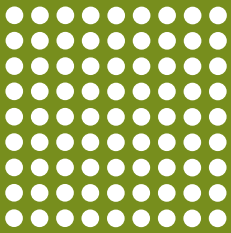


The Investment Selection Process

What Kind of Choice Is That?



Choosing investments for your own personal portfolio is: 1.) A science 2.) An art 3.) A hobby 4.) A thrill-ride? Or maybe all of the above. The key word is “personal”. You don’t have to answer to anyone but yourself. If you are choosing investments as a plan sponsor, however, your employees have every legal right to know how and why you chose the investments you did.

Perhaps you chose them on the advice of a service provider. Do you know how or why your service provider selected your investments? And do you know what determined the investment universe of choices you were given? As a fiduciary, you must be able to answer those questions in order to defend your buying decisions. As we said before, under the law, ignorance is no excuse when it comes to fiduciary responsibility. Federal law requires you to document the criteria used in the investment selection and monitoring process. You must be able to demonstrate thoughtful, careful analysis of all aspects of the decision-making process.

In today’s litigious society and with the specter of the mutual fund scandals casting a glaring light over the entire retirement plan world, every decision you make as a plan sponsor is open to scrutiny. Given that plan participants may well hold you responsible for investment decisions, your service provider should be able to explain clearly, in writing, how it determined its investment universe. This information will be an important part of your Investment Policy Statement (IPS), your basic and best defense against any future accusations of poor decision making.

A good IPS clarifies the purpose of the plan, how decisions are made and by whom. Most importantly, it sets forth the criteria to be used in the investment selection and monitoring process. An IPS is a working document that will prompt you through the key points of investment planning decisions, as well as archive your decision making process. Your legal duty as a plan sponsor is not to pick the “right” investments — no one expects you to have a crystal ball into the financial markets — but you are expected to have documented a prudent decision-making process.

Your first step in the decision-making process is choosing the right service provider. As I said before, I often recommend a provider for two reasons: first, a firm that does not offer its own brand-name funds is, by definition, protected from any potential conflicts of interest that arise in deciding whether to make available proprietary or non-proprietary investment products. Second, a firm that provides plan sponsors with a documented process for choosing and monitoring investments wins hands down over firms that do not. Let's look at an example.

ADP provides every client with a sample investment policy statement which they can easily customize and make their own. More than that, ADP uses the same IPS for its own investment pre-selection and monitoring process. Not only is the investment universe carefully constructed based on clearly defined selection criteria, but every quarter ADP reviews each fund's performance in light of the ongoing monitoring criteria. If a fund doesn't meet the criteria set forth in the investment policy statement, the fund is placed on "watch" status. And if the poor performance continues, the fund is no longer made available to new clients and current clients are notified of its status. Furthermore, as a client of ADP, you are kept informed of their monitoring process so that you can follow it in your own investment monitoring process. (We'll be talking about that in the next article.)

Your provider must first create a universe of high quality investment options based on a rigorous selection process. Then, you have to work within that universe to create a portfolio that's right for your company.

Putting it All Together: Fund Selection Criteria and Process

There are several criteria to consider when selecting specific funds. Typically, these criteria are outlined in the IPS so that the plan has a reference point in which to evaluate funds and performance over time. Putting together a well-designed portfolio to meet your participants' needs cannot be reduced to a simple formula. It comes down to doing your homework, using reliable data, making informed choices and

documenting the process. A good IPS will use some or all of the following criteria.

- Annualized Investment Performance over 1, 3, 5, and 10-Year Periods
- Risk-adjusted Performance over 1, 3, 5, and 10 year Periods
- Performance vs. Peer Group and Best-fit Index over 1, 3, 5, and 10-Year Periods
- Expenses
- Turnover Ratio
- Manager Tenure
- Fund Size
- Top Ten Holdings and Portfolio Composition
- Style Consistency

The investment selection process begins with a critical look at your service provider. For your best protection, choose a provider without any conflicts of interest, i.e., no “product” to sell. And make sure your provider has in place a well documented, easy to understand investment selection process in place before signing in. By teaming with a service provider that meets these criteria, and working with them to develop a strong IPS, you can rest assured that you have met your fiduciary responsibility to document a careful, prudent decision-making process in accordance with ERISA.

Look for our next edition in this series where we’ll explore the importance of monitoring plan investment performance.

— FROM THE DESK OF MATTHEW GNABASIK

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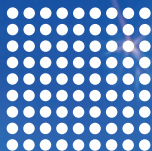
Selecting and Administering a Safe 401(k) Plan

Please note that neither Blue Prairie Group nor ADP can provide you with legal advice regarding your fiduciary duties under ERISA. This article and those following are not intended to constitute or be relied on as legal advice, but a description of applicable principles. Please consult with your attorney for legal advice on matters contained in these articles.

If you would like more information on ADP's investment monitoring process, please call:

1-800-432-4015 PROMO CODE: **421**

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