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The "New" Investment Policy Statement

Plan Guidelines for Selecting and Monitoring Managed Accounts, Lifestyle or Lifetime Funds and Self-directed Brokerage Accounts

by Mary L. Patch, QKA, QPFC

While ERISA does not require a plan to create an Investment Policy Statement (IPS), it does state that a plan must "provide a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan." Unfortunately, the devil is in the details of what exactly the IPS should include. Many are boilerplate; they do not specifically address the inner workings of the employer's retirement plan. As the plan changes, the impact on the IPS is sometimes overlooked.

With the popularity of Managed Accounts, Lifestyle or Lifetime Funds and Self-directed Brokerage Accounts within a retirement plan, it is important to cover the selection of these investments within the framework of the IPS. Policies, objectives and reporting requirements should be identified within the IPS, along with any additional criteria for monitoring and reviewing existing investments.

Managed Accounts

An advisor may create a Managed Account comprised of stocks, bonds, exchange-traded funds, mutual funds or other investments. Management service can also be outsourced to a separate account manager providing for institutional money management at reduced account minimums. The underlying investments are subject to the same standards applied to other investments utilized by the plan.

Managed Accounts, whether managed by an advisor or by a separate account manager, are used to provide a lower cost investment alternative. By eliminating the marketing and distribution costs of traditional mutual funds, the Managed Account should have better performance as a result of the reduced expense. Many large qualified retirement plans utilize professional institutional money managers for this reason.

By completing a questionnaire, an employee can be directed to a predetermined allocation of investments that matches his or her risk tolerance and time horizon.

When developing the criteria used to monitor a Managed Account, the following should be considered: long-term risk-adjusted performance, risk objective, time horizon for the investment, liquidity needs for distributions, strategic and tactical allocation objectives, correlation to a specific style, total assets under management and organizational stability of the management company. The IPS should establish clearly defined benchmarks for monitoring each of these areas.

When working with an advisor who recommends the use of a separate account manager, it is important to review the advisor's fee. In some cases, the cost effectiveness of using a separate account manager can be overshadowed by this additional cost. Determining an appropriate fee for this service can be difficult.

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As the investment universe continues to evolve, the criteria for monitoring the investments should also evolve.

Lifestyle and Lifetime Funds

Employees are no longer required to build their own investment portfolios. By completing a questionnaire, an employee can be directed to a predetermined allocation of investments that matches his or her risk tolerance and time horizon.

There are two different types of strategies; one is based on a combination of risk tolerance and time horizon (Lifestyle Funds) and the other is based strictly on time horizon (Lifetime Funds). Many mutual fund companies have created one or the other style, or both, to compete in this increasingly popular participant option. This type of fund offers an employee a tremendous amount of simplicity. As a result, many qualified plans have added or will be adding Lifestyle or Lifetime Funds to their fund lineup.

Lifestyle or Lifetime Funds can be in the form of a pre-packaged mutual fund or comprised of a group of funds. While a mutual fund requires registration with the Securities Exchange Commission, a new brand of "Fund of Funds" alternative does not. An advisor can create a "recommended allocation strategy" comprised of virtually any investment the advisor deems appropriate. A "Fund of Funds" can consist of mutual funds, stocks, bonds or even exchange traded funds. The advisor selects the appropriate percentages allocated to the different investments, monitors the holdings and rebalances the fund as necessary.

When establishing the criteria to monitor Lifestyle or Lifetime Funds, the underlying investments must be reviewed separately and as a whole. These funds can have a varying degree of risk associated with them. Since industry standards do not currently exist for appropriately benchmarking these types of investments, monitoring the funds within a qualified plan can be challenging. Standards should be set within the IPS to specify the allocation between bonds and stocks within each Lifestyle Strategy. The IPS should also address the periodic review and monitoring of the holdings of the funds to determine if the proper weighting between stocks and bonds exists. The level of risk associated with each fund should also be analyzed and identified.

By way of example, a conservative Lifestyle Fund may hold any percentage of stocks and bonds the fund company or the advisor feels is appropriate for a conservative investor. Without any set standards, funds may add more exposure to equities in an effort to increase performance of their fund. This tactic could result in additional risk for the investor and underscores the need for the IPS to address such standards.

Fees can also be a concern for Lifestyle and Lifetime Funds. Some funds charge a "wrap" fee in addition to the expense ratio of the underlying mutual fund while others do not. Reviewing the expenses listed in the fund prospectus will help determine the underlying investment expenses as well as any additional fees that may exist.

Another area of concern with respect to Lifestyle and Lifetime Funds is finding funds that have an established performance track record. Since many of these funds have been created within the last few years, it can be difficult to find funds having significant performance history. Most Investment Policy Statements are written to specifically eliminate funds that have shorter than a five-year track record. Careful consideration should be given to ensure the IPS addresses this issue.

Self-directed Brokerage Accounts

Allowing participants to utilize Self-directed Brokerage Accounts can significantly increase the complexities of the retirement plan. If highly compensated employees are afforded this option, it must be made available to all other employees in a non-discriminatory fashion. This requirement may create a problem, as even the most unsophisticated investor will have the ability to purchase virtually any investment available in the marketplace.

There are two different schools of thought regarding the availability of Self-directed Brokerage Accounts. One line of thought is that by providing every option available, none of the employees could complain they did not have access to a specific fund. The second line of thought contends there is significant risk to the fiduciary because the employees can now purchase any investment on the open market, whether appropriate for them or not.

While the first thought is somewhat of an accurate assumption, the difficulty the fiduciary will face is educating the employees on the options now available to them. By opening up the entire investment universe to the employees, providing effective education on every mutual fund, stock, bond and exchange traded fund would be virtually impossible. It should be noted, however, that the 1992 Preamble to the 404(c) regulations regarding "Disclosures Made to All Participants" provides:

> In the case of plans which permit participants and beneficiaries to invest in any asset administratively feasible for the plan to hold, a general statement so apprising participants and beneficiaries would be adequate, although participants and beneficiaries should be encouraged

to obtain and review materials relating to potential investments prior to making such an investment.

The second thought addresses the additional liability the employer may have by allowing employees access to a self-directed brokerage account. In the Morningstar article *Fiduciary Focus: Risk of Self-Directed Brokerage Accounts in 401(k)s,* written by W. Scott Simon, the author raises a valid point of concern. It is not so much that the employee is allowed to buy whatever investment he or she wants; what happens in the event of dissolution of marriage or the death of the participant? The spouse may challenge that the employee was allowed to purchase investments without regard to "suitability" for the account, thereby making the employer liable for any losses the employee incurred.

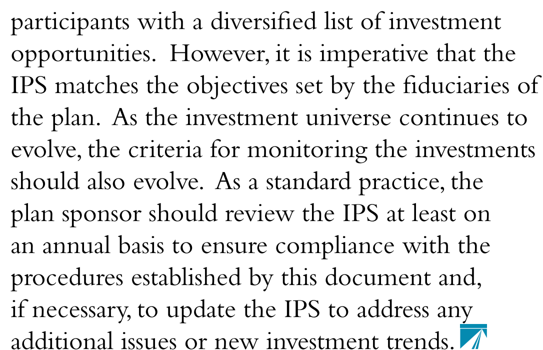
In order to protect the employer, it may be necessary to construct a "hold harmless" agreement, to be signed by the employee as well as the spouse, that outlines the risks of utilizing a self-directed brokerage option. This practice has not been tested in the courts, but may provide for some relief in the event of a lawsuit.

Another hurdle the employee will face is not having sufficient payroll deposits to reach the purchase minimums of many mutual funds. The result may be that the employee purchases individual stocks instead and pays the stock-trading fee. Alternatively, the employee's payroll may be invested in a money market sweep investment until the sweep account has sufficient funds to purchase a mutual fund. With the latter approach, it could take an employee an entire year to accumulate enough to make one mutual fund purchase.

The IPS should be customized to clearly define the use of self-directed brokerage accounts within the qualified plan. The types of investments allowed within the brokerage environment should also be documented; for example, some plans only allow employees to purchase mutual funds within the brokerage window. Common restrictions on brokerage accounts include related party investments (prohibited transactions), unlisted securities, loans, real estate, general partnership interests, investments that could result in Unrelated Business Taxable Income (UBTI), etc. The IPS should detail the review process of these accounts and list the individual(s) responsible for monitoring the holdings and enforcing any restrictions.

Conclusion

By providing Managed Accounts, Lifestyle or Lifetime Funds and Self-directed Brokerage Accounts, a plan sponsor can provide the participants with a diversified list of investment opportunities. However, it is imperative that the IPS matches the objectives set by the fiduciaries of the plan. As the investment universe continues to evolve, the criteria for monitoring the investments should also evolve. As a standard practice, the plan sponsor should review the IPS at least on an annual basis to ensure compliance with the procedures established by this document and, if necessary, to update the IPS to address any additional issues or new investment trends.



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