Developing Investment Policy and Structure

Balancing Diversity and Simplicity

ERISA says that plan sponsors should provide participants with the opportunity to choose from a broad range of investment options in order to effectively diversify their accounts among the various options. Participants should be offered ***at least 3*** different investment options, *each of which must:*

1) Be diversified
2) Have materially different risk and return characteristics
3) Help to minimize the participant's overall risk when combined with other investments

INVESTMENT OVERSIGHT

The challenge for plan sponsors comes when trying to satisfy a wide range of participant investment styles, while also maintaining simplicity to help ease participants' decision-making ***and minimize overall plan and participant risk***.

While there is no single solution that will prove optimal for all plans, we recommend establishing and following policy guidelines to help drive your investment decisions. Furthermore, it is important to develop benchmarks against which you will measure each of the plan's investments, as well as criteria that will drive your fund selection, monitoring, and replacement when necessary. *Following are key considerations for your investment policy and selection:*

1) **Participant Investment Knowledge and Sophistication**
2) **Fit With Overall Investment Menu**
3) **Risk/Return Tradeoff**
4) **Manager Track Record and Consistency**

Balancing Risks

1. Participant Knowledge and Sophistication. Participants with limited investment knowledge or sophistication can benefit from the simplification offered by single fund diversified options (e.g. target date funds and lifecycle funds). On the other hand, more knowledgeable participants may want to create their own diversified portfolios by allocating their accounts across several single category funds (e.g. Intermediate US Bond, US Large Value Stock, International Stock, etc.). While you want to address different investment styles, be aware that *offering too many fund choices can overwhelm some participants and cause them to postpone or even avoid making a selection.*

2. Fit With Overall Investment Menu. When developing or refining your investment menu, we recommend focusing on the different investment categories and considering how each fund fits into your overall investment structure. We believe that the easier it is to explain your investment menu to your plan participants, the more likely you are to get the desired outcomes.

It is critical that participants understand the parallels between a single fund solution (target date or lifecycle) and a portfolio consisting of a diversified blend of several category specific funds. Furthermore, "do-it-myself" investors need to be able to easily categorize each individual (or category specific) fund to prevent unintentional diversification mistakes.

Balancing Risks

3. Risk/Return Tradeoff. While we all would prefer to invest in low risk/high return funds, we must recognize the reality that *risk and return are negatively correlated.* Measured over short periods of time this relationship may temporarily fall out of balance, but throughout history the balance has repeatedly been restored over longer time periods.

The risk/return balance needs to be carefully considered when selecting a fund(s) for each of your investment categories. For example, a target date fund manager's 5-year returns may be near the top of his/her peer group. However, this could largely be the result of elevated risk-taking paying off during a bull stock market. In a bear stock market this same manager may perform near the bottom of the peer group.

In short, you will want to decide on an appropriate risk/return balance for each fund category on your investment menu, and then select the investment manager whose objectives and long-term track record best meet your plan's established goals.

4. Manager Track Record and Consistency. Continuing our discussion on investment managers, it is vital to gain an understanding of each manager's goals and objectives. In an effort to avoid surprises, you will want to *select investment managers whose stated objectives are consistent with both your plan's objectives and their own investment track record.*

While some of us may like surprises, they are not welcome when it comes to protecting yourself against fiduciary risk. With this in mind, we caution you to be wary of a fund manager's significant over-performance relative to peers in the same way you would take pause when a fund manager's returns are significantly less favorable. In fulfilling your fiduciary obligations, *emphasis needs to be placed on the overall long-term investment strategy and the risk/return balance, and not just on returns.*

Looking ahead, we will continue our discussion on how PlanPilot works with our clients to achieve their plan objectives through a five-step process, with our next letter focused on service provider consultation:

1) Building a Strong Foundation: Plan Compliance and Governance
2) Maximizing Plan Design to Increase Employee Impact
3) Developing Investment Policy and Structure: Balancing Diversity and Simplicity
4) **Improving Plan Efficiency to Maximize Return on Investment**
5) Helping Participants Make Better Decisions

We hope the thoughts contained in this letter help you improve the management of your retirement plan(s).

PlanPILOT is Here to Help

We welcome the opportunity to assist you and your retirement oversight committee in managing your retirement program. Please do not hesitate to call us at **(312) 973-4911** to discuss how we can be of assistance to you and your plan oversight committee.