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# USING INVESTMENT POLICY TO CHOOSE ASSET CLASSES AND INVESTMENT FUNDS

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Sponsors of defined contribution plans face a series of complex questions when selecting investment options. Should funds be selected based on popularity? Should plan participants have a voice in the selection process? What responsibilities does ERISA impose for prudent selection processes? How can investment theory and generally accepted portfolio design principles assist with the selection process?

Thankfully, a well drafted investment policy statement (IPS) can significantly streamline the fund selection process. In addition to providing the theoretical foundation underlying the sponsor's objectives, and documenting the process, the IPS will simplify fund selection by bifurcating the decisions that must be made. First, the IPS should identify which investment categories will be represented in the plan. Then the IPS should define the process for selecting funds to represent each designated investment category.

## USING AN IPS TO CHOOSE ASSET CATEGORIES

Sponsors of defined contribution plans often have questions regarding the fund selection process. Which are the best investment categories to offer? Morningstar, Inc., an independent mutual fund rating and data service provider, organizes mutual funds into 51 investment categories. Should all of these categories be represented in a plan? How many funds should be selected to represent each category? Is one enough, or should the plan select multiple funds in some categories? Although the final decision regarding a plan's investment lineup depends on each specific plan's unique characteristics, most plan sponsors set two important objectives. Funds selected must:

- Conform with the provisions of Section 404(c) of ERISA; and
- Enable plan participants to construct a portfolio with risk and return characteristics appropriate for the participant.

Investment policy can be extremely useful in streamlining the process of identifying appropriate investment categories and selecting funds to represent the designated categories.

### Conforming with ERISA Section 404(c)

Section 404(c) of ERISA provides limited scope relief from fiduciary liability for sponsors of Participant-Directed Individual Account Plans. Briefly, Section 404(c) provides that when a participant or beneficiary exercises control over the assets in his or her account, no person who is otherwise a fiduciary shall be liable for any loss which results from such participant's or beneficiary's exercise of control. What makes con-

forming to Section 404(c) somewhat difficult is the regulation's definition of "exercise of control". Although a complete description of Section 404(c) goes well beyond the scope of this article, in very general terms, plans must provide a broad range of investment options, and must provide participants with sufficient information that they can make informed investment decisions. The regulations describing "broad range of investment options" define different standards for a plan's "core" investment options, and for elective "non-core" investment options.

### Core Investment Options

The core investment options must include at least three diversified investment alternatives:

- 1) Each of which is diversified;
- 2) Each of which has materially different risk and return characteristics;
- 3) Which in the aggregate enable the participant by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant; and
- 4) Each of which when combined with investments in the other alternatives tends to minimize through diversification the overall risk of a participant's portfolio.

To satisfy these requirements, a defined contribution plan should designate three *core* investment vehicles representing each of the following asset classes:

- **Cash Equivalents** – this should be a money market fund investing in high quality, short-term fixed income securities.
- **Common Stocks** - this should be a publicly traded pooled investment vehicle investing primarily in the shares of large U.S. corporations.
- **Bonds** - this should be a publicly traded pooled investment vehicle investing in U.S. Government Notes and Bonds or investment grade corporate bonds.

These core categories represent the three archetypal asset classes as defined by Roger Ibbotson in his classic study, *Stocks, Bonds, Bills and Inflation* (Bills refers to Treasury Bills, short-term US Government fixed income securities, a primary component of many money market funds). Most observers agree that the Department of Labor had

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these three asset classes in mind when they developed the subsection of the Section 404(c) regulations that defines “core investment options”.

**Alternative Investment Categories**

Once the plan sponsor has selected the plan’s core investment options and has satisfied the minimum Section 404(c) requirements, the sponsor can consider non-core investment categories. The primary purpose of the non-core options is to permit participants to fine tune their portfolios to address individual return objectives and risk tolerance. Non-core options are analogous to elective classes in a collegiate degree program. After the basic requirements have been met, electives can round out the program.

*Matrix of Dimensions For Stock Funds*

In considering which alternative categories a plan should offer, it may be helpful to think of the alternative categories as an expanded matrix of the three primary asset classes. The matrix dimensions are listed below:

- 1) **Geographic dimension:** Stocks of domestic or foreign companies;
- 2) **Size dimension:** Stocks of large or small companies; and
- 3) **Investment Style dimension:** Stocks of growth-oriented or value-oriented companies.

The nature of the first two dimensions is reasonably intuitively. However, the third dimension, investment style, may require some explanation. Style refers to the type of stocks that a manager selects. Fund managers generally employ one of two primary stock selection approaches. Growth managers select stocks based on their assessment of the company’s potential for future earnings growth. Value managers attempt to identify companies that have been undervalued by the market. The first approach is growth driven; the second approach is value driven; hence the growth and value monikers for the respective investment styles.

The following table summarizes the primary investment categories for domestic stock funds:

	Large	Small
Growth	Large Growth	Small Growth
Value	Large Value	Small Value

An identical table could be developed for foreign stock funds. Consequently, implementing this simple two-by-two-by-two matrix suggests that a plan should offer eight stock investment options; four domestic stock funds and four foreign stock funds. Although this approach makes sense, in actual practice, most plan sponsors prefer to offer fewer foreign stock fund choices.

Reviewing this matrix approach to fund classification helps explain why Morningstar tracks so many fund categories. For domestic stock funds, Morningstar builds a three-by-three matrix for mutual funds. Funds are classified as investing in large capitalization stocks, mid capitalization stocks or small capitalization stocks. Within each size category, funds are assigned to a particular investment style: growth, blend or value. Consequently, Morningstar tracks nine categories for general purpose (i.e., not sector specific) domestic equity funds. Morningstar tracks an additional ten categories for sector funds.

*Selecting Categories Along the Geographic Dimension*

The primary reason for offering funds that invest in foreign equity markets is diversification. The correlation between the performance of foreign and U.S. stocks is relatively low. This means that the world’s stock markets tend to experience different patterns of return over time. By diversifying internationally, Plan participants can take advantage of the stability implicit in enhanced diversification without reducing expected portfolio return.

Although foreign stock categories could be selected using the same matrix used for domestic funds, many plan sponsors opine that a proliferation of foreign fund choices is likely to confuse participants, without adding significant diversification opportunities. Consequently, most sponsors offer just one or two foreign stock categories, such as a general foreign fund and a foreign fund focussed on small stocks or value stocks.

*Selecting Categories Along the Size Dimension*

The primary reason for offering funds that invest in the stocks of smaller companies is enhancing return potential. Historically, small company stocks have outperformed the market as a whole. For example, for the period

*...as most plan sponsors are aware, communicating the differences between eight bond funds would be extremely difficult. Thankfully, the investment characteristics of bond funds are such that two or three bond funds should be sufficient to address the range of risk and return characteristics normally required by plan participants.*

1926 through 1995, stocks whose capitalization puts them in the lowest fifth of the overall stock market have had an average return of 12.5%. This is well above the average return of 10.5% for large stocks, as measured by Standard & Poor's 500 Stock Index. Small company stocks have produced higher returns than large companies in foreign markets as well.

Modern Portfolio Theory suggests that the higher return is rational, as investments in smaller company stocks entail higher risks than those of larger companies. Consequently, investors demand a higher return for assuming greater risk. While the additional risk implicit in small company stocks is unavoidable, when diversified with the shares of large U.S. and foreign companies, the risk can be substantially reduced.

#### *Selecting Categories Along the Style Dimension*

Numerous academic studies (for example, Fama & French, "The Cross-Section of Expected Stock Returns," Journal of Finance, June 1992; or Capaul and Sharpe "International Value and Growth Stock Returns", Financial Analysts Journal, January/February 1993) indicate that over extended time periods, value styles tend to outperform growth or blend styles. This outperformance has been observed in both domestic and foreign stocks, and with large and small companies. Growth styles, in particular, tend to exhibit greater variability in return, and over time tend to deliver less compound wealth than the other categories. The blend style includes elements of both growth and value investments. Since market capitalization weighting naturally tends to place greater emphasis on the growth component of a blend style, offering both growth and blend funds in the same investment category tends to introduce some redundancy. To avoid unnecessary fund duplication, most advisors generally recommend that plans refrain from offering both growth and blend funds in any sub-asset class

#### **Matrix Dimensions for Fixed Income (Bond) Funds**

Just as the stock asset class could be subdivided along three dimensions, so too the fixed income asset class incorporates three dimensions. They include:

- 1) **Term dimension.** Long-term, intermediate term and short-term bonds;

- 2) **Geographic dimension.** Bonds of domestic or foreign governments or companies; and
- 3) **Quality dimension.** Bonds of organizations with high creditworthiness and bonds with some credit risk.

Adopting the fixed-income matrix directly would imply that plans should offer at least eight fixed-income funds. However, as most plan sponsors are aware, communicating the differences between eight bond funds would be extremely difficult. Thankfully, the investment characteristics of bond funds are such that two or three bond funds should be sufficient to address the range of risk and return characteristics normally required by plan participants.

#### *Selecting Categories Along the Term Dimension*

For most participant directed plans, the most appropriate fixed income will invest in debt instruments with an average duration of five years or less. This statement is based on extensive empirical research that has established that longer durations, while riskier, do not consistently produce greater returns. In terms of the variability of return, long-term bonds act more like stocks than bills. Yet, over long time periods, their returns have consistently lagged those of equities. Since the primary purpose of fixed income funds in a qualified plan is to moderate investment risk, long-term bond funds are generally inappropriate choices for most participant directed plans.

Similarly, extremely short term fixed income funds tend to have performance characteristics that are quite similar to money market funds. Although short term fixed income funds may have a slight yield advantage relative to money market funds, there is significant overlap between these two categories. Consequently, most sponsors choose to focus on intermediate term fixed income funds.

#### *Selecting Categories Along the Geographic Dimension*

Just as foreign stocks provide significant diversification benefits, so too, foreign bonds can be valuable diversifiers. In fact, foreign bond funds tend to have extremely low correlation with both stocks and domestic bonds. However, if a plan elects to offer a foreign or

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global bond fund, care should be exercised in selecting and communicating the fund's investment approach. Foreign bond funds are exposed to the same risks that apply to domestic funds, and are also exposed to currency risk (i.e., the risk that the foreign currency will decline in value relative to the US dollar). Some funds hedge against this risk; other funds don't. The sponsor should understand the fund's hedging policy, and should communicate this policy to plan participants so that all risks are appropriately disclosed.

#### *Selecting Categories Along the Quality Dimension*

Although bond funds that invest in lower quality fixed income securities may offer higher yields than high quality funds of comparable duration, this higher yield comes at the cost of greater volatility. Since the primary purpose of bond funds is to mitigate risk, most plans are better served by offering just high quality bond funds. Nonetheless, some plans have good success offering high yield (low quality) bond funds to represent a hybrid choice between equity and fixed income funds.

#### *Money Market Funds*

Money Market funds are relatively simple. Plan sponsors generally select between US Treasury Money Market funds (funds that invest in short-term securities backed by the US Treasury) and general purpose Money Market funds. For most sponsors, the yield advantage available on general purpose Money Market funds is sufficient to compensate for the marginally greater risk of the general purpose fund.

#### **Other Investment Categories**

There are several other investment categories that aren't really dimensions of the three core asset classes, but, due to their unique risk and return characteristics, afford opportunities for portfolio diversification and consequently merit consideration for inclusion in a plan's investment line-up. Very briefly, these other categories include:

- ***International Emerging Markets Stock Funds.*** The potential for long term economic growth in emerging markets may equal or exceed that of developed markets. Furthermore, performance tends to have a low correlation with the performance of

developed markets. Consequently, emerging markets funds offer potential for good long-term performance and significant diversification benefits.

- ***Real Estate Funds.*** Unlike other sector specific funds, real estate funds directly own significant underlying assets that provide a hedge against inflation. Additionally, performance tends to offer certain diversification benefits to a stock portfolio.
- ***Stable Value Funds.*** Stable value funds generally offer a yield advantage relative to money market funds, with similar volatility. Although these funds incur sector specific risk that may not manifest in the fund's volatility, from the participant's perspective, they may represent an attractive alternative to a money market fund.

#### **Summary of Recommended Investment Categories: How Many Funds is Enough?**

The table on the following page summarizes investment categories that should generally be represented in most participant directed defined contribution plans, to meet the ERISA Section 404(c) guidelines and to permit participants to build appropriately diversified portfolios. Each category has been identified as *core* (i.e., should be represented in virtually every plan); *recommended* (i.e., appropriate for most plans); and *optional* (i.e., useful diversifiers, but not crucial to constructing appropriate portfolios).

The table illustrates that a plan should offer funds in at least three investment categories to satisfy the minimum Section 404(c) standards. To provide for additional diversification, a plan could offer three additional domestic stock categories, and a foreign stock category, for a total of seven represented categories. For optimal diversification, a plan could add as many as eleven additional investment categories. Thus, a plan could offer eighteen funds without duplicating funds in any specific category.

*Studies indicate that participants have a difficult time differentiating between investment choices when more than twelve funds are offered.*

*Given the complexity of the investment decisionmaking process, many plan sponsors elect to simplify the plan by offering a series of portfolios constructed from the plan's underlying investment vehicles.*

Asset Class/Category	Core	Recommended	Optional
<b>Cash Equivalents/Stable Value Funds</b>			
Money Market	X		
Stable Value			X
<b>Fixed Income/Bond Funds</b>			
Short-term Fixed Income			X
Intermed-term Fixed Inc.	X		
High Yield Bond			X
Global Bond			X
<b>Domestic Stock Funds</b>			
Large Cap Blend	X		
Large Cap Growth			X
Large Cap Value		X	
Small Cap Blend		X	
Small Cap Growth			X
Small Cap Value		X	
Mid Cap			X
Specialized Real Estate			X
<b>Foreign Stock Funds</b>			
Diversified Large Cap		X	
Diversified Small Cap			X
Diversified Value			X
Emerging Markets			X

Studies indicate that participants have a difficult time differentiating between investment choices when more than twelve funds are offered. Consequently, most observers agree that plans should offer a single fund choice in each investment category, to provide participants with the opportunity for exposure to as many categories as possible, while remaining within the constraints of the plan's administrative structure and the participants' ability to differentiate between the available investment alternatives.

*Simplifying Selection Process with Portfolio Options*

Given the complexity of the investment decisionmaking process, many plan sponsors elect to simplify the plan by offering a series of portfolios constructed from the plan's underlying investment vehicles. These portfolios incorporate each of the plan's investment options in a manner designed to provide optimal diversification. Each portfolio represents a specific level of risk and return, ranging from conservative to aggressive.

**USING INVESTMENT POLICY TO SELECT INVESTMENT FUNDS**

Investment policy can be a powerful tool for streamlining a 401(k) plan's investment fund selection procedures. Generally, the IPS will incorporate a step-by-step approach that:

- Defines what types of investment vehicles the plan will use;
- Identifies what asset classes should be represented in the plan;
- Describes what investment management styles are authorized; and
- Establishes procedures for selecting funds representing designated asset classes and investment styles.

Each of these steps is described in greater detail, below.

**Selecting Type of Investment Vehicle**

The type of investment vehicle used will generally be a function of the type of provider selected to serve your plan, your plan's size and your plan's position with respect to conforming with ERISA Section 404(c) standards. Most pooled investment structures should qualify as "look through" investment vehicles, as that term is defined under Section 404(c). Due to their organizational structure, mutual funds have prospectuses that simplify compliance with Section 404(c) information dissemination requirements. The other types of investment vehicles may also have similar informational materials available. Plans administered by mutual fund companies tend to use retail mutual funds as investment vehicles. Retail mutual funds are also popular when fund name recognition is important to plan participants. Larger plans often prefer to take advantage of the economies of scale and lower investment management fees available through institutional arrangements, such as institutional classes of mutual funds, common/collective funds and separate accounts.

**Selecting Asset Classes**

In determining what asset classes should be represented, two primary issues should be considered in the investment policy:

- 1) What types of return objectives are commonly represented among the plan's participant group, and what

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asset classes offer risk/return patterns likely to meet these participant objectives?

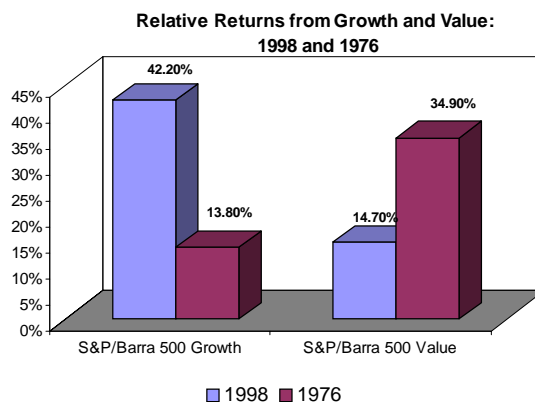
In her article, *The Duty and Opportunity Presented by Investment Policy*, Julie Jason describes this issue as defining the character of the investment lineup. She reminds us that, "...the investment lineup must flow from your determination of what tools your employees need in order to create retirement income for themselves...the policy needs to flow from the interests of 80% of the employee base." To demonstrate that this issue has been appropriately addressed, it might be helpful to include a brief summary of the risk and return characteristics of the asset classes offered through the plan.

- 2) How would a prospective asset class interact with other asset classes selected for the plan? Could the prospective asset class be used in combination with other available asset classes to construct a portfolio with superior risk and return characteristics?

To demonstrate that this issue has been appropriately addressed, it might be helpful to include an analysis of how the selected asset classes can be expected to perform in combination with each other. This could take the form of a correlation matrix listing each selected asset class, or an asset allocation model demonstrating the risk/return characteristics of a portfolio comprised of all selected asset classes.

**Impact of Style on A Manager's Investment Performance**

Empirical evidence demonstrates that investment management style can have a dramatic impact on portfolio return within any given asset class. For example, the Standard & Poors 500 stock index (S&P 500) generally represents the asset class of US large capitalization stocks. The subset of S&P 500 stocks representing the growth investment management style is the S&P/Barra 500 growth index. The subset of S&P 500 stocks representing the value investment management style is the S&P/Barra 500 value index. Consider the performance of each of the style specific indices in 1998 and in 1976:



In 1998, the growth style dramatically outperformed value. In 1976, value trounced growth. In order to appropriately benchmark an investment fund's performance, it is important to know what investment style the fund is intended to represent. Without knowing what style a manager has adopted, it is impossible to evaluate performance. Further, the investment policy should define the rationale supporting inclusion or exclusion of specific investment styles for each designated asset class. This protects the sponsor against the retrospective claim that a different style would have generated significantly better investment performance.

**Selecting an Investment Manager**

Developing prudent criteria for selecting investment managers is an important function of investment policy. Consultants disagree about which factors are most likely to be predictive of an investment manager's future success, while many academics argue that the use of historical data to predict future investment success is an exercise in futility. Regardless of the outcome from this debate, ERISA requires that a plan's fund selection process must be prudently managed and implemented. To satisfy the ERISA prudence standards, an appropriate fund search should consider (at least) the following factors:

- Fund expense ratio;
- Fund turnover ratio;
- Manager tenure;
- Fund performance; and
- Risk adjusted fund performance;

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formance when selecting funds. Consistency of investment approach is the more important factor. Money managers who don't maintain reasonably consistent approaches can wreak havoc with a carefully constructed investment portfolio. Richard Glass commented on this topic in his article, "A Guide to Selecting Investment Options for DC Plans".

*Trustees of self-directed retirement plans have a responsibility to pick funds that will not deviate from the asset classes in which they are supposed to be investing ... Trustees all too often ignore their selection responsibility and pick well-known funds that have a lot of sizzle and high ratings, presumably to create a high comfort level for participants. This tack is fraught with fiduciary problems, however.*

#### **Selecting Active or Passive Funds**

Fiduciaries must also decide whether to use actively managed or passively managed investment funds. Empirical evidence demonstrates that, as a group, active managers tend to underperform passive benchmarks, despite charging much higher fees than would be assessed by comparable index funds. Richard Glass summarizes the issue by asking the question:

*Do the trustees feel that either they or their consultants can pick the funds that will be winners in the future? If they feel their crystal balls work well, active management is the way to go. Otherwise, they better fully understand the pros and cons of both approaches and be able to justify their decisions.*

As the active/passive question appears to remain unresolved, the prudent fiduciary would be well advised to incorporate both actively managed and passively managed funds into the investment mix, leaving the final decision to plan participants.

#### **CONCLUSIONS**

Selecting investment options for a defined contribution plan can be an extremely difficult task. Many plan sponsors find that they are faced with an endless supply of opinions regarding how the problem should be addressed. Further, they lack a rational framework for coherently addressing the selection process.

An investment policy statement can be an

invaluable tool for streamlining investment selection and documenting the prudence of the sponsor's selection process. The effort implicit in drafting a high quality investment policy statement will be well rewarded.

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