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Step 3 of the Fiduciary Process: Implementing the Investment Strategy

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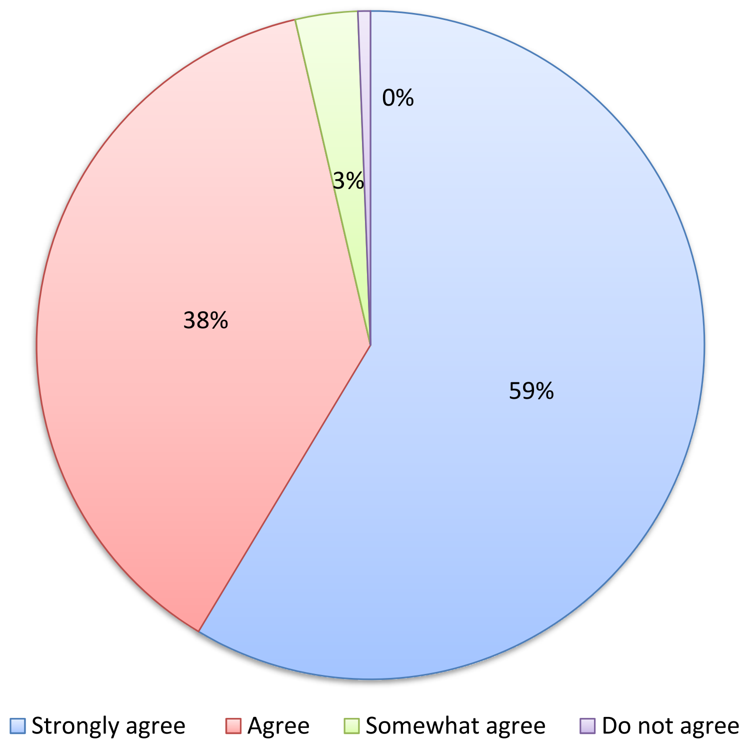
Topics

- Recognize what it means to be a fiduciary
- Identify the seven fiduciary precepts that comprise a fiduciary process
- Recognize the four-step Fiduciary Quality Management System
- Understand the importance of implementing a client portfolio

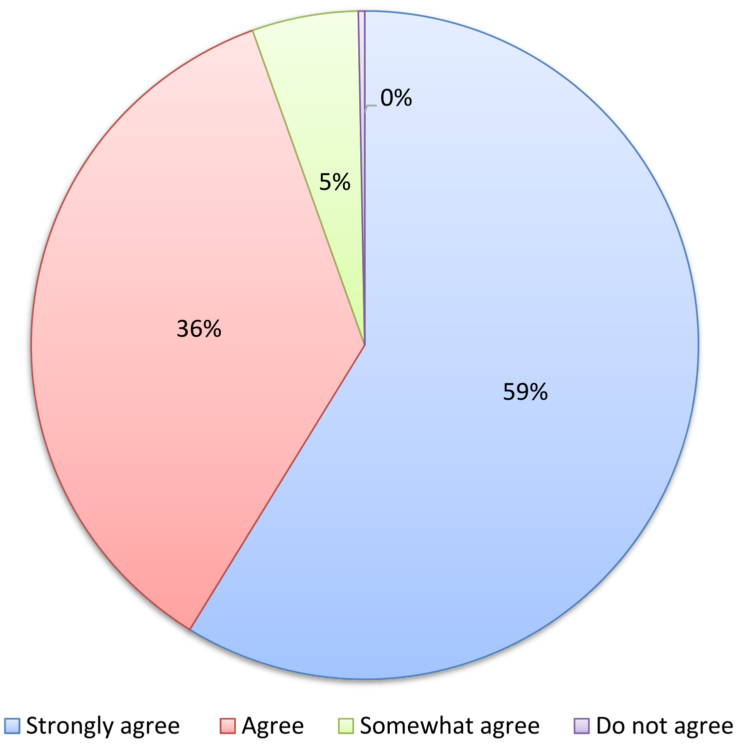
Polling Question #1

Having a repeatable process makes my practice more efficient. (349 respondents)

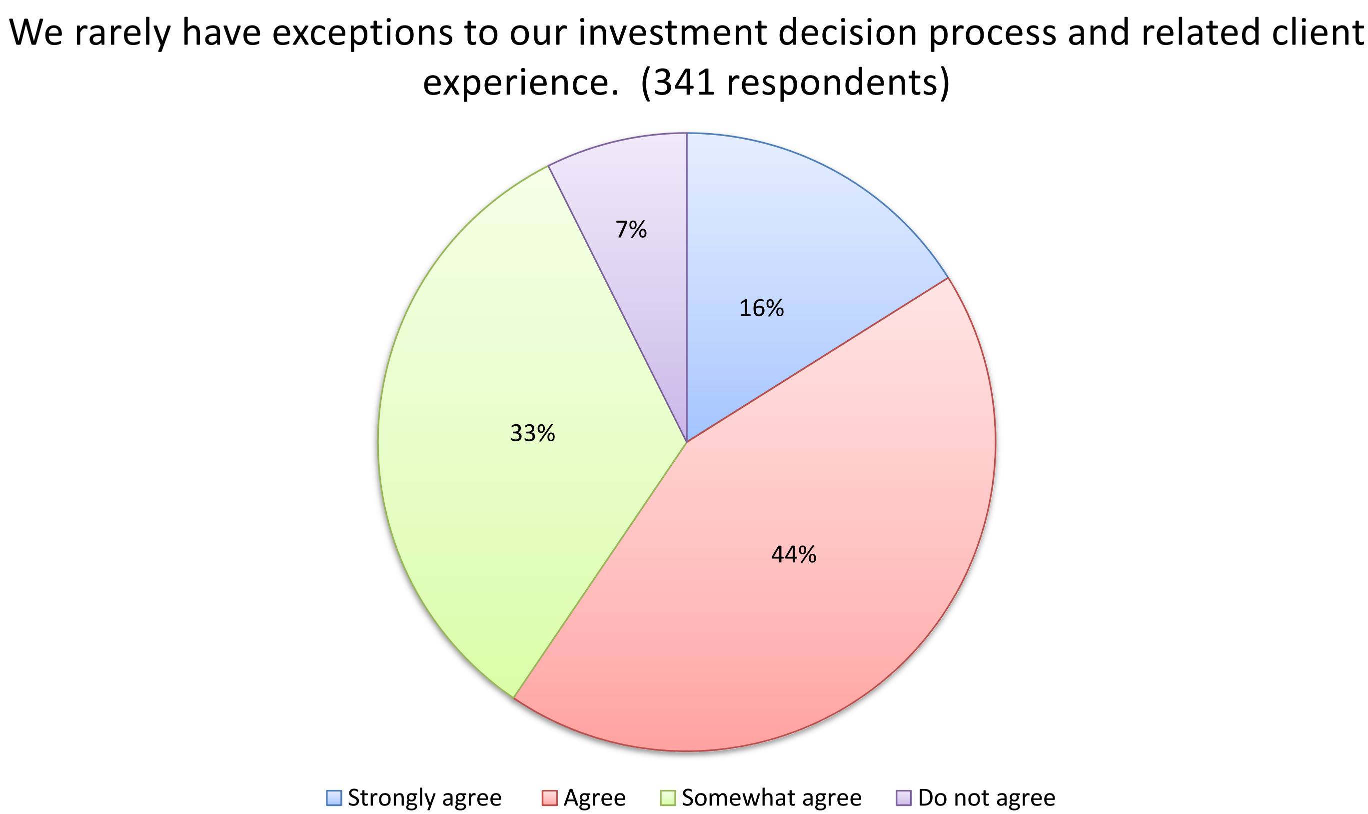


Polling Question #2

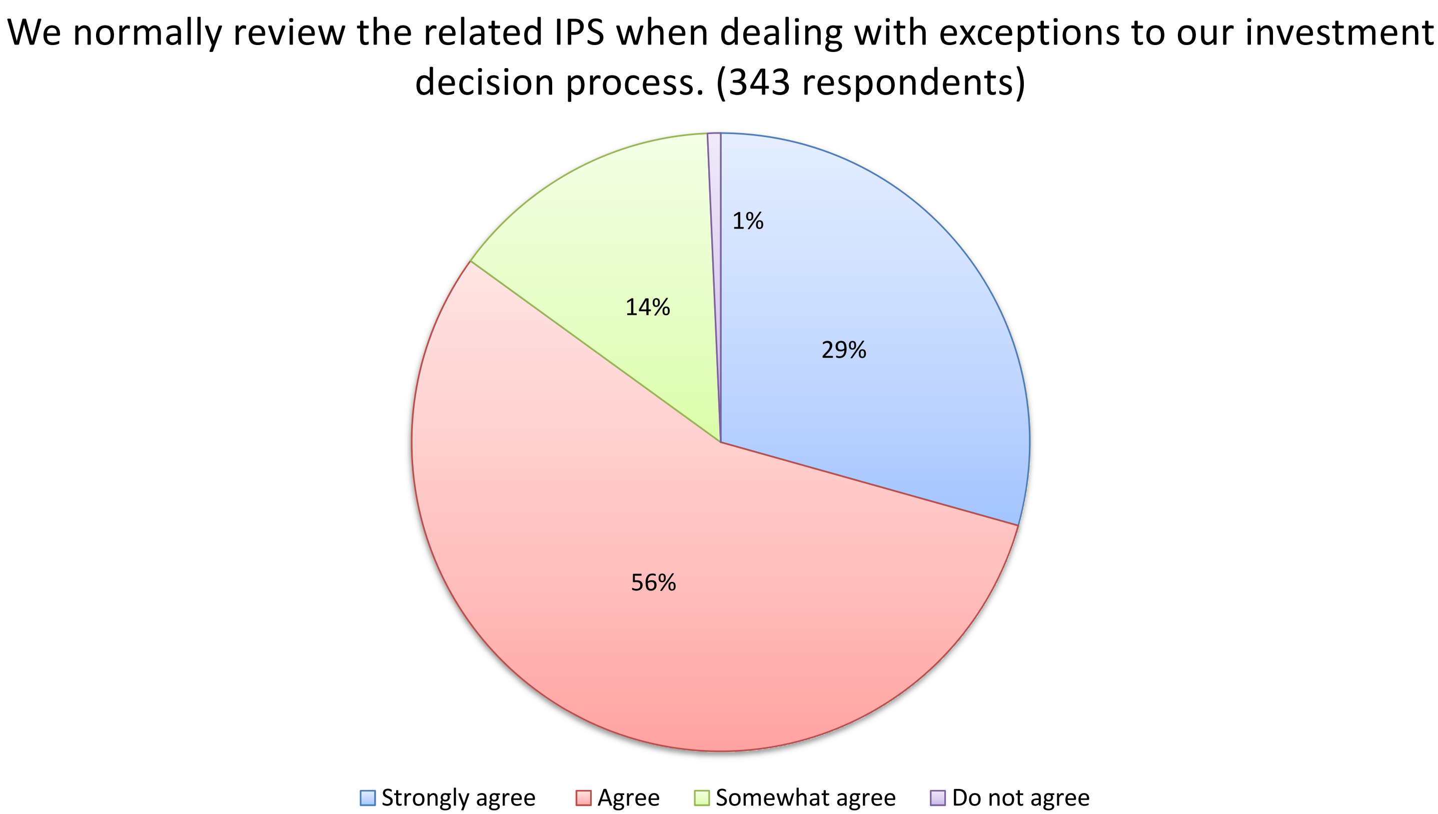
Having a repeatable process is good for our clients. (345 respondents)



Polling Question #3

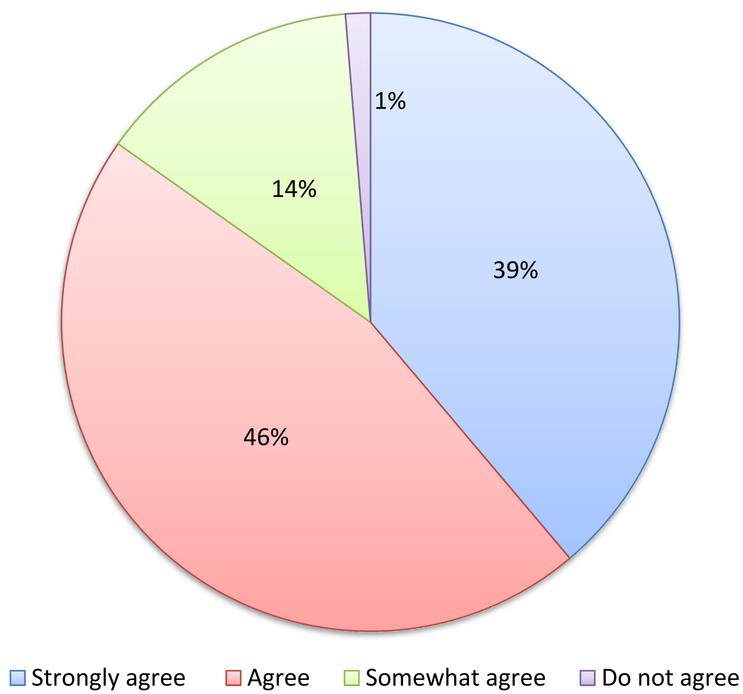


Polling Question #4



Polling Question #5

When there are exceptions, the decisions and reasons are consistently documented and tracked. (345 respondents)



Process, Not Performance

- A fiduciary’s conduct is measured by the process employed, not by the investment outcomes obtained.
- Fiduciary excellence is prudent processes, consistently applied.

Fi360's Prudent Practices

Legal Substantiation from:

- **ERISA:** Employee Retirement Income Security Act (Qualified retirement plans)
- **UPIA:** Uniform Prudent Investor Act (Private trusts, the default standard if nothing else "fits")
- **UPMIFA:** Uniform Prudent Management of Institutional Funds Act (Foundations, endowments, and government sponsored charitable institutions)
- **UMPERSA:** Uniform Management of Public Employees Retirement Systems Act (State, county, and municipal retirement plans)
- **IAA:** The Investment Advisers Act of 1940

Global Fiduciary Precepts

1. Know standards, laws, and trust provisions
2. Diversify assets
3. Prepare investment policy statement
4. Use “prudent experts” and document due diligence
5. Control and account for investment expenses
6. Monitor the activities of “prudent experts”
7. Avoid conflicts of interest

1. Rules 2. Diversify 3. IPS 4. Due Diligence 5. Expenses 6. Monitor 7. Conflicts

The Fiduciary Quality Management System (FQMS)

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Step 3 - Implement

- Service provider due diligence
- ERISA Safe Harbors
- Investment selection

Use “Prudent Experts” and Document Due Diligence

- Service providers must be selected using a consistent, prudent process.
- Service providers provide special expertise or capabilities to help stewards execute their fiduciary duties.

Service Provider Due Diligence

- Define service requirements
- Use RFP or RFI process
- Capabilities, costs, and security are key criteria
- Require 408(b)(2) type disclosure
- Documentation is essential

Due Diligence for the Custodian

- Custodian roles include:
  - Hold securities for safekeeping
  - Report on holdings and transactions
  - Collect interest and dividends, and, if required,
  - Affect trades
- Require 408(b)(2) type disclosure
- Data provided by custodian facilitates best execution oversight

Safe Harbors

- Voluntary
- May insulate the fiduciary from liability
- Require the fiduciary to demonstrate compliance with the defined requirements:
  - Prudent selection
  - Prudent monitoring
  - Acknowledgement of fiduciary status

Summary of ERISA Related Safe Harbors

	Protection from liability for:
405(c)	Actions of party delegated to
404(c)	Actions of participants
Fiduciary Adviser	Advice of Fiduciary Adviser
QDIA	Having placed participant assets without their direction
Auto-rollovers	Selection of IRA and investment of related funds

405(c) or General Safe Harbor Provisions

- When investment decisions are delegated, the following safe harbor requirements apply:
  - Plan must allow for delegation of investment decisions
  - Procedures for delegation must be prudent
  - Investment decisions must be delegated to “prudent experts”
  - Experts must be selected following a prudent process
  - Prudent experts must be given discretion
  - If prudent expert is an RIA, it must acknowledge fiduciary status
  - Prudent experts must be monitored

404(c) Safe Harbor Provisions

- In addition to the general safe harbor requirements, 404(c) requires the following:
  1. Notification in writing of intent to constitute a 404(c) plan
  2. At least three different investment options
  3. Opportunity for participants to give investment directions
  4. Opportunity for participants to change their investment strategy or allocation consistent with other investment alternatives in the plan
  5. Opportunity for participants to change their investment strategy or allocation so as to minimize risk of large losses
  6. Information on the different investment options
  7. Opportunity for participants to change their investment strategy or allocation with a frequency that is appropriate in light of market volatility; at least quarterly
  8. Plan administrator must comply with participant disclosure requirements as per 404a-5

Qualified Default Investment Alternative Safe Harbor (QDIA)

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- For "defaulting" participants who defer to the plan, but who does not direct the investment of their accounts.
- QDIAs: investment options selected by plan fiduciaries for the defaulting participants.
- Must be based on generally accepted investment theories and must consist of a combination of equity and fixed income investments.

continued . . .

Qualified Default Investment Alternative Safe Harbor (QDIA)

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- A plan sponsor can avoid liability for participant investment decisions by offering a QDIA, which are defined as:
  - Age-based funds or models
  - Risk-based funds or models
  - Managed accounts
- Money market type accounts allowable only for short periods – 120 days.
- Employer stock is permitted under certain circumstances
- Participants must be notified in advance of initial investments, annually thereafter, or when changes are made.

Automatic Rollover Safe Harbor Provisions

- Applies to forced distributions:
  - Pursuant to IRC §401(a)(31)(B)
  - Generally for account balances >$1k and <$5k
- Protects ERISA fiduciary as to the:
  - Selection of the individual retirement plan; e.g., IRA
  - Investment of the related funds

Managing the Investment Menu in DC Plans

- Use professional investment managers
- Manage the managers
- Fiduciaries must engage in a prudent process to select investments, applying generally accepted investment theories and prevailing investment industry practices.
- Commonly accepted that fiduciaries should look at:
  - investment expenses
  - quality of the investment management
  - past performance compared to an appropriate benchmark
  - other accepted factors

Due Diligence Philosophy

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- Same process for funds, separate account managers, etc.
- No proprietary formulas
- Simple, replicable process
- Dual (search and monitor) application screens

Choosing Investment Managers: Suggested Minimum Criteria

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Fi360 Recommended Due Diligence Screens	
1	**Regulatory Oversight** Threshold: Managed by a bank, insurance company, registered investment company, or RIA
2	**Minimum track record** Threshold: At least three years history
3	**Stability of the organization** Threshold: Manager tenure of at least two years
4	**Assets in the product** Threshold: At least $75 million
5	**Holdings consistent with style** Threshold: At least 80%
6	**Correlation to style or peer group** Threshold: Consistent with asset class being implemented
7	**Expense ratios/fees** Threshold: Above 75th percentile of peer group
8	**Performance relative to assumed risk** Threshold: Compare Alpha and Sharp Ratio to peer group median
9	**Performance relative to a peer group** Threshold: Compare year performance to peer group median

Selecting and Monitoring Target Date Funds

- The DOL Tips for ERISA Plan Fiduciaries about target date funds (TDFs):
  - Is the glidepath “to retirement” or “through retirement?”
  - How do the investment strategies, performance, glidepaths and investment-related fees compare to other target date funds?
  - How do the TDF characteristics align with employee demographics?
  - Is the TDF suite performing in a manner consistent with its asset allocations and strategies?
  - Consider whether a non-proprietary TDF or a custom TDF would be a better fit for the plan.
  - Consider whether the employee communication materials provided by the TDF family satisfy the needs of the participants.

Non-Volatile Income Investments

- Money market funds (MMFs):
  - Retail: tend to fluctuate in value
  - Institutional: may limit ability to withdraw
  - Government: no floating NAV and no withdrawal restrictions
- Stable value funds (SVFs):
  - Alternative to MMFs used by large plans
  - May fluctuate in value
  - Assets may be withdrawn at guaranteed value backed by insurance contracts
- Guaranteed investment contracts (GICs) (also called fixed account products) from insurance companies:
  - Guarantees principal of the investment and rate of return for set period of time

Rollover Advice and Due Diligence

- Rollover advice is a fiduciary act under DOL's conflict of interest rule
- Advisors have 5 options:
  - Adhere to ERISA's general fiduciary duties of loyalty and care when no safe harbor is available
  - Rely on the BIC Exemption
  - Rely on the Level-Fee Fiduciary Exemption
  - Provide only educational guidance; no recommendation
  - Decline to provide advice, or make a referral

Due Diligence Process for Rollover Advice

- Advisor must document the specific reason(s) why the recommendation is in the investor's best interest.
- Principal factors to identify (and document) in the due diligence inquiry
  - Cost differential between options
  - Difference in level of products and services provided
- If only educational advice is provided, the process also should be documented.
- Due diligence process should be consistent for all rollover clients.

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