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How Should a 401k Plan Sponsor Construct an Appropriate Investment Policy Statement?

by Christopher Carosa, CTFA June 07http://www.fiduciarynews.com/2011/06/how-401-plan-sponsors-can-construct-an-appropriate-investment-policy-statement/?utm_source=FiduciaryNews&utm_medium=The4KeyElementsofaSuccssful401kPlanEducationProgram&utm_campaign=022712y

What worries the ERISA fiduciary most? After achieving sustainable profitability for their business, 401k plan sponsors greatest concern most likely centers on their liability exposure as a result of their responsibility for investing

institutional funds. Constructing an appropriate Investment Policy Statement (IPS) – one that truly unites the corporate vision and mission with the investment objective – represents the best method to alleviate this concern. An IPS is essential for the reduction of liability. The statement must document the plan's mission and investment objectives, as well as the justification for these objectives. Without a written statement in place, 401k plan sponsors will not be able to effectively evaluate their true fiduciary liability. *Does your plan have all the elements of an appropriate Investment Policy Statement or do you only think you have all the elements?*

What is an 'Appropriate' IPS?

There exists at least one codified framework legislated to provide individual trustees and fiduciaries with some liability protection. Many states began passing some form of the "Prudent Investor Act" in the mid-1990s. In addition to these state laws, corporate retirement plans fall under the jurisdiction of ERISA, regulated by the federal Department of Labor.

A written IPS can act as the cornerstone to regulatory and legal compliance. With this written IPS, the fiduciary has documented the justification of the appropriateness of the institution's mission and investment objectives. From this, the fiduciary can better evaluate and monitor the institutional fund's investment performance. Therefore, the objectives of an 'appropriate' IPS include:

- A reiteration of the institution's Vision and Mission statements
- An insurance the IPS is consistent with the institution's corporate goals
- A provision of the Plan's mission statement
- A listing of the specific methods used to avoid the most common mistakes of Modern Portfolio Theory
- A thoroughly documented structure with clearly written prose that can be understood by all interested parties
- An outline of measurable procedures for trustees' and participants' education
- An accommodation for all other interested parties (if any)
- Meaningful goals
- A proper accounting of real risks as they pertain to the plan's exact demographics
- A well laid out identification of the method of evaluation
- An explicit timeline to regularly review and updated the document

How to Create a Structure for the IPS

We can assimilate the above in an intuitive, easy-to-understand table of contents. We'll break these down and follow each with a brief explanation of how to create them. Bear in mind, this process involves a substantial degree of due diligence. The 401k plan sponsor who lacks experience in this area may wish to complete this process with the help of a qualified fiduciary consultant.

I. Objective of IPS

This can be as simple as incorporating some form of the above paragraph "What is an appropriate IPS" as modified to meet the needs of the specific institution. For example, if there are specific regulatory criteria the plan must address, it should be stated here.

II. Statement of Corporate Vision

The components of corporate vision fall into three categories. These refer to those elements that define the rigid parameters within which the company moves as it seeks to achieve success in its business. Fiduciaries must fully understand these rigid parameters before they can even begin to define the Plan's mission statement and its IPS. Typically, this section would include: 1) a brief paragraph describing the company; 2) a list of the company's core values and beliefs; 3) a statement as to the company's overall purpose (i.e., its ideal role in society); and, 4) a statement of the mission of the company (i.e., its tangible goal). The corporate vision statement is often completed as a task separate and distinct from matters pertaining to the company's retirement plan. Nonetheless, it remains important to incorporate this body of work into the IPS. The tangible goal(s) derived from the mission statement is (are) used to identify the Investment Objectives and Method of Due Diligence in Sections V and VI below.

III. The Plan's Mission Statement

Unlike the Corporate Mission Statement, which usually identifies dollar denominated financial goals and needs, the mission statement of the ERISA plan contains broader language as to the general intent of the plan and its investments.

IV. Summary of the Plan's Vital Information

As with individual investment portfolios, here we list all the key individuals, including trustees, advisers and service providers, of the institution. In the specific case of retirement plans, we'll also include plan demographics.

V. Outline of Investment Objectives

The IPS now begins to define the broader investment objectives that will permit the portfolio to accomplish its stated mission. First and foremost, the fiduciary must determine if a "Total Return" or "Assigned Asset" methodology will be used. The Total Return method utilizes the entire portfolio to meet a financial goal. The Assigned Asset method assigns a specific portion of the portfolio to meet a specific goal. This section then outlines meaningful investment objectives that seek to accommodate all constituencies. These broadly defined objectives must outline and address the issues identified above.

In general, the Investment Objectives will consist of differing weights of the following standard objectives (for a more comprehensive explanation of these Modern Investment Objectives, see "401k Plan Sponsors: Is Your Investment Policy Statement Still Using Outdated Language?" *Fiduciary News*, May 17, 2011):

1. **Wealth Accumulation (usually receives a higher weighting)** – This Investment Objective is appropriate for investors wishing to grow assets over time. It implies a long-term time horizon. As such, it places long-term growth at a higher priority than reducing short-term volatility.
2. **Wealth Preservation (usually receives a lower weighting)** – This Investment Objective is appropriate for investors wishing to begin using assets in the very near future. It implies a short-term time horizon. As such, it places a greater emphasis on reducing short-term volatility rather long-term growth.
3. **Wealth Distribution (commonly used in specific circumstances)** – This Investment Objective is appropriate for investors who seek to implement an asset distribution plan over time. The time period may be short-term or long-term. As such, this goal typically incorporates elements of Wealth Preservation depending on the exact nature of the distribution plan.

Finally, the IPS should explicitly state how it plans to satisfy some of the more common negative issues surrounding Modern Portfolio Theory. Because much of the industry still commits these mistakes, the fiduciary should pro-actively address them through the IPS. For example, most academics now acknowledge the use of standard deviation (or similar statistical models) as a measure of risk may be no longer appropriate.

One word of warning here: Although the DOL has specified Target Date Funds as "qualified" for auto-enrollment, establishing a "target date" may actually harm investors and could create liabilities for the 401k plan sponsor. Why? Quite simply, employees have their own unique circumstances. While the retirement dates of some employees may be the same, there return requirements may be different. As a result, establishing "Goal-Oriented Targets" for return assumptions may be more appropriate.

VI. Method of Due Diligence and Evaluation

The IPS must define the specific criteria used to determine specific qualifications and evaluation parameters of the investment options. The Corporate Mission will typically identify cash flow assumptions, including any potential matching in the company's 401k plan. The fiduciary, often with the help of the fiduciary consultant, uses this data to calculate each investment option's Goal-Oriented Target (GOT). Portfolio management (including that within chosen mutual funds) and evaluation must then be conducted to conform to this GOT. The investment option's GOT is often a much better evaluation benchmark than industry indices or averages, which too often rely too heavily on relative performance (as opposed to the absolute needs of the investor).

VII. Trustee's/Fiduciary's Education Plan

It is generally a good idea to formulate a plan to provide ongoing education to individual trustees and fiduciaries of the plan. A fiduciary consultant can provide this service. It's important the 401k plan sponsor be careful here to insure the avoidance of any conflicts of interest between the investment provider and the educational program, although this will be of greater concern in the next section. For example, if a non-fiduciary (like a broker or a mutual fund company) offers trustee education, they may omit certain views because those views are not represented in their product offerings.

VIII. Employee's Education Plan

The company has employees that will have educational needs that are appropriately address in the IPS. Here it is of paramount important that the education provider be independent of the investment adviser, including any related mutual funds. We want to eliminate any conflict-of-interest which has the organization responsible for serving education needs possessing a vested interest in the investment of certain options over other options. An example here would be a broker or mutual fund family having the opportunity, through their "education" program, to funnel employees' investments into higher fee investment options which benefit the broker or mutual fund family. Be mindful, though, as most employees will need to invest in long-term options, even an independent education provider will direct most employees towards equity options – and these tend to have higher fees than stable income options.

IX. Compliance Review Plan

Lastly, the IPS should delineate a Compliance Review Plan taking into consideration the specific circumstances of the particular institution for which it is written. This section will address three areas: 1) the Annual Review of the IPS; 2) a Provide Analysis; and, 3) a Compliance Review and Audit. The degree of specificity of each of these areas will depend on the nature of the company, the size of the plan and the regulatory environment in which it exists.

Summary and Conclusion

Creating an appropriate Investment Policy Statement should not intimidate any individual trustee or fiduciary. The process represents a structured methodology meant to comprehensively address the fiduciary concerns of an individual who may or may not be a financial expert. Indeed, the end result of the process leads to the delegation of that duty – and at least a portion of the fiduciary liability – to a professional specifically trained for such services.