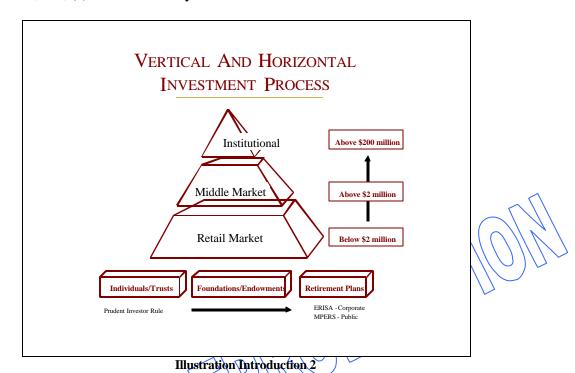
UPIA Uniform Prudent Investor Act (impacts private trusts, and may impact foundations and endowments). [See *Comments Section* for states that have enacted UPIA.]

MPERS – Uniform Management of Public Employee Retirement Systems Act (proposed legislation that may impact state, county, and municipal retirement plans). [See *Comments Section* for states that have enacted MPERS.]

#### **Introduction (continued)**

A distinction will be made between what law requires and what represents a generally accepted practice in the investment industry. An **industry best practice** will be prefaced with **[IBP]**.

Throughout this handbook, periodically we will use the term *market segments* to refer to the different types of fiduciary accounts. To simplify this discussion, we have broken the different fiduciary accounts in to four groups: (1) defined benefit plans, in which investment decisions are generally committee-directed; (2) defined contribution plans, in which investment decisions generally are participant-directed; (3) foundations and endowments, also referred to eleemosynaries; and, (4) individual/family accounts.



This handbook is about the *Practices* that a fiduciary should follow to successfully manage investment decisions. By following a structured process based on these *Practices*, the fiduciary can be confident that critical components of an investment strategy are being properly implemented.

#### Comments Section

Several of the handbook's themes are from **The Management of Investment Decisions** (McGraw-Hill, New York, 1996) by Donald B Trone, William R Allbright, and Philip R Taylor.

The UPIA was released by the Uniform Law Commissioners in 1994, and subsequently approved by the American Bar Association and American Bankers Association.

#### **Introduction (continued)**

#### **STATE ADOPTIONS:**

Alaska Maine Ohio Oklahoma Arizona Massachusetts Arkansas Maryland\*\* Oregon Michigan California Pennsylvania Colorado Minnesota Rhode Island Connecticut Missouri South Carolina District of Columbia Nebraska *Tennessee* New Hampshire Utah Hawaii Idaho New Jersey Vermont Illinois New Mexico Virginia North Carolina Indiana Washington Iowa North Dakota West Virginia Kansas **Wyoming** 

#### 2002 INTRODUCTIONS:

Wisconsin

To date, only one state has formally adopted MPERS: South Carolina.

This handbook is not intended to be used as a legal opinion. The fiduciary should discuss results with an attorney knowledgeable in this specific area of the law. Nor is this handbook intended to represent specific investment advice.

The primary purpose of this handbook is to outline the **Practices** that define a prudent investment process for investment fiduciaries. The scope of this handbook will not include: (1) financial, actuarial, and/or record keeping issues; (2) valuations of closely held stock, limited partnerships, hard assets, insurance contracts, hedge funds, or blind investment pools; (3) risk management issues such as the use of derivative and/or synthetic financial instruments; and/or (4) organizational/structural issues of the fiduciary.

<sup>\*\*</sup>Substantially similar

# BENEFITS OF THE *PRACTICES* ¹ Help to establish evidence that the fiduciary is following a prudent investment process, which may minimize litigation risk. The *Practices* are easily adaptable to all types of portfolios, regardless of size or intended use. Serves as a practicum for all parties involved with investment decisions (money managers, investment advisors, consultants, accountants, and attorneys), and provides an excellent educational outline of the duties and responsibilities of investment fiduciaries. May help to increase long-term investment performance by identifying more appropriate

*	Diversifying the portfolio across multiple asset classes and peer groups;	

Evaluating investment management fees and expenses;

procedures for:

- Selecting money managers and/or mutual funds; and/or
- Terminating money managers and/or mutual funds that no longer are appropriate.
- Help to uncover investment and/or procedural risks not previously identified, which may assist in prioritizing investment management projects with consultants, advisors, and vendors.
- ☐ Encourage fiduciaries to compare their practices and procedures with those of their peers.
- Assist in establishing benchmarks to measure the progress of an investment committee and/or consultant.
- ☐ May enable the fiduciary to negotiate a lower insurance premium for Errors and Omissions coverage.

<sup>&</sup>lt;sup>1</sup> Several of the benefit concepts were developed by Independent Fiduciary Services, Inc., Washington, DC (202) 898-2270.

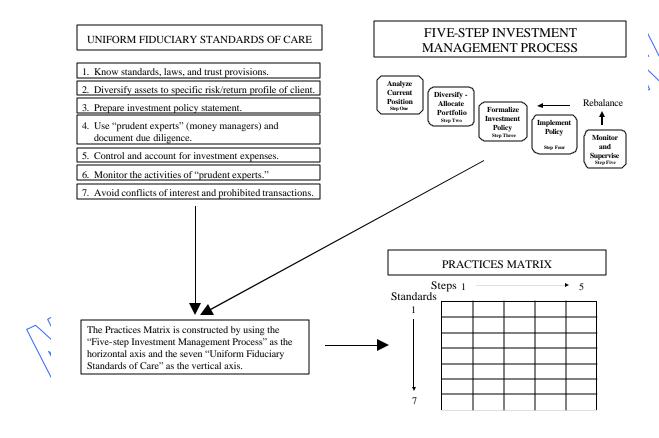
#### PRACTICES MATRIX

The twenty-seven *Practices* outlined in this handbook are intended to define a prudent investment process from beginning to end. A *Practices Matrix* has been constructed to facilitate the viewing of the *Practices*. Referring to the foldout in this handbook:

The vertical axis of the *Matrix* is the seven *Uniform Fiduciary Standards of Care*; the standards that are common to the three legislative acts that shape investment fiduciary standards – ERISA, UPIA, and MPERS. [The term *Uniform Fiduciary Standards of Care* has been coined by the authors to denote the seven standards of care that are common to the three legislative acts.]

The horizontal axis of the *Matrix* outlines the steps of a traditional investment management process, which we refer to as the *Five-Step Investment Management Process*.

The *Uniform Fiduciary Standards of Care* [legislated standards] and the *Five-Step Investment Management Process* frame a prudent investment process. To complete the picture, we have identified the twenty-seven *Practices* that provide the details to this process. For each cell of the *Matrix*, we have identified one or more *Practices*.



# Selected Quotes from the Department of Labor's Amended Brief of the Secretary of Labor Opposing the Motions to Dismiss Re: Pamela Tittle, et al., v. ENRON CORP., Oregon Corporation, et al.

The Secretary files this amicus brief expressing her view that, based on the allegations in the Complaint, ERISA required the fiduciaries to take action to protect the interests of the plans, their participants and beneficiaries, and that ERISA provides remedies for the failure to have done so. (Page 1)

ERISA's fiduciary obligations are among the "highest known to the law." <u>Bussian v. RJR Nabisco</u>, 223 F.3d 235, 294 (5<sup>th</sup> Cir. 2000). They do not permit fiduciaries to ignore grave risks to plan assets, stand idly by while participants' retirement security is destroyed, and then blithely assert that they had no responsibility for the resulting harm. (Page 2)

Corporate officers who appoint fiduciaries must "ensure that the appointed fiduciary clearly understands his obligations, that he has at his disposal the appropriate tools to perform his duties with integrity and competence, and that he is appropriately using those tools." Martin v. Harline, 15 EBC 1138, 1149 (D. Utah 1992). (Page 9)

Section 404(c) plan fiduciaries are still obligated by ERISA's fiduciary responsibility provisions to prudently select the investment options under the Plan and to monitor their ongoing performance. (Page 37)

The Supreme Court has expressly held that a nonfiduciary party-in-interest who has actual or constructive knowledge of the circumstances that made the fiduciary's actions a breach of duty and participates in that breach can be liable for appropriate equitable relief under ERISA. (Page 57)

# MISSION OF THE FOUNDATION FOR FIDUCIARY STUDIES

To develop and promote the Practices that define a prudent process for investment fiduciaries.

### FIDUCIARY CODE OF CONDUCT

If you're going to do it – *Do it right*.

As you manage investment decisions:

Document the process; Hire competent professionals; Monitor results; and *Always remember you have been entrusted with someone else's money*.

Never invest in something you don't understand or is difficult to value.

Know what you're paying for-

Don't hire the fox to count the chickens.

Understand that, when everyone is talking about making a killing - *The market already is dead*.

Cautiously approach investments that promise superior results.

Believe in the statement -

The past is no indication of future performance.

Relish the opportunity to be a steward of sound investment practices for, in the end,

it's *procedural prudence*, not performance, that counts.

Practice No. 1.1 Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements <sup>2</sup>
Our starting point is for the fiduciary is to analyze and review all of the documents pertaining to the establishment and management of the investments. As in managing any business decision, the fiduciary has to set definitive goals and objectives that are consistent with the portfolio's current and future resources; the limits and constraints of applicable trust documents and statutes; and, in the case of individual investors, the goals and objectives of the individual investor.
The following documents should be collected, reviewed, and analyzed:
☐ A copy of the Investment Policy Statement (IPS), written minutes, and/or files from investment committee meetings [See also <i>Practice No. 3.1</i> ]
☐ Applicable trust documents (including amendments) [See also <i>Practice No. 1.2</i> ]
☐ Custodial and brokerage agreements [See also <i>Practice Nos. 4.4 and 5.3</i> ]
2 Substantiating Code, Regulations, and Case Law for Practice No. 1.1:  Employee Retirement Income Security Act of 1974 [ERISA]  §3(38)(C); §104(b)(4); §402(a)(1); §402(b)(1); §402(b)(2); §403(a), §404(a)(1)(D)  §404(b)(2)
Regulations 29 C.F.R. §2509.75-5 FR-4; 29 C.F.R. Interpretive Bulletin 75-5; 29 C.F.R. §2509.94-2(2); 29 C.F.R. Interpretive Bulletin 94-2 (July 29, 1994)
Case Law  Morse v. New York State Teamsters Conference Pension and Retirement Fund, 580 F. Supp. 180 (W.D.N.Y. 1983), aff d, 761 F.2d 115 (2d Cir. 1985); Winpisinger v. Aurora Corp. of Illinois, 456 F. Supp. 559 (N.D. Ohio 1978); Liss v. Smith, 991 F.Supp. 278, 1998 (S.D.N.Y. 1998), Dardaganis v. Grace Capital, Inc., 664 F. Supp. 105 (S.D.N.Y. 1987), aff d, 889 F.2d 1237 (2d Cir. 1989).  Other
Interpretive Bulletin 75-5, 29 C.F.R. §2509.75-5; Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

 $\begin{array}{c} \textbf{Uniform Prudent Investor Act [UPIA]} \\ \S 2(a) \text{ - (d); } \S 4 \end{array}$ 

Management of Public Employee Retirement Systems Act [MPERS]  $\$4(a)-(d);\,\$7(6);\,\$8(b)$ 

Practice N	o. 1.1 (continued)
	Service agreements with investment management vendors (custodian, money managers, investment consultant, actuary, accountant, and attorney) [See also <i>Practice No. 1.4</i> ]
	Information on retained money managers; specifically the ADV for each separate account manager and prospectus for each mutual fund [See also <i>Practice No. 4.1</i> ]
	Investment performance reports from money managers, custodian, and/or consultant [See also $Practice\ No.\ 5.1$ ].
	lyzing the aforementioned documents, there are several follow-on questions which inswered:
1.	Do trust documents identify trustees and named fiduciaries? [See also <i>Practice No. 1.2</i> ]
2.	Do trust documents, statutes, and/or client instructions restrict or prohibit certain asset classes? [See also <i>Practice No. 2.4</i> ]
3.	Do trust documents allow for the fiduciaries to prudently delegate investment decisions to others? [See also <i>Practice Nos. 4.1 and 4.2</i> ]
-	ag on the <i>market segment</i> , (see <b>INTRODUCTION</b> ) there are additional documents that collected, reviewed, and analyzed:
For Defin	ned Contribution Plans:
	Participant education material Enrollment activity reports Loan activity reports
	IRS Form 5500 - Including schedules Independent accountant's audit report (required by IRS if there are more than 100
	participants) Summary Plan Description.
For Defin	ned Benefit Plans:
	IRS Form 5500 - Including schedules Independent accountant's audit report (required by IRS if there are more than 100
_	participants) Summary Plan Description Actuarial reports showing status of
	Actuarial reports showing status of: - Accumulated Benefit Obligation (ABO) - Projected Benefit Obligation (PBO)

## Practice No. 1.1 (continued) ☐ Actuarial reports showing assumptions for - Return - Interest rates - Participant pay/benefit rates. For Foundations and Endowments - Review reports that provide information on: ☐ The organization's purpose and mission-based investment strategy (if one has been adopted) [See also *Practice No. 3.7*] ☐ Equilibrium Spending Rate (ESR) to calculate inflation and investment expenseadjusted payments: ESR = Modeled Return - Inflation - Investment Management Expenses ☐ Smoothing rules to determine market value for application of ESR to calculate size of grants: - Moving average (over three years) - Preset amount over previous year (inflation adjusted) - Judging the need - committee retains option to adjust grants each year. For Individual/Family Wealth ☐ Tax status ☐ Estate and philanthropic objectives ☐ Spending rate.

#### Practice No. 1.2 Fiduciaries are aware of their duties and responsibilities<sup>3</sup>

As outlined in the **Introduction**, a fiduciary is defined as someone acting in a position of trust on behalf of, or for the benefit of, a third party. Fiduciary status is difficult to determine, and is based on *facts and circumstances*. In general, the issue is whether a person has control or influence over investment decisions. It is not uncommon for fiduciaries to be unaware of their status, which is one of the reasons why this *Practice* has been included.

Fiduciaries are responsible for the general management of the investments - in essence, the management of the twenty-seven *Practices* presented in his handbook. If statutes and trust provisions permit, the fiduciary may delegate certain decisions to professional money managers, trustees (co-fiduciaries), and/or investment advisors and consultants. But even when decisions have been delegated to a professional, a fiduciary can never fully abdicate his or her responsibilities; the fiduciary still has the ultimate responsibility for:

- 1. Determining investment goals and objectives
- 2. Approving an appropriate asset allocation strategy, or in the case of a 401(k) plan, the asset classes that will be represented by the investment options

<sup>3</sup> Substantiating Code, Regulations, and Case Law for Practice No. 1.2:

Employee Retirement Income Security Act of 1974 [ERISA] §404(a)(1)(B)

#### Case Law

Marshall v. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378 2 E.B.C. 1006 (D.Hawaii 1980); Katsakos v. Cody, 744 F.2d 270, 5 E.B.C. 1777 (2d Cir. 1984), cert. denied, Cody v. Donovan, 469 U.S. 1072, 105 S. Ct. 565, 83 L.Ed. 2d 506 (1984); Marshall v. Snyder, 1 E.B.C. 1878 (E.D.N.Y. 1979); Donovan v. Mazzola, 716 F.2d 1226, 4 E.B.C. 1865 (9th Cir. 1983), cert. denied, 464 U.S. 1040, 104 S. Ct. 704, L.Ed.2d 169 (1984); Fink v. National Savings and Trust Company, 772 F. 2d 951, 6 E.B.C. 2269 (D.C. Cir. 1985)

Other

Joint Committee on Taxation, Overview of the Enforcement and Administration of the Employee Retirement and Income Security Act of 1974 (JCX-16-90, June 6, 1990)

Uniform Prudent Investor Act [UPIA]

§1(a); §2(a); §2(d)

Management of Public Employee Retirement Systems Act [MPERS]

§7

Case Law

National Labor Relations Board v. Amax Coal Co., 453 U.S. 322, 101 S. Ct. 2789, 69 L.Ed. 2d 672 (1981)

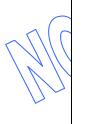
- 3. Approving an explicit, written investment policy statement consistent with goals and objectives
- 4. Approving appropriate money managers, mutual funds, or other *prudent experts* to implement the investment policy; or approving the due diligence process that will be used to select the same if investment discretion has been delegated to an investment advisor
- 5. Monitoring the activities of the overall investment program for compliance with the investment policy; or approving the performance measurement objectives and benchmarks that will be used to evaluate the same, if investment discretion has been delegated to an investment advisor
- 6. Avoiding conflicts of interest and prohibited transactions.

New trustees or investment committee members often are concerned about being qualified to perform their duties, citing their lack of Wall Street experience and acumen. This shouldn't be the case. The duties of an investment committee member are not too dissimilar to the responsibilities of any general line manager, which is: to identify goals and objectives; to determine how resources will be allocated; to prepare a business plan; to implement the business plan; and, on an ongoing basis, to monitor the results to see if the goals and objectives of the business plan are being met.

#### CHARACTERISTICS OF THE SUCCESSFUL FIDUCIARY

- 1. Does not require extensive experience in securities analysis or portfolio management.
- 2. A sincere commitment and courage to develop a consensus formulation of goals and objectives.
- 3. A personal interest in understanding the basics of capital markets.
- 4. The discipline to develop long-term investment policies, and the patience to evaluate events calmly in the context of long-term trends.
- 5. An understanding of personal and organizational strengths and weaknesses to determine when delegation and outsourcing is more appropriate.
- 6. The ability to get the right things done, otherwise known as effective management. A prudent process facilitates effective management by distinguishing important from unimportant tasks.

Illustration 1.1



	Practice No. 1.3 dealing <sup>4</sup>	Fiduciaries and parties in interest are not involved in self
--	---------------------------------------	--

**[IBP]** If a fiduciary even thinks he or she may have a conflict of interest - they probably do. The best advice is end it, or avoid it. It's that simple.

An important concept associated with this *Practice* is the term *party in interest*. The term is inclusive of, among others:

Any friend, business associate, or relative of the fiduciary

In the case of a retirement plan; any administrator, officer, trustee, counsel, or employee of the plan, or any person providing services to the plan.

**[IBP]** An excellent question every fiduciary should ask before deciding or voting on an investment issue is: *Who benefits most from this decision?* If the answer is any party other than the client (in the case of an individual or family account), participant (in the case of a retirement plan), and/or the beneficiary (in the case of a personal trust), the likelihood is the fiduciary is about to breach his or her duties.

The fundamental duty of the fiduciary is to manage investment decisions for the exclusive benefit of the client, retirement plan participant, and/or trust beneficiary. No one should receive a benefit simply because they are a friend, business associate, and/or relative of the fiduciary.

Internal Revenue Code of 1986, as amended [IRC]

Employee Retirement Income Security Act of 1974 [ERISA]

§3(14)(A) and (B); §404(a)(1)(A); §406(a) and (b)

Case Law Whitfield v. Tomasso, 682 F. Supp. 1287, 9 E.B.C. 2438 (E.D.N.Y 1988)

on Soft Dollars and Commission Recapture November 13, 1997

Other

DOL Advisory Council on Employee Welfare and Benefit Plans Report of the Working Group

Uniform Prudent Investor Act [UPIA]

§2; §5

Management of Public Employee Retirement Systems Act [MPERS]

§7(1) and (2); §17(c)(12) and (13)

Other

Forbes "Pay for Play," Sept 4, 2000; Pensions & Investments, "Trustee Queries Mercer on Work," p. 10; Fortune "The Seamy Side of Pension Funds," Aug 12, 2002.

<sup>&</sup>lt;sup>4</sup> Substantiating Code, Regulations, and Case Law for Practice No. 1.3:

#### Practice No. 1.3 (continued)

#### Examples of common breaches:

- Using retirement plan assets to buy real estate for corporate expansion
- \* Trading a client's account solely to generate additional commissions (also referred to as *churning* a client's account)
- Using the assets of a public retirement plan to invest in local high-risk business ventures
- Using the assets of a private trust to provide unsecured loans to related parties and/or entities of the trustee
- Using a company retirement plan as collateral for a line of credit
- \* Buying artwork and/or other collectibles with retirement plan assets, and putting the collectibles on display.

Generally speaking, every investment program has at least three components:

- 1. The money manager who is selecting the stocks and bonds for the portfolio
- 2. The brokerage firm that is executing the trades
- 3. The custodian that is holding and safeguarding the securities.

[IBP] Larger, institutional portfolios (\$200 million or more) should attempt to ensure that the three parties (money manager, broker, and custodian) are all separate and unrelated entities. This approach provides for a system of checks and balances. If one were to examine cases involving breaches of investment fiduciary responsibility, one would inevitably find that there was a breakdown in the checks and balances, and that the breaching party was fulfilling, or attempting to fulfill, multiple roles. A good example is the money manager who only uses its own broker dealer for executing trades.

[IBP] Another common problem is the pay-to-play schemes practiced by investment advisors/consultants that claim to be objective, independent third-parties, but are not. [This should not be confused with brokers who have properly disclosed that all or part of their compensation may be commission-based.]

The fiduciary has a responsibility to control and account for investment expenses (*Uniform Fiduciary Standards of Care*) and, therefore, should require his or her investment advisor/consultant to fully disclose and detail all revenue, benefits (such as trips for the purposes of *due diligence*), and /or income received as a result of:

- 1. Trades executed on behalf of the account, also known as directed brokerage [See also *Practice No. 5.3*]
- 2. Selling investment services, conference seminars, and/or any other consulting services to the very same money managers or service vendors that the advisor/consultant is recommending to the fiduciary.

# Practice No. 1.4 Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care<sup>5</sup>

A fiduciary is required to prudently manage investment decisions and should seek assistance from outside professionals, such as investment advisors/consultants and money managers, if the fiduciary lacks the requisite knowledge (assuming the trust documents permit the delegation of investment responsibilities). [See also *Practice No. 4.1*]

The fiduciary should take reasonable steps to protect the portfolio from loses, and to avoid misunderstandings when hiring such professionals. Therefore, fiduciaries should reduce any agreement of substance to writing in order to define the scope of the parties' duties and responsibilities; to ensure that the portfolio is managed in accordance with the written documents that govern the investment strategy; and, to confirm that the parties have clear, mutual understandings of their roles and responsibilities.

Employee Retirement Income Security Act of 1974 [ERISA]

\$3(44)(B) and (38)(C); \$3(38)(C); \$402(c)(2); \$403(a)(2); \$404(a)(1); \$408(b)(2)

Case Law

Liss v. Smith, 991 F. Supp. 278 (S.D.N.Y. 1998); Whitfield v. Tomasso, 682 F. Supp. 1287, 9 E.B.C. 2438 (E.D.N.Y. 1988)

Other

Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

**Uniform Prudent Investor Act [UPIA]** 

§2(a); §5; §7; §9(a)(2)

Management of Public Employee Retirement Systems Act [MPERS]

§5(a)(2); §6(b)(2); §7

<sup>&</sup>lt;sup>5</sup> Substantiating Code, Regulations, and Case Law for Practice No. 1.4:

**[IBP]** A good practice is to review contracts and service agreements at least once every three years. The investment industry is constantly evolving, and the fiduciary is likely to discover:

- 1. There may be an opportunity to take advantage of price breaks because the portfolio has grown in size.
- 2. The vendor's fees may have been reduced because of competitive pressures.
- 3. The scope of services required by the fiduciary may have changed.
- 4. The vendor's product offering may have expanded the fiduciary can benefit from more services without an increase in fees.
- 5. A *better* vendor has since come to market.

Practice No. 1.5	There is documentation to show timing and distribution of cash
flows, and the pay	yment of liabilities <sup>6</sup>

One of the fundamental duties of every fiduciary is to ensure there are sufficient assets to pay bills and liabilities when they come due, and in the case of a foundation or endowment, to provide a specified level of support when it has been promised.

<sup>6</sup> Substantiating Code, Regulations, and Case Law for Practice No. 1.5:

Employee Retirement Income Security Act of 1974 [ERISA]

§402(b)(1); §404(a)

Regulations

29 C.F.R. \$2550.404a-1(b)(2)

Other

Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2; H.R. Report No. 93-1280, 93d Congress, 2d Session (1974)

Uniform Prudent Investor Act [UPIA]

§1 Comments; §2 Comments; §2(a); §2(b); §2(c)

Case Law

Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830)

Management of Public Employee Retirement Systems Act [MPERS]

§7(1) and (2); §8(a)(1)(E)

It is important that the fiduciary prepare a schedule of the portfolio's anticipated cash flows for the coming five-year period, so that the investment time horizon can be determined. [See also *Practice No. 2.3*] The time horizon is defined as that point-in-time when more money is flowing out of the portfolio than is coming in from contributions and/or from portfolio growth. If the time horizon is less than five years, it is considered *short*, and if the time horizon is five years or more, it is considered *long*. A *short* time horizon typically is implemented with fixed income and cash, whereas a *long* investment time horizon can be prudently implemented across most asset classes. [See also *Practice No. 2.4*]

**[IBP]** If the client has a material disbursement within five years, 120 percent of the anticipated amount needed should be held in cash or short-term fixed income instruments. For example, if \$100,000 is going to be needed in three years, one would allocate \$120,000 to cash and/or short-term fixed income in the asset allocation strategy.

The cash flow schedule also provides the fiduciary with information to more effectively rebalance a portfolio's asset allocation strategy. [See also *Practice No. 3.3*] As an example, if a particular asset class is outside the range of the investment policy statement's strategic limit, one could use the cash flow information to effectively rebalance the portfolio.

Practice No. 1.6 Assets are within the jurisdiction of U.S. courts, and are protected from theft and embezzlement<sup>7</sup>

The fiduciary has the responsibility to safeguard entrusted assets, which includes keeping the assets within the purview of the U.S. judicial system. This provides a regulatory agency the ability to seize the assets if, in its determination, it is in the best interests of the beneficiaries and/or participants.

Employee Retirement Income Security Act of 1974 [ERISA]

§ 404(b); § 412(a)

Regulations

29 C.F.R. §2550 404b-1

Case Law

*Varity Corporation v. Howe*, 516 U.S. 489, 116 S. Ct. 1065, 134 L.Ed.2d 130 (1996)

Other

H.R. Report No. 93-1280 (93<sup>rd</sup> Congress, 2d Session, August 12, 1974)

**Uniform Prudent Investor Act [UPIA]** 

§2(a); §5; §9(d)

Management of Public Employee Retirement Systems Act [MPERS]

§2(21); §6(e); §7; §11(c) and Comments

<sup>&</sup>lt;sup>7</sup> Substantiating Code, Regulations, and Case Law for Practice No. 1.6:

#### Practice No. 1.6 (continued)

In addition, ERISA requires qualified retirement plans to maintain a surety bond to reimburse a plan for losses resulting from dishonest acts. Though not required for all other fiduciaries, it's a good industry practice to maintain similar coverage.

*Exception:* Investment advisors that are managing the personal assets of a high-net-worth client are not excluded from considering the establishment of offshore accounts. The presumption is that federal laws will continue to impose strict reporting and tracking requirements of foreign bank accounts and offshore trusts.

#### INTRODUCTION TO PRACTICE NOS. 2.1 - 2.5

The second step of the *Investment Management Process* is to diversify the portfolio's assets. *Practice Nos. 2.1 - 2.5* provide the details to the prudent procedures associated with Step 2.

The fiduciary's choice of asset classes and their subsequent allocation will have more impact on the long-term performance of the investment strategy than all other decisions. The fiduciary's role is to choose the appropriate combination of assets that optimizes (or approximately optimizes) a return (*Practice No. 2.2*) subject to a particular level of risk (*Practice No. 2.1*).

The acronym TREAT helps to define the key fiduciary inputs to the asset allocation strategy

- Tax status of the portfolio, whether it is taxable or tax-exempt
- **R** Risk level the investor or investment committee is willing to assume
- E Expected return the portfolio needs to achieve to meet goals and objectives
- A Asset class preferences of the investor or investment committee
- T Time horizon of the investment strategy

Computer optimization models can mathematically assist the fiduciary in determining alternative optimal asset mixes. Yet, these technological tools and comprehensive databases have not reduced the asset allocation decision to a computerized, mathematical solution. Quite the contrary.

# ASSET ALLOCATION VARIABLES T TAX STATUS R RISK LEVEL A ASSET CLASS PREFERENCE E EXPECTED RETURN T TIME HORIZON

Illustration 2.1

An optimizer requires three inputs:

Expected Return - the *modeled* return assumption that will be used for each asset class

Standard Deviation - the *probable* level of variability each asset class will exhibit

Correlation Coefficient - the *estimate* of the degree to which each asset class will perform relative to another. (Traditionally, equities and fixed income asset returns have not been similar over the same periods of time, therefore they would have a negative, or low correlation to one another.)

Note that all three optimizer variables are nothing more than estimates, models, or probable outcomes. The asset allocation strategy must be built upon carefully developed expectations for the capital markets and the way in which individual asset class is expected to perform in relation to, and in combination with, each other.

[IBP] The development of sound optimizer inputs involves as much *art* and intuition as *science*, and is well beyond the intended scope of this handbook. However, the fiduciary is well-advised to be familiar with the source and methodology used to develop any asset allocation strategy. Due to the great disparity between different models, the fiduciary is cautioned to carefully research the investment expertise of the source. The outputs of the computerized optimization models are only as good as the inputs. The old adage *garbage in* - *garbage out* has never been more applicable.

#### Introduction to *Practice Nos. 2.1 - 2.5* (continued)

#### Experience has shown:

- 1. Intuition is sometime as good, if not a better, guide than the optimizer. If it doesn't feel right, it probably isn't. Optimizers are only useful for making the rough cut between equity and fixed income. The fiduciary shouldn't become so enamored with the optimizer that he or she forgets to use common sense and good judgment.
- 2. There is less risk in being conservative with the capital markets inputs. A fiduciary generally does not get sued when actual results are higher than what was *modeled*.
- 3. A corollary to the previous point is that liability increases exponentially with the number of places to the right of the decimal point. The fiduciary should not convey a degree of accuracy in the asset allocation strategy that does not exist. A good suggestion is to round all allocations to whole numbers, even rounding the allocations to the nearest five percent.
- 4. Asset allocation is a social science. If it does not reflect the needs of the client or the temperament of the investment committee, no matter how sophisticated the process by which it was determined, it likely will be abandoned at the first sign of short-term pain.

#### Practice No. 2.1 A risk level has been identified<sup>8</sup>

The term *risk* has different connotations, depending on the fiduciary's and/or the investor's frame of reference, circumstances, and objectives. Typically, the investment industry defines risk in terms of statistical measures, such as standard deviation. These statistical measures, however, often fail to adequately communicate the potential negative consequences an investment strategy can have on the fiduciary's, or the investor's, ability to meet investment objectives.

Simply stated, an investment strategy can fail by being too conservative or too aggressive. A fiduciary could adopt a very safe investment strategy by keeping a portfolio in cash, but then see the portfolio's purchasing power whither under inflation. Or, a fiduciary could implement a long-term growth strategy that overexposes a portfolio to equities, when a more conservative fixed income-strategy would have been sufficient to cover the identified goals and objectives.

One suggested approach is to stress test a proposed investment strategy by analyzing possible investment outcomes (worst case, most likely, and best case) over a one, three, and five-year period. The fiduciary should then consider the possible consequences of each outcome:

- 1. Will the investment results enable the fiduciary to cover short- and long-term liabilities and/or objectives?
- 2. Can the fiduciary stomach the *worst-case* scenario? If not, the fiduciary will likely abandon a sound long-term strategy during a market downturn, and alter the investment strategy at precisely the wrong time and for the wrong reasons.

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)(1)(B)

Regulations

29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(B)(i-iii)

Case Law

Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313, 23 E.B.C. 1001 (5<sup>th</sup> Cir.), reh'g and reh'g en banc denied, 184 F.3d 820 (5<sup>th</sup> Cir.), cert. denied, 528 U.S. 967, 120 S.Ct. 406, 145 L.Ed.2d 316 (1999); Chase v. Pevear, 383 Mass. 350, 419 N.E.2d 1358 (1981)

**Uniform Prudent Investor Act [UPIA]** 

§2(b) and (c); §2 Comments

Management of Public Employee Retirement Systems Act [MPERS]

§8(b); §8 Comments

<sup>&</sup>lt;sup>8</sup> Substantiating Code, Regulations, and Case Law for Practice No. 2.1:

**[IBP]** A good way to define risk is to evaluate the *worst-case scenario* in a given year. Specifically, identify the statistical *worst-case scenario* at the 95<sup>th</sup> percentile of a mean-variance bell-shaped curve. This theoretically represents a 1-in-20 event that could be as bad, or worse, then the worst-case scenario. Or stated differently, there is a 5 percent probability that the *worst-case scenario* will be *worse* then indicated.

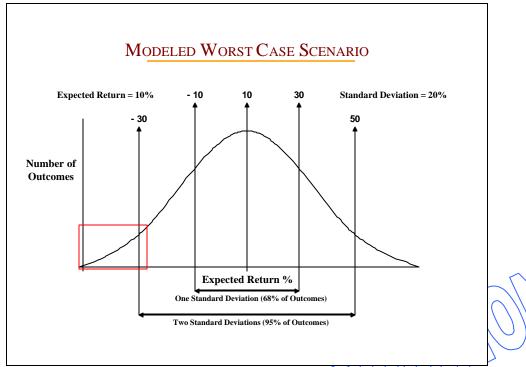


Illustration 2.2

Besides statistical risk, we also should explore whether the fiduciary, or investor, is concerned or impacted by other risk issues such as:

- \* Liquidity Risk Will there be sufficient cash to meet anticipated disbursements? For example, if a foundation is committed to funding the construction of a new building that is scheduled to be completed in three years, is there sufficient cash and short-term fixed income to cover the cash calls during construction?
- \* Boardroom Risk Is the board willing to set appropriate long-term investment strategies and stick to them? Boards of all sizes are subject to internal and external pressures. In light of these pressures, it can be difficult for board members to focus on long-term performance, particularly when they're serving for a limited term.
- Lost Opportunity Risk Is the investment committee or the investor attempting to employ a market timing strategy in an effort to minimize short-term pain? In other words, has a long-term investment strategy been developed but do concerns over current market conditions keep the investment committee from implementing the strategy?

#### Practice No. 2.1 (continued)

Specific Issue, or Implementation Risk - Has the investment committee or investor prudently diversified a portfolio among appropriate asset classes, but has not prudently diversified the portfolio within the asset class? As an example, an allocation to equities presumes the portfolio will be invested in at least twenty securities. Less than twenty, and the portfolio may be subject to specific issue risk.

## Practice No. 2.2 An expected, modeled return to meet investment objectives has been identified

The fiduciary should determine whether trust documents, spending policies, and/or actuarial reports (for defined benefit retirement plans) establish a minimal investment return expectation or requirement. In all cases, the fiduciary should determine the *modeled*, or expected return a given investment strategy should produce. In this context, the term *model* means to replicate; to determine the probable returns of an investment strategy given current and historical information. There is no requirement, or expectation, that the fiduciary forecast future returns. Rather, the fiduciary is required to state the presumptions that are being used to *model* the probable outcomes of a given investment strategy.

The *modeling* of a probable return for a given asset allocation strategy is very difficult to develop. Simple extrapolations of recent historical data are not only likely to be poor estimates of future performance, they also may cause the fiduciary to overweight an asset class that has had recent superior performance and underweight the laggards, setting the stage for the fiduciary to make the classic investment mistake - buying high and selling low.

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)(1)(A) and (B)

Regulations

29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(A)

Case Law

Rederal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944); Communications Satellite Corporation v. Federal Communications Commission, 611 F.2d 883 (D.C. Cir. 1977); Tennessee Gas Pipeline Company v. Federal Energy Regulatory Commission, 926 F.2d 1206 (D.C. Cir. 1991)

**Uniform Prudent Investor Act [UPIA]** 

§2(b); §2(c)(1-8)

Management of Public Employee Retirement Systems Act [MPERS]

§8(a)(1)(A-F); §8(b)

<sup>&</sup>lt;sup>9</sup> Substantiating Code, Regulations, and Case Law Practice No. 2,2:

#### Practice No. 2.2 (continued)

Be wary of an optimizer that derives its inputs only from historical data. Most investment professionals utilize a *risk-premium* model. Developing the *risk premium* is quite involved, but, simply stated, the process starts by calculating the *premium* each asset class has earned over the risk-free-rate-of-return. The *premium* is then adjusted, or tweaked, based on possible economic scenarios that may impact the asset class over the rext five years. The adjusted, or tweaked, premium is then added to the anticipated risk-free-rate-of-return over the next five years (anticipated rate of inflation also could be used as a proxy) to come up with the final *modeled* return.

#### Practice No. 2.3 An investment time horizon has been identified<sup>10</sup>

It is important that the fiduciary prepare a schedule of the portfolio's anticipated cash flows so that the portfolio's investment time horizon can be identified. [See also *Practice No. 1.5*] The portfolio's investment time horizon is defined as the point in time when disbursements in a given year exceed the sum of contributions, and increase in assets as a result of investment performance. In other words, at what point in time is there more money going out then coming in? The identification of the portfolio's time horizon is one of the most important decisions the fiduciary has to manage.

The time horizon is the primary variable in determining the allocation between equities and fixed income. An investment time horizon of less than five years is considered *short*, while five years or more is considered *long*. Ordinarily, a *short-term* time horizon would call for an allocation to fixed income and cash, whereas a *long-term* strategy could include a prudent allocation to most other asset classes.

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)(1)(B)

Regulations

29 C.F.R. §2550,404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(A)

Case Law

Metzler v. Graham, 112 F.3d 207, 20 E.B.C. 2857 (5<sup>th</sup> Cir. 1997)

Other

Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1; H.R. Report No. 1280, 93d Congress, 2d Session (1974)

**Uniform Prudent Investor Act [UPIA]** 

§2(a); §2(b)

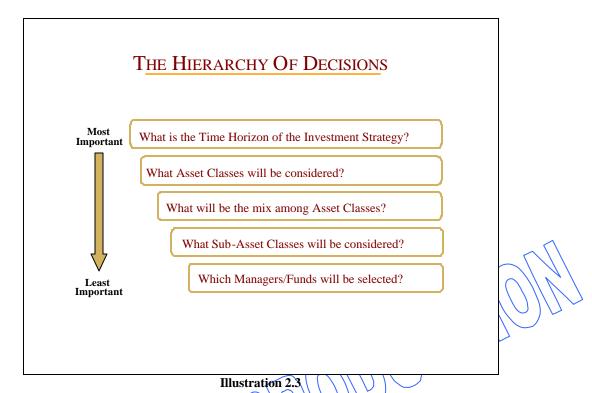
Management of Public Employee Retirement Systems Act [MPERS]

§8; §10(b)

<sup>10</sup> Substantiating Code, Regulations, and Case Law Practice No. 2.3:

#### Practice No. 2.3 (continued)

There is a hierarchy to the decisions that the fiduciary has to manage. Illustration 2.3 depicts this hierarchy and shows that the most important decision the fiduciary has to manage is the determination of the time horizon. Based on the time horizon, the fiduciary then can determine which asset classes can be appropriately considered; what the allocation should be between the selected asset classes; whether there should be an allocation made among subasset classes; and, finally, which money managers or mutual funds should be retained to manage each asset class.



Note that the least important decision in the hierarchy is the selection of the money managers or mutual funds. The inexperienced decision maker often will reverse this hierarchy - chasing Wall Street's latest hot manager and abdicating the most important decisions the investor has to manage, the asset allocation decisions, to a complete stranger - the money manager.

	Practice No. 2.4	Selected asset classes are consistent with the identified risk
	return, and time l	orizon <sup>11</sup>

The fiduciary's role is to choose the appropriate combination of asset classes that optimizes the identified risk and return objectives, consistent with the portfolio's time horizon. [See also *Practice Nos. 2.1 - 2.3*]

The fundamental question associated with this *Practice* is: Will investment goals and objectives be reasonably obtained with the allocation? Several examples are worth noting:

Example 1: The retired individual investor/couple who want to maintain the purchasing power of their portfolio: Ordinarily, the only way an investment strategy can be made inflation-proof over the long-term is to have at least a 20 percent allocation to equities. An all fixed-income and cash portfolio has only a 70 percent probability of beating inflation over the long term. [See Illustration 2.4]

Example 2: The defined benefit retirement plan that is nearing fully funded status and still is heavily invested in equities: If the funding objectives can be met in the near-term (less than five years) with a fixed-income strategy, the investment committee should be reducing equity exposure to reduce the risk associated with a major market correction.

Example 3: The foundation that has made a commitment to build a new hospital wing within the next three years, and has a large percentage of the designated assets in long-term fixed-income securities: Ordinarily, the foundation is better off *immunizing* the fixed income strategy. That is, matching the maturity or duration of the fixed-income securities to the anticipated cash-call requirements of the building project.

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)(1)(B)

Regulations

29 C.F.R. §2550.404a-1; 29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-

1(b)(2)(B)(i-iii)

Case Law

GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729 (11<sup>th</sup> Cir. 1990); Leigh v. Engle, 858 F.2d 361 (7<sup>th</sup> Cir. 1988)

Other

Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1

**Uniform Prudent Investor Act [UPIA]** 

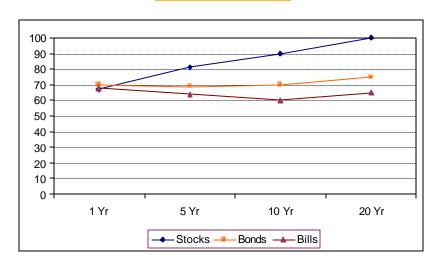
§2(b)

Management of Public Employee Retirement Systems Act [MPERS]

§8(b)

<sup>11</sup> Substantiating Code, Regulations, and Case Law for Practice No. 2.4:

## PROBABILITY OF AN ASSET CLASS EXCEEDING INFLATION OVER TIME



#### Illustration 2.4

Example 4: For fiduciaries of defined contribution plans where investment decisions are participant-directed: Fiduciaries should be aware of the "1/n" phenomenon, where "n" is the number of investment options provided to the participant. Research has shown that a large number of plan participants will equally allocate across all investment options; particularly, when the number of options is small (less than ten). As an example, if five investment options are offered, most participants will equally weight their allocation across the five options - putting 20 percent in each option. Imagine the consequences if an emerging markets mutual fund were one of five investment options, considering the number of participants who would likely invest 20 percent of their portfolio in emerging markets.

This *Practice* also assumes that the investments within each asset class are appropriately diversified to eliminate *specific issue risk*. [See also *Practice No. 2.1*] As an example, a fiduciary may have prudently diversified the portfolio with an allocation to equities only to discover that the equity investment option was heavily concentrated in only a few securities.

#### Practice No. 2.5 The number of asset classes is consistent with portfolio size 12

There is no formula the fiduciary can follow to determine the *best* number of asset classes - the *appropriate* number is determined by facts and circumstances.

How many asset classes should be considered? Or in the case of participant-directed retirement plans, how many investment options should be offered? The answer is dependent upon the:

- 1. Size of the portfolio
- 2. Investment expertise of the investment decision makers
- 3. Ability of the decision makers to properly monitor the strategies and/or investment options
- 4. Sensitivity to investment expenses more asset classes and/or options ordinarily will mean higher portfolio expenses. The additional *costs* should be evaluated in light of the *price* the fiduciary pays for being under-diversified.

[IBP] Which asset classes should be considered first? Illustration 2.5 is provided as a suggested frame of reference. The illustration is based on the premise that the time horizon is greater than five years. Ordinarily, the most appropriate asset classes to be used as a starting point are the broad market classes representing the full capitalization weighted range of investment opportunities. Simply stated; stocks, bonds, and cash. From this starting point, additional asset classes and peer groups should be added that provide meaningful risk and return benefits to the overall investment strategy.

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)(1)(C)

Other

H.R. Report No. 1280, 93<sup>rd</sup> Congress, 2d Sess.304, reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Uniform Prudent Investor Act [UPIA]

§2(b)

Other

Restatement of Trusts 3d: Prudent Investor Rule §227, comment

Management of Public Employee Retirement Systems Act [MPERS]

§8(a)(1); §8(a)(4); §10(2)

<sup>12</sup> Substantiating Code, Regulations, and Case Law for Practice No. 2.5:

# Adding Asset Classes To An Implementation Matrix

# OF OPTIONS		ASSET and SUB-ASSET CLASSES	
3		Large Blend, Multisector Fixed & Cash	
4	Add	International Equity Blend	
5	Add	Small Blend	
6	Add	Intermediate Fixed	
7	Add	Mid-Cap Blend	
8	Add	Large Value, Large Growth	
9	Add	Emerging Markets	
10	Add	Real Estate	
11	Add	High-Yield Fixed	
12	Add	International Bond	

Illustration 2.5

The fiduciary should keep in mind that the allocation also must be implemented and monitored. It makes no sense to make an allocation to an asset dass that the fiduciary cannot effectively and efficiently implement and/or monitor on an ongoing basis. [See also *Practice Nos. 4.1 and 5.1*]

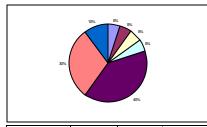
Illustration 2.6 is a table depicting four diversified portfolios using the methodology and *Practices* described in this handbook. The portfolios can also double as performance measurement indexes. The number in parenthesis (20, 40, 60, and 80) represents the total equity exposure in the index. The return of the index is calculated by multiplying the percentage represented by each asset class by the median mutual fund return for the respective peer group.

#### **Trustee Counseling Index (Total Equity Exposure)**

For the Tax-Exempt Investor

The purpose of the indexes: (1) To help define a prudently diversified multi-asset class model; and (2) To provide performance benchmarks that are reflective of actual mutual fund results. The returns are based on the median mutual fund manager for each peer group represented in the model.

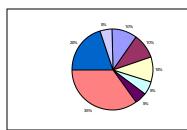
Data as of 06.30.2002



%
5
5
5
5
40
30
10

TCI(20)

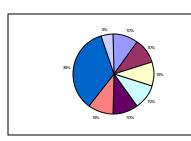
	2ndQtr	YTD	1 Yr	3 Yr	5 Yr	2001	2000	1999	1998	1997
TCI(20)	-0.26	-0.22	1.45	3.47	5.17	2.54	5.40	5.56	9.50	10.42



Peer Group	%
Large Value	10
Large Blend	10
Large Growth	10
Small Blend	5
Foreign Stock	5
Intermediate Bond	35
Short Bond	20
Money Market	5

TCI(40)

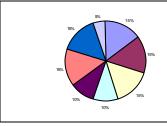
	2ndQtr	YTD	1 Yr	3 Yr	5 Yr	2001	2000	1999	1998	1997
TCI(40)	-2.94	-2.64	-2.42	1.41	4.83	-0.39	3.71	8.88	11.34	14.41



Peer Group	%
Large Value	10
Large Blend	10
Large Growth	10
Mid-Cap Blend	10
Small Blend	10
Foreign Stock	10
Intermediate Bond	35
Money Market	5

TCI(60)

	2ndQtr	YTD	1 Yr	3 Yr	5 Yr	2000	1999	1998	1997	1996
TCI(60)	-4.79	-3.87	-5.22	0.40	4.60	-2.99	2.58	12.96	11.04	17.35



Peer Group	%
Large Value	15
Large Blend	15
Large Growth	15
Mid-Cap Blend	10
Small Blend	10
Foreign Stock	15
Intermediate Bond	15
Money Market	5

TCI(80)

	2ndQtr	YTD	1 Yr	3 Yr	5 Yr	2001	2000	1999	1998	1997
TCI(80)	-7.49	-6.49	-9.92	-2.51	3.72	-7.54	-0.98	18.14	13.57	19.95

Copyright © 2001, 2002. invest<sup>mgt</sup> (www.investmgt.com)

**ILLUSTRATION 2.6** 

#### INTRODUCTION TO PRACTICE NOS. 3.1 - 3.7

The preparation and maintenance of the investment policy statement ("IPS") is one of the most critical functions of the fiduciary. The IPS should be viewed as the business plan and the essential management tool for directing and communicating the activities of the portfolio. It is a formal, long-range strategic plan that allows the fiduciary to coordinate the management of the investment program in a logical and consistent framework. All material investment facts, assumptions, and opinions should be included.

[IBP] The fiduciary is required to manage investment decisions with a reasonable level of detail. By reducing that detail to writing, preparing a written IPS, the fiduciary can: (1) avoid unnecessary differences of opinion and the resulting conflicts; (2) minimize the possibility of missteps due to lack of clear guidelines; (3) establish a reasoned basis for measuring their compliance; and, (4) establish and communicate reasonable and clear expectations with participants, beneficiaries, and investors.

There are a number of benefits to having a well-written IPS:

- 1. In the event of an audit, litigation, and or a dispute, it supports the *paper trail*. One of the first documents a litigator or auditor is likely to review is the IPS, because it should provide an outline of the overall investment strategy.
- 2. It helps negate *Monday morning quarterbacking*. Inevitably, there will be turn-over of investment committee members and trustees. Former investment decision makers don't want to be caught in the uncomfortable position of having new committee members second-guess their decisions.
- 3. It helps to insulate investment decision makers from market noise. During periods of over- and under-confidence in the capital markets, the IPS helps to keep decision makers focused on the long-term goals and objectives.
- 4. It helps to provide implementation guidance during estate planning, particularly when one spouse is still actively managing all or a significant portion of the investable assets. Inevitably, it's the *investing spouse* that is the first to become incapacitated, leaving the surviving spouse and/or executor with the near impossible task of continuing the former investment strategy. An IPS thoughtfully prepared in advance and integrated within the overall estate plan would help ensure the smooth transition of the investment strategy.
- 5. It helps to reassure donors of a foundation's or endowment's investment stewardship. Fundraisers should carry a copy of the IPS to show potential donors how the entrusted assets are being prudently managed.

### Practice No. 3.1 There is detail to implement a specific investment strategy<sup>13</sup>

The IPS should have sufficient detail that a third party should be able to implement the investment strategy; be flexible enough that it can be implemented in a complex and dynamic financial environment; and yet not be so detailed it requires constant revisions and updates. The IPS should combine elements of planning and philosophy, and should address the management of each of the fiduciary standards of care (vertical axis of the Practices Matrix). Addendums should be used to identify information that will change on a more frequent basis such as the names of board members, accountant, attorney, actuary, and money managers/mutual funds; and the capital markets assumptions used to develop the plan's asset allocation.

[IBP] We have provided a sample IPS in Enclosure 1. The sample is for a retirement plan in which the investment decisions are committee-directed. This sample also can be used as a template for an IPS for: (1) foundations and endowments; (2) high net-worth families/investors; and, (3) retirement plans in which investment decisions are participant-directed.

Changes/additions that would have to be made to the sample IPS for foundations and endowments (eleemosynaries) include the following:

- 1. The background section of the IPS should address whether the eleemosynary has adopted a mission-based investment strategy. [See *Practice No. 3.7*, which covers the subject of mission-based and socially responsible investing.]
- 2. The IPS should address the eleemosynary's Equilibrium Spending Rate (ESR). The ESR is used to calculate the level of grants that can be made based on the eleemosynary's modeled asset allocation return, adjusted for inflation and investment expenses. [See *Practice No. 1.1* and the **Glossary of Terms** for a more detailed explanation.]

Employee Retirement Income Security Act of 1974 [ERISA]

Other

Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]

§2(b); §4

Other

Restatement of Trusts 3d: Prudent Investor Rule §227(a)

 $\label{eq:management} \begin{tabular}{ll} \textbf{Management of Public Employee Retirement Systems Act [MPERS]} \\ \$8(b) \end{tabular}$ 

<sup>13</sup> Substantiating Code, Regulations, and Case Daw for Practice No. 3.1:

3. There should be a discussion of the smoothing rules that will be followed in applying the ESR. Typically the eleemosynary does not apply the ESR to the year-end market value, but rather averages the year-end value of the previous three years. This practice reduces the volatile swings in the dollar amounts of grants that the eleemosynary makes each year.

Changes/additions that would have to be made to the sample IPS for high net-worth families/investors include the following:

- 1. The background section of the IPS should identify the assets that are covered by the IPS versus the total net worth of the family/investor. For example, the family may have a net worth of \$2 million, but \$400,000 is invested in a vacation condo. Therefore, the IPS is only covering the investabal assets of \$1.6 million.
- 2. If the family/individual has stock options or closely-held business assets, the background section of the IPS should contain a discussion of how the closely-held and/or restricted assets are going to be modeled, or not, in the overall investment strategy. There are two possible approaches. The first is to simply hold the value of the assets outside the scope of the IPS, recognizing that the anticipated cash value of the closely-held asset will be available for diversification at some point in the future. The second approach is to incorporate the closely-held asset in the overall asset allocation strategy.
- 3. Determine whether the taxable and tax-exempt assets are going to be segregated, each modeled with its own IPS, or whether all of the assets will be identified under one IPS. Again, there is no one right approach, but the later approach is preferred unless the client is retired or nearing retirement.
- 4. Note in the background section whether the IPS is tied to estate planning and, if so, note in the Appendix the person who is most familiar with the estate strategy.
- 5. For family offices, (typically formed when a family has in excess of \$50 million) consideration should be given to developing a different IPS for each family unit or tax ID. The risk/return profile of the matriarch and patriarch is likely to be quite different from the risk/return profile of each of the siblings.
- 6. The background of the IPS should address whether the family has adopted a mission-based investment strategy. [See *Practice No. 3.7*]

Changes/additions that would have to be made to the sample IPS for retirement plans in which investment decisions are participant directed (such as most 401(k) plans) include the following:

- 1. Whether the plan sponsor has formally adopted 404(c) Safe Harbor provisions. [404(c) will be addressed in more detail in *Practice No. 4.2.*]
- 2. The number of investment options that will be offered in the plan.
- 3. The asset class that will be mapped to each investment option.

# Practice No. 3.2 The investment policy statement defines the duties and responsibilities of all parties involved<sup>14</sup>

There are numerous parties involved in the investment process, and each should have their specific duties and requirements detailed in the IPS. This ensures continuity of the investment strategy when there is a change in fiduciaries; helps to prevent misunderstandings between parties; and helps to prevent omission of critical fiduciary functions. The IPS should include sections on:

- 1. The role of the investment committee [See also *Practice No. 1.2*]
- 2. The role of the investment consultant (if one is retained)
- 3. The role of the custodian [See also *Practice No. 4.4*]

Employee Retirement Income Security Act of 1974 [ERISA]

\$3(38)(c); \$402(a)(1); \$402(b)(2) and (3); \$403(a)(2) \$405(c)(1)

3 103(c)(1)

Uniform Prudent Investor Act [UPIA]

 $\S9(a)(1)$  and (2)

Other

Restatement of Trusts 3d: Prudent Investor Rule §171 (1992)

Management of Public Employee Retirement Systems Act [MPERS]

§6(a) and (b); §8(b)

<sup>14</sup> Substantiating Code, Regulations, and Case Law for Practice No. 3.2:

- 4. The role of the separate account manager(s). [See also *Practice No. 4.1*] [Not necessary for mutual funds since the investment strategy of the fund already is specified in the fund's prospectus.] The instructions for the money manager should include:
  - a. Securities guidelines
  - b. Responsibility to seek *best price and execution* on trading the securities [See also *Practice No. 5.3*]
  - c. Responsibility to account for *soft dollars* [See also *Practice No. 5.3*]
  - d. Responsibility to vote all proxies [See also *Practice No. 5.3*].

# Practice No. 3.3 The investment policy statement defines diversification and rebalancing guidelines<sup>15</sup>

One of the challenges of writing a complete IPS is to create investment guidelines specific enough to clearly establish the parameters of the desired investment process, yet provide enough latitude so as not to create an oversight burden. This is particularly true when establishing the portfolio's asset allocation and rebalancing limits.

15 Substantiating Code, Regulations, and Case Law for Practice No. 3.3:

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)(1)(C)

Regulations

29 C.F.R. §2550.404a-1(b)(2)(i)

Case Law

Leigh v. Engle, 858 F.2d 361, 10 E.B.C. 1041 (7<sup>th</sup> Cir. 1988), cert. denied, 489 U.S. 1078, 109 S.Ct. 1528, 103 L.Ed.2d 833 (1989)

Other

H.R. Report No. 1280, 93<sup>rd</sup> Cong. 2d Sess. 304, reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Uniform Prudent Investor Act [UPIA]

§2; §3 and Comments

Management of Public Employee Retirement Systems Act [MPERS]

§8 and Comments

Other

Restatement of Trusts 3d: Prudent Investor Rule §227, comment g

The strategic asset allocation should be that specific mix of asset classes that meets the mutually agreed upon risk/return profile of the investor or investment committee. [See also *Practice No. 2.4*] [IBP] The acronym **TREAT** can assist in defining the specific variables that should be included in the asset allocation decision:

- Tax status of the portfolio, whether it is taxable or tax-exempt
- **R** Risk level the investor or investment committee is willing to assume
- E Expected return the portfolio needs to achieve to meet identified goals and objectives
- A Asset class preference of the investor or investment committee
- Time horizon of the asset allocation strategy, defined as that point in time when there is a negative cash flow more money being disbursed than is being contributed and/or as a result of portfolio growth.

If there are asset classes that have been omitted for a specific reason, these also should be identified in the IPS. As an example, if the investment committee states that they do not want high-yield bonds in the asset allocation, than this restriction should be noted in the IPS.

The rebalancing limits define the points when a portfolio should be reallocated to bring it back in line with the established asset allocation target. The discipline of rebalancing, in essence, controls risk and forces the portfolio to move along a predetermined course. It takes gains from stellar performers or favored asset classes, and reallocates them to lagging styles.

[IBP] While the legal requirement for diversification is clear, the need for rebalancing is not explicitly addressed. Nevertheless, rebalancing is an inherent concept of diversification, where the goal is to create a portfolio that balances appropriate levels of risk and return. That balance, once achieved, can only be maintained by periodically rebalancing the portfolio to maintain the appropriate diversification.

The process of setting an appropriate rebalancing limit is somewhat subjective. [IBP] Ordinarily, rebalancing limits of plus-or-minus five percent should keep the parameters tight enough to maintain the risk/return profile of the strategy, yet require rebalancing only once or twice a year. When it is necessary to rebalance, the fiduciary should determine the cash flows over the next quarter to determine if the portfolio can be rebalanced with contributions or disbursements. [See also *Practice No. 1.5*]

## Practice No. 3.4 The investment policy statement defines due diligence criteria for selecting investment options 16

A well-written IPS can serve to insulate the fiduciary from *market noise*, or in the context of this *Practice*, the temptation to chase the latest hot manager on Wall Street. By establishing specific asset allocation parameters and money manager (or mutual fund) selection criteria, it is much easier to determine whether a prospective manager fits into the general investment program. [See also *Practice Nos. 2.4 and 4.1*]

[IBP] There is no explicit requirement for fiduciaries to define due diligence criteria for the selection of money managers, however, it is implicit in other fiduciary requirements. As a practical matter, these provisions require a fiduciary to define the due diligence process and criteria for selecting investment options.

The fiduciary should investigate the qualities, characteristics, and merits of each money manager, and to identify the role each plays in the furtherance of the investment strategy. However, such an investigation and the related analysis cannot be conducted in a vacuum - it must be within the context of the needs of the investment strategy. Once the needs have been defined, and the general strategies developed, specific money managers should be chosen within the context of this strategy.

16 Substantiating Code, Regulations, and Case Law for Practice No. 3.4:

Employee Retirement Income Security Act of 1974 [ERISA]

§402(c)(3); §404(a)(1)(B)

Regulations

29 C.F.R. \$2550.404a-1(b)(1)(A); 29 C.F.R. \$2550.404a-1(b)(2)

Case Law

*In re Unisys Savings Plan Litigation*, 74 F.3d 420, 19 E.B.C. 2393 (3<sup>rd</sup> Cir.), *cert. denied*, 510 U.S. 810, 117 S.Ct. 56, 136 L.Ed.2d 19 (1996)

Other

Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

**Uniform Prudent Investor Act [UPIA]** 

§2(a); §4

Management of Public Employee Retirement Systems Act [MPERS]

§8(b); §8(a)

## Practice No. 3.5 The investment policy statement defines monitoring criteria for investment options and service vendors 17

The fiduciary duty to monitor the performance of investment managers and other service providers is inherent in the obligations of fiduciaries to act prudently in carrying out their duties. The investment management process triggers a number of reviews of the numerous parties involved in the investment process:

Monthly, the custodial statement should be reviewed for accuracy and to determine whether hired money managers are continuing to seek *best execution* on trades. [See also *Practice No. 5.3*]

*Periodically* [**IBP** - Quarterly], a performance report should be prepared indicating how well selected managers and/or funds are performing relative to the objectives set forth in the IPS, against their peers, and against an appropriate industry index. [See also *Practice No. 5.1*]

Annually, the IPS should be reviewed to determine whether there have been any material changes to the goals and objectives, or to the risk/return profile. [See also *Practice Nos. 1.1 and 2.4.*]

Specific performance criteria and objectives should be identified for each money manager and/or mutual fund. The one decision that is typically more difficult to make than Which manager or fund to hire? Is Is it time to fire the manager or fund? When performance criteria are agreed to in advance, the decision is easier to manage and to make.

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)

Case Law

Morrissey v. Curran, 567 F.2d 546, 1 E.B.C. 1659 (2<sup>nd</sup> Cir. 1977); Harley v. Minnesota Mining and Manufacturing Company, 42 F. Supp.2d 898 (D.Minn. 1999), aff'd, 284 F.3d 901 (8<sup>th</sup> Cir. 2002); Whitfield v. Cohen, 682 F.Supp. 188, 9 E.B.C. 1739 (S.D.N.Y. 1988); Liss v. Smith, 991 F.Supp. 278 (S.D.N.Y. 1988)

Other

Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8; Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2(2)

Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1(e)

**Uniform Prudent Investor Act [UPIA]** 

§9(a)(1), (2) and (3)

Management of Public Employee Retirement Systems Act [MPERS]

§6(b)(2) and (3); §8(b)

<sup>17</sup> Substantiating Code, Regulations, and Case Law for Practice No. 3.5;

## Practice No. 3.6 The investment policy statement defines procedures for controlling and accounting for investment expenses 18

In order for the fiduciary to fulfill the general fiduciary obligation to manage investment decisions with the requisite level of care, skill, and prudence; and the specific obligation of the fiduciary to defray only reasonable and necessary expenses; the fiduciary must establish procedures for controlling and accounting for investment expenses. [IBP] In order to clearly define those procedures and to facilitate their implementation, they should be reduced to writing - most certainly as a matter of best practices and, most likely, as a factor in measuring the prudent conduct of the fiduciary.

Investment management costs and expenses can be broken down into four categories, and the IPS should contain instructions and procedures on how these fees and expenses will be accounted for and monitored. The fiduciary is cautioned that each can be obscured or moved from one category to another to create apparent savings. [See also *Practice No. 5.3*] The fiduciary should examine:

- 1. Money manager fees and/or the annual expenses of mutual funds
- 2. Trading costs, including commission charges and execution expenses
- 3. Custodial charges, including custodial fees, transaction charges, and cash management fees
- 4. Consulting and administrative costs and fees. In the case of defined contribution plans, demonstrate that 12b-1 fees [See Glossary of Terms], subtransfer agency fees, and/or other revenue sharing arrangements have been appropriately applied to offset recordkeeping and other administrative costs of the plan.

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)(1)(A)(i and ii); §406(a)(1)(C); §408(b)(2)

Case Law

Liss v. Smith, 991 F.Supp. 278 (S.D.N.Y. 1998)

Other

Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]

§2 Comments; §2(a); §7

Other

OCC Interpretive Letter No. 722 (March 12, 1996), citing the Restatement of Trusts 3d: Prudent Investor Rule §227, comment m at 58 (1992)

Management of Public Employee Retirement Systems Act [MPERS]

§7(2), (3) and (5); §7(5) and Comments; §8(b) and Comments

<sup>18</sup> Substantiating Code, Regulations, and Case Law Practice No. 3.63

## Practice No. 3.7 The investment policy statement defines appropriately structured, socially responsible investment strategies (when applicable)<sup>19</sup>

There is an increasing interest by fiduciaries to incorporate social, ethical, moral, and/or religious criteria into their investment strategy. The desire is to align investment decisions with the fiduciary's, investor's, and/or the beneficiary's core values. There are two terms that are used interchangeably by the industry; mission-based investing, and socially responsible investing (SRI).

However worthwhile or well-intended, fiduciary standards of care cannot be abrogated to accommodate the pursuit of a SRI strategy. As a general rule, any restriction on an investment program has the potential to reduce the portfolio's total return - itself a breach of fiduciary responsibility.

The key to successfully incorporating a SRI strategy is for the fiduciary to demonstrate that investment results were not negatively impacted. [IBP] It has become a generally accepted practice to permit the inclusion of a SRI strategy as a secondary screen to a normal (unrestricted) investment process. If there are equally attractive investment options, then social factors may be considered.

For fiduciaries guided by the UPIA, there are possibly three notable exceptions:

- 1. The trust documents establishing the private trust, foundation, or endowment permit the use of SRI
- 2. A donor directs the use of a SRI Strategy
- 3. A reasonable person would deduce from the foundation's endowment's mission that SRI would be adopted. As an example, a reasonable person would expect that a foundation for a woman's shelter would exclude tobacco, firearms, and alcohol from its investment strategy.

Employee Retirement Income Security Act of 1974 [ERISA]

§403(c)(1); §404(a)(1)

Other

ERISA Opinion Letter 98-04A (May 28, 1998); Interpretive Bulletin 94-1, 29 C.F.R. §2509.94-1

**Uniform Prudent Investor Act [UPIA]** 

§2(a); §2(c); §5

Management of Public Employee Retirement Systems Act [MPERS]

§7(1), (2) and (3); §8(a) (1) and (2); §8(a)(5); §8(b)

<sup>19</sup> Substantiating Code, Regulations, and Case Law for Practice No. 3.7:

[IBP] For defined contribution plans, in which investment decisions are participant-directed, a general investment option of the same peer group should be offered alongside each SRI investment option. As an example, if the investment committee chose to offer a SRI large-cap equity index fund, then a second large cap equity index fund that is not constrained by a SRI strategy also should be offered.

There are a number of different approaches the fiduciary can employ to execute mission-based and SRI strategies. The following is a brief synopsis:

- 1. The fiduciary can direct a hired money manager (or search for a mutual fund) to incorporate certain securities screens. The screens may be either inclusionary, or exclusionary. Inclusionary qualitative screens might include companies that emphasize:
  - Product quality/consumer relations
  - Environmental performance
  - Community relations
  - Diversity
  - Employee relations

### Exclusionary screens might include:

- The *sin* stocks alcohol, tobacco, firearms
- Nuclear power
- Military weapons
- Life ethics
- 2. The fiduciary may wish to pursue a strategy of shareholder activism actually purchasing shares of stock in a targeted company so that the fiduciary can participate in corporate governance activities.
- 3. The fiduciary may wish to pursue Economically-Targeted Investing (ETI). ETI is the use of portfolio assets to produce collateral benefits such as jobs, housing loans, and venture capital. ETI is very popular with Taft-Hartley (multi-employer) plans and public retirement plans.
- 4. The fiduciary may wish to employ money managers that are minority and/or women-owned business enterprises.

The most widely used performance benchmark for mission-based and SRI investment strategies is the Domini 400 Social Index. The Domini Social Index is comprised of: 250 stocks from the S&P 500, 100 stocks from the next 1,000 largest companies, and 50 stocks from the small-cap universe. The cap weighting of the Domini Index is less than the S&P 500, but generally the Domini 400 Social Index has been comparable to the S&P 500 index.

### Sample language for the IPS

The manager is instructed to evaluate all investment options according to objective economic criteria established by the manager and, if there are equally attractive investments, social factors may be considered.

### INTRODUCTION TO PRACTICE NOS. 4.1 - 4.4

The *Practices* associated with Step 4 of the *Investment Management Process* detail the prudent procedures for implementing the investment strategy. Whether investment decisions are delegated to professionals (strongly encouraged) or retained by the fiduciary, the fiduciary should demonstrate that a due diligence process was followed in selecting each investment option.

Besides the prudence of such conduct, it also makes good sense. When managers or funds are selected without following a due diligence process, there are potential problems:

- 1. Important search criteria can be omitted.
- 2. Performance may be compared to inappropriate indexes or peer groups.
- 3. Information provided by the manager or fund may focus on what the manager or fund wants the fiduciary to hear, and not necessarily what the fiduciary needs to know.

One of the more important responsibilities of the fiduciary is the development of a due diligence process, which can be used to select and monitor the investment options. [IBP] As a general rule, the fiduciary should develop due diligence criteria with the following in mind:

- 1. Develop a process that can be applied to both mutual funds and separate account managers, so that investment decision makers can easily migrate from one alternative to another.
- 2. Develop a process that can be applied to any of the readily available databases on mutual funds and/or separate account managers.
- Develop a simple process that can be easily understood by other fiduciaries, participants, and/or beneficiaries.
- 4. Develop screens that can serve a dual purpose apply to searches as well as to the monitoring of the managers.

## *Practice No. 4.1* The investment strategy is implemented in compliance with the required level of prudence<sup>20</sup>

Investment returns and risks are largely determined by asset allocation decisions. But what starts as strategy must be translated into reality with implementation.

Fiduciary legislation does not expressly require the use of professional money managers and/or mutual funds. However, fiduciaries will be held to the same expert standard of care, and their activities and conduct will be measured against those of investment professionals. [IBP] The prudent fiduciary should follow the time-proven maxim of doing what one does best and delegating (when trust documents permit) the rest to professionals.

As previously stated in this handbook, the primary role of the fiduciary is to manage the investment process. It is not to make investment decisions - it is not to attempt to make individual stock and bond picks. Let professional money managers build the portfolio. The fiduciary can be far more effective and efficient spending his or her time managing the managers. Therefore, for the purposes of this handbook, the emphasis is going to be on the due diligence process the fiduciary should develop in selecting the money managers.

<sup>20</sup> Substantiating Code, Regulations, and Case Law No. 4.1:

Employee Retirement Income Security Act of 1974 [ERISA]

\$402(c)(3); \$403(a)(1) and (2); \$404(a)(1)(B)

Regulations

29 C.F.R. §2550.404a-1(b)(1) and (2)

Case Law

Howard v. Shay. 100 F.3d 1484, 20 E.B.C. 2097 (9<sup>th</sup> Cir. 1996), cert. denied, 520 U.S. 1237, 117 S.Ct. 1838, 137 L.Ed.2d 1042 (1997); Fink v. National Savings and Trust Co., 772 F.2d 951 (D.C. Cir. 1985); Katsaros v. Cody, 744 F.2d 270, 5 E.B.C. 1777 (2<sup>nd</sup> Cir.), cert. denied, 469 U.S. 1072, 105 S.Ct. 565, 83 L.Ed.2d 506 (1984); Donovan v. Mazzola, 716 F.2d 1226 (9<sup>th</sup> Cir. 1983), cert. denied, 464 U.S. 1040, 104 S.Ct. 704, 79 L.Ed.2d 169 (1984); United States v. Mason Tenders Dist. Council of Greater New York, 909 F.Supp. 882, 19 E.B.C. 1467 (S.D.N.Y. 1995); Trapani v. Consolidated Edison Employees' Mutual Aid Society, 693 F.Supp. 1509 (S.D.N.Y. 1988)

**Uniform Prudent Investor Act [UPIA]** 

§2(c); §2(f); §9(a)(1-3)

Management of Public Employee Retirement Systems Act [MPERS]

§6(a); §6(b)(1); §6(b)(3); §7(3); §8(a)(1)

**[IBP]** The **Foundation for Fiduciary Studies** has identified a due diligence process which the **Foundation** believes constitutes the minimum due diligence process that should be followed in selecting a money manager. It can be used to screen both managers and funds; be applied to any database; and can be used for both the searching and the monitoring of managers. The due diligence process includes eight screens:

### Due Diligence Criteria For Selecting Investment Otpions

- 1. Performance relative to peer group.
- 2. Performance relative to assumed risk.
- 3. Inception date of product.
- 4. Correlation to peer group.
- 5. Assets under management.
- 6. Holdings consistent with style.
- 7. Expense ratios or fees.
- 8. Stability of the organization.

### Illustration 4.1

- 1. Rolling performance of the investment product on a 1-3-, and 5-year basis. The performance comparison should be made against the median return of the manager's peer group. If the manager is performing below median for the 1-, 3-, and/or 5-year period, the manager would be deemed to have a shortfall it doesn't mean the manager has failed, but simply that the performance should be evaluated in more detail to determine the source of the underperformance.
- 2. Three-year investment performance adjusted for risk. The more common screen would be to evaluate the manager's Alpha and/or Sharpe ratio. [See Glossary of Terms] The comparison should be made to the median Alpha and/or Sharpe ratio for the manager's peer group. An Alpha and/or Sharpe ratio below median would indicate a shortfall. Again, it doesn't mean the manager has failed, or shouldn't be considered, but simply the risk-adjusted performance should be evaluated in more detail to determine the source of the underperformance.

- 3. *Inception date of the investment product*. The appropriate threshold is three years. Investment statistics, such as the Alpha, Sharpe ratio, and standard deviation require a minimum of 12 observations (12 quarterly returns) before a meaningful calculation can be made.
- 4. Correlation of the investment product to the asset class, or peer group, being implemented. The selection of a money manager is based on the assumption the manager will adhere to a specific strategy or style. To do otherwise renders the search process useless, and makes monitoring of the manager a near impossible task. Furthermore, the asset allocation strategy being followed is based on the assumption that each asset class is going to be implemented by a manager and/or fund that exhibits the same performance characteristics (risk/return) as the asset class. Determining a manager's appropriate peer group, or sub-asset class, is a tricky business. There are no industry standards for determining a money manager's investment style, or peer group, which makes it virtually impossible to track the same manager across different databases. The fiduciary should understand how a particular data base provider determines a manager's peer group. One database might evaluate a manager's style by the securities held in the portfolio; another data base by the pattern of performance returns. Some databases have a policy that every manager is assigned to a peer group, while other databases only assign a manager to a peer group if there is a good fit. A good data base provider will examine both quantitative and qualitative data on the manager, and even take the time to interview the manager, to ensure that the information on record is correct.
- 5. Total assets in the investment product being considered. The threshold for this screen is \$75 million. This can be a particularly slippery screen for mutual funds when there is more than one share class for a series of funds all being managed to the same process. It's reasonable, in such a situation, to total the assets across each of the share classes to determine if the \$75 million threshold has been met.
- 6. Holdings consistent with style. 80 percent of the securities should be from the broad asset class associated with the product. As an example, if the fiduciary is examining a large cap growth fund, at least 80 percent of the securities should be in domestic equities.
- 7. Fees and expenses associated with the investment product. The fiduciary has a responsibility to control and account for investment expenses including the fees paid for investment management. The industry has never drawn a line in the sand to say that expenses on this side of the line are reasonable, and expenses on the other side of the line are not. The **Foundation** has determined that a reasonable line can be drawn at the 75<sup>th</sup> percentile. That is, when the fees for a particular peer group are ranked least expensive (1<sup>st</sup> percentile) to most expensive (100<sup>th</sup> percentile), the shortfall occurs at the 75<sup>th</sup> percentile.

8. Organizational stability - specifically manager tenure. The same investment team should be in place for a minimum of two years. This screen also would include a review of qualitative information that may be available to the fiduciary. The fiduciary should check to see if there is pending litigation against the money management firm; internal management struggles; a recent change in ownership; and/or, a rapid growth or loss of assets under management. Common sense should prevail. Organizational instability, as with any business, will ultimately be reflected by poor performance.

On the surface the eight due diligence screens may appear to be relatively easy hurdles to clear but, on average, only 6 percent of the managers (or mutual funds) are able to pass each of the screens every quarter. That is not to say that 94 percent of all remaining investment products have failed, but rather the remaining investment products have one or more shortfalls, and the shortfalls define the agenda for the fiduciary for additional research and due diligence.

There are several other important concepts the fiduciary should be familiar with in the context of this *Practice*. [IBP] The first is to appreciate *the value of diversifying across multiple sub-asset classes, or peer groups*.

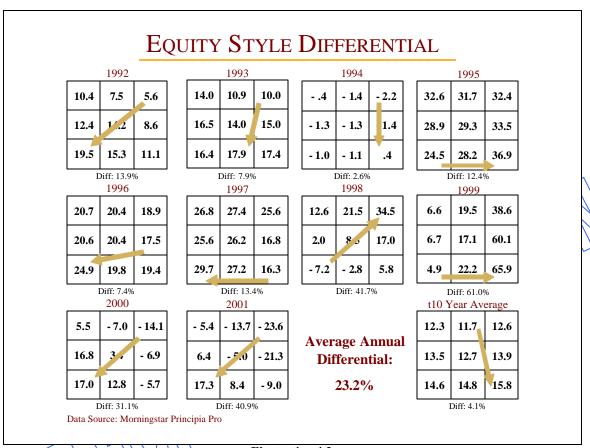
Illustration 4.2 depicts the familiar representation of peer groups by market cap size and style. The top row represents the large cap peer groups, the second row mid-cap, and the bottom row small-cap. The left-hand column represents value, the far right growth, and the middle blend or core.

### Equity Style Matrix

Large	Large	Large
Equity	Blend	Growth
Mid-Cap	Mid-Cap	Mid-Cap
Value	Blend	Growth
Small	Small	Small
Value	Blend	Growth

**Illustration 4.2** 

Keeping Illustration 4.2 in mind, examine Illustration 4.3, which depicts the median mutual fund return for each peer group for the period 1992 - 2001. As an example, in 1992 the median large-cap value mutual fund had a return of 10.4 percent and the median large cap growth manager had a return of 5.6 percent. An arrow is used to show the trend in annual performance. The tail of the arrow is on the worst performing peer group and the head is on the best. Next, the difference between the performance of the head and tail is calculated for each year. Surprisingly, the average annual differential is 23.2 percent or 2,320 basis points. [See **Glossary of Terms**] All too often, fiduciaries under-allocate across the peer groups, resulting in relative underperformance.



**Illustration 4.3** 

Active versus passive investing, or the appropriate application of index funds. Academia has written volumes on this subject, and this handbook won't attempt to revisit the debates. [IBP] What is emerging as an industry best practice is to index those market sectors that receive the most attention from securities analysts, such as large cap core. It's difficult for an active money manager to consistently discover gold nuggets in a data stream that already has been panned by so many others. Active money management makes more sense in the outlying peer groups - the far edges of value and growth, and with mid-cap and small-cap stocks. The decision to use index funds or active money managers is not an either/or decision - the fiduciary is smart to use a combination of both.

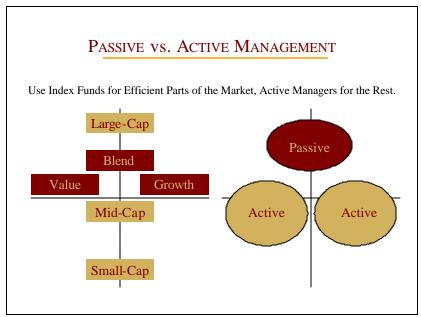


Illustration 4.4

The fiduciary also should be familiar with the different fixed income strategies. Fixed income management can simply be broken down into four strategies:

- 1. The fixed-income manager who can add value over a buy-and-hold strategy by anticipating changes in interest rates.
- 2. The fixed-income manager who can add value by anticipating changes in an issuer's credit quality.
- 3. By capitalizing on trading inefficiencies. As an example, there's a very successful municipal bond manager who buys munts from brokers in Florida, where there's no state income tax, and therefore is able to purchase the bonds from the brokers at a discount. The money manager then sells the very same bonds back to brokers in the states where the bonds were issued, where the brokers are willing to pay a premium for the bonds.
- 4. The fixed income manager who can add value by being proficient in sector selection knowing when to rotate out of government bonds and into corporate bonds, or vice versa,

There are many fiduciaries who believe a buy-and-hold strategy for a fixed income portfolio is the best approach, but the recommended approach is the use of professional money managers. [See also *Practice No. 4.2*] First, the money manager often can cover his or her fees by obtaining better execution in the purchase of the bonds. And second, the fiduciary that attempts the buy-and-hold strategy is still going to be held to a *prudent expert* standard. If the fixed-income portfolio blows up, the fiduciary is going to be held accountable.

	Practice No. 4.2 (when elected) <sup>21</sup>	Fiduciary is following applicable	"Safe Harbor"	provisions
--	---	-----------------------------------	---------------	------------

Only two of the twenty-seven *Practices* are elective; *Practice No. 3.7*, and this *Practice, No. 4.2*.

[IBP] Though *Practice No. 4.2* is a voluntary *Practice*, the fiduciary is forewarned that it is incredibly foolhardy not to take advantage of available *safe harbor* provisions. When the *safe harbor rules* are adopted, the fiduciary may be insulated from certain liabilities associated with the management of the portfolio's assets. There are no certainties with this or any of the *Practices*, except to say that, if the *safe harbor rules* are not adopted, the fiduciary will have far more liability exposure.

If investment decisions are being managed by a committee and/or by an investment advisor, then there are five generally recognized provisions to the *safe harbor rules*:

- 1. Use prudent experts to make the investment decisions. The fiduciary should manage the investment decision-making process. In turn, hired professional money managers should make the investment decisions actually select the stocks and bonds for the portfolio. Simply stated, a prudent expert is defined as a regulated financial services entity, including: banks, insurance companies, registered investment advisors, and registered investment companies (mutual funds). As of the publication of this handbook, there is pending pension-reform legislation that also will recognize registered representatives (brokers) as appropriate sources of expert advice.
- 2. Demonstrate that the **prudent expert** was selected by following a due diligence process. Practice No. 4.1 captures the substance of this provision in fact, if all of the Practices in this handbook are followed, all five of the safe harbor provisions will be met by the fiduciary.

**Employee Retirement Income Security Act of 1974 [ERISA]** 

§402(c)(3); §404(a) and (c); §405(d)(1)

Regulations

29 C.F.R. §2550.404a-1; 29 C.F.R. §2550.404a-1(b)(1) and (2)

Other

Interpretive Bulletin 75-8, 29 C.F.R. \$2509.75-8 (FR-17Q); Interpretive Bulletin 94-2, 29 C.F.R. \$2509.94-2; DOL Miscellaneous Document, 4/13/98-5 Study of 401(k) Plan Fees and Expenses; Fed. Reg., Vol. 44, p. 37255

**Uniform Prudent Investor Act [UPIA]** 

§9(a); §9(c)

Management of Public Employee Retirement Systems Act [MPERS]

§6(b); §6(d)

<sup>&</sup>lt;sup>21</sup> Substantiating Code, Regulations, and Case Law for Practice No. 4.2:

- 3. Give the **prudent expert** discretion over the assets. This is best accomplished with an appropriately worded services agreement [See also *Practice No. 1.4.*] and by inclusion in the *Duties and Responsibilities Section* of the investment policy statement. [See *Practice No. 3.2*]
- 4. Have the **prudent expert** acknowledge their co-fiduciary status. This, again, is best accomplished with the services agreement, and by having the *expert* sign the fiduciary's investment policy statement. Mutual funds are excluded from the necessity of signing the investment policy statement. Instead, the fiduciary is advised to keep the most recent copy of the mutual fund's prospectus.
- 5. Monitor the activities of the **prudent expert** to ensure that the **expert** is performing the agreed upon tasks. [See also *Practice Nos. 5.1 5.5.*]

If investment decisions are participant-directed, as often is the case for defined contribution plans (401(k) plans), then there are *additional* provisions. The word, *additional*, is emphasized because the investment committee, which is constructing the matrix of investment options which will be made available to the participants, should start with the previously stated *safe harbor* provisions, and then add the following four additional provisions:

- 1. Plan participants must be notified that the plan sponsor intends to constitute a 404 c plan, including a statement that the fiduciaries of the plan may be relieved of certain liabilities.
- 2. Participants must be provided at least three different investment options, each with a unique risk/return profile to provide the participant the opportunity for prudent diversification.
- 3. Participants must receive sufficient education on the different investment options so that each participant can make an informed investment decision. [IBP] Participant education should include:
  - a. Each investment option's most recent prospectus, or similar document
  - b. A general description of the investment objectives and risk/return characteristics of each investment option
  - c.\ Information on the fees and expenses associated with each investment option
  - d. A listing of the securities held by each investment option
  - e. The performance of each investment option
  - f. Portfolio statistics, such as the Alpha, Sharpe ratio, and standard deviation of each investment option.
- 4. Participants must be provided the opportunity to change their investment strategy/allocation with a frequency that is appropriate in light of market volatility. [IBP] The current industry practice is to permit changes at least quarterly.

## Practice No. 4.3 Investment vehicles are appropriate for the portfolio size 22

The primary focus of this *Practice* is the implementation of the investment strategy with appropriate investment vehicles, specifically the proper use of mutual funds and separate account managers. Other investment vehicles such as Exchange-Traded Funds (ETFs) and iShares will not be covered, but only because of the volume of material that needs to be covered, and not because they may be deemed inappropriate in a fiduciary setting.

To help illustrate the need for this *Practice*, consider the following two examples:

- 1. The investment committee, which is implementing an investment strategy for a portfolio with \$400,000 in total assets, and implements the portfolio with two wrap fee separate account managers. There is a very high probability that the portfolio will not be prudently diversified if only two managers are retained. [IBP] A more appropriate structure would be the use of one separate account manager to manage a core strategy, and the use of mutual funds to round out the diversification needs.
- 2. The investment advisor who is implementing a strategy for a \$100,000 portfolio and is using 20 different mutual funds. Diversification also carries a cost, and over-diversification can erode the associated benefits.

A challenging question for most fiduciaries is: At what point should there be a migration from mutual funds to separate account managers? [IBP] The following is a suggested guide:

<sup>22</sup> Substantiating Code, Regulations, and Case Law for Practice No. 4.3:

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)(1)(B); §404(a)(1)(C)

Regulations

29 C.F.R. §2550.404c-1(b)(3)(i)(C)

Case Law

Metzler v. Graham, 112 F.3d 207, 20 E.B.C. 2857 (5<sup>th</sup> Cir. 1997); Marshall v. Glass/Metal Ass'n and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378 (D.Hawaii 1980); GIW Industries, Inc., v. Trevor, Stewart, Burton & Jacobsen, Inc., 10 E.B.C. 2290 (S.D.Ga. 1989); aff'd, 895 F.2d 729 (11<sup>th</sup> Cir. 1990); Leigh v. Engle, 858 F.2d 361, 10 E.B.C. 1041 (7<sup>th</sup> Cir. 1988), cert. denied, 489 U.S. 1078, 109 S.Ct. 1528, 103 L.Ed.2d 833 (1989)

Other

H.R. Report No. 1280, 93<sup>rd</sup> Congress, 2d Sess. (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

**Uniform Prudent Investor Act [UPIA]** 

§2(a); §3; §3 Comments

Management of Public Employee Retirement Systems Act [MPERS]

§7(3); §8(a)(1)

- 1. For portfolios with total assets of less than \$300,000 implementation should be with just mutual funds. For portfolios with less than \$300,000, the operative word is *diversification*. To effectively *diversify* a portfolio across the broad asset classes (both domestic and international), the fiduciary should consider the use of mutual funds.
- 2. For portfolios between \$300,000 and \$30 million, a combination of both funds and separate account managers. For portfolios between \$300k and \$30 million, the operative word is *effectiveness* the most *effective* way to implement investment portfolios of the middle market is with a combination of funds and separate account managers. Separate account manager minimum account sizes, however, will vary from asset class to asset class. The logical minimum account size for a large-cap equity manager is going to be quite different than the effective minimum account size for an intermediate fixed-income manager. Consider the following *suggested* separate account minimums:

For large-cap equities	\$100,000
Small-to-mid cap equities	\$250,000
International equities	\$250,000
Intermediate fixed-income	\$1 million
And, for global fixed-income	\$5 million.

3. For portfolios greater than \$30 million, the operative term is *cost efficiency*. It is at this level that implementation with separate accounts can, as a general rule, be more *cost-effective* than with funds. But even at these levels, there are notable exceptions. The implementation of a large-cap blend strategy may still be more efficiently and effectively implemented with an index fund. Short-term, fixed-income, emerging markets, and most alternative investment strategies, also may still be more efficiently implemented with funds.

It is important for the fiduciary understand the pros and cons of both mutual funds and separate account managers. No one implementation structure is *right* for all occasions.

The benefits of mutual funds can be summarized as follows:

- 1. Greater liquidity there is ease in entering and exiting the asset class.
- 2. Requires smaller dollar amounts to open accounts.
- 3. Ease in putting cash to work while money is in transition. For example, if the investment committee of a large pension plan has increased its allocation to equities, but a separate account manager has yet to be selected, the assets could be put in an equity fund while the manager search is conducted.
- 4. For smaller allocated amounts, the mutual fund can achieve a greater degree of diversification.

- 5. Generally speaking, there is greater ease in meeting asset allocation and rebalancing guidelines. A combination of specialized funds can achieve more-specific asset allocation guidelines than a broadly defined separate account manager mandate.
- 6. There is far greater ease in conducting due diligence on mutual funds.
- 7. A corollary to the previous benefit, mutual fund information is required to be audited.
- 8. Ease in implementing international portfolios, particularly investments in foreign entities that have more arcane securities registration and tax laws.
- 9. Cash-flows coming in to a mutual fund may meet disbursement requirements, eliminating the need for the manager to liquidate positions.
- 10. Fees may be netted from distributions, reducing taxable income.

Likewise, there are a number of benefits associated with separately managed accounts:

- 1. Accounts can be funded and opened with securities-in-kind. This is particularly valuable to taxable clients that have assets with low or preferred tax basis.
- 2. Separate accounts do not generate a phantom tax, which has been the bane of many mutual fund investors. Depending on when the investor purchases a mutual fund, the investor may be hit with taxable gains even though the investor never benefited from a performance gain.
- 3. Permits for year-end tax harvesting and the gifting of appreciated securities to charitable organizations.
- 4. It is easier to ascertain which securities are held in the portfolio, and information on the portfolio is reported on a more timely basis.
- 5. There is an opportunity to negotiate for a reduction in fees as total assets grow.
- 6. Brokerage can be directed for soft dollar or commission recapture programs. [See also *Practice No.* 5.3.]
- Managers can be given specific securities guidelines, such as socially responsible investment instructions. [See also *Practice No. 3.7*]
- 8. Management fees may be tax deductible.

One of the challenges the fiduciary may face if the portfolio is less than \$30 million is determining whether the separate account manager being considered is really part of the *institutional*, varsity team. The fiduciary needs to be particularly sensitive to this issue when selecting a money manager from a managed-account or wrap-fee program. The fiduciary's analysis should include:

## SEPARATE ACCOUNTS VS. MANAGED ACCOUNTS (WRAP FEES) DUE DILIGENCE PROCESS

	Separate Accounts	Managed Accounts
Performance	Results of institutional clients	Compare institutional to managed results
People	Identify persons who created institutional results	Identify persons who created managed results
Process	Process followed to create institutional results	Process followed to create managed results
Procedures	Procedures to ensure "best execution"	Management of queue list
Taxable Procedures	Individual tax lot management	Quasi-omnibus account management

### Illustration 4.5

- 1. If shown a money manager's performance, ask whether the performance reflects clients in the manager's managed account program, or the performance of the institutional clients. Get both records and compare the two. One would ordinarily expect institutional clients to receive better performance because management fees will be less. But, if the performance differential is more than 50 basis points, the fiduciary should dig deeper to determine if there is a material difference between the investment process the institutional clients are receiving versus the managed account clients.
  - Ask for the name of the person, or persons, responsible for the creation of the institutional track record and the managed account record. Ascertain if it is the same team for both.
- 3. Inquire into the average number of securities held in the portfolios of the institutional clients and compare that to the number of securities in the managed account. The typical institutional equity portfolio will have about 86 securities the typical managed account, about 36.

- 4. Determine how the account will be traded: will the securities be block-traded with the rest of the institutional clients (which typically translates to the better execution of trades and at lower commissions both of which have a positive impact on performance), or will the trades have to flow back to the broker dealer sponsoring the managed account?
- 5. In the case of managers offering tax-sensitive investment management, determine whether the manager has the capacity for tax-lot portfolio management. If the manager is not tracking the adjusted basis of the individual securities within the portfolio, then it is arguably very difficult for the manager to claim that a fully tax-sensitive strategy is being employed.

The implementation of an investment strategy with mutual funds is fairly straightforward. As the fiduciary migrates to the use of separate account managers, the learning curve gets steeper and there are a number of additional factors that should be considered:

- 1. What will be the electronic protocol that will link the money manager, custodian, and fiduciary. With today's technology, there's no reason why this electronic protocol should not be Internet-based, enabling all parties to review portfolio account data on a daily basis. A common protocol also facilitates the production of performance reports. [See also *Practice No. 5.1*]
- 2. How long will it take for the equity money manager to become fully invested? Not all managers become fully invested as soon as money becomes available. The fiduciary may want to avoid a situation in which there is an anticipation that the manager is going to put new money to work right away, and then discover at the end of the quarter that half the portfolio is still sitting in eash. Conversely, during a bear market the fiduciary may prefer the manager that is holding cash, patiently waiting for buying opportunities.
- 3. How does the money manager seek best price and execution in trading the account? The manager has a fiduciary responsibility to shop the trades to seek the best strike price and the best commission for each trade. Money managers may use a particular brokerage firm to generate soft dollars [See Glossary of Terms] to pay for research the brokerage firm has generated, which ordinarily, is an acceptable practice. However, when if the fiduciary sees all of the trades, or the bulk of the trades going through one brokerage firm, then the fiduciary may have a situation where the manager is not seeking best execution.
- The fiduciary has a responsibility to ensure proxy votes are properly executed. The most expeditious way of handling this requirement is to delegate the responsibility to the money manager. The money manager also is the most logical choice after all, it is the manager who has conducted the research on the company, and he or she in the best position to determine the impact that a proxy vote may have on a company.

- 5. For taxable investors Will the manager handle low-basis or restricted stock? Having a professional money manager unwind the stock over appropriate periods of time can be a great advantage to the taxable client. Will the manager accept tax-lot information on the low-basis or restricted stock? And, will the manager do tax-lot accounting and reporting?
- 6. Will the manager review the portfolio of a previous manager? If the fiduciary is terminating a manager and hiring a new one, the fiduciary should not liquidate the holdings of the *old* manager until the *new* manager has reviewed the portfolio. The last thing the fiduciary needs is to generate expenses by selling a security in the *old* portfolio, only to have the new manager buy the same security. This is particularly true for taxable clients. If the fiduciary is considering two money managers, the fiduciary should show the *old* portfolio to both and ask them which of the securities they would continue to hold. All other things being equal, the money manager that can work with the most securities from the *old* portfolio would be preferable because it would generate fewer taxable gains and reduce the overall expenses of the transition.
- 7. Will the manager take SRI direction? [See also *Practice No. 3.7*] Most money managers can handle the usual SRI objectives, such as no sin stocks tobacco, alcohol, and firearms but some managers will struggle with such exclusions.
- 8. Will the manager produce a performance report? [IBP] The fiduciary should request performance reports from the money managers and the custodian, even if the plan is for someone else to produce the report, such as an investment consultant. Performance reporting always is a challenge, and having different parties calculating the performance for the same portfolio can help triangulate and locate the position of reporting errors.

When a manager or mutual fund is offering tax sensitive investment management, it's important for the fiduciary to determine the strategy, or strategies, the money manager is going to employ. Generally, there are four broad strategies, and as is often the case in the investment world, no one strategy works best in every type of market environment. The ideal situation is when the manager is capable of implementing any one or combination of strategies when appropriate: (1) Buying low-dividend stocks; (2) Harvesting losses at year end; (3) Implementing a low-turnover strategy; and, (4) When thinning a position, reducing the number of shares of a particular company, selling the shares with the highest basis first, referred to as HIFO (Highest In, First Out).

	A due diligence process is followed in selecting service providers,
including the cust	odian <sup>23</sup>

Custodial selection is one of the most overlooked fiduciary functions. Most fiduciaries simply abdicate the decision to a vendor, advisor, or money manager. Yet, as with other prudent practices, there are a number of important decisions that need to be managed.

The role of the custodian is to: (1) hold securities for safekeeping; (2) report on holdings and transactions; (3) collect interest and dividends; and, (4) if required, effect trades.

At the retail level, the custodian typically is a brokerage firm. Most securities are held in street name, with the assets commingled with those of the brokerage firm. To protect the assets, brokerage firms are required to obtain insurance from the Securities Investor Protection Corp (SIPC).

**[IBP]** Most institutional investors choose to use trust companies as custodians. The primary benefit is that the assets are held in a separate account, and are not commingled with other assets of the institution.

The fiduciary's inquiry should include:

- 1. An examination into the financial stability of the custodian.
- 2. An examination of the expense ratio of the cash sweep vehicle that will be used. Custodians often offer an array of cash sweep vehicles, and the expense ratios can vary from 8 to 80 basis points.

**Employee Retirement Income Security Act of 1974 [ERISA]** 

§402(a)(1); §402(b)(2); §404(a)(1)(B)

Other \

Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1; DOL Information Letter, Qualified Plan Services (7/28/98); DOL Information Letter, Service Employee's International Union (2/19/98)

**Uniform Prudent Investor Act [UPIA]** 

§2(a); §7; §7 Comments; §9(a) (1), (2) and (3)

Management of Public Employee Retirement Systems Act [MPERS]

§6(a) and (b)(1) and (2); §7

<sup>&</sup>lt;sup>23</sup> Substantiating Code, Regulations, and Case Law for Practice No. 4.4:

- 3. The level of detail the custodian is able to provide in the monthly statement. The fiduciary needs to have the capacity to see transaction data, specifically, the name of the broker dealer used for each transaction, the strike price of the security being purchased/sold, and the commission paid.
- 4. If the account is holding mutual funds, whether the custodian is willing to provide corrected year-end statements? Many mutual funds pay out their dividend at year-end, which causes havoc in the pricing of the mutual fund shares at year-end.
- 5. Will the custodian provide tax reporting? This can greatly reduce the cost and pain of tax preparation.
- 6. Will the custodian provide performance reporting? This is a service the fiduciary may have to request; it's often not offered as part of a standard package. However, if the fiduciary negotiates for performance reporting upfront, the additional charge typically is nominal.

### INTRODUCTION TO PRACTICE NOS. 5.1 - 5.5

Once the optimal portfolio has been designed and the investment policy statement prepared and implemented, the final critical step is the ongoing monitoring and supervision of the investment process. The monitoring function extends beyond a strict examination of performance; by definition, monitoring occurs across all policy and procedural issues previously addressed in this handbook.

A long-term investment strategy requires alteration only when the underlying factors of the investment objectives change: **TREAT** - tax status, risk tolerance, expected return, asset class preferences, and time horizon. [See also *Practice* Wo. 2.4] These changes tend to be infrequent, if not rare, and reviews directed toward constantly reassessing existing policy tend to be counterproductive.

An effective monitoring program should provide the fiduciary with sufficient information to evaluate the investment program's strength and weaknesses, and to keep the program on track in achieving investment objectives. The establishment of appropriate performance measurement objectives:

- 1. Facilitates effective communications between the fiduciary and service providers and money managers, and helps to confirm mutually agreed-upon goals and objectives of the investment policy [See also *Practice No. 3.5*]
- 2. Facilitates the evaluation of the asset allocation strategy as directed by the investment policy statement with respect to the portfolio's risk tolerance and modeled return expectations [See also *Practice No. 3.3*]

### **Introduction to** *Practice Nos. 5.1 - 5.5* (continued)

- 3. Supports the qualitative judgment about the continued confidence, or lack of it, in the money manager's abilities [See also *Practice No. 5.2*]
- 4. Facilitates effective communications between all parties involved in determining the continued appropriateness of the overall investment policy.

Monitoring includes an analysis of not only *what happened*, but also *why?* The analysis combines the elements of performance measurement - the *science* - with performance evaluation - the *art*. Performance measurement primarily is a technical accounting function that computes the return of the portfolio and component parts. Performance evaluation uses the information generated by performance measurement to determine what contributed to, or detracted from, the portfolio's return.

Practice No. 5.1 Periodic performance reports compare the performance of money managers against appropriate index, peer group, and IPS objectives<sup>24</sup>

The ongoing review, analysis, and monitoring of the money managers and/or mutual funds is just as important as the due diligence implemented during the manager selection process. There is considerable legal substantiation for the fiduciary requirement to monitor all phases of the investment management program, particularly the monitoring of the money managers and/or mutual funds. What has not been specified is the frequency of the monitoring meetings or the requirement that the monitoring reports be reduced to writing.

Employee Retirement Income Security Act of 1974 [ERISA]

§3(38); §402(c)(3)

Case Law

Leigh v. Engle, 727 F.2d 113, 4 E.B.C. 2702(7<sup>th</sup> Cir. 1984); Atwood v. Burlington Indus. Equity. Inc., 18 E.B.C. 2009 (M.D.N.C. 1994)

### Other

Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q); Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

**Uniform Prudent Investor Act [UPIA]** 

§2(a); §9(a) (1 - 3)

Management of Public Employee Retirement Systems Act [MPERS]

§6(a) and (b)(1 - 3); §6 Comments; §6(d); §8(b)

<sup>&</sup>lt;sup>24</sup> Substantiating Code, Regulations, and Case Law for Practice No. 5.1:

In keeping with the duty of prudence, a fiduciary appointing a money manager (or selecting a mutual fund) must determine the frequency of the reviews necessary, taking into account such factors as: (1) the general economic conditions then prevailing; (2) the size of the portfolio; (3) the investment strategies employed; (4) the investment objectives sought; and, (5) the volatility of the investments selected. Some degree of informal monitoring should take place between the scheduled monitoring meetings so that immediate action can be taken when there are extreme or sudden deviations from the performance objectives established in the investment policy statement. [See also *Practice No. 3.5*]

[IBP] The fiduciary should establish performance objectives for each money manager and/or mutual fund, and record the same in the investment policy statement. Money manager performance should be evaluated in terms of an appropriate market index (as an example, the S&P 500 index for large-cap domestic equity manager) and the relevant peer group (as an example, the large-cap growth mutual fund universe for a large-cap growth mutual fund).

On a periodic basis [IBP - at least quarterly] the fiduciary should review whether each money manager and/or mutual fund continues to conform to the performance objectives, specifically:

- 1. The manager's adherence to the guidelines established by the investment policy statement
- 2. Material changes in the manager's organization, investment philosophy, and or personnel
- 3. Any legal, SEC, and/or other regulatory agency proceedings that may affect the manager.

The investment policy statement also should describe the actions to be taken when a money manager fails to meet the established criteria. [See also *Practice No. 3.5*] The fiduciary should acknowledge that fluctuating rates of return characterize the securities markets, particularly during short-term time periods. Recognizing that short-term fluctuations may cause variations in performance, the fiduciary should evaluate manager performance from a long-term perspective. [IBP] Ordinarily, in this context, a *long-term* perspective would be defined as two to three years.

[IBP] There often will be times when a money manager is beginning to exhibit shortfalls in the defined performance objectives but, in the opinion of the fiduciary, does not warrant termination. It is strongly suggested that, in such situations, the fiduciary establish in the investment policy statement specific *Watchlist* procedures.

As an example, a money manager may be placed on the *Watchlist* when:

- 1. A money manager performs below median for their peer group over a 1-, 3-, and/or 5-year cumulative period.
- 2. A money manager's 3-year risk adjusted return (Alpha and/or Sharpe) falls below the peer group's median risk adjusted return.

- 3. There is a change in the professionals managing the portfolio.
- 4. There is a significant decrease in the product's assets.
- 5. There is an indication the money manager is deviating from his/her stated style and/or strategy.
- 6. There is an increase in the product's fees and expenses.
- 7. Any extraordinary event occurs that may interfere with the manager's ability to fulfill his or her role in the future.

**[IBP]** When a money manager is placed on the *Watchlist*, an evaluation may include the following steps:

- 1. A letter to the money manager asking for an analysis of their underperformance
- 2. An analysis of recent transactions, holdings, and portfolio characteristics to determine the cause for underperformance or to check for a change in style
- 3. A meeting with the money manager, which may be conducted on-site, to gain insight into organizational changes and any changes in strategy or discipline.

The decision to retain or terminate a manager cannot be made by a formula It is the fiduciary's confidence in the money manager's ability to perform in the future that ultimately determines the retention of a money manager.

[IBP] While there is no explicit requirement that the performance reviews be documented in writing, best practices and general fiduciary requirements suggest otherwise. The reports should include, at a minimum, the performance of each money manager and/or mutual fund against indices, peer groups, and the performance objectives established in the investment policy statement. [See also *Practice No. 3.5*]

A common mistake is the failure to compare a money manager to an appropriate peer group, or comparing the manager to benchmarks that may not be relevant. For example, not all equity managers should have their performance compared to the S&P 500. Equity managers that follow a value strategy should be compared against other value managers.

## Practice No. 5.2 Periodic reviews are made of qualitative and/or organizational changes to money managers <sup>25</sup>

The fiduciary has a continuing duty to exercise reasonable care, skill, and caution in monitoring the performance of investment decision makers, particularly when investment duties have been delegated to a noney manager. The fiduciary's review of a money manager and/or mutual fund must be based on more than recent investment performance results, for all professional money managers will experience periods of poor performance. Fiduciaries also should not be lulled into rethinking their manager lineup simply because of the reported success of other managers.

**[IBP]** In addition to the quantitative review of the money manager, [See also *Practice No. 5.1*] periodic reviews of the qualitative performance and/or organizational changes to the investment manager should be made at reasonable intervals:

- 1. **Staff turnover** Has there been turnover in the professional or service staff of the investment manager such as that the quality of the service and investment results provided by the investment manager in the past may not be maintained in the future?
- 2. Organizational structure Are there, or have there been, any changes to the organization structure of the money manager, including mergers and/or acquisitions involving the money manager, such as that the quality of the service and investment results provided by the money manager in the past may not be maintained in the future?
- 3. **Level of service provided** Does the money manager provide the same or better level of service that is available in the marketplace for comparable fees? Where applicable, does the money manager provide online access to account information?

Employee Retirement Income Security Act of 1974 [ERISA]

\$3(38); \$402(c)(3); \$404(a)(1)(B)

Regulations

29 C.F.R. §2550.408b-2(d); 29 C.F.R. §2550.408c-2

Other

Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8; Booklet: A Look at 401(k) Plan Fees, U.S. Department of Labor, Pension and Welfare Benefits Administration

**Uniform Prudent Investor Act [UPIA]** 

§2(a); §7; §9(a)

Management of Public Employee Retirement Systems Act [MPERS]

§6(a) and (b)(1 - 3); §7(5)

<sup>&</sup>lt;sup>25</sup> Substantiating Code, Regulations, and Case Law for Practice No. 5.2:

- 4. The quality and timeliness of the money manager's reports to the fiduciary Do the reports contain all of the information that is necessary and useful to the appointing fiduciary? Are the reports consistently provided on a timely basis?
- 5. The quality and timeliness of the money manager's response to requests for information Does the investment manager consistently respond to requests for information by the fiduciary in a timely manner? Do the responses contain the information requested? Are the responses easily understood?
- 6. **Investment education** Where applicable, does the money manager provide adequate explanation of the investment decisions it makes and the factors it considers in making such decisions so that the fiduciary can understand and appropriately monitor such actions?
- Practice No. 5.3 Control procedures are in place to periodically review a money manager's policies for best execution, soft dollars, and proxy voting<sup>26</sup>

The fiduciary has a responsibility to control and account for investment expenses - that the expenses are prudent and are applied in the best interests of the investor, participant (in the case of a retirement plan), or beneficiary (in the case of a private trust, foundation, or endowment). The fiduciary, therefore, must monitor that:

1. Best execution practices are followed in securities transactions.

<sup>26</sup> Substantiating Code, Regulations, and Case Law for Practice No. 5.3.

Employee Retirement Income Security Act of 1974 [ERISA]

§3(38); §402(c)(3); §403(a)(1) and (2); §404(a)(1)(A) and (B)

Case Law

Herman v. Nations Bank Trust Co., (Georgia), 126 F.3d 1354, 21 E.B.C. 2061 (11<sup>th</sup> Cir. 1997), reh's denied, 135 F.3d 1409 (11<sup>th</sup> Cir.), cert. denied, 525 U.S. 816, 19S.Ct. 54, 142 L.Ed.2d 42 (1998)

Other

Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q); Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2(1); DOL Prohibited Transaction Exemption 75-1, Interim Exemption, 40 Fed. Reg. 5201 (Feb. 4, 1975); DOL Information Letter, Prescott Asset Management (1/17/92) (fn. 1); DOL Information Letter, Refco, Inc. (2/13/89); ERISA Technical Release 86-1 (May 22, 1986)

**Uniform Prudent Investor Act [UPIA]** 

§2(a); §2(d); §7; §9(a)

Management of Public Employee Retirement Systems Act [MPERS]

§6(2) and (3); §7(5); §8(a)(3)

- 2. *Soft dollars* are expended only for brokerage, research, or other services for the benefit of the investment program, and are reasonable in relationship to the value of such services.
- 3. *Proxies are voted* in a manner most likely to preserve or enhance the value of the subject stock.

The terms, best execution, soft dollars, and proxy voting have specific technical meanings, and warrant further discussion.

Best Execution. The fiduciary has an ongoing responsibility to periodically monitor the trades of the money manager to determine whether the manager is seeking best execution in trading the portfolio's securities. In seeking best execution, money managers are required to shop their trades with various brokerage firms, taking into consideration: (1) commission costs; (2) an analysis of the actual strike price of the security; and, (3) the quality and reliability of the trade.

### The DOL has described best execution as:

Those who invest plan assets ... have traditionally been guided by the **best execution** principle, namely, securing the best price for the plan in executing the purchase or sale of securities without regard to whether the broker-dealer or bank functions in an agency (broker) relationship, or in a principal (dealer) relationship to the plan. [DOL Prohibited Transaction Exemption 75-1, Interim Exemption, 40 Fed. Reg. 5201 (Feb. 4, 1975)]

Soft Dollars represent the excess in commission costs; the difference between what a brokerage firm charges for a trade versus the brokerage firm's actual costs.

As an example:

Commission

Brokerage firm's actual cost for trade

Soft Dollar

6 cents/share
2 cents/share
4 cents/share

The fiduciary has a responsibility to ensure that soft dollars are applied to the purchase of goods and services that directly support the investment program, such as: consulting services, investment research, custodial services, rating or technical services, and/or subscriptions to investment periodicals. The failure of the fiduciary to monitor soft dollars may subject the investment program to expenditures which yield no benefit, itself a fiduciary breach.

The DOL has described *soft dollars* as follows:

Section 28(e) of the [Securities Exchange Act of 1934] provides generally that no person who exercises investment discretion with respect to a securities transactions will be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of paying brokerage commissions for effecting a securities transaction in excess of the amount of commission another broker-dealer would have charged, if such person determined in good faith that the commission was reasonable in relation to the value of brokerage and research services provided by the broker-dealer. [PWBA ERISA Technical Release 86-1 (May 22, 1986)]

*Proxy voting*. The fiduciary also has a responsibility to account for the *voting of proxies*. The fiduciary can either retain the power to vote the proxies, or instruct the money manager to vote on behalf of the fiduciary. [IBP] Typically, only the largest of fiduciary portfolios elect to take responsibility for voting their proxies. The majority of fiduciaries delegate that responsibility to the money manager via instructions in the investment policy statement. [See also *Practice No. 3.2.*]

### The DOL has described *proxy voting* as follows:

The fiduciary duties described at ERISA §404(a)(1)(A) and (B), require that, in voting proxies, the responsible fiduciary consider those factors that may affect the value of the plan's investment, and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives. These duties also require that the named fiduciary appointing an investment manager periodically monitor the activities of the investment manager with respect to the management of plan assets, including decisions made and actions taken by the investment manager with regard to proxy voting decisions. The named fiduciary must carry out this responsibility solely in the interest of the participants and beneficiaries, and without regard to its relationship with the plan sponsor.

It is the view of the Department that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring. Thus, the investment manager or other responsible fiduciary would be required to maintain accurate records as to proxy voting ... the proxy voting records must enable the fiduciary to review not only the investment manager's voting procedure ... but also to review the actions taken in individual proxy voting situations. [29 CFR 2509.94-2(1)]

## Practice No. 5.4 Fees for investment management are consistent with agreements and with the law<sup>27</sup>

The fiduciary responsibility in connection with the payment of fees is to determine: (1) whether the fees can be paid from portfolio assets [See also *Practice No. 1.1*]; and (2) whether the fees are reasonable in light of the services to be provided to the plan. [See also *Practice No. 1.4*] Accordingly, the fiduciary must negotiate all forms of compensation to be paid for investment management to ensure that the aggregate (and individual components) is reasonable compensation for the services rendered.

Money manager fees vary widely, depending on the asset class to be managed, the size of the account, and whether the funds are to be managed separately or placed into a commingled or mutual fund. Fees usually are charged in terms of basis points (100 basis points = 1.0%) and are applied to the market value of the portfolio at the end/beginning of a calendar quarter. Fees often decline significantly with increasing asset size.

[IBP] Illustration 5.1 depicts the quartile rankings for the expense ratios of mutual funds for each peer group. As discussed in *Practice No. 4.1*, the **Foundation** has proposed that the 75<sup>th</sup> percentile be a reasonable expense cutoff. That is, if the expense ratio of a mutual fund is greater than the expense ratio at the 75<sup>th</sup> percentile, the fiduciary should be concerned about a potential breach.

Employee Retirement Income Security Act of 1974 [ERISA] \$3(14)(B); \$404(a)(1)(A),(B) and (D); \$406(a)

Regulations 29.C F.R. 82550.408

29 C.F.R. §2550 408(b)(2)

Other

Booklet: A Look at 401(k) Plan Fees, U.S. Department of Labor, Pension and Welfare Benefits Administration; DOL Advisory Opinion Letter (7/28/98) 1998 WL 1638072; DOL Advisory Opinion Letter 89-28A (9/25/89) 1989 WL 435076; Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q)

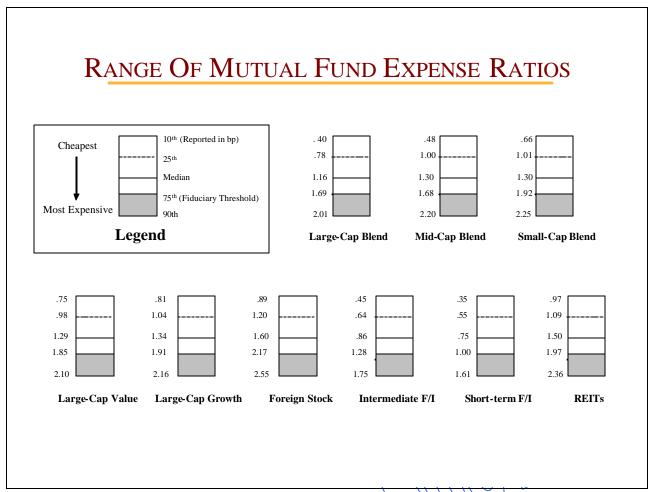
**Uniform Prudent Investor Act [UPIA]** 

§2(a); §7 and Comments; §9 Comments

Management of Public Employee Retirement Systems Act [MPERS]

§7(2) and (5); §7 Comments

<sup>&</sup>lt;sup>27</sup> Substantiating Code, Regulations, and Case Law for Practice No. 5.4:



**Illustration 5.1** 

A minority of money managers offer performance-based fees. Under these arrangements, the manager receives a higher fee if they are able to exceed a predesignated benchmark over a specified period of time. Performance-based fees are not permitted in all states and, where permitted, may only be used by entities with assets in excess of \$1 million.

Ш	Practice No. 5.5 "Finders fees," 12b-1 fees, or other forms of compensation that
	have been paid for asset placement are appropriately applied, utilized, and
	documented <sup>28</sup>

The fiduciary has a duty to control and account for investment expenses. [See also *Practice Nos. 3.6, 4.3, 5.3, and 5.4*] This requires the fiduciary to account for all dollars spent for services, whether those dollars are paid directly from the account or through *soft dollars*, 12b-1 fees [See **Glossary of Terms**], or other fee-sharing arrangements.

In addition, the fiduciary has the responsibility to identify those parties that have been compensated for placing portfolio assets with a particular vendor to ensure that no party is unduly compensated. It is not uncommon for a broker to receive a commission stream in perpetuity on assets placed with a particular vendor. Though the broker should, ordinarily, be entitled to some form of compensation for the *introduction*, the fiduciary has a responsibility to apply a *reasonableness* test to the amount of compensation received by the broker.

In the case of a *bundled*, *wrap*, or *all-inclusive fee* investment product, there are basically four cost components. The fiduciary should investigate how the various service vendors associated with each component are compensated to ensure that no one vendor is receiving unreasonable compensation, and to compare the costs of the same services on an *ala carte* basis. The four components are:

- 1. The money manager who is selecting the stocks and bonds for the portfolio
- 2. The brokerage firm that is executing the trades
- 3. The custodian that is holding and safeguarding the securities

Employee Retirement Income Security Act of 1974 [ERISA]

§404(a)(1)(A) and (B); §406(a)(1); §406(b)(1); §406(b)(3)

Case Law

Brock v. Robbins, 830 F.2d 640, 8 E.B.C. 2489 (7th Cir. 1987)

Other

DOL Advisory Opinion Letter 97-15A; DOL Advisory Opinion Letter 97-16A (5/22/97)

Uniform Prudent Investor Act [UPIA]

§2(a); §7; §7 Comments

Case Law

Matter of Derek W. Bryant, 188 Misc. 2d 462, 729 NYS 2d 309 (6/21/01)

Other

McKinneys EPTL11-2.3(d)

Management of Public Employee Retirement Systems Act [MPERS]

§6(b)(2) and (3); §7(2) and (5)

<sup>&</sup>lt;sup>28</sup> Substantiating Code, Regulations, and Case Law for Practice No. 5.5.

4. The investment advisor, or broker, who is servicing the account

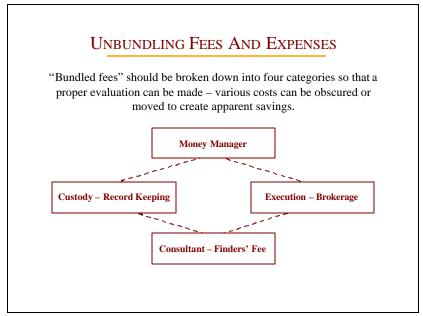


Illustration 5.2

In the case of defined contribution plans, it is austomary to offer investment options that carry 12-b-1 fees. The 12-b-1 fees are often used to offset the plan's record-keeping and administrative costs. For a new plan with few assets, such an arrangement is, ordinarily, beneficial for the participants. [IBP] However, as the assets grow, the fiduciary should periodically determine whether it is more advantageous to pay for the record-keeping and administrative costs on an *ala carte* basis, switching to mutual funds that have a lower expense ratio, and reducing the overall expenses of the investment program.

#### CONCLUSION

The *Practices* identified in this handbook prescribe a timeless and flexible process for the successful management of investment decisions. Once familiar with the *Practices*, the fiduciary will understand that no new investment product or technique will be good or bad *per se*, nor will it be valuable because it worked for other fiduciaries. Furthermore, the *Practices* will help the fiduciary understand which new investment strategies, products, and techniques fit into their priorities, and which do not.

The intelligent and prudent management of investment decisions requires the fiduciary to maintain a rational, disciplined investment program. The mind-boggling array of investment choices coupled with *market noise* from Wall Street understandably can result in financial paralysis from information overload. Fiduciaries clearly need a framework for making investment decisions that allows them to consider developing investment trends, and to thoughtfully navigate the possibilities.

### Enclosure 1

# Investment Policy Statement

# **FOR**

# **ABC COMPANY**

(DEFINED BENEFIT PLAN)

Approved on September 13, 2002

By ABC Investment Board

This investment policy statement should be reviewed and updated at least annually. Any change to this policy should be communicated in writing on a timely basis to all interested parties.

This investment policy statement has been prepared by the Foundation for Fiduciary Studies. It is intended to serve as an example of the type of information that would be included in a comprehensive IPS. Clients are advised to have legal counsel review their investment policy statement before it is approved.

# **EXECUTIVE SUMMARY**

**Type of Plan:** Defined Benefit Plan

**Plan Sponsor:** ABC Company

Plan IRS Tax Identification: 56-1234567

**Current Assets:** \$200,000,000

**Time Horizon:** Greater than 5 years

**Modeled Return:** 7.6% (4.6% over CPI)

**Modeled Loss:** -8.9% (Probability level of 5%)

Asset Allocation:	Lower Limit	Strategic Allocation	Upper <u>Limit</u>	
	<u></u>	2 222 0 0 0 2 2		
Domestic Large-Cap Equities				11
Value	5%	10%	15%\	11.
Blend	5%	10%	15%	$ \cdot  \setminus \bigvee$
Growth	5%	10%	15%	
Mid-Cap	5%	10%	15%	
Small-Cap	5%	10%	15%	
International Equities	5%	(H0%\\\\	15%	
Intermediate-Term Fixed Income	30%	() \\35% \\	40%	
Cash Equivalents	0%	5%	10%	

**Evaluation Benchmarks:** 

Trustee Counseling Index<sup>TM</sup> (Equity Exposure)\*

	LCV	LCB	LCG	MCB	SCB	ΙE	MM	SB	IB
TCI(20)	5	5	5	0	0	5	10	30	40
TCI(40)	10	10	10	0	5	5	5	20	35
TCI(60)	10	10	10	10	10	10	5	0	35
TCI(80)	15	15	15	10	10	15	5	0	15

<sup>\*</sup> The TCI<sup>TM</sup> series of indexes are designed to illustrate the performance of a diversified portfolio, calculated by using the performance of the median mutual fund manager for each peer group represented in the allocation.

#### **PURPOSE**

The purpose of this Investment Policy Statement (IPS) is to assist the Defined Benefit Board of Trustees (Board) [See Appendix A] in effectively supervising, monitoring and evaluating the investment of the Company's Retirement Plan (Plan) assets. The Plan's investment program is defined in the various sections of the IPS by:

- 1. Stating in a written document the Board's attitudes, expectations, objectives, and guidelines for the investment of all Plan assets.
- 2. Setting forth an investment structure for managing all Plan assets. This structure includes various asset classes, investment management styles, asset allocation, and acceptable ranges that, in total, are expected to produce a sufficient level of overall diversification and total investment return over the long-term.
- 3. Providing guidelines for each investment portfolio that control the level of overall risk and liquidity assumed in that portfolio, so all Plan assets are managed in accordance with stated objectives.
- 4. Providing rate-of-return and risk characteristics for each asset class represented by various investment options. [See Appendix B]
- 5. Encouraging effective communications between the Board, the investment consultant (Consultant), and hired money managers.
- 6. Establishing formal criteria to monitor, evaluate, and compare the performance results achieved by the money managers on a regular basis.
- 7. Complying with all ERISA, fiduciary, prudence, and due diligence requirements experienced investment professionals would utilize, and with all applicable laws, rules and regulations from various local, state, federal, and international political entities that may impact Plan assets.

This IPS has been formulated, based upon consideration by the Board of the financial implications of a wide range of policies, and describes the prudent investment process the Board deems appropriate.

#### **BACKGROUND**

The Plan is a defined benefit plan established in conjunction with the spin-off of Defined Benefit in July 1985. The Plan covers the hourly employees of Defined Benefit, including those who were previously covered under the Defined Benefit Corporation Retirement Plan for Hourly Rate Employees. The Board will discharge its responsibilities under the Plan solely in the long-term interests of Plan participants and their beneficiaries.

The Plan currently covers 364 employees. The number is anticipated to increase at the rate of 10% per year for the next 5 years. Plan size currently is \$200,000,000 and annual contributions are currently not required due to the well-funded status of the Plan. Under current regulations, the Plan is not [is] required to make any quarterly contributions for the current year.

### **Key Information:**

Name of Plan: ABC Retirement Plan

**Plan Sponsor:** ABC Company

**Plan IRS Tax ID:** 56-1234567

Other Related Retirement Plans: ABC Defined Contribution Plan

Key information, which is subject to change from time-to-time, is contained in Appendix A

#### STATEMENT of OBJECTIVES

This IPS has been arrived at upon consideration by the Board by a wide range of policies, and describes the prudent investment process the Board deems appropriate. This process includes offering various asset classes and investment management styles that, in total, are expected to offer participants a sufficient level of overall diversification and total investment return over the long-term. The objectives are:

- 1. Maintain the purchasing power of the current assets and all future contributions by producing positive real rates of return on Plan assets.
- 2. Maintain a fully funded status with regard to the Accumulated Benefit Obligation and 90% of the Projected Benefit Obligation.
- 3. Have the ability to pay all benefit and expense obligations when due.

- 4. Maintain a funding cushion for unexpected developments and for possible future increases in benefit structure and expense levels.
- 5. Maintain flexibility in determining the future level of contributions.
- 6. Maximize return within reasonable and prudent levels of risk in order to minimize contributions.
- 7. Control costs of administering the plan and managing the investments.

Investment results are the critical element in achieving the investment objectives, while reliance on contributions is a secondary element.

#### Time Horizon

The investment guidelines are based upon an investment horizon of greater than five years. Interim fluctuations should be viewed with appropriate perspective. Similarly, the Plan's strategic asset allocation is based on this long-term perspective. Short-term liquidity requirements are anticipated to be nonexistent, or at least should be covered by the annual contribution.

- or -

[There is a requirement to maintain sufficient liquid reserves to provide for the payment of retirement benefits. Analysis of the cash flow projections of the Plan indicates benefit payments will exceed contributions for at least several years. The Board's Secretary will notify the Investment Managers well in advance of the withdraw orders to allow sufficient time to build up necessary liquid reserves.]

#### Risk Tolerances

The Board recognizes the difficulty of achieving the Plan's investment objectives in light of the uncertainties and complexities of contemporary investment markets. The Board also recognizes some risk must be assumed to achieve the Plan's long-term investment objectives. In establishing the risk tolerances of the IPS, the ability to withstand short- and intermediate-term variability were considered. These factors were:

- ABC Company is in an industry that should experience milder fluctuations than the general economy. ABC believes it should be able to achieve above average growth during the next several years.
- ABC's strong financial condition enables it to adopt a long-term investment perspective.

- Demographic characteristics of participants suggest an above-average risk tolerance due to the younger-than-average work force.
- Actuarial data related to future projected benefit payments, along with future projected expenses of the Plan, are significantly less than conservative forecasted investment income projections. Therefore, liquidity requirements are immaterial over the next ten years, which implies that a higher risk profile is acceptable.
- Current Plan assets have been accumulated to exceed the value of the Plan's total accrued benefit liability, allowing for a less aggressive risk tolerance.

In summary, ABC Company's prospects for the future, current financial condition, and several other factors suggest collectively the Plan can tolerate some interim fluctuations in market value and rates of return in order to achieve long-term objectives.

### Performance Expectations

The desired investment objective is a long-term rate of return on assets that is at least 7.6%, which is 4.6% greater than the anticipated rate of inflation as measured by the Consumer Price Index (CPI). The target rate of return for the Plan has been based upon the assumption that future real returns will approximate the long-term rates of return experienced for each asset class in the IPS.

The Board realizes market performance varies and a 7.6% rate of return may not be meaningful during some periods. Accordingly, relative performance benchmarks for the managers are set forth in the **Control Procedures** section. Over a complete business cycle, the Plan's overall annualized total return, after deducting for advisory, money management, and custodial fees, as well as total transaction costs; should perform above a customized index comprised of market indices weighted by the strategic asset allocation of the Plan.

#### ASSET CLASS GUIDELINES

The Board believes long-term investment performance, in large part, is primarily a function of asset class mix. The Board has reviewed the long-term performance characteristics of the broad asset classes, focusing on balancing the risks and rewards.

History shows that while interest-generating investments, such as bond portfolios, have the advantage of relative stability of principal value; they provide little opportunity for real long-term capital growth due to their susceptibility to inflation. On the other hand, equity investments, such as common stocks, clearly have a significantly higher expected return but have the disadvantage of much greater year-by-year variability of return. From an investment decision-making point of view, this year-by-year variability may be worth accepting, provided the time horizon for the equity portion of the portfolio is sufficiently long (five years or greater).

The performance expectations (both risk and return) of each asset class are contained in Appendix B. The following eight asset classes were selected and ranked in ascending order of risk (least to most):

Money Market (MM)

Intermediate Bond (IB)

Large-Cap Value (LCV)

Large-Cap Blend (LCB)

Large-Cap Growth (LCG)

Mid-Cap Blend (MCB)

Small-Cap Blend (SCB)

International Equity (IE)

The Board has considered the following asset classes for inclusion in the asset mix, but has decided to exclude these asset classes at the present time:

Global Fixed Income

Real Estate

### Rebalancing of Strategic Allocation

The percentage allocation to each asset class may vary as much as plus or minus 5%, depending upon market conditions. When necessary and/or available, cash inflows/outflows will be deployed in a manner consistent with the strategic asset allocation of the Plan. If there are no cash flows, the allocation of the Plan will be reviewed quarterly.

If the Board judges cash flows to be insufficient to bring the Plan within the strategic allocation ranges, the Board shall decide whether to effect transactions to bring the strategic allocation within the threshold ranges. (Strategic Allocation)

#### **DUTIES and RESPONSIBILITIES**

#### **Board Investment Committee**

As fiduciaries under the Plan, the primary responsibilities of the Board are:

- 1. Prepare and maintain this investment policy statement
- 2. Prudently diversify the Plan's assets to meet an agreed upon risk/return profile
- 3. Prudently select investment options
- 4. Control and account for all investment, record keeping, and administrative expenses associated with the Plan
- 5. Monitor and supervise all service vendors and investment options
- 6. Avoid prohibited transactions and conflicts of interest.

#### Investment Consultant

The Board will retain an objective, third-party Consultant to assist the Board in managing the overall investment process. The Consultant will be responsible for guiding the Board through a disciplined and rigorous investment process to enable the Board to meet the fiduciary responsibilities outlined above.

#### Investment Managers

As distinguished from the Board and Consultant, who are responsible for *managing* the investment process, investment managers are responsible for *making* investment decisions (security selection and price decisions). The specific duties and responsibilities of each investment manager are:

1. Manage the assets under their supervision in accordance with the guidelines and objectives outlined in their respective Service Agreements, Prospectus, or Trust Agreement.

- 2. Exercise full investment discretion with regards to buying, managing, and selling assets held in the portfolios.
- 3. If managing a separate account (as opposed to a mutual fund or a commingled account), seek approval from the Board prior to purchasing and/or implementing the following securities and transactions:
  - Letter stock and other unregistered securities; commodities or other commodity contracts; and short sales or margin transactions
  - Securities lending; pledging or hypothecating securities
  - Investments in the equity securities of any company with a record of less than three years continuous operation, including the operation of any predecessor
  - Investments for the purpose of exercising control of management
- 4. Vote promptly all proxies and related actions in a manner consistent with the long-term interest and objectives of the Plan as described in this IPS. Each investment manager shall keep detailed records of the voting of proxies and related actions and will comply with all applicable regulatory obligations.
- 5. Communicate with the Board all significant changes pertaining to the fund it manages or the firm itself. Changes in ownership, organizational structure, financial condition, and professional staff are examples of changes to the firm in which the Board is interested.
- 6. Effect all transactions for the Plan subject to best price and execution. If a manager utilizes brokerage from the Plan assets to effect soft dollar transactions, detailed records will be kept and communicated to the Board.
- 7. Use the same care, skill, prudence, and due diligence under the circumstances then prevailing that experienced investment professionals, acting in a like capacity and fully familiar with such matters, would use in like activities for like retirement Plans with like aims in accordance and compliance with ERISA and all applicable laws, rules, and regulations.
- 8. If managing a separate account (as opposed to a mutual fund or a commingled account), acknowledge co-fiduciary responsibility by signing and returning a copy of this IPS.

#### Custodian

Custodians are responsible for the safekeeping of the Plan's assets. The specific duties and responsibilities of the custodian are:

- 1. Maintain separate accounts by legal registration
- 2. Value the holdings
- 3. Collect all income and dividends owed to the Plan
- 4. Settle all transactions (buy-sell orders) initiated by the Investment Manager
- 5. Provide monthly reports that detail transactions, cash flows, securities held and their current value, and change in value of each security and the overall portfolio since the previous report.

#### INVESTMENT MANAGER SELECTION

The Board will apply the following due diligence criteria in selecting each money manager or mutual fund:

- 1. Regulatory oversight: Each investment manager should be a regulated bank, an insurance company, a mutual fund organization, or a registered investment adviser.
- 2. Correlation to style or peer group: The product should be highly correlated to the asset class of the investment option. This is one of the most critical parts of the analysis, since most of the remaining due diligence involves comparisons of the manager to the appropriate peer group.
- 3. Performance relative to a peer group: The product's performance should be evaluated against the peer group's median manager return, for 1-, 3-, and 5-year cumulative periods.
- 4. Performance relative to assumed risk: The product's risk-adjusted performance (Alpha and/or Sharpe Ratio) should be evaluated against the peer group's median manager's risk-adjusted performance.
- 5. *Minimum track record:* The product's inception date should be greater than three years.

- 6. Assets under management: The product should have at least \$75 million under management.
- 7. Holdings consistent with style: The screened product should have no more than 20% of the portfolio invested in "unrelated" asset class securities. For example, a Large Cap Growth product should not hold more than 20% in cash, fixed-income, and/or international securities.
- 8. *Expense ratios/fees:* The product's fees should not be in the bottom quartile (most expensive) of their peer group.
- 9. *Stability of the organization:* There should be no perceived organizational problems the same portfolio management team should be in place for at least two years.

#### CONTROL PROCEDURES

#### Performance Objectives

The Board acknowledges fluctuating rates of return characterize the securities markets, particularly during short-term time periods. Recognizing that short-term fluctuations may cause variations in performance, the Board intends to evaluate manager performance from a long-term perspective.

The Board is aware the ongoing review and analysis of the investment managers is just as important as the due diligence implemented during the manager selection process. The performance of the investment managers will be monitored on an ongoing basis and it is at the Board's discretion to take corrective action by replacing a manager if they deem it appropriate at any time.

On a timely basis, but not less than quarterly, the Board will meet to review whether each manager continues to conform to the search criteria outlined in the previous section; specifically:

- 1. The manager's adherence to the Plan's investment guidelines
- 2. Material changes in the manager's organization, investment philosophy, and/or personnel
- 3. Any legal, SEC, and/or other regulatory agency proceedings affecting the manager.

The Board has determined it is in the best interest of the Plan's participants that performance objectives be established for each investment manager. Manager performance will be evaluated in terms of an appropriate market index (e.g. the S&P 500 stock index for large cap domestic equity manager) and the relevant peer group (e.g. the large cap growth mutual fund universe for a large cap growth mutual fund).

Asset Class/ Peer Group	Index	Peer Group Universe		
Large Cap Equity				
Large-Cap Value	S&P 500	Large-Cap Value		
Large-Cap Blend	S&P 500	Large-Cap Blend		
Large-Cap Growth	S&P 500	Large-Cap Growth		
Mid-Cap Equities	S&P 400	Mid-Cap Blend		
Small-Cap Equities	Russell 2000	Small-Cap Blend		
International Equity	MSCI EAFE	Foreign Stock		
Fixed Income				
Intermediate Bond	Salomon 3 - 7 Year Treas.	Intermediate-Term Bond		
Money Market	90 day T-Bills	Money Market Database		

A manager may be placed on a *Watchlist* and a thorough review and analysis of the investment manager may be conducted, when:

- 1. A manager performs below median for their peer group over a 1-, 3-, and/or 5-year cumulative period.
- 2. A manager's 3-year risk adjusted return (Alpha and/or Sharpe) falls below the peer group's median risk adjusted return.
- 3. There is a change in the professionals managing the portfolio.
- 4. There is a significant decrease in the product's assets.
- 5. There is an indication the manager is deviating from his/her stated style and/or strategy.
- 6. There is an increase in the product's fees and expenses.

7. Any extraordinary event occurs that may interfere with the manager's ability to fulfill their role in the future.

A manager evaluation may include the following steps:

- 1. A letter to the manager asking for an analysis of their underperformance
- 2. An analysis of recent transactions, holdings, and portfolio characteristics to determine the cause for underperformance or to check for a change in style
- 3. A meeting with the manager, which may be conducted on-site, to gain insight into organizational changes and any changes in strategy or discipline.

The decision to retain or terminate a manager cannot be made by a formula. It is the Board's confidence in the manager's ability to perform in the future that ultimately determines the retention of a manager.

#### Measuring Costs

The Board will review, at least annually, all costs associated with the management of the Plan's investment program including:

- 1. Expense ratios of each investment option against the appropriate peer group
- 2. Custody fees: The holding of the assets, collection of the income and disbursement of payments
- 3. Whether the manager is demonstrating attention to best execution in trading securities.

The Board will review this IPS at least annually to determine whether stated investment objectives are still relevant, and the continued feasibility of achieving the same. It is not expected that the IPS will change frequently. In particular, short-term changes in the financial markets should not require adjustments to the IPS.

Prepared:	Approved:
Consultant	Board
September 13, 2002	September 13, 2002

# **APPENDIX A**

Board or Investment Committee Members	
, Chairman	
, Secretary	
, Investment Committee Member or Trustee	
, Investment Committee Member or Trustee	
, Investment Committee Member or Trustee	
, Investment Committee Member or Trustee	
, Investment Committee Member or Trustee	
, Investment Committee Member or Trustee	_
NOT FOR PREPARED	

# **APPENDIX B**

# Summary of Capital Markets Inputs

Asset Class	Modeled Return	Modeled Standard Deviation	Index Proxy	
Large-Cap Equity	9.13	15.98	S&P 500	
Mid-Cap Equity	9.55	19.00	S&P Mid-Cap 400	
Small-Cap Equity	9.63	20.89	Russell 2000	
International Equity	9.06	19.00	MSCI EAFE IL	
REITS	7.32	15.29	Wilshire REIT	
Global Fixed Income	6.08	12.00	Salomon Bros. Non-\$ World Gov.	
Broad Fixed Income	5.81	7.00	Lehman Bros. Aggregate	
Intermediate Fixed Income	5.36	5.00	Lehman Bros. Interm.	
Short-Term Fixed Income	4.62	3.31	Dehman Bros. 1-3 Year Govt.	
Money Market	2.84	<u> </u>	3 Month T-Bill	

## **ENCLOSURE 2: GLOSSARY OF TERMS**

This glossary was compiled from the following sources.

Eugene B. Burroughs, CFA, *Investment Terminology (Revised Edition)*, International Foundation of Employee Benefit Plans, Inc., 1993.

John Downes, Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms (Third Edition)*, Barron's Educational Series, Inc.

John W. Guy, *How to Invest Someone Else's Money*, Irwin Professional Publishing, Burr Ridge, Illinois.

Donald B. Trone, William R. Allbright, Philip R. Taylor, *The Management of Investment Decisions*, Irwin Professional Publishing, Burr Ridge, Illinois.

Donald B. Trone and William R. Allbright, *Procedural Prudence for Fiduciaries*, self-published, 1997.

AIMR Performance Presentation Standards These standards, effective January 1, 1993, are designed to promote full disclosure and fair representation in the reporting of investment results in order to provide uniformity in comparing manager results. These standards include ethical principles, and apply to all organizations serving investment management functions. Compliance is verified at two levels: Tevel 1 and Level 2. (Level 2 is a more comprehensive verification process). Specific information regarding these standards can be obtained by calling AIMR at (804) 980-3547.

Alpha This statistic measures a portfolio's return in excess of the market return adjusted for risk. It is a measure of the manager's contribution to performance with reference to security selection. A positive alpha indicates that a portfolio was positively rewarded for the residual risk, which was taken for that level of market exposure.

Asset Allocation The process of determining the optimal altocation of a fund's portfolio among broad asset classes.

**Basis Point** 100 Basis Points = 1%

Best Execution This is formally defined as the difference between the strike price (the price at which a security is actually bought or sold) and the "fair market price", which involves calculating opportunity costs by examining the security price immediately after the trade is placed. Best execution occurs when the trade involves no lost opportunity cost, for example, when there is no increase in the price of a security shortly after it is sold.

**Beta** A statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security in comparison to a market index. The beta value measures the expected change in return per one percent change in the return on the market. Thus, a portfolio with a beta of 1.1 would move 10% more than the market.

**Cash Sweep Accounts** A money market fund into which all new contributions, stock dividend income, and bond interest income is placed ("swept") for a certain period of time. At regular intervals, or when rebalancing is necessary, this cash is invested in assets in line with the asset allocation stipulated in the IPS.

**Commingled Fund** An investment fund that is similar to a mutual fund in that investors purchase and redeem units that represent ownership in a pool of securities. Commingled funds usually are offered through a bank-administered plan allowing for broader and more efficient investing.

**Commission Recapture** An agreement by which a plan Fiduciary earns credits based upon the amount of brokerage commissions paid. These credits can be used for services that will benefit the plan such as consulting services, custodian fees, or hardware and software expenses.

**Correlation Coefficient** Correlation measures the degree to which two variables are associated. Correlation is a commonly used tool for constructing a well-diversified portfolio. Traditionally, equities and fixed-income asset returns have not moved closely together. The asset returns are not strongly correlated. A balanced fund with equities and fixed-income assets represents a diversified portfolio that attempts to take advantage of the low Correlation between the two asset classes.

**Defined Benefit Plan** A type of employee benefit plan in which employees know (through a formula) what they will receive upon retirement or after a specified number of years of employment with an employer. The employer is obligated to contribute funds into the defined benefit plan based on an actuarially determined obligation that takes into consideration the age of the workforce, their length of service and the investment earnings that are projected to be achieved from the funds contributed. Defined Benefit Plans are over funded if the present value of the future payment obligations to employees is less than the current value of the assets in the Plan. It is under funded if the obligations exceed the current value of these Plan assets. The **Pension Benefit Guarantee Corporation** insures a specified amount of these future pension benefit payments on a per employee basis.

**Defined Contribution Plan** A type of employee benefit plan in which the employer (Fiduciary) makes annual contributions (usually discretionary in amount or possibly based on a percentage of the profits of the company e.g. **Profit Sharing Plan**) into the plan for the ultimate payment to employees at retirement. Each employee's account value will be determined by the contribution made, the earnings achieved and (usually a vesting percentage - e.g., 20% per year after one year of service).

**Directed Brokerage** Circumstances in which a board of trustees or other fiduciary requests that the investment manager direct trades to a particular broker so that the commissions generated can be used for specific services or resources. See **Soft Dollars**.

**Dollar-weighted Rate of Return** Method of performance measurement that calculates returns based on the cash flows of a security or portfolio. A dollar-weighted return applies a discounted cash flow approach to obtain the return for a period. The discount rate that equates the each inflow at the end of the period plus any net cash flows within the period with the initial outflow is the dollar-weighted rate of return. This return also is referred to as the internal rate of return (IRR).

**Economically-Targeted Investment** (ETI) Investments where the goal is to target a certain economic activity, sector, or area in order to produce corollary benefits in addition to the main objective of earning a competitive risk-adjusted rate of return.

**End Point Sensitivity** The performance of a manager/fund may vary depending on which ending time periods are used to analyze performance. Therefore it is important to look at performance for a number of market cycles of time periods to gain an accurate assessment of the manager/fund's performance.

**Equal Weighted** In a portfolio setting, this is a composite of a manager's return for accounts managed that gives equal consideration to each portfolio's return without regard to size of the portfolio. Compare to **Size-Weighted Return**. In index context, equal weighted means each stock is given equal consideration to the index return without regard to market capitalization. The Value Line Index is an example of an equal weighted index.

**Equilibrium Spending Rate** Specific to foundations and endowments, the "spending rate" which offsets inflation and additional cost increases.

**ERISA** The Employee Retirement Income Security Act is a 1974 law governing the operation of most private pension and benefit plans. The law eased pension eligibility rules, set up the **Pension Benefit Guaranty Corporation**, and established guidelines for the management of pension funds.

**Fiduciary** Indicates the relationship of trust and confidence where one person (the Fiduciary) holds or controls property for the benefit of another person. For example, the relationship between a trustee and the beneficiaries of the trust.

Any person who (1) exercises any discretionary authority or control over the management of a plan or the management or disposition of its assets, (2) renders investment advice for a fee or other compensation with respect to the funds or property of a plan, or has the authority to do so, or (3) has any discretionary authority or responsibility in the administration of a plan.

**Funding-Support Ratio** The *funding-support ratio* (the fraction of the budget supported by the fund) is the key strategic variable used by experienced committees to track and manage contributions to an institution's or recipient's annual budget. Although increasing the spending rate increases the fund's current contribution to the overall budget, more spending obviously means less reinvestment, a smaller growth rate and, all other things being equal, a lower funding support ratio in the future.

**Geometric Return** A method of calculating returns which links portfolio results on a quarterly or monthly basis. This method is best illustrated by an example, and a comparison to **Arithmetic Returns**, which does not utilize a time link. Suppose a \$100 portfolio returned +25% in the first quarter (ending value is \$125) but lost 20% in the second quarter (ending value is \$100). Over the two quarters the return was 0% - this is the geometric return. However, the arithmetic calculation would simply average the two returns: (+25%)(.5) + (-20%)(.5) = +2.5%.

Liquidity Risk The risk that there will be insufficient cash to meet the fund's disbursement and expense requirements.

Market Capitalization A common stock's current price multiplied by the number of shares outstanding. It is the measure of a company's total value on a stock exchange.

Market Timing A form of Active Management that moves funds between asset classes based on short-term expectations of movements in the capital markets. (Not recommended as a prudent process.) It is very difficult to improve investment performance by attempting to forecast market peaks and troughs. A forecasting accuracy of at least 71% is required to outperform a buy and hold strategy.

Market-Weighted Typically used in an index composite. The stocks in the index are weighted based on the total Market Capitalization of the issue. Thus, more consideration is given to the index's return for higher market capitalized issues than smaller market capitalized issues.

Money Markets Financial markets in which financial assets with a maturity of less than one year are traded. Money market funds also refer to open-end mutual funds that invest in low-risk, highly liquid, short-term financial instruments and whose net asset value is kept stable at \$1 per share. The average portfolio maturity is 30 to 60 days.

**Profit Sharing Plan** Retirement plan that receives contributions as a percentage of the company's profits. See **Defined Contribution Plan**.

**Proxy Voting** A written authorization given by a shareholder to someone else to vote his or her shares at a stockholders annual or special meeting called to elect directors or for some other corporate purpose.

**Real Estate Investment Trust (REIT)** An investment fund whose objective is to hold real estate-related assets, either through mortgages, construction and development loans, or equity interests.

**Residual Risk** Residual risk is the unsystematic, firm-specific, or diversifiable risk of a security or portfolio. It is the portion of the total risk of a security or portfolio that is unique to the security or portfolio itself and is not related to the overall market. The residual risk in a portfolio can be decreased by including assets that do not have similar unique risk. For example, a company that relies heavily on oil would have the unique risk associated with a sudden cut in the supply of oil. A company that supplies oil would benefit from a cut in another company's supply of oil. A combination of the two assets helps to cancel out the unique risk of the supply of oil. The level of residual risk in a portfolio is a reflection of the "bets" which the manager places in a particular asset class or sector. Diversification of a portfolio can reduce or eliminate the residual risk of a portfolio.

**Risk-adjusted Return** The return on an asset or portfolio, modified to explicitly account for the risk of the asset or portfolio.

**Risk Free Rate of Return** The return on a 90-day Treasury bills. This is used as a proxy for no risk due to its US Government issuance and short-term maturity. The term is really a misnomer since nothing is free of risk. It is utilized since certain economic models require a "risk free" point of departure. See **Sharpe Ratio**.

**R-squared** ( $\mathbb{R}^2$ ) Formally called the coefficient of determination, this measures the overall strength or "explanatory power" of a statistical relationship. In general, a higher  $\mathbb{R}^2$  means a stronger statistical relationship between the variables that have been estimated, and therefore more confidence in using the estimation for decision-making.

Safe Harbor Rules A series of guidelines which when in full compliance may limit a fiduciary's liabilities.

Sharpe Ratio This statistic is a commonly used measure of risk-adjusted return. It is calculated by subtracting the Risk-free Return (usually 3Month Treasury Bill) from the portfolio return and dividing the resulting "excess return" by the portfolio's total risk level (standard deviation). The result is a measure of return gained per unit of total risk taken. The Sharpe ratio can be used to compare the relative performance of managers. If two managers have the same level of risk but different levels of excess return, the manager with the higher Sharpe ratio would be preferable. The Sharpe ratio is most helpful when comparing managers with both different returns and different levels of risk. In this case, the Sharpe ratio provides a permit measure of the two managers that enables a comparison.

**Socially-Targeted Investment** An investment that is undertaken based upon social, rather than purely financial, guidelines. See also **Economically-Targeted Investment**.

Soft Dollars The portion of a plan's commissions expense incurred in the buying and selling of securities that is allocated through a **Directed Brokerage** arrangement for the purpose of acquiring goods or services for the benefit of the plan. In many soft dollar arrangements, the payment scheme is effected through a brokerage affiliate of the consultant. Broker consultants servicing smaller plans receive commissions directly from the counseled account. Other soft dollar schemes are effected through brokerages that, while acting as the clearing/transfer agent, also serve as the conduit for the payment of fees between the primary parties to the directed fee arrangement.

**Standard Deviation** A statistical measure of portfolio risk. It reflects the average deviation of the observations from their sample mean. Standard deviation is used as an estimate of risk since it measures how wide the range of returns typically is. The wider the typical range of returns, the higher the standard deviation of returns, and the higher the portfolio risk. If returns were normally distributed (i.e., has a bell shaped curve distribution) then approximately 2/3 of the returns would occur within plus or minus one standard deviation from the sample mean.

**Strategic Asset Allocation** Rebalancing back to the normal mix at specified time intervals (quarterly) or when established tolerance bands are violated  $(\pm 10\%)$ .

**Tactical Asset Allocation** The "first cousin" to **Market Timing** because it uses certain "indicators" to make adjustments in the proportions of portfolio invested in three asset classes - stocks, bonds, and cash.

**Time-Weighted Rate of Return** Method of performance measurement that strips the effect of cash flows on investment performance by calculating sub period returns before and after a cash flow and averaging these sub period returns. Because dollars invested do not depend on the investment manager's choice, it is inappropriate to weight returns within a period by dollars.

**Trading Costs** Behind investment management fees, trading accounts for the second highest cost of plan administration. Trading costs usually are usually quoted in cents per share. Median institutional trading costs range around 5 to 7 cents per share.

**90-Day US Treasury Bill** The 90-Day T-Bill provides a measure of risk less return. The rate of return is the average interest rate available in the beginning of each month for a T-Bill maturing in 90 days.

Variance The Variance is a statistical measure that indicates the spread of values within a set of values. For example, the range of daily prices for a stock will have a variance over a time period that reflects the amount that the stock price varies from the average, or mean price of the stock over the time period. Variance is useful as a risk statistic because it gives an indication of how much the value of a portfolio might fluctuate up or down from the average value over a given time.



# FIDUCIARY CODE OF CONDUCT

If you're going to do it – *Do it right*.

As you manage investment decisions:

Document the process; Hire competent professionals; Monitor results; and *Always remember you have been entrusted with someone else's money.* 

Never invest in something you don't understand or is difficult to value.

Know what you're paying for —

Don't hire the fox to count the chickens.

Understand that, when everyone is talking about making a killing *The market already is dead.* 

Cautiously approach investments that promise superior results.

Believe in the statement —

The past is no indication of future performance.

Relish the opportunity to be a steward of sound investment practices, for, in the end,

it's procedural prudence, not performance, that counts.

Copyright © 2000 – 2002. Foundation for Fiduciary Studies Pittsburgh, PA (412) 390-5077 www.ffstudies.org