THE EXCELLENT FIDUCIARY

The Plan Sponsor's Guide to Delegating, Part III: Money Managers—The Faceless Vendors

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Directing the investment of a retirement plan's assets is complicated and time consuming, even for those individuals possessing the requisite skills for this activity. Federal pension law mandates that retirement plan sponsors who lack this expertise hire an investment expert, or money manager, to oversee and make decisions regarding their company's investment portfolio. Due to the esoteric knowledge an effective investment strategy requires, many plan sponsors opt to outsource this important responsibility, in order to serve the best interest of their plan participants.

However, very few retirement plan sponsors ever actually meet the individuals who decide which stocks and bonds populate their retirement plans' investment funds. To most plan sponsors, their money managers are distant professional investors to whom they entrust great responsibility. The retirement future of the plan sponsor's entire employee community rests on their money manager's shoulders. The Employee Retirement Income Security Act ("ERISA") requires that money managers are selected and monitored by a person called a Plan Administrator (who typically is an appointed executive within the plan sponsor organization). As a fiduciary that is expected to act in the best interests of his plan participants, the Plan Administrator is required to use great care and skill in his role as overseer of the retirement plan process. Yet, few members of the Plan Administrator class know very much about how to evaluate the

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Investment managers, or money managers, are individuals and firms registered with the U.S. Securities and Exchange Commission who are responsible for managing the securities portfolios they oversee. Mutual fund companies are perhaps the best examples. They have a legal duty—a fiduciary responsibility—to perform their work in the best interest of the retirement plans they serve. Companies that sponsor retirement plans appoint a person to serve as the Plan Administrator, or the primary fiduciary, who is required by law to select and monitor vendors using a careful, diligent, and documented process. Yet, unlike the personal interaction that Plan Administrators have with other vendors, relatively few Administrators ever actually meet their plans' money managers face-to-face. This article explores the challenges inherent in dealing with a category of vendors that 1) is rarely seen by buyers (i.e., Plan Administrators) and 2) provides services that can be difficult for corporate managers to evaluate.

differences between money managers, or how to assess the quality of their existing money managers' services. This article will shed light on the money manager role, and provide straightforward tips for plan sponsors on how to effectively choose a money manager and evaluate their service quality for a given retirement plan.

WHAT IS A MONEY MANAGER?

Not to be confused with an ERISA 3(38) Investment Manager ("EIM"), which has emerged from the ranks of the boutique pension consulting market in recent years and who has direct contact with the plan sponsor, a money manager assembles the portfolio of securities that comprises a retirement plan's investments. Mutual funds are an excellent example of such portfolios. Typically, money managers do not have direct contact with the plan sponsor overseeing the retirement plans that they serve.

A money manager's value lies in this professional's ability to devise the ideal investment portfolio that meets a retirement plan's strategic goals and maximizes plan participants' assets. The money manager, however, is not liable for the performance of any of the investments he or she chooses for the plan, so careful monitoring by the plan sponsor is required in order to establish confidence that the money manager is, in fact, acting in the best interest of the plan participants. Protecting plan participants' interests is, ultimately, the most important function of the Plan Administrator role.

WHY DO PLAN SPONSORS HIRE MONEY MANAGERS?

ERISA encourages Plan Administrators to hire experts if they lack specific skills related to retirement plan management, such as making investment decisions about their employees' retirement accounts. This lack of skill is no fault of the Plan Administrator; conversely, ERISA accounts for this lack of specialty expertise because most Plan Administrators have responsibilities that far exceed overseeing their company's retirement plan process. As mentioned earlier, the vast majority of Plan Administrators are, in fact, members of the c-suite at the respective plan sponsor organizations—so their highest priority is focusing on the strategic activities of the organization, rather than delving into the "nitty gritty" details of retirement plan investments. Further, most Plan Administrators have not undergone training for their fiduciary role, but rather have been somewhat arbitrarily assigned this role either by others in the organization or by default (according to ERISA, if no Plan Administrator is named for a retirement plan, the plan sponsor becomes the Administrator by default).

Regardless of the level of investment expertise of a Plan Administrator, as a fiduciary, he or she still bears the ultimate responsibility for managing the investment decision-making process related to the retirement plan. Hence, it makes logical sense for many Plan Administrators to hire money managers that are solely dedicated to the trade of selecting stocks and bonds. Additionally, Plan Administrators are not responsible for the rate of investment returns achieved by their plans' money managers. Yet, they do have a legal duty to ensure that money managers perform their work consistent with the plan's investment policy, and that the fees paid to their money managers are reasonable.

Key reasons that Plan Administrators hire money managers include:

- Alleviating some of ERISA's fiduciary burden;
- Gaining freedom to focus on the strategic needs of the retirement plan and its participants by outsourcing the tactics of investing;
- Eliminating the need for plan sponsors to maintain

a staff of trained and experienced professional investors; and

- Affording the plan broad access to a variety of investing options and styles.

HOW DO MONEY MANAGERS DIFFER FROM ONE ANOTHER?

Apart from differences in employment policies and corporate messaging, firms that offer investment management services differ on key fundamental issues that should impact Plan Administrators' hiring decisions. The primary two differentiating factors between money managers are their investment philosophy and their investment style. Let's explore these two areas a bit further.

Passive Versus Active Philosophy

Active and passive investing are two differing approaches regarding how and when to make investment decisions. Active investing attempts to pick specific "winners" among stocks or bonds, which requires a more fast-paced, up-to-the-moment investment practice. Passive investing endeavors to capture gains from entire markets of stocks or bonds.

More specifically, an actively managed large cap mutual fund will invest in 125-200 stocks listed in the S&P 500 Index, while a passively managed fund, (also called an index fund) will be invested in all 500 stocks contained in the S&P 500 Index. Passive funds trade less frequently than actively managed funds, have lower fees, and are less speculative. The majority of mutual funds underperform index funds. Therefore, a retirement plan's investment policy should dictate the balance between active and passive management, as desired by the Plan Administrator.

Investment Style

Investment style refers to different characteristics of specific securities, such as stocks and bonds. Passive and active philosophies have a direct effect on a money manager's investment style. Money managers that pursue an active philosophy can be separated into growth and value categories. Managers in the growth category seek stocks of businesses that they hope will grow in profits by a range of 15% to 25%. On the other hand, value-oriented money managers look for cheap stocks that have lost appeal to most investors due to predictable business cycles. Monitoring a money manager's consistent pursuit of its stated investment style is a key step in a Plan Administrator's fiduciary process.

WHICH TRAITS SHOULD BE EXAMINED WHEN SELECTING A MONEY MANAGER?

Since Roland|Criss has been involved with rating money managers for over 15 years, Plan Administrators will often ask us what they should be looking for when they hire firms to handle their plans' assets. Evaluating money managers, both initially and ongoing, is an art and a science. The examination of objective and subjective traits is critical to create a legally defensible "prudent process." Subjective traits represent the greatest challenge for most Plan Administrators to evaluate. Consequently, we will explore six key qualitative factors Plan Administrators can use to guide them in their evaluation process:

1. The Investment Firm
2. The Money Managers
3. Investing Philosophy and Fees
4. Process and Execution
5. Risk/Return Management
6. Performance Assessment.

1. The Investment Firm

The market for investment managers has swelled in recent years, as firms that were formerly only consultants to retirement plans added "ERISA 3(38) Investment Manager" to their branding materials. Many such firms lack the experience and breeding that characterizes the mutual fund market. Care should be taken to thoroughly evaluate the competency of firms that lack a mutual fund management track record, before hiring them. Firms that have been audited for their compliance with the Global Investment Performance Standards ("GIPS") or have earned an EIM Rating of Superior make good candidates.

2. The Money Managers

Money managers are individuals employed by organizations that offer investment management services to ERISA plans. A money manager's greatest value to an ERISA plan is his or her ability to achieve maximum results given the plan's investment policy constraints. Plan Administrators should closely evaluate money managers' track record, including their analytical abilities, inquisitiveness, and potential claims of securities issuers. Verifying those qualities is a key element of a Plan Administrator's fiduciary duty.

3. Investing Philosophy

Investment management firms have a range of investment philosophies. An example of this is the manager that focuses on return on invested capital ("ROIC") as the key way to measure value in a company's stock. Another manager may hold the view that securities markets continuously offer investors with opportunities that are driven by divestitures, restructurings, and new products. Plan Administrators should ensure that their due diligence files contain evidence that they have examined the investing philosophies of their plan's money managers and deemed them to be appropriate for their specific plan's needs.

4. Process and Execution

The process that investment managers use to select and sell stocks is a fundamental due diligence issue for Plan Administrators to test. A money manager's investment process should be clear and easy to understand. While money managers often promote the "repeatability" of their investment management processes, the consistency with which they execute those processes is of paramount importance. Research is a vital activity that can make a significant difference in investment outcomes, but learning how money managers apply the information garnered from that research is just as important.

5. Risk/Return Management

Developing and adhering to "sell" policies is a vital part of risk management. Best-in-class money managers evaluate each investment opportunity in the context of such risk inducing factors as the economy, politics, changing market conditions, and regulatory activity. Plan Administrators that ignore a money manager's process for addressing risk may be subject to subpar outcomes.

6. Performance Assessment and Fees

Money managers that have performed well in the past may or may not perform well in the future. In light of that uncertainty, Plan Administrators can increase the likelihood of obtaining results that parallel the market by hiring managers from investment management firms renowned for hiring experienced, educated, and motivated professionals. Consequently, assessing the performance of an investment management firm requires more effort than merely reading investment reports. Minimizing fees and expenses ensures that investment returns reach their best potential. The asset-based fee approach, for example has been the standard pricing structure in the industry for the past four years. Performance-based fees, however, are gaining traction as Plan Administrators become more aware of the impact of fees on overall returns.

CONCLUSION

As with many other retirement plan service providers, the outsourced money manager role can be either an enormous advantage to a Plan Administrator, or an unsuspecting detriment to the plan and its participants. An understanding of the unique role of the money manager, and his general lack of visibility with Plan Administrators, is the first step to ensuring a dependable process for selecting and monitoring this vendor. Up-front due diligence and targeted questions around a money manager's investment philosophy and style can provide Plan Administrators with a clear view of a potential money manager's approach and investing behaviors. Lastly, examining other subjective factors, such as the investment firm, overall process, risk management approach, past performance, and fees will increase Plan Administrators' confidence in their final decision, while also providing an extremely important checklist of evaluation criteria to populate their legally defensible "prudent process" under ERISA.