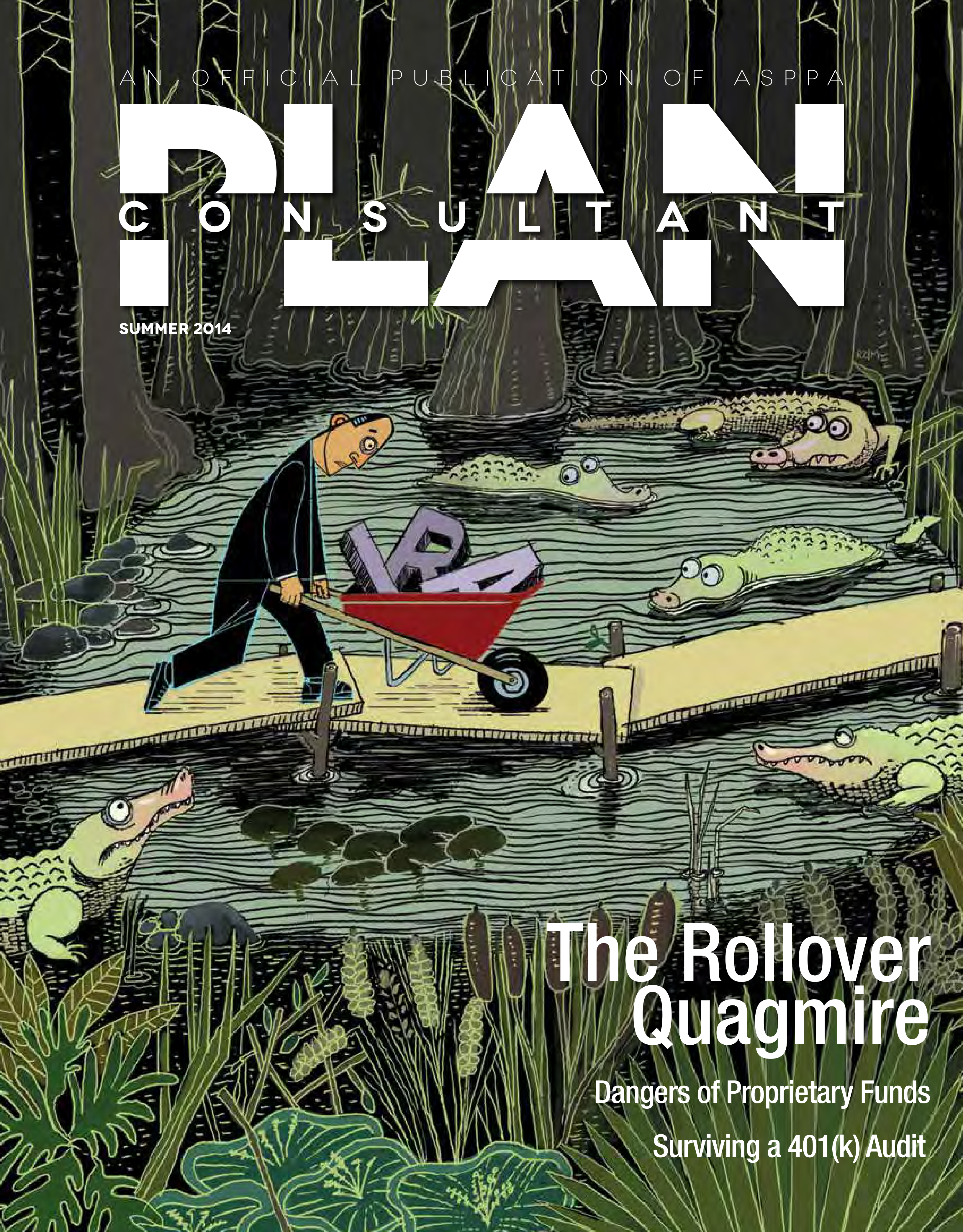
AN OFFICIAL PUBLICATION OF ASPPA

PLAN CONSULTANT

SUMMER 2014



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Outcome-Focused Investment Strategies

The Benefits and Challenges of Looking Beyond Benchmark-Driven Investments

BY JOHN J. SOHN

Portfolio risk has become a subject of concern for many plan participants, especially those who saw firsthand what extreme market volatility could do to their retirement savings during the financial crisis in 2008. To better address these concerns, asset managers have implemented outcome-focused investment strategies that are designed to actively manage risk and improve retirement outcomes for participants.

Many of these strategies bear a close resemblance to traditional investment strategies, but feature an outcome-oriented "twist." For example, a target date investment with an outcome-focused strategy may use a conventional glide path to determine its target asset allocation in neutral market conditions. But as an added twist, it may also offer various forms of downside protection during periods of elevated market risk, utilizing active risk management for the purpose of improving retirement outcomes for participants.

These non-traditional investment strategies can help plan sponsors meet their fiduciary obligations under ERISA in addition to improving participant outcomes. However, outcome-focused strategies are not typically associated with a traditional benchmark index, and the fact that these strategies are "benchmark agnostic" could potentially discourage plan sponsors from considering them.

Fortunately, plan fiduciaries and their advisors are finding prudent ways of selecting and monitoring outcome-focused strategies in accordance with the fiduciary standards of ERISA, even when traditional benchmark indices are not available to evaluate them.

> When benchmark indices are not readily available, plan fiduciaries should consider using alternative measures, such as peer group performance, customized benchmarks and risk-adjusted performance metrics."

BENEFITS OF OUTCOME-FOCUSED STRATEGIES

Plan sponsors and their advisors may have varying views on what "outcome-focused" or "outcome-oriented" strategies are, but there is a general consensus that these types of strategies are appreciably different from conventional benchmark-driven investments. Typically, outcome-focused strategies strike a delicate balance, offering market-based returns that can reduce the longevity risk of participants who could conceivably outlive their retirement savings, while also offering some form of downside protection or risk management when market conditions become unfavorable.

Outcome-focused strategies may include multi-asset class and all-in-one investment solutions, such as balanced and other risk-based portfolios as well as target date investments. They can also include single asset-class investment strategies that provide either fixed income or equity exposures. For example, a fixed income portfolio manager with an outcome-focused orientation may actively manage the duration of its bond portfolio, shortening it when there is an elevated risk of loss from rising interest rates.

Similarly, an equity portfolio manager with an outcome-oriented strategy may utilize sector rotation to help mitigate downside risk, overweighting defensive sectors such as consumer staples and utilities during a period of contraction in a business cycle.

FIDUCIARY ADVANTAGES OF ADDED DIVERSIFICATION

The fiduciary advantages of offering outcome-focused investment options to participants may be significant for plan sponsors and other investment fiduciaries. By their nature, outcome-focused investments are not benchmark-driven, which means that their returns will not be highly correlated with those of traditional investment strategies that are designed to outperform a conventional benchmark index. Thus, outcome-focused investment alternatives may give participants a significant boost to their ability to diversify their plan accounts.

For instance, a plan may offer a number of traditional fixed income fund options that are specifically managed to outperform various benchmark indices, such as the Barclays U.S. Aggregate Index. The addition of a fixed income strategy with an outcome-based orientation that is benchmark agnostic could give participants the ability to further diversify their fixed income exposure.

Under ERISA, plan sponsors are subject to a fiduciary duty to diversify the investments of the plan so as to minimize the risk of large losses. When a plan offers participant-directed investments, plan sponsors must ensure that the plan's investment menu includes a sufficiently diversified range of investment choices.[1] Thus, when considering the investment options to be included in the plan's menu, plan fiduciaries may wish to consider a wide and varied assortment of options, including outcome-focused investment alternatives. Offering these types of investment choices to participants can help plan fiduciaries demonstrate that they are acting in accordance with their fiduciary duty to provide a sufficiently diversified menu.

1 If the plan is intended to comply with the fiduciary safe harbor under ERISA Section 404(c), the plan's menu must include a "broad range of investment alternatives" within the meaning of Section 2550.404c-1(b)(3) of the DOL regulations.

FIDUCIARY CONSIDERATIONS FOR ALL-IN-ONE INVESTMENTS

Plan sponsors are also subject to a fiduciary duty to select and monitor the plan's investment options in a prudent manner in accordance with the requirements of ERISA. Specifically, plan fiduciaries must give "appropriate consideration" under ERISA to those factors that are relevant to the investment strategy, including the role that the investment strategy will play in the plan.[2] These rules have a special application to all-in-one investment solutions, such as target date and balanced investment alternatives. When selecting these types of investment options for a plan, plan fiduciaries must give appropriate consideration to their investment role and how participants are expected to utilize an all-in-one investment.

Participants who invest in a target date investment, for example, would be expected to invest all of their respective plan savings in this single investment alternative. Given the fact that these participants would effectively be "putting all of their eggs in one basket," plan fiduciaries should consider the benefits of offering a target date investment with an outcome-oriented strategy. The benefits may be especially meaningful in the case of a target date investment that can provide prudent risk management and timely downside protection.

Furthermore, plan fiduciaries should also consider the drawbacks of a conventional target date investment that does not actively adjust for risk when market conditions deteriorate, potentially leaving participants exposed to unmitigated risk and volatility.

Of course, the mere fact that an all-in-one investment solution does not provide for active risk management does not automatically make it an imprudent investment choice. However, given the central role that these types of investment options have in an individual participant's account, it would make sense for plan fiduciaries to give "appropriate consideration" to whether a target date or balanced investment is designed to manage risk when market conditions become unfavorable.

Plan sponsors are subject to fiduciary liability under ERISA to the extent that participants suffer investments losses resulting from a breach of the sponsor's duties to the plan, which include the fiduciary duty to make investment decisions prudently. Giving appropriate consideration to all relevant factors, including whether an all-in-one investment solution or any other type of investment alternative includes a risk management feature, can help plan fiduciaries demonstrate that they are acting prudently.

Even if the plan sponsor ultimately decides against selecting them, the fact that it gave appropriate consideration to the possibility of utilizing prospective outcome-focused strategies may help the plan sponsor establish that it is managing the plan's investments prudently. And if prudent outcome-focused strategies are added to the plan, participants may be made significantly better off when they finally reach retirement. In general, participants who are satisfied with their plan and the level of their retirement savings are less likely to file legal complaints against the plan and its fiduciaries. Thus, once properly selected, outcome-focused strategies may help plan sponsors mitigate their fiduciary risk and help improve the overall success and effectiveness of the plan.

LIMITATIONS OF TRADITIONAL BENCHMARK INDICES

While there may be fiduciary advantages to considering outcome-focused investment strategies, a plan fiduciary may feel uncomfortable when potentially considering these benchmark agnostic strategies for the first time. They may even prefer to stick with what they know, benchmark-driven investments that are associated with familiar benchmark indices.

Benchmark indices are, of course, immensely helpful to plan fiduciaries. They provide useful reference points that can help plan fiduciaries evaluate an investment strategy's relative performance, as well as identity style drift and other related problems. There is a potential danger, however, when plan fiduciaries become too dependent on these traditional investment benchmarks. Specifically, if benchmark indices are used as the starting point for determining which investment alternatives will be offered to participants, they will effectively define the investment menu and limit the diversity of the plan's investment alternatives. Rather than helping plan fiduciaries, an overreliance on benchmark indices can inadvertently hinder a plan sponsor's ability to choose the best investment options for the plan's participants.

EVALUATING PERFORMANCE WITHOUT TRADITIONAL BENCHMARK INDICES

It is important for plan sponsors to implement and follow prudent processes when evaluating outcome-focused investment strategies. The fact that an investment strategy incorporates risk management is no guarantee that the investment risk of participants will in fact be mitigated. For example, an investment adviser that utilizes questionable short-term market timing techniques in an attempt to manage risk could potentially increase volatility, rather than minimize it.

Moreover, even if an investment adviser is utilizing a prudent and disciplined approach to managing risk based on intermediate- and long-term market outlooks, any defensive

2 Section 2550.404a-1 of the DOL regulations.

action taken may be too late to protect participants from heavy losses in a declining market. Conversely, defensive actions may be taken prematurely, causing participants to miss out on substantial market-related gains.

As a legal matter, plan fiduciaries are not obligated to use a traditional benchmark index to evaluate the plan's investment options for participants. Plan fiduciaries must act prudently and give appropriate consideration to all relevant information, but there is no specific requirement that they utilize a conventional benchmark index. In actuality, they have a high degree of flexibility when it comes to evaluating any plan investment. In the case of outcome-focused investment strategies, plan fiduciaries do not have the option of utilizing benchmark indexes, but they may utilize other measures when evaluating outcome-focused strategies and their risk management features.

ALTERNATIVE MEASURES FOR OUTCOME-FOCUSED STRATEGIES

One method utilized by plan fiduciaries to evaluate an outcome-focused investment strategy is to compare the applicable strategy's performance against other similar outcome-focused strategies. It is a simple matter for plan sponsors to inquire about and to identity competing strategies that are similar to a particular outcome-focused investment strategy, and to use the track record of the competing strategies to evaluate the particular strategy.

When traditional investment benchmarks are not readily available to help evaluate an outcome-oriented strategy, plan fiduciaries can also utilize customized benchmarks. Customized benchmarks are already used to evaluate the performance of many traditional target date funds. These customized benchmarks are typically composites of popular benchmark indices (*e.g.,* S&P 500 Index, Barclays U.S. Aggregate Index), which in turn are weighted according to the fund's target allocations.

Similarly, customized benchmarks may also be used to evaluate the performance of outcome-focused investment strategies. But instead of weighting the component benchmark indices according to the portfolio's target allocations, in the case of an outcome-focused portfolio, the composite benchmark may be weighted according to the portfolio's Beta, which is a measure of the portfolio's volatility as it relates to the market.[3] For example, if a balanced portfolio with an outcome-oriented risk management strategy were to have a Beta of 0.6, the portfolio's performance could be evaluated against a composite index based on the S&P 500 Index and cash, with the Beta of 0.6 as the weight for the S&P 500 Index and (1 – Beta) or 0.4 as the weight for cash.[4]

Plan fiduciaries may also utilize risk-adjusted performance metrics, such as the Sharpe Ratio, to help them evaluate the extent to which participant investors are being well compensated for an outcome-focused portfolio's level of risk.[5] The higher the Sharpe Ratio, the better the portfolio's risk-adjusted performance over the applicable measurement period.

Risk-adjusted performance metrics are powerful diagnostic tools, in that they can be applied to both outcome-focused strategies and their benchmark-driven counterparts. For example, a traditional target date fund may have a higher absolute return than an outcome-focused target date strategy for a given performance period, but a review of their respective Sharpe Ratios may reveal that the traditional target date fund is actually underperforming in comparison to the outcome-focused strategy on a risk-adjusted basis. This information is especially valuable to plan fiduciaries, since an outcome-focused strategy would be expected to experience somewhat lower returns while providing for substantially less risk in comparison to its benchmark-driven counterpart.

MAINTAINING FIDUCIARY PERSPECTIVE

Plan sponsors do not need to use traditional benchmark indices to select and monitor outcome-focused investment strategies. They may compare the strategy's track record against the historical performance of similar outcome-focused strategies and also use customized benchmarks. Additionally, they may use performance metrics like the Sharpe Ratio to make an "apples to apples" comparison of the risk-adjusted returns of an outcome-focused portfolio and those of competing benchmark-driven strategies.

As noted in many investment disclaimers, past returns do not guarantee future results. Therefore, plan fiduciaries should never rely exclusively on performance-based information, including customized benchmarks and risk-adjusted performance metrics, which are ultimately based on past returns. But in light of a plan sponsor's duty to give appropriate consideration to all relevant information, plan fiduciaries should strongly consider enhancing their procedures for evaluating outcome-focused strategies by including a review of this type of investment data.

PROBLEMATIC RESTRICTIONS IN IPA DOCUMENTS

To help ensure that the plan's investment alternatives are selected and monitored prudently, many

3 The Beta of the market is 1. A portfolio is riskier than the market if its Beta is greater than 1, and it is not as risky as the market if its Beta is less than 1.

4 This type of composite benchmark may also be established for a single asset-class portfolio with an outcome-oriented strategy.

5 The Sharpe Ratio is a risk-adjusted measure that is calculated using standard deviation and excess return to determine reward per unit of risk.

> "Fortunately, plan fiduciaries and their advisors are finding prudent ways of selecting and monitoring outcome-focused strategies in accordance with the fiduciary standards of ERISA."

plan sponsors maintain a written investment policy statement, or IPS. The IPS document typically provides specific investment criteria and procedural guidelines for plan fiduciaries to follow when evaluating the plan's current and prospective investment options. For ERISA purposes, the IPS is considered to be part of the plan's governing document, meaning that the plan sponsor and other fiduciaries are obligated to follow the written terms of the IPS.[6] Thus, a problem arises when the plan sponsor is interested in offering an outcome-focused investment alternative to participants, but the IPS document either prohibits or discourages these types of non-traditional investments.

For example, an IPS document may rigidly require the plan's investment options to either outperform or passively achieve various benchmark returns in pre-determined asset categories. This type of IPS document would be too inflexible to accommodate an outcome-focused investment alternative with a benchmark agnostic strategy. And even if specific benchmark-driven investments are not explicitly mandated, an IPS document may rigidly state that all investment alternatives under the plan should be evaluated using a recognized benchmark index, implicitly limiting the plan's investment menu to benchmark-driven investments.

SUGGESTED AMENDMENTS FOR IPS DOCUMENTS

The good news is that an IPS document that is too rigid to accommodate outcome-focused strategies can easily be amended to give plan sponsors the flexibility to offer these and other types of non-traditional investment alternatives. Specifically, the IPS document may be revised to expressly authorize outcome-oriented investment alternatives that are not associated with a conventional benchmark index. In order to provide procedural guidance to plan fiduciaries, the IPS document may be further amended to include review guidelines for outcome-focused strategies.

As discussed above, when benchmark indices are unavailable, plan sponsors may simply compare the applicable outcome-focused strategy's track record against the historical performance of other similar outcome-focused strategies. Plan sponsors may also use customized benchmarks as well as risk-adjusted performance metrics like the Sharpe Ratio to help them review these benchmark agnostic strategies. To give plan fiduciaries as much flexibility as possible, the IPS document should be amended to give fiduciaries the option, but not the obligation, to utilize any of these alternative measures when evaluating an outcome-focused strategy.

CONCLUSION

Outcome-focused strategies can help plan sponsors meet their fiduciary obligations under ERISA as well as improve the overall success and effectiveness of the plan. The fact that these types of strategies are not typically associated with benchmark indices should not deter plan sponsors from offering them to participants. When benchmark indices are not readily available, plan fiduciaries should consider using alternative measures, such as peer group performance, customized benchmarks and risk-adjusted performance metrics.

If the plan's IPS is too rigid to accommodate outcome-focused strategies, the plan sponsor should consider amending the IPS document so that these non-traditional investment alternatives may be offered to participants. Outcome-focused investment strategies offer many potential benefits to participants as well as plan fiduciaries, and plan sponsors should strongly consider offering these types of strategies even if conventional benchmark indices cannot be used to evaluate their performance. PC

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6 ERISA Section 404(a)(1)(D).