# Winning Strategies for Selecting Investment Options in Retirement Plans

# Questions

- What makes a good investment policy statement, and do I even need one at all?
- How do I select investment options?
- How many investment options are too many?
- What is the best way to monitor investment suitability?
- When should I change investment options?
- How should I communicate investment changes to participants?
- What is the best way to measure effectiveness?
- What changes are we seeing in retirement plan investment options?



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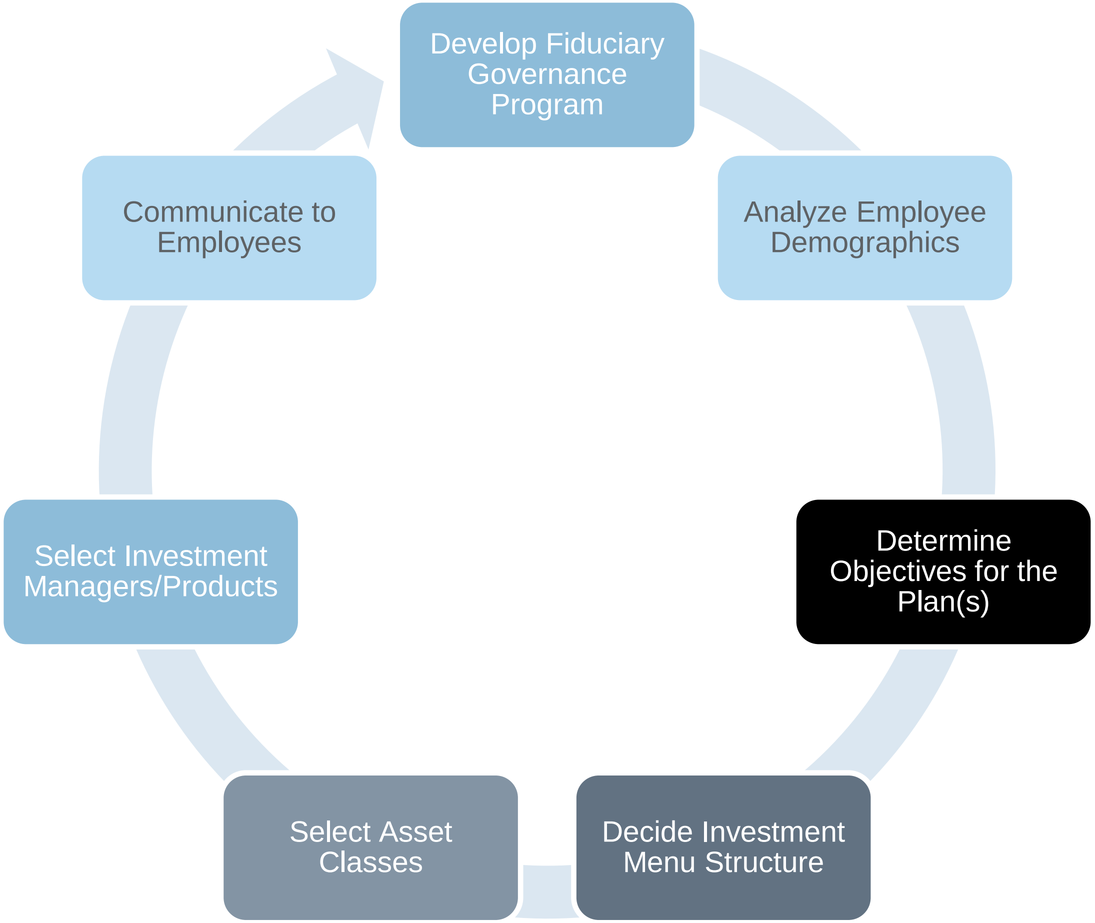
# Erik Daley, CFA

Erik is the Managing Principal for Multnomah Group. He is a member of Multnomah Group's Investment Committee and leads the firm's tax-exempt practice, focusing on higher education and healthcare organizations. Erik consults regularly with clients on a variety of retirement plan related topics to help manage their fiduciary risks. He is a speaker on retirement plan issues at the local, regional, and national level.

Prior to founding the Multnomah Group in 2003, Erik served as a Vice President of Retirement Services and led the Portland, Oregon practice of a national retirement services firm. In that position Erik was a founding member of the firm's national Investment Committee and had oversight for business development in the western United States.

Erik is a member of the CFA Institute, the CFA Society of Portland, the CFA Society of Seattle, the American Society of Pension Professionals and Actuaries, the Portland Chapter of the Western Pension & Benefits Council, and the Society for Human Resource Management. Erik holds a B.B.A. from the University of Iowa.

# Plan Sponsor Best Practices



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# Investment Philosophies

- Markets are Efficient
- Risk and Return are Highly Correlated
- Different Asset Classes have Different Risk Profiles
- Investment Style Drives Performance
- Expenses Matter

# Markets are Efficient

Efficient Market Hypothesis

What does Efficiency Mean:

- Current prices incorporate all available information and expectations
- Current prices are the best approximation of intrinsic value
- Price changes are due to unforeseen events
- "Mispricings" can occur but not in predictable patterns that can lead to consistent outperformance

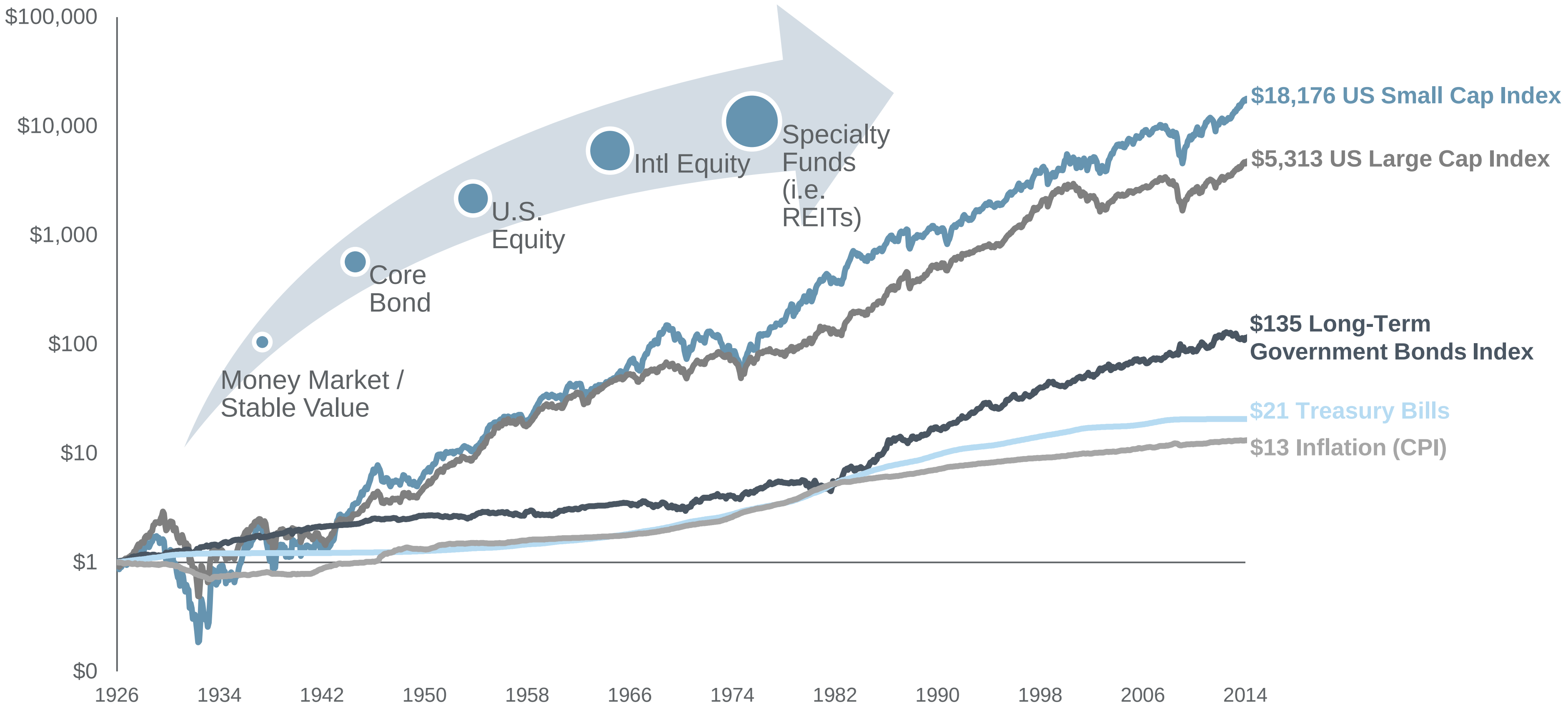
What Efficiency Does Not Mean:

- All investors are rational
- Prices are always "right"
- Prices are stable
- Professional money managers can't earn higher than market returns

Eugene F. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work," *Journal of Finance* 25, no. 2 (May 1970): 383-417.
Eugene F. Fama, "Foundations of Finance," *Journal of Finance* 32, no. 3 (June 1977): 961-64.

# Risk and Return are Highly Correlated

## Monthly growth of wealth ($1), 1926-2014



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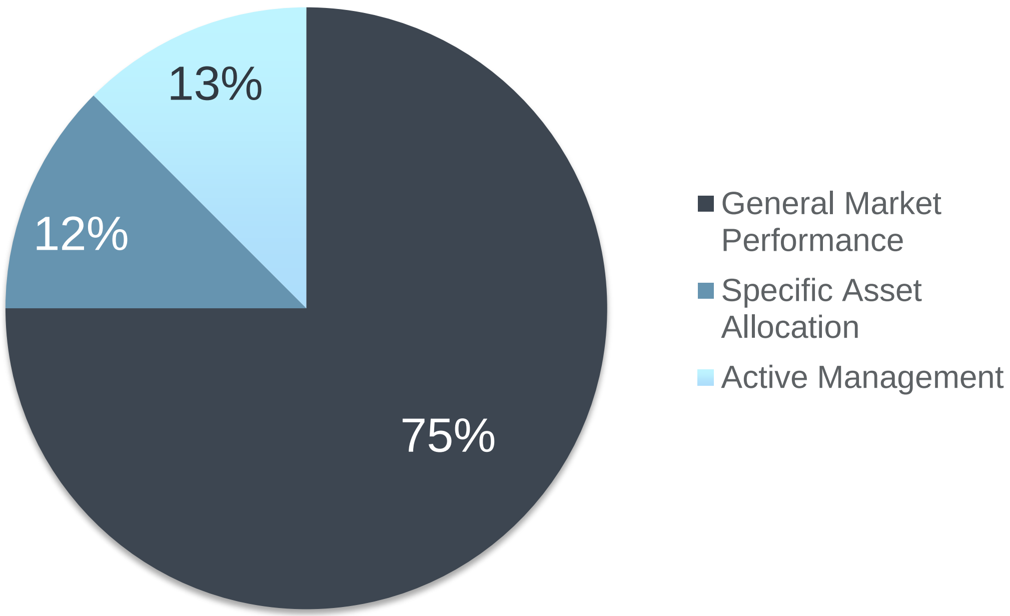
# Investment Style Drives Performance




"The Equal Importance of Asset Allocation and Active Management"
Roger G. Ibbotson, James X. Xiong, CFA, Thomas M. Idzorek, CFA and Peng Chen CFA (2010)



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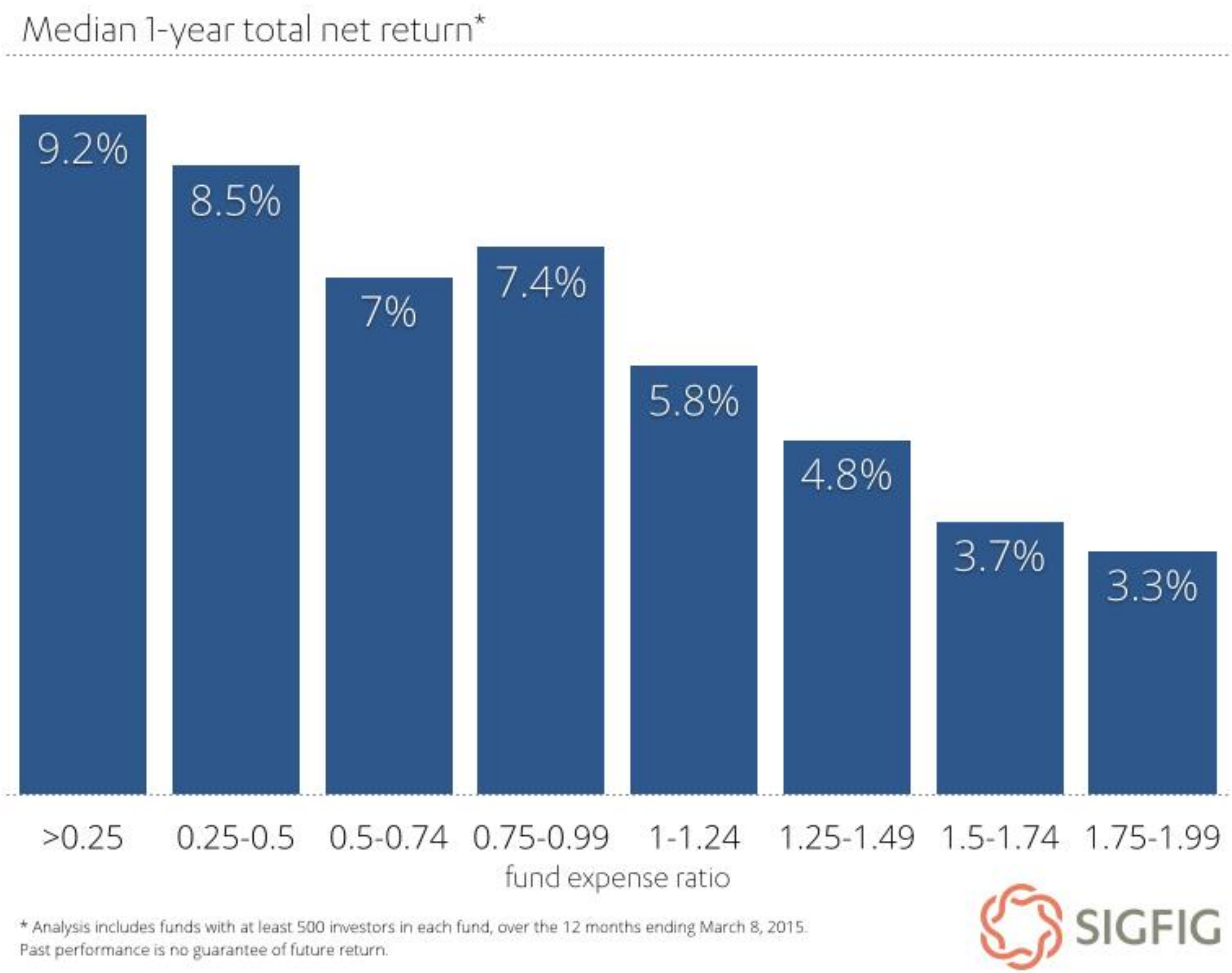
# Expenses Matter



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# Participants are Wacky

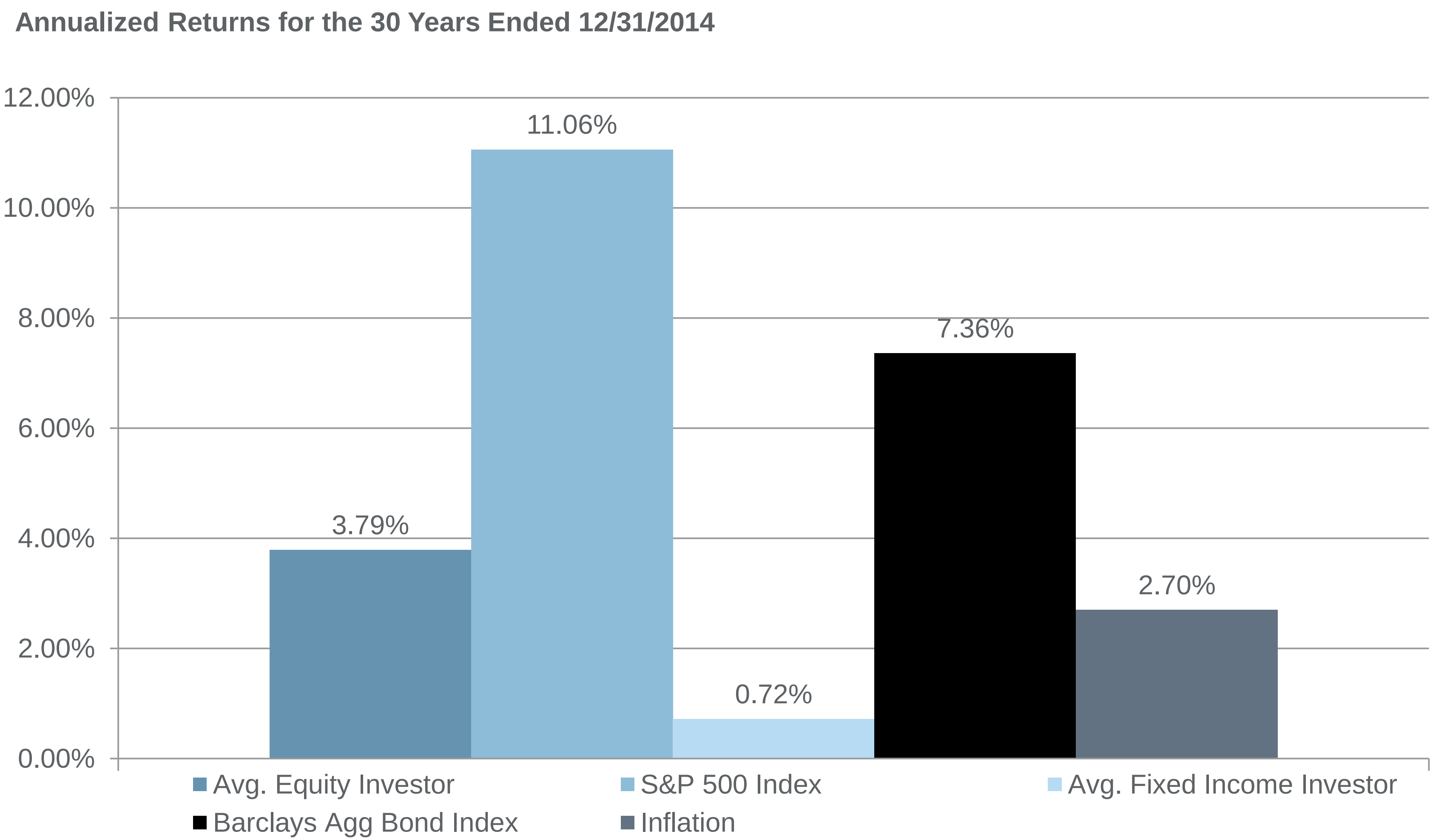
**Markets**

- Markets are Efficient
- Risk and Return are Highly Correlated
- Investment Style Drives Performance
- Expenses Matter

**Participants**

- Participants are Inefficient
- Participants Fear Risk more than they Value Return
- Participants Have Low Financial Literacy
- Participants Don’t Understand Expense and Will Pay Anything for Help

# Participants are Inefficient




*Source: Dalbar, Inc. 2015 Quantitative Analysis of Investor Behavior*



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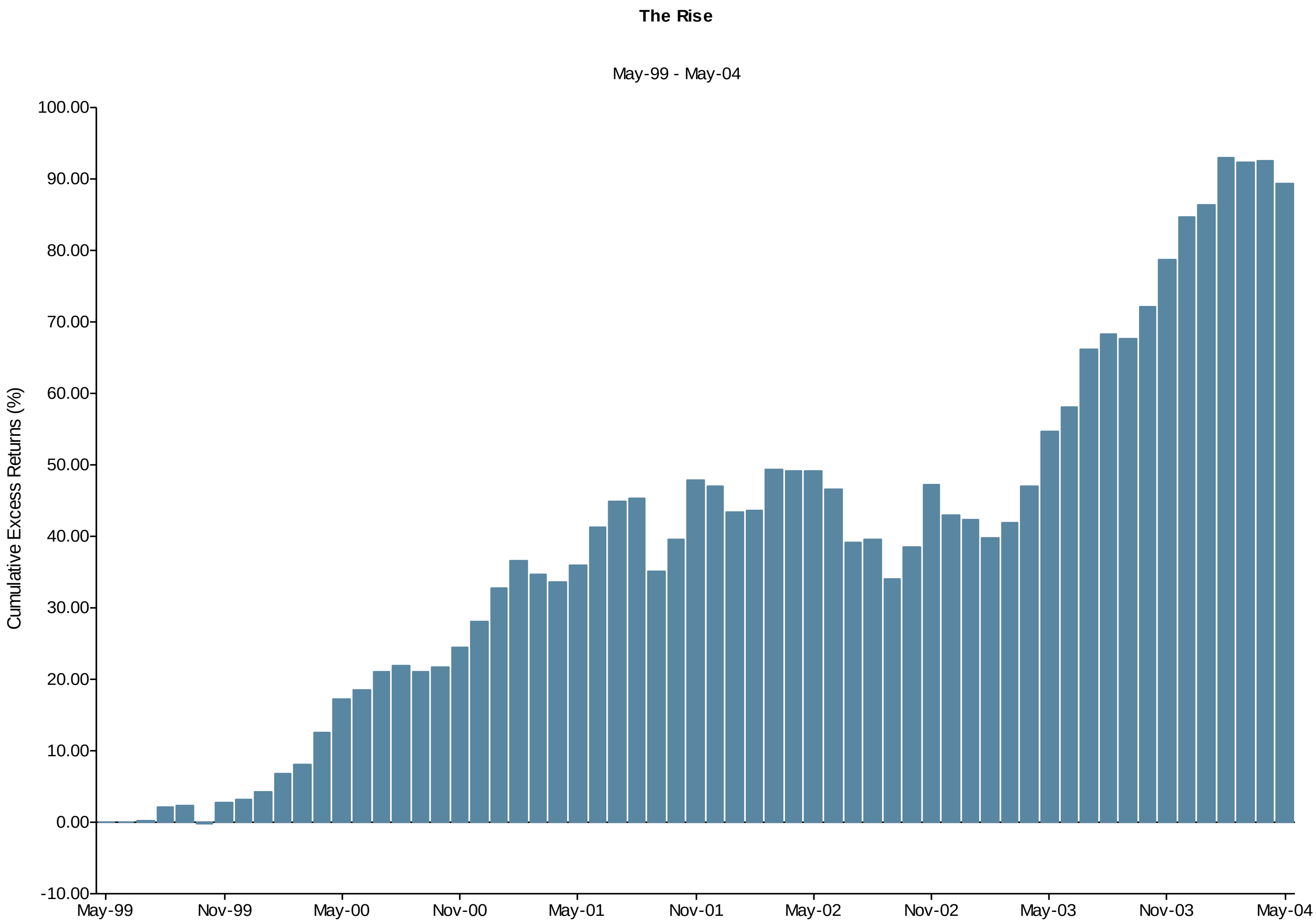
# Committees are No Better


*Source: "The Selection and Termination of Investment Management Firms by Plan Sponsors," Amit Goyal, Sunil Wahal (The Journal of Finance, Volume 63, Issue 4, printed August 2008). Data: 8,775 hiring decisions by 3,417 plan sponsors delegating $627 billion in assets; 869 firing decisions by 482 plan sponsors withdrawing $105 billion in assets. Analysis covers the period 1996 through 2003.*

# Fund Added



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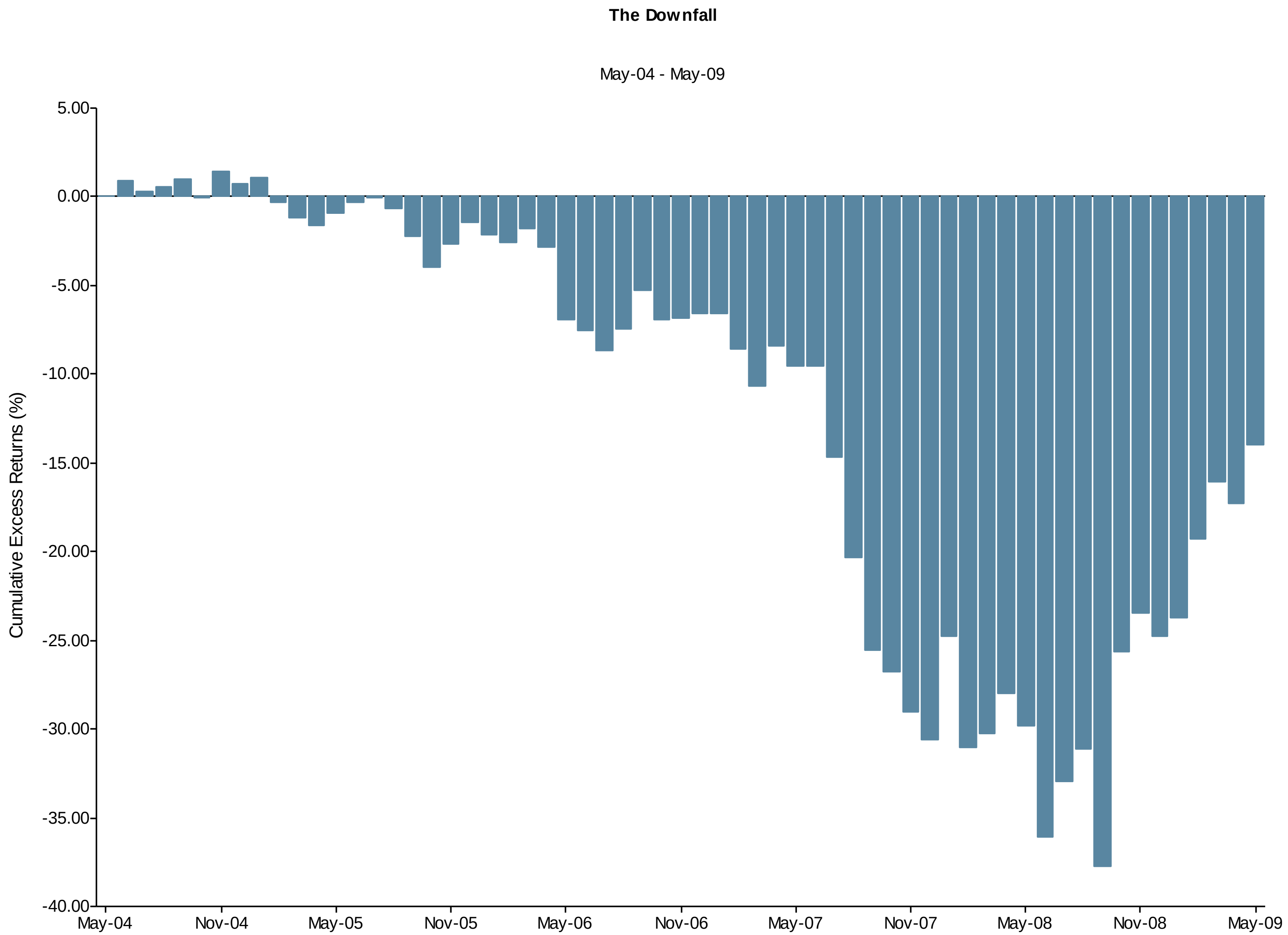
# Fund Removed



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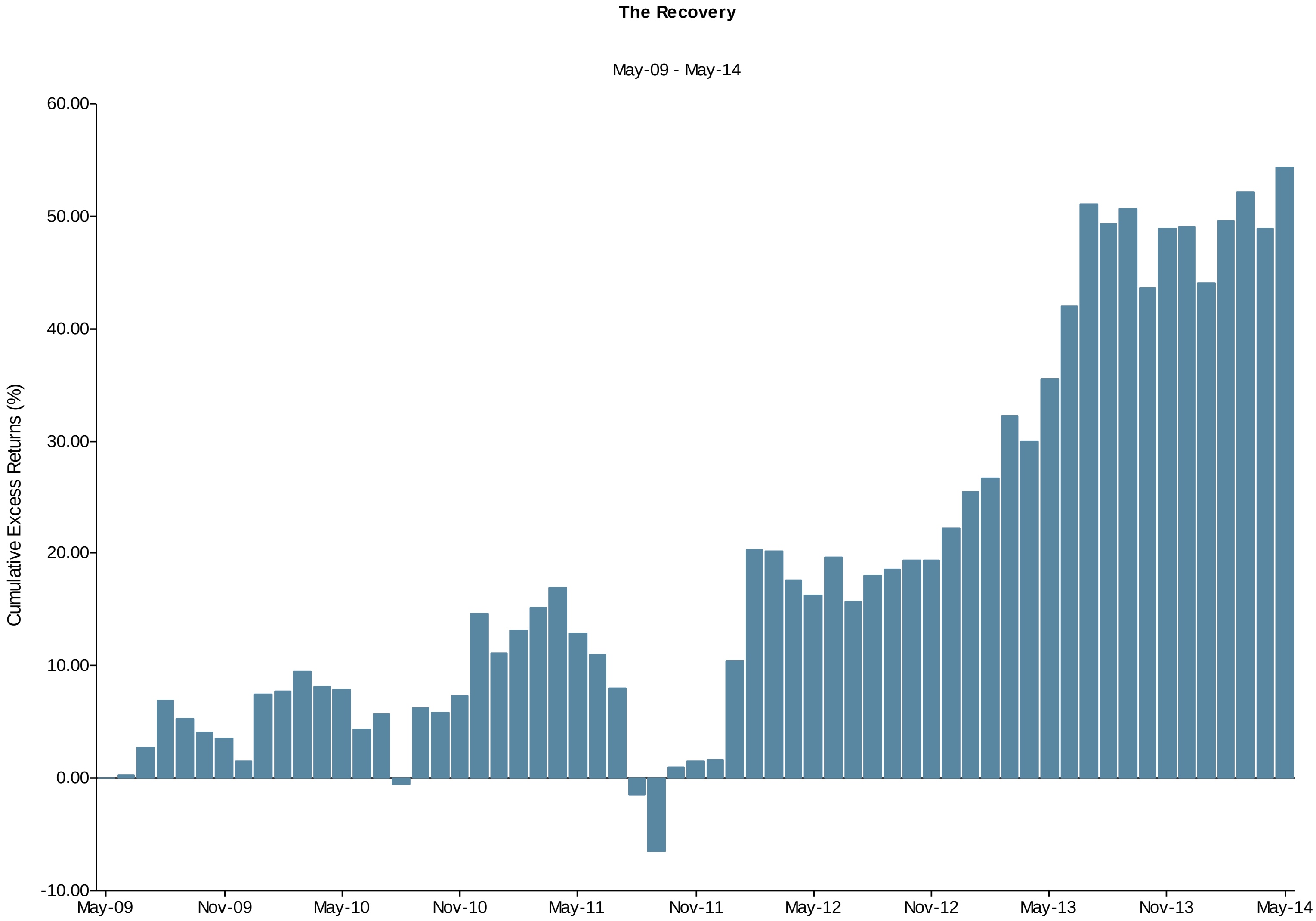
# Fund Since Removal



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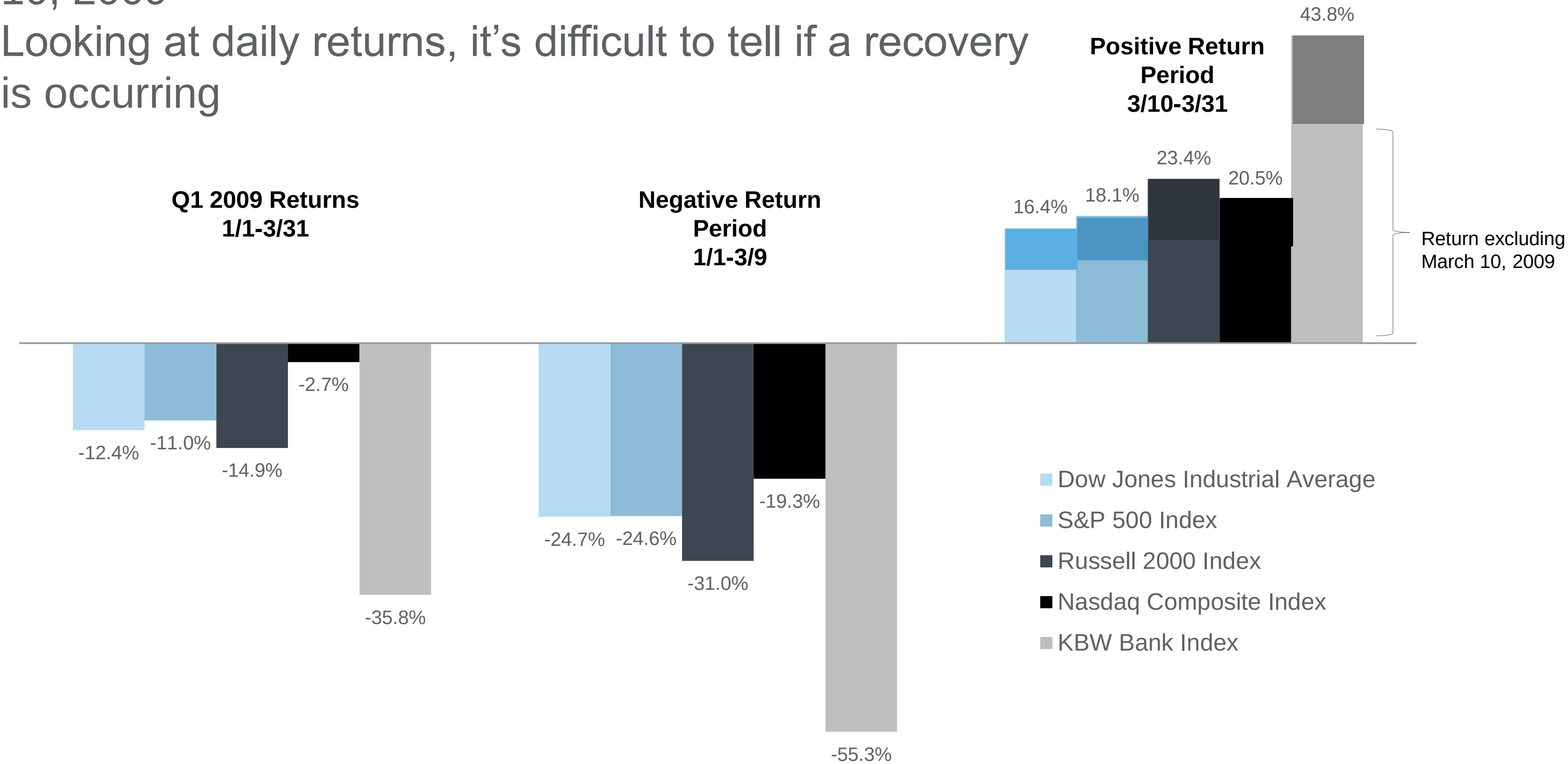
# Participants Fear Risk more than they Value Return

- March 9, 2009 was the low closing date for four of the five featured indices year-to-date
- The Dow Jones Industrial Average rose 5.8% on March 10, 2009
- Looking at daily returns, it's difficult to tell if a recovery is occurring




Returns are from market-close to market-close. Indices are not available for direct investment; their performance does not reflect the expenses associated with the management of an actual portfolio. The S&P data are provided by Standard & Poor's Index Services Group. Dow Jones data provided by Dow Jones Indexes. Russell data copyright © Russell Investment Group 1995-2010 all rights reserved. Mutual fund universe statistical data and non-Dimensional money managers' fund data provided by Morningstar, Inc. Nasdaq Composite Index data provided by The Nasdaq Stock Market, Inc. KBW Bank Index data provided by Keefe, Bruyette & Woods, Inc. (KBW). Past performance is not a guarantee of future results.



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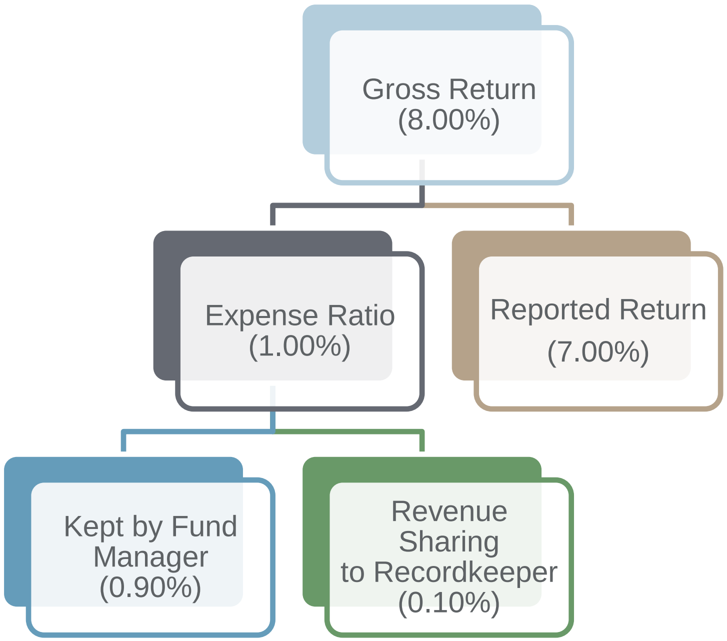
# Participants Have Low Financial Literacy

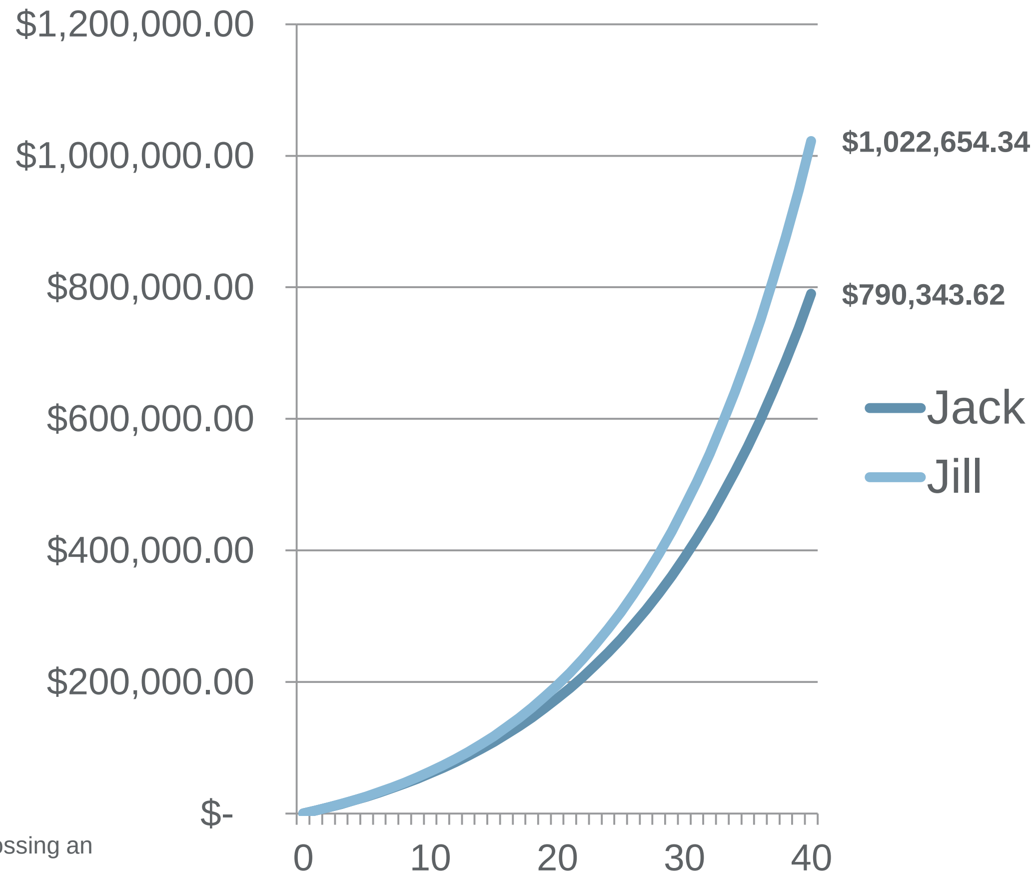
1. A 2008 Health and Retirement Survey concluded that older Americans “lack even a rudimentary understanding of stock and bond prices, risk diversification, portfolio choice, and investment fees”
2. Across multiple studies, there was considerable uncertainty by respondents about whether stocks were the best long-term asset class
3. In a 2010 Northwestern Mutual Life Insurance study to determine Americans’ general financial knowledge, 69% of the 1,664 participants failed the quiz
4. In the Northwestern Mutual study, only 32% of the participants could accurately define the term “index fund”
5. In a 2009 Financial Industry Regulatory Authority (FINRA) study, only 21% of the respondents were correct in knowing that bond prices typically will fall when interest rates rise
6. Only 52%, in the FINRA study, correctly answered “False” to the following: “Buying a single company stock provides a safer return than a stock mutual fund”
7. In a Moneytrack/IPT Investing Survey from 2007, only 39% of the participants could correctly define the term “diversification”
8. An alarming 43% of investors in a 2007 MoneyTrack/IPT Investing Secrets Survey demonstrated a susceptibility to fraud
9. In the 2008 survey of high-school seniors and college students, scores sank to an all-time low (students began taking the annual survey in 1997)

*19 Alarming Things We Learned About Financial Literacy in America – The Motley Fool. September 5, 2012*

# Participants Don’t Understand the Impact of Expenses

58.6% of online survey respondents incorrectly answered a question about calculating standard mutual fund fees




*Assumes gross contributions of $4,500 annually into a portfolio grossing an 8% return.
*Jack pays 1.5% in expenses
*Jill pays 0.5% in expenses

# What Really Matters

$$FV = S\left(\frac{(1+r)^n - 1}{r}\right)$$

$FV$ = Future Value of Portfolio

*$S$ = Savings Amount

$r$ = Rate of Return

*$n$ = Number of Years

## Impact on Success

1. Savings Amount
2. Number of Years
3. Rate of Return



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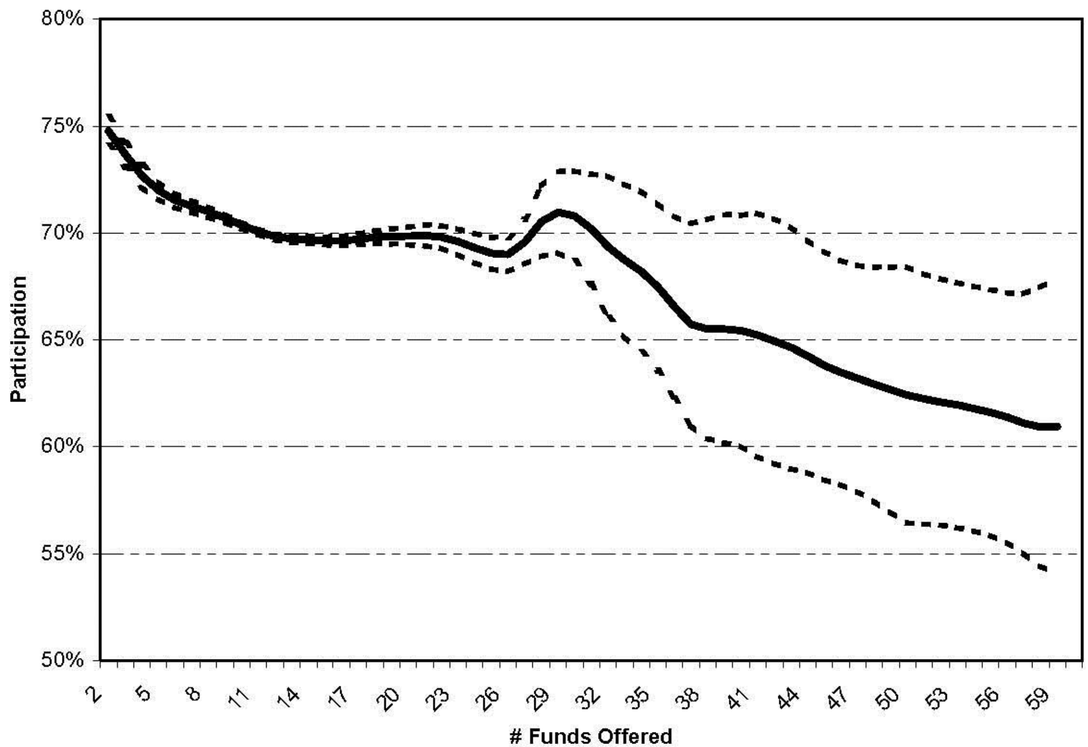
# Savings Rate

## Impact of Choice on Participation Rates




*Source: Iyengar, Sheena S.; Jiang, Wei; Huberman, Gur "How Much Choice is Too Much?: Contributions to 401(k) Retirement Plans"*



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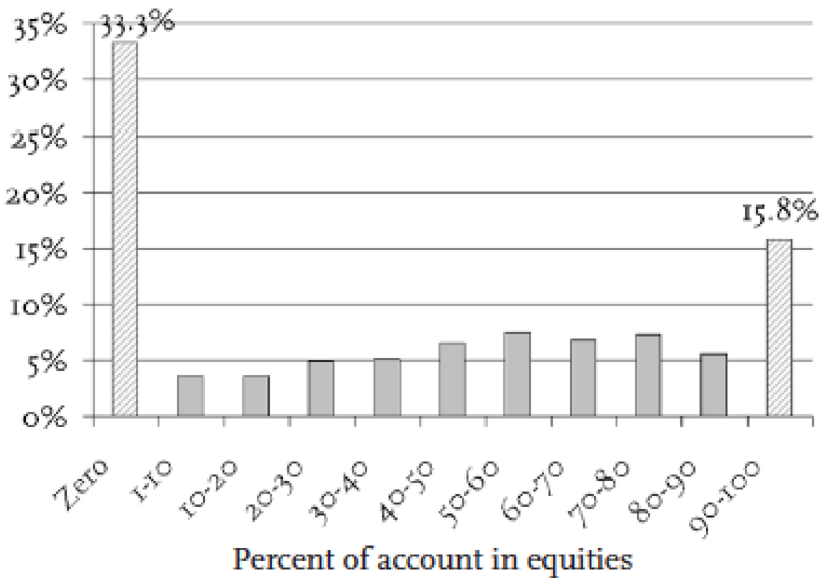
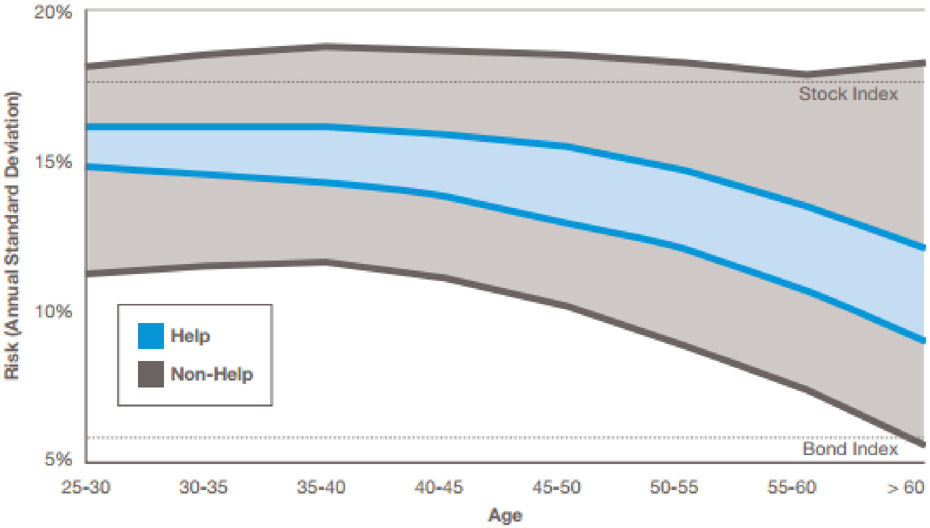
# Rate of Return




*Investment Returns: Defined Benefit vs. 401(k) – Center for Retirement Research at Boston College*




*Help in Defined Contribution Plans: 2006-2012 Financial Engines and Aon Hewitt*



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# Characteristics of the “Right” Investment Menu

1. Encourages Participation
2. Discourages return chasing, risk avoidance, and tactical approaches to investing
3. Minimizes impact of cost drag
4. Is easy to understand and utilize for least sophisticated participants
5. Allows sponsor to focus limited time and resources on high impact and higher risk elements of plan management



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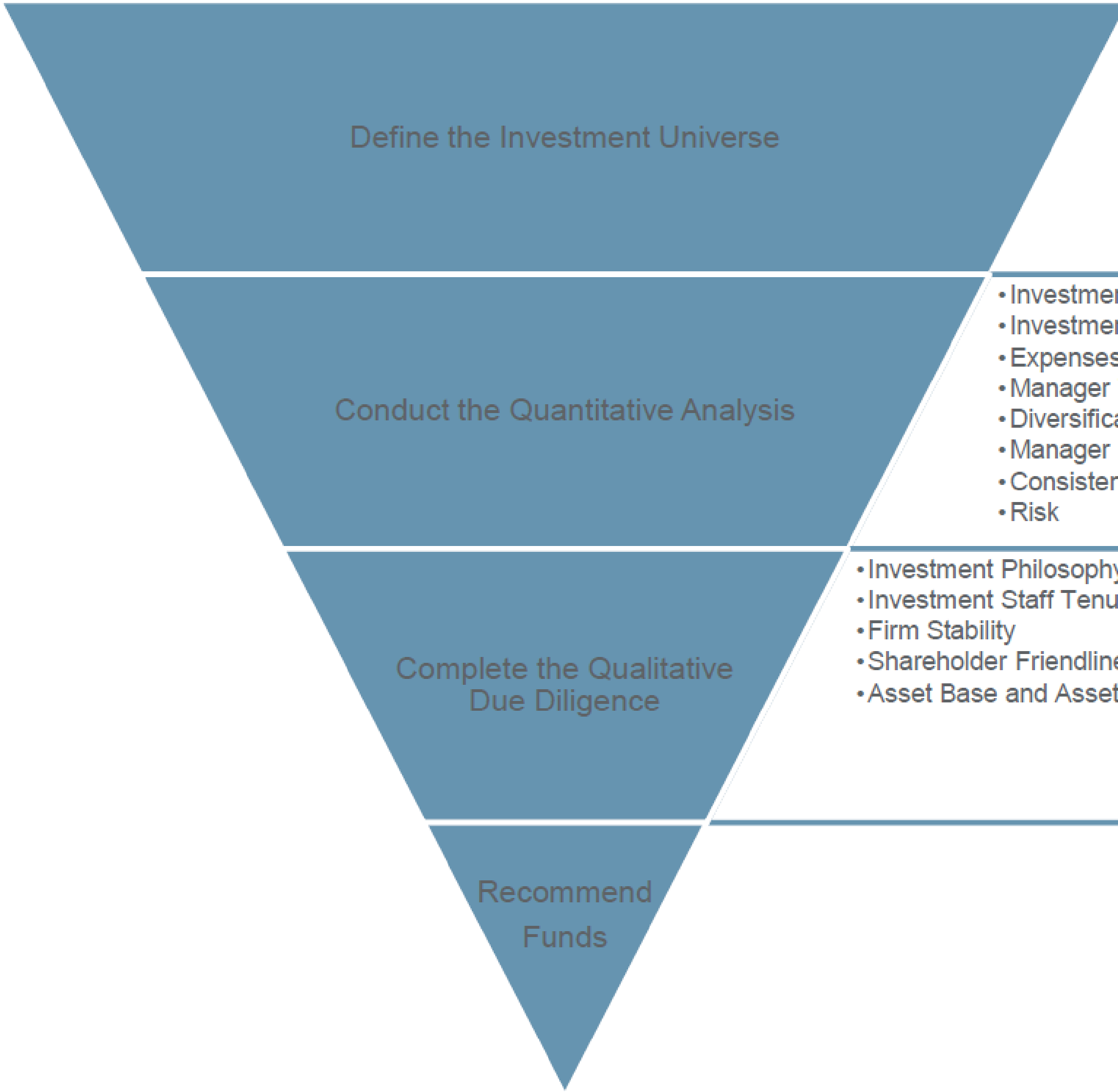
# Process Overview




- Investment Style Purity
- Investment Style Consistency
- Expenses
- Manager Tenure
- Diversification
- Manager Skill
- Consistency of Manager Skill
- Risk

- Investment Philosophy and Process
- Investment Staff Tenure and Experience
- Firm Stability
- Shareholder Friendliness
- Asset Base and Asset Growth



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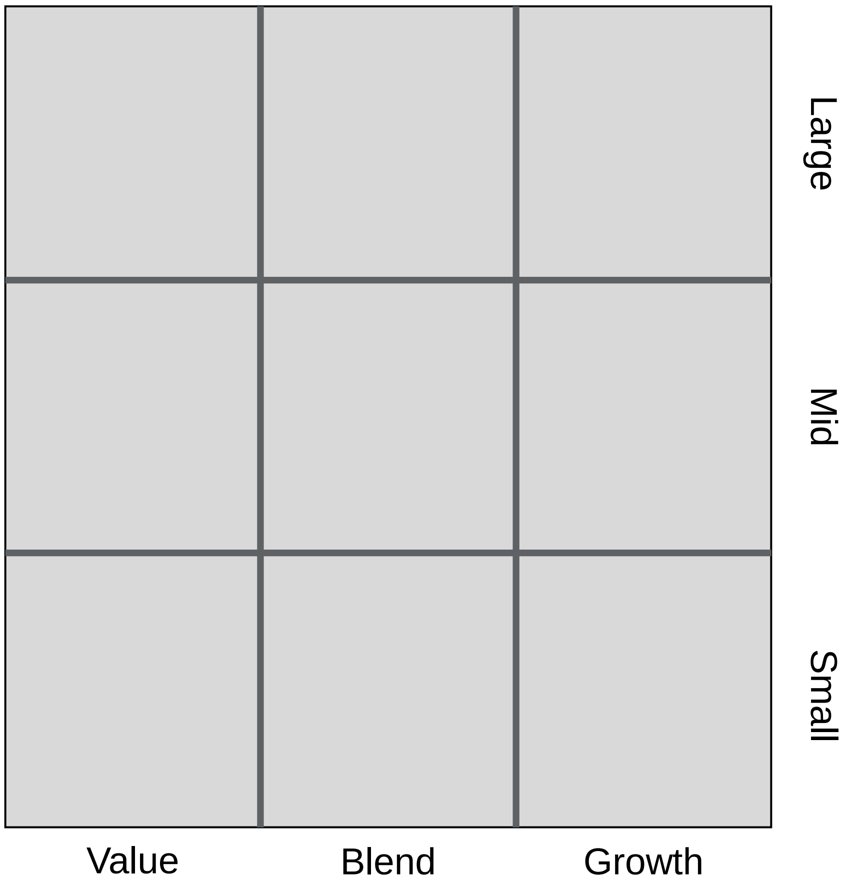
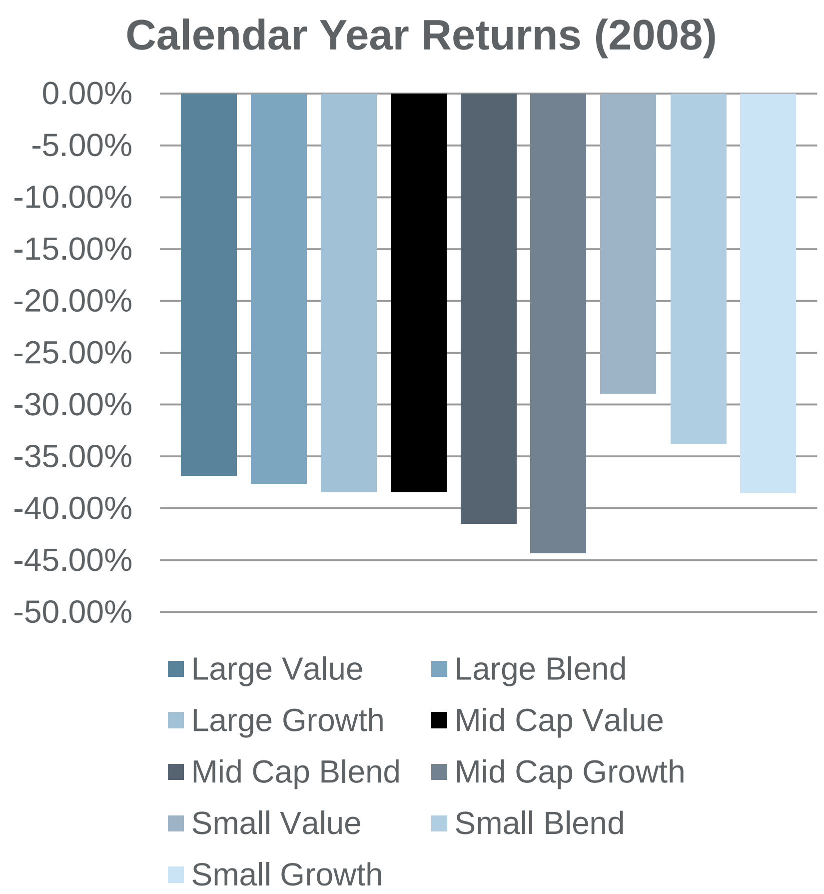
# Style Boxes ≠ Asset Classes



# Process Overview

**Define the Investment Universe**

**Conduct the Quantitative Analysis**

- Investment Style
- Expenses
- Manager Tenure
- Diversification
- Manager Success
- Consistency of Manager Skill
- Risk

**Qualitative Due Diligence**

- Understand the Why
    - Firm approach
    - Investment Strategy
    - Shareholder Friendliness



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# Investment Changes Should Be Rare

- Typically less than 10% of an investment menu changes annually
- Issues that may lead to investment changes
  - Changes in the regulatory environment
  - Changes to participant utilization of investment options
  - Changes in the team managing the investment product
  - Changes in the objective of the investment product
  - Changes in the amount of assets managed by the investment provider



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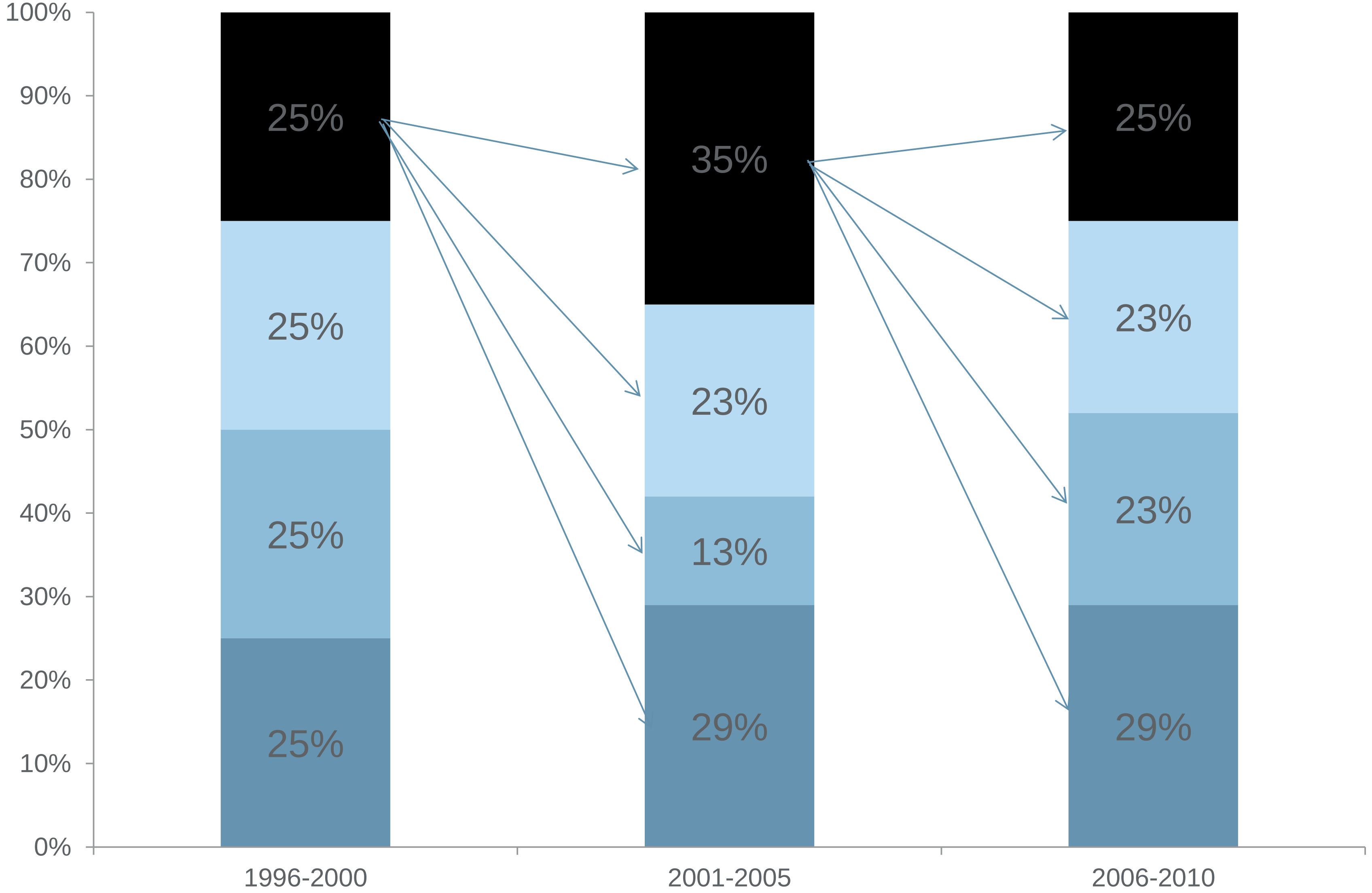
# Manager Performance Does Not Repeat




*Source: Morningstar; 190 funds with 15 year track records*



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# Communicating Investment Changes

- Separate what is required from what is useful
- Communicate clearly the why
- Make no promises
- Make no apologies
- If participant action is required, make the action very clear and very easy

# Fundamentals of Good Investment Governance

1. Documentation of Decision Making is as Important as the Decision Made
2. Investment Policy Statements are for Process and Objectives not for Decisions
3. Spend Time Getting Your Menu Objectives Right
4. Never Use Investment Products You and Your Participants Cannot Understand
5. Investment Changes Should Reflect Changes in Fundamental Factors not Relative Performance
6. Participant Returns Matter (Fund Returns Don't)

# Disclosures

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