Prudent Investment Practices

A Handbook for Investment Fiduciaries

Persons who have the legal responsibility for managing someone else's money.

- Investment Committees of Retirement Plans, Foundations, and Endowments
- Investment Advisors, Consultants, Private Bankers, Financial Planners
- Trustees of Private Trusts

Written by the
FOUNDATION FOR FIDUCIARY STUDIES

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

A Handbook for Investment Fiduciaries

Written by the Foundation for Fiduciary Studies

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AICPA Editorial Statement to Readers

The Personal Financial Planning Division of the American Institute of Certified Public Accountants (AICPA) has served as the technical editor for "**Prudent Investment Practices: A Handbook for Investment Fiduciaries**" (Handbook). The AICPA's participation in the development of the Handbook is intended to promote and protect the interests of the consumer public, and to perpetuate the delivery of competent and objective investment advice.

The Handbook was developed specifically for investment advisors, trustees, attorneys, consultants, institutional investors, money managers, financial planners, and anyone else who is involved in investment decision-making. The Handbook will serve as a foundation for prudent investment fiduciary practices. It provides investment fiduciaries with an organized process for making informed and consistent decisions. Fiduciaries must, however, exercise professional judgment when applying the Practices; consulting legal counsel and other authorities when appropriate.

The investment fiduciary practices contained within this Handbook have not been approved, disapproved, or otherwise acted upon by any senior technical committee of the American Institute of Certified Public Accountants and have no official or authoritative status. The AICPA's participation is solely in the capacity of a technical editor.

Although the fiduciary practices address many of the legal requirements of investment fiduciaries, the scope of the Handbook addresses primarily the Employee Retirement Income Securities Act, the Uniform Prudent Investor Act, and the Uniform Management of Public Employee Retirement Systems Act. The investment fiduciary must become familiar, and comply, with all other federal and state laws applicable to the fiduciary's particular field of practice including the rules and restrictions imposed by regulatory bodies such as the Securities and Exchange Commission, General Accounting Office, Department of Labor/ERISA, and the Internal Revenue Service.

We gratefully acknowledge the invaluable contributions of the many CPAs who were instrumental in the review of the Handbook. The PFP Division would also like to acknowledge the special efforts of Clark Blackman II, CPA/PFS; Ken Dodson, CPA/PFS; Bruce Fillpot, CPA/PFS; and Meloni Hallock, CPA/PFS, who were all instrumental in the completion of the Handbook.

The American Institute of Certified Public Accountants (AICPA) is the national, professional organization of CPAs, with more than 330,000 members in business and industry, public practice, government, and education. For more information about the AICPA, visit its Web site at www.aicpa.org.

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Selected Quotes from the Department of Labor's *Amended Brief of the Secretary of Labor Opposing the Motions to Dismiss*

Re: Pamela Tittle, et al.,
v. ENRON CORP., Oregon Corporation, et al.

The Secretary files this amicus brief expressing her view that, based on the allegations in the Complaint, ERISA required the fiduciaries to take action to protect the interests of the plans, their participants and beneficiaries, and that ERISA provides remedies for the failure to have done so.

ERISA's fiduciary obligations are among the "highest known to the law." *Bussian v. RJR Nabisco,* 223 F.3d 235, 294 (5th Cir. 2000). They do not permit fiduciaries to ignore grave risks to plan assets, stand idly by while participants' retirement security is destroyed, and then blithely assert that they had no responsibility for the resulting harm.

Corporate officers who appoint fiduciaries must "ensure that the appointed fiduciary clearly understands his obligations, that he has at his disposal the appropriate tools to perform his duties with integrity and competence, and that he is appropriately using those tools." *Martin v. Harline,* 15 EBC 1138, 1149 (D. Utah 1992).

Section 404(c) plan fiduciaries are still obligated by ERISA's fiduciary responsibility provisions to prudently select the investment options under the Plan and to monitor their ongoing performance.

The Supreme Court has expressly held that a nonfiduciary party-in-interest who has actual or constructive knowledge of the circumstances that made the fiduciary's actions a breach of duty and participates in that breach can be liable for appropriate equitable relief under ERISA.

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Introduction

The primary purpose of this handbook is to outline the *Practices* that define a prudent process for investment fiduciaries. It is intended to be a reference guide for knowledgeable investment decision-makers, as opposed to a "*how to*" manual for persons who are not familiar with basic investment management procedures.

The term *fiduciary* is inclusive of the more than five million people who have the legal responsibility for managing someone else's money, including members of investment committees of retirement plans, foundations, and endowments; trustees of private trusts; and investment advisors. Fiduciary status is determined by facts and circumstances, but generally is defined as a person who:

- Manages property for the benefit of another;
- Exercises discretionary authority or control over assets; and/or
- Acts in a professional capacity of trust, and renders comprehensive and continuous investment advice.

Fiduciaries have the most important, yet most misunderstood role in the investment process: to manage the investment practices, without which the other components of the investment plan can be neither defined, implemented, or evaluated. Statutes, case law, and regulatory opinion letters dealing with fiduciary status further reinforce this important concept.

The legal and practical scrutiny a fiduciary undergoes is tremendous, and it comes from multiple directions and for various reasons. It is likely that complaints and/or lawsuits alleging fiduciary misconduct will increase. Fiduciary liability is not determined by investment performance, but rather by whether prudent investment practices were followed. *It's not whether you win or lose, it's how you play the game.*

A fiduciary demonstrates prudence by the process through which investment decisions are managed, rather than by showing that investment products and techniques are chosen because they were labeled as "prudent." Most investments are not imprudent on their face. It is the way in which they are used, and how decisions as to their use are made, that will be examined to determine whether the prudence standard has been met. Even the most aggressive and unconventional investment can meet that standard if arrived at through a sound process, while the most conservative and traditional one may not measure up if a sound process is lacking.

Primary Duty of the Fiduciary

To *manage* a prudent investment process, without which the components of an investment plan cannot be defined, implemented, or evaluated. Statutes, case law, and regulatory opinion letters dealing with investment fiduciary responsiblity further reinforce this important concept.

On a more positive note, the *Practices* also make good investment sense. The *Practices* provide the foundation and framework for following a disciplined investment process, and help to keep fiduciaries from making *ad hoc* investment decisions influenced by emotions and market noise.

This handbook covers twenty-seven *Practices* that define a prudent investment management process from beginning to end. A second handbook has been published, *Legal Memorandums for Prudent Investment Practices*, which provides the legal memorandums for each of the twenty-seven *Practices*. [The legal memorandums were prepared by the law firm of **Reish Luftman McDaniel & Reicher**. To purchase a copy, contact the **Foundation for Fiduciary Studies** at www.ffstudies.org.]

The legislative basis for each of the twenty-seven *Practices* includes:

ERISA – Employee Retirement Income Security Act (impacts qualified retirement plans).

UPIA – Uniform Prudent Investor Act (impacts private trusts, and may impact foundations and endowments). [See *Comments Section*.]

MPERS – Uniform Management of Public Employee Retirement Systems Act (proposed legislation that may impact state, county, and municipal retirement plans). [See *Comments Section*.]

A distinction will be made between what is required by law and what represents a generally-accepted practice in the investment industry. An **industry best practice** will be highlighted in the margin to distinguish the law from best practice.

Periodically, we will use the term *market segments* to refer to the different types of fiduciary accounts. To simplify this discussion, we have broken the different fiduciary accounts into four groups: (1) individual/family accounts and private trusts; (2) defined benefit plans, in which investment decisions are generally committee-directed; (3) defined contribution plans, in which investment decisions generally are participant-directed; and (4) foundations and endowments.

This handbook is about the *Practices* that a fiduciary should follow to successfully manage investment decisions. By following a structured process based on these *Practices*, the fiduciary can be confident that critical components of an investment strategy are being properly implemented.

Comments Section

Several of the handbook's themes are from ***The Management of Investment Decisions*** *(McGraw-Hill, New York, 1996) by Donald B. Trone, William R. Allbright, and Philip R. Taylor.*

The UPIA was released by the National Conference of Commissioners on Uniform State Laws in 1994, and subsequently approved by the American Bar Association and American Bankers Association. The UPIA serves as a default statute for private trusts. Ordinarily, the provisions of a private trust prevail. If a trust document is silent regarding a particular fiduciary duty, such as the duty to diversify, then the provisions of the UPIA apply.

State Adoptions:

Alaska	Maine	Oklahoma
Arizona	Massachusetts	Oregon
Arkansas	Maryland*	Pennsylvania
California	Michigan	Rhode Island
Colorado	Minnesota	South Carolina
Connecticut	Missouri	Tennessee
District of Columbia	Nebraska	Utah
Hawaii	New Hampshire	Vermont
Idaho	New Jersey	Virginia
Illinois	New Mexico	Washington
Indiana	North Carolina	West Virginia
Iowa	North Dakota	Wyoming
Kansas	Ohio	

**Substantially similar.*
2002 Introductions: Wisconsin

To date, only one state has formally adopted MPERS: South Carolina.

This handbook is not intended to be used as a legal opinion. The fiduciary should discuss the topics with an attorney knowledgeable in this specific area of the law. Nor is this handbook intended to represent specific investment advice.

The scope of this handbook will not include: (1) financial, actuarial, and/or record keeping issues; (2) valuations of closely held stock, limited partnerships, hard assets, insurance contracts, hedge funds, or blind investment pools; (3) risk management issues such as the use of derivative and/or synthetic financial instruments; and/or (4) organizational/structural issues of the fiduciary.

The *Practices* are easily adaptable to all types of portfolios, regardless of size or intended use, and should:

❑ Help to establish evidence that the fiduciary is following a prudent investment process, which may minimize litigation risk.

❑ Serve as a practicum for all parties involved with investment decisions (money managers, investment advisors, consultants, accountants, and attorneys), and provides an excellent educational outline of the duties and responsibilities of investment fiduciaries.

❑ Potentially help increase long-term investment performance by identifying appropriate procedures for:

  – Diversifying the portfolio across multiple asset classes and peer groups;

  – Evaluating investment management fees and expenses;

  – Selecting money managers and/or mutual funds; and/or

  – Terminating money managers and/or mutual funds that no longer are appropriate.

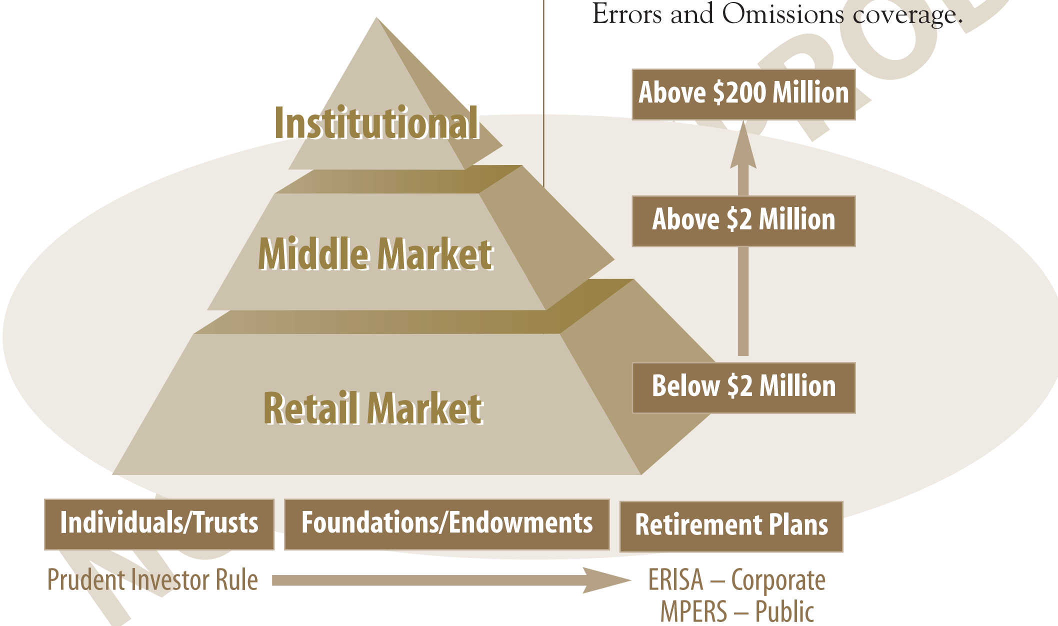
❑ Help uncover investment and/or procedural risks not previously identified, which may assist in prioritizing investment management projects with consultants, advisors, and vendors.

❑ Encourage fiduciaries to compare their practices and procedures with those of their peers.

❑ Assist in establishing benchmarks to measure the progress of an investment committee and/or consultant.

❑ Potentially enable the fiduciary to negotiate a lower insurance premium for Errors and Omissions coverage.

The *Practices* are easily adaptable to all types of portfolios, regardless of size or intended use.



**Several of the benefit concepts were developed by Independent Fiduciary Services, Inc., Washington, D.C. (202) 898-2270.*

Practices Matrix

The twenty-seven *Practices* outlined in this handbook are intended to define a prudent investment process from beginning to end. A *Practices Matrix* has been constructed to facilitate the viewing of the *Practices*.

Referring to the *Practices Matrix* on the inside back cover:

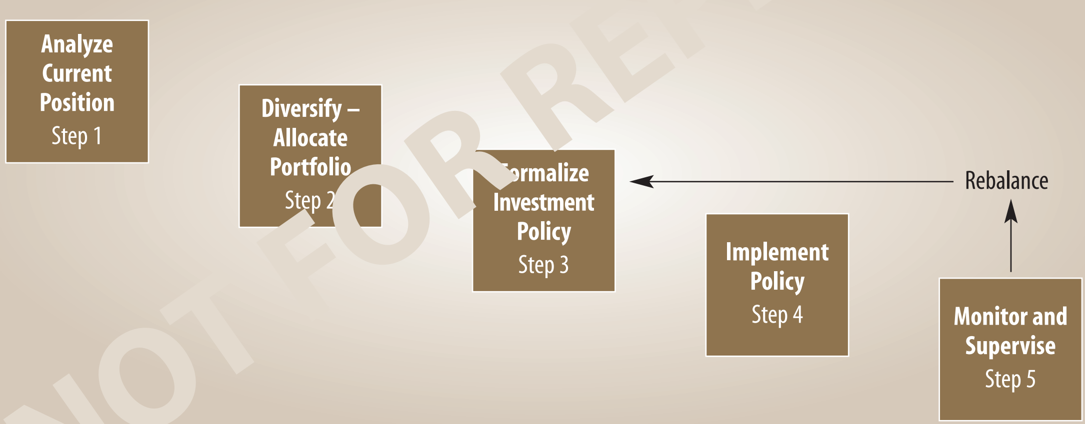
The vertical axis of the *Matrix* is the seven *Uniform Fiduciary Standards of Care*; the standards that are common to the three legislative acts that shape investment fiduciary standards – ERISA, UPIA, and MPERS [See *Introduction*].

Uniform Fiduciary Standards of Care

1. Know standards, laws, and trust provisions.
2. Diversify assets to specific risk/return profile of client.
3. Prepare investment policy statement.
4. Use "prudent experts" (money managers) and document due diligence.
5. Control and account for investment expenses.
6. Monitor the activities of "prudent experts."
7. Avoid conflicts of interest and prohibited transactions.

The Vertical Axis of the Practices Matrix on the inside back cover

Five Step Investment Management Process



The Horizontal Axis of the Practices Matrix on the inside back cover

The horizontal axis of the *Matrix* outlines the steps of a traditional investment management process, which we refer to as the *Five-Step Investment Management Process*.

The *Uniform Fiduciary Standards of Care* [legislated standards] and the *Five-Step Investment Management Process* frame a prudent investment process.

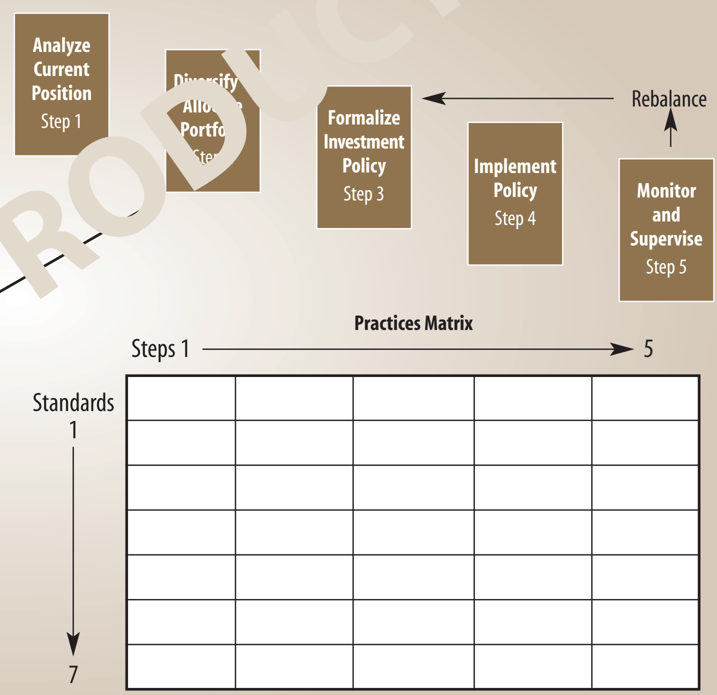
To complete the picture, we have identified the twenty-seven *Practices* that provide the details to this process. For each cell of the *Matrix*, we have identified one or more *Practices*.

Constructing the Practices Matrix

Uniform Fiduciary Standards of Care

1. Know standards, laws, and trust provisions.
2. Diversify assets to specific risk/return profile of client.
3. Prepare investment policy statement.
4. Use "prudent experts" (money managers) and document due diligence.
5. Control and account for investment expenses.
6. Monitor the activities of "prudent experts."
7. Avoid conflicts of interest and prohibited transactions.

Five Step Investment Management Process



The Matrix is constucted by using the "*Five Steps of the Investment Management Process*" as the horizontal axis and the seven "*Uniform Fiduciary Standards of Care*" as the vertical axis.

Practices Associated with Step 1

Analyze Current Position

Practice No. 1.1

Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements

The starting point for the fiduciary is to analyze and review all of the documents pertaining to the establishment and management of the investments. As in managing any business decision, the fiduciary has to set definitive goals and objectives that are consistent with the portfolio's current and future resources; the limits and constraints of applicable trust documents and statutes; and, in the case of individual investors, the goals and objectives of the individual investor. Proof that such a framework has been established presumes written documentation exists in some form.

Substantiating Code, Regulations, and Case Law for Practice No. 1.1:

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38)(C); §104(b)(4); §402(a)(1); §402(b)(1); §402(b)(2); §403(a); §404(a)(1)(D) §404(b)(2)

Regulations
29 C.F.R. §2509.75-5 FR-4; 29 C.F.R. Interpretive Bulletin 75-5; 29 C.F.R. §2509.94-2(2); 29 C.F.R. Interpretive Bulletin 94-2 (July 29, 1994)

Case Law
Morse v. New York State Teamsters Conference Pension and Retirement Fund, 580 F. Supp. 180 (W.D.N.Y. 1983), aff'd, 761 F.2d 115 (2d Cir. 1985); *Winpisinger v. Aurora Corp. of Illinois*, 456 F. Supp. 559 (N.D. Ohio 1978); *Liss v. Smith*, 991 F. Supp. 278, 1998 (S.D.N.Y. 1998); *Dardaganis v. Grace Capital, Inc.*, 664 F. Supp. 105 (S.D.N.Y. 1987), aff'd, 889 F.2d 1237 (2d Cir. 1989)

Other
Interpretive Bulletin 75-5, 29 C.F.R. §2509.75-5; Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2(a) – (d); §4

Management of Public Employee Retirement Systems Act [MPERS]
§4(a) – (d); §7(6); §8(b)

Industry Best Practice

The following documents, at a minimum, should be collected, reviewed, and analyzed:

- A copy of the Investment Policy Statement (IPS), written minutes, and/or files from investment committee meetings. [See also *Practice No. 3.1.*]
- Applicable trust documents (including amendments). [See also *Practice No. 1.2.*]
- Custodial and brokerage agreements. [See also *Practices Nos. 4.4 and 5.3.*]
- Service agreements with investment management vendors (custodian, money managers, investment consultant, actuary, accountant, and attorney). [See also *Practice No. 1.4.*]
- Information on retained money managers; specifically the ADV for each separate account manager and prospectus for each mutual fund. [See also *Practice No. 4.1.*]
- Investment performance reports from money managers, custodian, and/or consultant. [See also *Practice No. 5.1.*]

Practice No. 1.2

Fiduciaries are aware of their duties and responsibilities

A fiduciary is defined as someone acting in a position of trust on behalf of, or for the benefit of, a third party. Fiduciary status is difficult to determine, and is based on *facts and circumstances*. In general, the issue is whether a person has control or influence over investment decisions. It is not uncommon for fiduciaries to be unaware of their status, which is one of the reasons why this *Practice* has been included.

Fiduciaries are responsible for the general management of the investments – in essence, the management of the twenty-seven *Practices* presented in this handbook. If statutes and trust provisions permit, the fiduciary may delegate certain decisions to professional money managers, trustees (co-fiduciaries), and/or investment advisors and consultants. But even when decisions have been delegated to a professional, a fiduciary can never fully abdicate these primary responsibilities:

- Determining investment goals and objectives.
- Choosing an appropriate asset allocation strategy.
- Establishing an explicit, written investment policy consistent with the goals and objectives.
- Approving appropriate money managers, mutual funds, or other "prudent experts" to implement the investment policy.
- Monitoring the activities of the overall investment program for compliance with the investment policy.
- Avoiding conflicts of interest and prohibited transactions.

Substantiating Code, Regulations, and Case Law for Practice No. 1.2:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B)

Case Law
Marshall v. Glass/Metal Association and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378 2 E.B.C. 1006 (D.Hawaii 1980); Katsaros v. Cody, 744 F.2d 270, 5 E.B.C. 1777 (2d Cir. 1984), *cert. denied, Cody v. Donovan*, 469 U.S. 1072, 105 S. Ct. 565, 83 L.Ed. 2d 506 (1984); *Marshall v. Snyder*, 1 E.B.C. 1878 (E.D.N.Y. 1979); *Donovan v. Mazzola*, 716 F.2d 1226, 4 E.B.C. 1865 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040, 104 S. Ct. 704, L.Ed.2d 169 (1984); *Fink v. National Savings and Trust Company*, 772 F. 2d 951, 6 E.B.C. 2269 (D.C. Cir. 1985)

Other
Joint Committee on Taxation, *Overview of the Enforcement and Administration of the Employee Retirement and Income Security Act of 1974* (JCX-16-90, June 6, 1990)

Uniform Prudent Investor Act [UPIA]
§1(a); §2(a); §2(d)

Management of Public Employee Retirement Systems Act [MPERS]
§7

Case Law
National Labor Relations Board v. Amax Coal Co., 453 U.S. 322, 101 S. Ct. 2789, 69 L.Ed. 2d 672 (1981)

Practice No. 1.3

Fiduciaries and parties in interest are not involved in self-dealing

The fundamental duty of the fiduciary is to manage investment decisions for the exclusive benefit of the client, retirement plan participant, and/or trust beneficiary. No one should receive a benefit simply because they are a friend, business associate, and/or relative of the fiduciary.

Substantiating Code, Regulations, and Case Law for Practice No. 1.3:

Internal Revenue Code of 1986, as amended [IRC]
§4975

Employee Retirement Income Security Act of 1974 [ERISA]
§3(14)(A) and (B); §404(a)(1)(A); §406(a) and (b)

Case Law
Whitfield v. Tomasso, 682 F. Supp. 1287, 9 E.B.C. 2438 (E.D.N.Y 1988)

Other
DOL Advisory Council on Employee Welfare and Benefit Plans Report of the Working Group on Soft Dollars and Commission Recapture November 13, 1997

Uniform Prudent Investor Act [UPIA]
§2; §5

Management of Public Employee Retirement Systems Act [MPERS]
§7(1) and (2); §17(c)(12) and (13)

Other
Forbes "Pay for Play," Sept 4, 2000; Plan Sponsor *"Fiduciary Fundamentals"* May 5, 2000, p. 25; *Fortune* "The Seamy Side of Pension Funds," Aug 12, 2002

Industry Best Practice

If a fiduciary even *thinks* he or she may have a conflict of interest – they probably do. The best advice is end it, or avoid it. It's that simple. An excellent question every fiduciary should ask before deciding or voting on an investment issue is: *Who benefits most from this decision?* If the answer is any party other than the client, participant, and/or the beneficiary, the likelihood is the fiduciary is about to breach his or her duties.

Examples of common breaches:

1. Using retirement plan assets to buy real estate for corporate use.
2. Trading a client's account solely to generate additional commissions (also referred to as *churning* a client's account).
3. Using the assets of a public retirement plan to invest in local high-risk business ventures.
4. Using the assets of a private trust to provide unsecured loans to related parties and/or entities of the trustee.
5. Using a company retirement plan as collateral for a line of credit.
6. Buying artwork and/or other collectibles with retirement plan assets, and putting the collectibles on display.

Practice No. 1.4

Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care

A fiduciary is required to prudently manage investment decisions and should seek assistance from outside professionals such as investment advisors/consultants and money managers if the fiduciary lacks the requisite knowledge (assuming trust documents permit the delegation of investment responsibilities). [See also *Practice No. 4.1*.]

The fiduciary should take reasonable steps to protect the portfolio from losses, and to avoid misunderstandings when hiring such professionals. Therefore, fiduciaries should reduce any agreement of substance to writing in order to define the scope of the parties' duties and responsibilities: to ensure that the portfolio is managed in accordance with the written documents that govern the investment strategy; and to confirm that the parties have clear, mutual understandings of their roles and responsibilities.

Substantiating Code, Regulations, and Case Law for Practice No. 1.4:

Employee Retirement Income Security Act of 1974 [ERISA]
§3(14)(B) and (38)(C); §3(38)(C); §402(c)(2); §403(a)(2); §404(a)(1); §408(b)(2)

Case Law
Liss v. Smith, 991 F. Supp. 278 (S.D.N.Y. 1998); *Whitfield v. Tomasso*, 682 F. Supp. 1287, 9 E.B.C. 2438 (E.D.N.Y. 1988)

Other
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2(a); §5; §7; §9(a)(2)

Management of Public Employee Retirement Systems Act [MPERS]
§5(a)(2); §6(b)(2); §7

Practice No. 1.5

There is documentation to show timing and distribution of cash flows and the payment of liabilities

One of the fundamental duties of every fiduciary is to ensure there are sufficient liquid assets to pay bills and liabilities when they come due, and in the case of a foundation or endowment, to provide a specified level of support when it has been promised.

Substantiating Code, Regulations, and Case Law for Practice No. 1.5:

Employee Retirement Income Security Act of 1974 [ERISA]
§402(b)(1); §404(a)

Regulations
29 C.F.R. §2550.404a-1(b)(2)

Other
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2; H.R. Report No. 93-1280, 93d Congress, 2d Session (1974)

Uniform Prudent Investor Act [UPIA]
§1 Comments; §2 Comments; §2(a); §2(b); §2(c)

Case Law
Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830)

Management of Public Employee Retirement Systems Act [MPERS]
§7(1) and (2); §8(a)(1)(E)

Industry Best Practice

It is important that the fiduciary prepare a schedule of the portfolio's anticipated cash flows for the coming five-year period, so that the investment time horizon can be determined. [See also *Practice No. 2.3*.] The time horizon is defined as that point-in-time when more money is flowing out of the portfolio than is coming in from contributions and/or from portfolio growth. If the time horizon is less than five years, it is considered *short*, and if the time horizon is five years or more, it is considered *long*. A *short* time horizon typically is implemented with fixed income and cash, whereas a *long* investment time horizon can be prudently implemented across most asset classes. [See also *Practice No. 2.4*.]

The cash flow schedule also provides the fiduciary with information to more effectively rebalance a portfolio's asset allocation strategy. [See also *Practice No. 3.3*.] As an example, if a particular asset class is outside the range of the investment policy statement's strategic limit, one could use the cash flow information to effectively rebalance the portfolio.

Practice No. 1.6

Assets are within the jurisdiction of U.S. courts, and are protected from theft and embezzlement

The fiduciary has the responsibility to safeguard entrusted assets, which includes keeping the assets within the purview of the U.S. judicial system. This provides a regulatory agency the ability to seize the assets if, in its determination, it is in the best interests of the beneficiaries and/or participants.

In addition, ERISA requires qualified retirement plans to maintain a surety bond to reimburse a plan for losses resulting from dishonest acts. Though not required for all other fiduciaries, it's a good industry practice to maintain similar coverage.

Exception: Investment advisors that are managing the personal assets of an individual client are not precluded from considering the establishment of offshore accounts. The presumption is that federal laws will continue to impose strict reporting and tracking requirements of foreign bank accounts and offshore trusts.

Substantiating Code, Regulations, and Case Law for Practice No. 1.6:

Employee Retirement Income Security Act of 1974 [ERISA]
§ 404(b); § 412(a)

Regulations
29 C.F.R. §2550.404b-1

Case Law
Varity Corporation v. Howe, 516 U.S. 489, 116 S. Ct. 1065, 134 L.Ed.2d 130 (1996)

Other
H.R. Report No. 93-1280 (93rd Congress, 2d Session, August 12, 1974)

Uniform Prudent Investor Act [UPIA]
§2(a); §5; §9(d)

Management of Public Employee Retirement Systems Act [MPERS]
§2(21); §6(e); §7; §11(c) and Comments

Practices Associated with Step 2

Diversify – Allocate Portfolio

Practice No. 2.1

A risk level has been identified

The term *risk* has different connotations, depending on the fiduciary's and/or the investor's frame of reference, circumstances, and objectives. Typically, the investment industry defines risk in terms of statistical measures, such as standard deviation. However, these statistical measures may fail to adequately communicate the potential negative consequences an investment strategy can have on the fiduciary's, or the investor's, ability to meet investment objectives.

Substantiating Code, Regulations, and Case Law for Practice No. 2.1:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B)

Regulations
29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(B)(i-iii)

Case Law
Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313, 23 E.B.C. 1001 (5th Cir.), *reh'g and reh'g en banc denied*, 184 F.3d 820 (5th Cir.), *cert. denied*, 528 U.S. 967, 120 S.Ct. 406, 145 L.Ed.2d 316 (1999); *Chase v. Pevear*, 383 Mass. 350, 419 N.E.2d 1358 (1981)

Uniform Prudent Investor Act [UPIA]
§2(b) and (c); §2 Comments

Management of Public Employee Retirement Systems Act [MPERS]
§8(b); §8 Comments

Industry Best Practice

Simply stated, an investment strategy can fail by being too conservative or too aggressive. A fiduciary could adopt a very safe investment strategy by keeping a portfolio in cash, but then see the portfolio's purchasing power whither under inflation. Or, a fiduciary could implement a long-term growth strategy that overexposes a portfolio to equities, when a more conservative fixed-income strategy would have been sufficient to cover the identified goals and objectives.

Practice No. 2.2

An expected, modeled return to meet investment objectives has been identified

There is no requirement, or expectation, that the fiduciary forecast future returns. Rather, the fiduciary is required to state the presumptions that are being used to *model* the probable outcomes of a given investment strategy. In this context, the term *model* means to replicate; to determine the probable returns of an investment strategy given current and historical information.

The fiduciary should determine whether trust documents, spending policies, and/or actuarial reports (for defined benefit retirement plans) establish a minimum investment return expectation or requirement. In all cases, the fiduciary should determine the expected return a given investment strategy is designed to produce.

Substantiating Code, Regulations, and Case Law Practice No. 2.2:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(A) and (B)

Regulations
29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(A)

Case Law
Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944); *Communications Satellite Corporation v. Federal Communications Commission*, 611 F.2d 883 (D.C. Cir. 1977); *Tennessee Gas Pipeline Company v. Federal Energy Regulatory Commission*, 926 F.2d 1206 (D.C. Cir. 1991)

Uniform Prudent Investor Act [UPIA]
§2(b); §2(c)(1-8)

Management of Public Employee Retirement Systems Act [MPERS]
§8(a)(1)(A-F); §8(b)

Practices Associated with Step 2

Diversify – Allocate Portfolio

Practice No. 2.3

An investment time horizon has been identified

It is important that the fiduciary prepare a schedule of the portfolio's anticipated cash flows so that the portfolio's investment time horizon can be identified. [See also *Practice No. 1.5*.]

Substantiating Code, Regulations, and Case Law Practice No. 2.3:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B)

Regulations
29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(A)

Case Law
Metzler v. Graham, 112 F.3d 207, 20 E.B.C. 2857 (5th Cir. 1997)

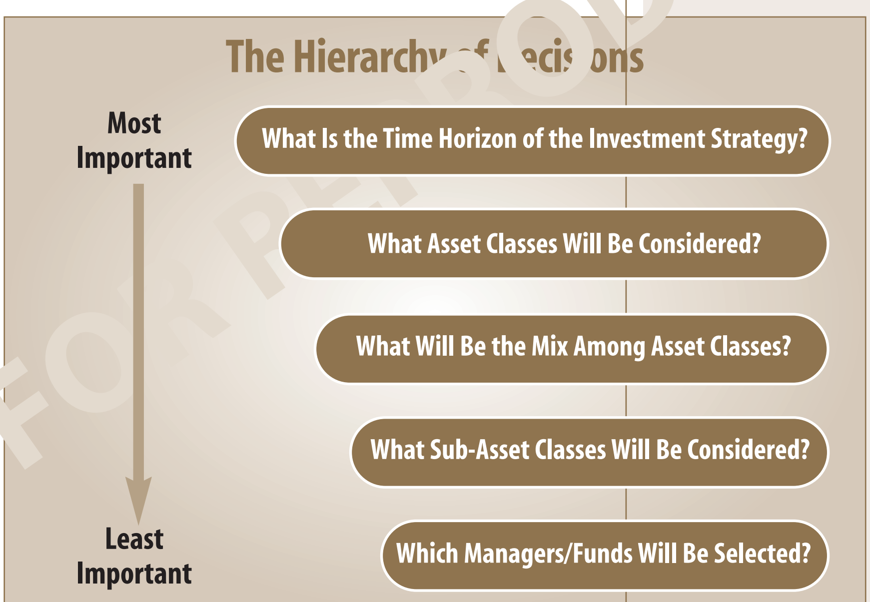
Other
Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1; H.R. Report No. 1280, 93d Congress, 2d Session (1974)

Uniform Prudent Investor Act [UPIA]
§2(a); §2(b)

Management of Public Employee Retirement Systems Act [MPERS]
§8; §10(b)

Industry Best Practice

One of the most important decisions the fiduciary has to manage is the determination of the time horizon. Based on the time horizon, the fiduciary then can determine which asset classes can be appropriately considered; what the allocation should be between the selected asset classes; whether there should be an allocation made among sub-asset classes; and, finally, which money managers or mutual funds should be retained to manage each asset class.



Practice No. 2.4

Selected asset classes are consistent with the identified risk, return, and time horizon

The fiduciary's role is to choose the appropriate combination of asset classes that optimizes the identified risk and return objectives, consistent with the portfolio's time horizon. [See also *Practices Nos. 2.1 – 2.3*.] The fiduciary's choice of asset classes and their subsequent allocation will have more impact on the long-term performance of the investment strategy than all other decisions. The fiduciary's role is to choose the appropriate combination of assets that optimizes (or approximately optimizes) a return [*Practice No. 2.2*.] subject to a particular level of risk [*Practice No. 2.1*.].

Substantiating Code, Regulations, and Case Law for Practice No. 2.4:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B)

Regulations
29 C.F.R. §2550.404a-1; 29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)(B)(i-iii)

Case Law
GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729 (11th Cir. 1990); *Leigh v. Engle*, 858 F.2d 361 (7th Cir. 1988)

Other
Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1

Uniform Prudent Investor Act [UPIA]
§2(b)

Management of Public Employee Retirement Systems Act [MPERS]
§8(b)

Asset Allocation Variables

- **T** Tax Status
- **R** Risk Level
- **E** Expected Return
- **A** Asset Class Preference
- **T** Time Horizon

Practice No. 2.5

The number of asset classes is consistent with portfolio size

There is no formula the fiduciary can follow to determine the *best* number of asset classes – the *appropriate* number is determined by facts and circumstances. How many asset classes should be considered? Or in the case of participant-directed retirement plans, how many investment options should be offered? The answer is dependent upon the:

- Size of the portfolio
- Investment expertise of the investment decision-makers
- Ability of the decision-makers to properly monitor the strategies and/or investment options
- Sensitivity to investment expenses – more asset classes and/or options may mean higher portfolio expenses. The additional *costs* of added diversification should be evaluated in light of the *price* the fiduciary pays for being less-diversified.

Substantiating Code, Regulations, and Case Law for Practice No. 2.5:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(C)

Other
H.R. Report No. 1280, 93rd Congress, 2d Sess.304, reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Uniform Prudent Investor Act [UPIA]
§2(b)

Other
Restatement of Trusts 3d: Prudent Investor Rule §227, comment

Management of Public Employee Retirement Systems Act [MPERS]
§8(a)(1); §8(a)(4); §10(2)

Practice No. 3.1

There is detail to implement a specific investment strategy

The preparation and maintenance of the investment policy statement ("IPS") is one of the most critical functions of the fiduciary. The IPS should be viewed as the business plan and the essential management tool for directing and communicating the activities of the portfolio. It is a formal, long-range, strategic plan that allows the fiduciary to coordinate the management of the investment program in a logical and consistent framework. All material investment facts, assumptions, and opinions should be included.

The IPS should have sufficient detail that a third party would be able to implement the investment strategy; be flexible enough that it can be implemented in a complex and dynamic financial environment; and yet not be so detailed it requires constant revisions and updates. The IPS should combine elements of planning and philosophy, and should address the management of each of the Uniform Fiduciary Standards of Care (vertical axis of the *Practices Matrix*).

Addendums should be used to identify information that will change on a more frequent basis such as the names of board members, accountant, attorney, actuary, and money managers/mutual funds; and the capital markets assumptions used to develop the plan's asset allocation.

Substantiating Code, Regulations, and Case Law for Practice No. 3.1:

Employee Retirement Income Security Act of 1974 [ERISA]

Other
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2(b); §4

Other
Restatement of Trusts 3d: Prudent Investor Rule §227(a)

Management of Public Employee Retirement Systems Act [MPERS]
§8(b)

Industry Best Practice

The fiduciary is required to manage investment decisions with a reasonable level of detail. By reducing that detail to writing, preparing a written IPS, the fiduciary can: (1) avoid unnecessary differences of opinion and the resulting conflicts; (2) minimize the possibility of missteps due to a lack of clear guidelines; (3) establish a reasoned basis for measuring their compliance; and, (4) establish and communicate reasonable and clear expectations with participants, beneficiaries, and investors.

Practice No. 3.2

The investment policy statement defines the duties and responsibilities of all parties involved

There are numerous parties involved in the investment process, and each should have their specific duties and requirements detailed in the IPS. This ensures continuity of the investment strategy when there is a change in fiduciaries; helps to prevent misunderstandings between parties; and helps to prevent omission of critical fiduciary functions. The IPS should include sections on:

- The role of the investment committee [See also *Practice No. 1.2*.]
- The role of the investment consultant (if one is retained)
- The role of the custodian [See also *Practice No. 4.4*.]
- The role of the separate account manager(s). [See also *Practice No. 4.1*.] [Not necessary for mutual funds, since the investment strategy of the fund already is specified in the fund's prospectus.] The instructions for the money manager should include: (a) Securities guidelines; (b) Responsibility to seek *best price and execution* on trading the securities [See also *Practice No. 5.3*.] (c) Responsibility to account for *soft dollars* [See also *Practice No. 5.3*.]; and (d) Responsibility to vote all proxies [See also *Practice No. 5.3*.].

Substantiating Code, Regulations, and Case Law for Practice No. 3.2:

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38)(c); §402(a)(1); §402(b)(2) and (3); §403(a)(2)
§405(c)(1)

Uniform Prudent Investor Act [UPIA]
§9(a)(1) and (2)

Other
Restatement of Trusts 3d: Prudent Investor Rule §171 (1992)

Management of Public Employee Retirement Systems Act [MPERS]
§6(a) and (b); §8(b)

Industry Best Practice

Rebalancing is inherent to the element of diversification, where the goal is to create a portfolio that balances appropriate levels of risk and return. That balance, once achieved, only can be maintained by periodically rebalancing the portfolio to maintain the appropriate diversification.

The rebalancing limits define the points when a portfolio should be reallocated to bring it back in line with the established asset allocation target. The discipline of rebalancing, in essence, controls risk and forces the portfolio to move along a predetermined course. It takes gains from stellar performers or favored asset classes, and reallocates them to lagging styles, without attempting to time the market.

The process of setting an appropriate rebalancing limit is somewhat subjective. Ordinarily, rebalancing limits of plus-or-minus five percent should keep the parameters tight enough to maintain the risk/return profile of the strategy, yet require rebalancing only once or twice a year. When it is necessary to rebalance, the fiduciary should determine the cash flows over the next quarter to determine if the portfolio can be rebalanced with contributions or disbursements. [See also *Practice No. 1.5*.]

Practice No. 3.3

The investment policy statement defines diversification and rebalancing guidelines

One of the challenges of writing a complete IPS is to create investment guidelines specific enough to clearly establish the parameters of the desired investment process, yet provide enough latitude so as not to create an oversight burden. This is particularly true when establishing the portfolio's asset allocation and rebalancing limits. The strategic asset allocation is a specific mix of asset classes that meets the mutually agreed upon risk/return profile of the investor or investment committee. [See also *Practice No. 2.4*.]

Substantiating Code, Regulations, and Case Law for Practice No. 3.3:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(C)

Regulations
29 C.F.R. §2550.404a-1(b)(2)(i)

Case Law
Leigh v. Engle, 858 F.2d 361, 10 E.B.C. 1041 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078, 109 S.Ct. 1528, 103 L.Ed.2d 833 (1989)

Other
H.R. Report No. 1280, 93rd Cong. 2d Sess. 304, reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Uniform Prudent Investor Act [UPIA]
§2; §3 and Comments

Management of Public Employee Retirement Systems Act [MPERS]
§8 and Comments

Other
Restatement of Trusts 3d: Prudent Investor Rule §227, comment g

Practice No. 3.4

The investment policy statement defines due diligence criteria for selecting investment options

A well-written IPS can serve to insulate the fiduciary from the temptation to chase the latest top performing assets class or hot manager on Wall Street. By establishing specific asset allocation parameters and money manager (or mutual fund) selection criteria, it is much easier to determine whether a prospective manager fits into the approved investment program. [See also *Practices Nos. 2.4 and 4.1*.]

Substantiating Code, Regulations, and Case Law for Practice No. 3.4:

Employee Retirement Income Security Act of 1974 [ERISA]
§402(c)(3); §404(a)(1)(B)

Regulations
29 C.F.R. §2550.404a-1(b)(1)(A); 29 C.F.R. §2550.404a-1(b)(2)

Case Law
In re Unisys Savings Plan Litigation, 74 F.3d 420, 19 E.B.C. 2393 (3rd Cir.), *cert. denied*, 510 U.S. 810, 117 S.Ct. 56, 136 L.Ed.2d 19 (1996)

Other
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2(a); §4

Management of Public Employee Retirement Systems Act [MPERS]
§8(b); §8(a)

Industry Best Practice

There is no statutory requirement for fiduciaries to define due diligence criteria for the selection of money managers; however, it is implicit in other fiduciary requirements and ERISA case law. As a practical matter, these provisions require a fiduciary to define the due diligence process and criteria for selecting investment options.

The fiduciary should investigate the qualities, characteristics, and merits of each money manager; and identify the role each plays in the furtherance of the investment strategy. However, such an investigation and the related analysis cannot be conducted in a vacuum – it must be within the context of the needs of the investment strategy. Once the needs have been defined, and the general strategies developed, specific money managers should be chosen within the context of this strategy.

Industry Best Practice

- *Periodically* [quarterly], a performance report should be prepared indicating how well selected managers and/or funds are performing relative to the objectives set forth in the IPS, against their peers, and against an appropriate index. [See also *Practice No. 5.1*.]
- *Periodically* [annually], the IPS should be reviewed to determine whether there have been any material changes to the goals and objectives, or to the risk/return profile. [See also *Practice Nos. 1.1 and 2.4*.]
- The custodial statement should be reviewed for accuracy and to determine whether hired money managers are continuing to seek best execution on trades. [See also *Practice No. 5.3*.]
- Specific performance criteria and objectives should be identified for each money manager and/or mutual fund. When performance criteria are agreed upon in advance, it is easier for the fiduciary to identify when a manager or fund should be replaced.

Practice No. 3.5

The investment policy statement defines monitoring criteria for investment options and service vendors

The fiduciary duty to monitor the performance of investment managers and other service providers is inherent in the obligations of fiduciaries to act prudently in carrying out their duties. The investment management process triggers a number of reviews of the numerous parties involved in the investment process.

Substantiating Code, Regulations, and Case Law for Practice No. 3.5:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)

Case Law
Morrissey v. Curran, 567 F.2d 546, 1 E.B.C. 1659 (2nd Cir. 1977); *Harley v. Minnesota Mining and Manufacturing Company*, 42 F. Supp.2d 898 (D.Minn. 1999), *aff'd*, 284 F.3d 901 (8th Cir. 2002); *Whitfield v. Cohen*, 682 F. Supp. 188, 9 E.B.C. 1739 (S.D.N.Y. 1988); *Liss v. Smith*, 991 F.Supp. 278 (S.D.N.Y. 1988)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8; Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2(2)

Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1(e)

Uniform Prudent Investor Act [UPIA]
§9(a)(1), (2) and (3)

Management of Public Employee Retirement Systems Act [MPERS]
§6(b)(2) and (3); §8(b)

Practice No. 3.6

The investment policy statement defines procedures for controlling and accounting for investment expenses

The fiduciary must establish procedures for controlling and accounting for investment expenses in order to fulfill the obligation to manage investment decisions with the requisite level of care, skill, and prudence; and to fulfill the specific obligation of the fiduciary to pay only reasonable and necessary expenses.

Substantiating Code, Regulations, and Case Law Practice No. 3.6:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(A)(i and ii); §406(a)(1)(C); §408(b)(2)

Case Law
Liss v. Smith, 991 F. Supp. 278 (S.D.N.Y. 1998)

Other
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2 Comments; §2(a); §7

Other
OCC Interpretive Letter No. 722 (March 12, 1996), citing the Restatement of Trusts 3d: Prudent Investor Rule §227, comment m at 58 (1992)

Management of Public Employee Retirement Systems Act [MPERS]
§7(2), (3) and (5); §7(5) and Comments; §8(b) and Comments

Industry Best Practice

Investment management costs and expenses can be broken down into four categories, and the IPS should contain instructions and procedures on how these fees and expenses will be accounted for and monitored. The fiduciary should examine:

- Money manager fees and/or the annual expenses of mutual funds
- Trading costs, including commission charges and execution expenses
- Custodial charges including custodial fees, transaction charges, and cash management fees
- Consulting and administrative costs and fees.

Industry Best Practice

The key to successfully incorporating a SRI strategy is for the fiduciary to demonstrate that prospective investment results were not negatively impacted. It has become a generally accepted practice to permit the inclusion of a SRI strategy as a secondary screen to a normal (unrestricted) investment process. If there are equally attractive investment options, then social factors may be considered.

For fiduciaries guided by the UPIA, there are three notable exceptions:

- The trust documents establishing the private trust, foundation, or endowment permit the use of SRI
- A donor directs the use of a SRI Strategy
- A reasonable person would deduce from the foundation's/endowment's mission that SRI would be adopted.

Practice No. 3.7

The investment policy statement defines appropriately structured, socially responsible investment strategies (when applicable)

There is an increasing interest by fiduciaries to incorporate social, ethical, moral, and/or religious criteria into their investment strategy. The desire is to align investment decisions with the fiduciary's, investor's, and/or the beneficiary's core values. There are two terms that are used interchangeably by the industry; mission-based investing, and socially responsible investing (SRI).

However worthwhile or well-intended, fiduciary standards of care cannot be abrogated to accommodate the pursuit of a SRI strategy. As a general rule, any restriction on an investment program has the potential to reduce the portfolio's total return – itself a breach of fiduciary responsibility.

Substantiating Code, Regulations, and Case Law for Practice No. 3.7:

Employee Retirement Income Security Act of 1974 [ERISA]
§403(c)(1); §404(a)(1)

Other
ERISA Opinion Letter 98-04A (May 28, 1998); Interpretive Bulletin 94-1, 29 C.F.R. §2509.94-1

Uniform Prudent Investor Act [UPIA]
§2(a); §2(c); §5

Management of Public Employee Retirement Systems Act [MPERS]
§7(1), (2) and (3); §8(a) (1) and (2); §8(a)(5); §8(b)

Practice No. 4.1

The investment strategy is implemented in compliance with the required level of prudence

Fiduciary law does not expressly require the use of professional money managers. However, fiduciaries will be held to the same expert standard of care, and their activities and conduct will be measured against those of investment professionals.

Substantiating Code, Regulations, and Case Law No. 4.1:

Employee Retirement Income Security Act of 1974 [ERISA]
§402(c)(3); §403(a)(1) and (2); §404(a)(1)(B)

Regulations
29 C.F.R. §2550.404a-1(b)(1) and (2)

Case Law
Howard v. Shay, 100 F.3d 1484, 20 E.B.C. 2097 (9th Cir. 1996), *cert. denied*, 520 U.S. 1237, 117 S.Ct. 1838, 137 L.Ed.2d 1042 (1997); *Fink v. National Savings and Trust Co.*, 772 F.2d 951 (D.C. Cir. 1985); *Katsaros v. Cody*, 744 F.2d 270, 5 E.B.C. 1777 (2nd Cir.), *cert. denied*, 469 U.S. 1072, 105 S.Ct. 565, 83 L.Ed.2d 506 (1984); *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040, 104 S.Ct. 704, 79 L.Ed.2d 169 (1984); *United States v. Mason Tenders Dist. Council of Greater New York*, 909 F. Supp. 882, 19 E.B.C. 1467 (S.D.N.Y. 1995); *Trapani v. Consolidated Edison Employees' Mutual Aid Society*, 693 F. Supp. 1509 (S.D.N.Y. 1988)

Uniform Prudent Investor Act [UPIA]
§2(c); §2(f); §9(a)(1-3)

Management of Public Employee Retirement Systems Act [MPERS]
§6(a); §6(b)(1); §6(b)(3); §7(3); §8(a)(1)

Industry Best Practice

The prudent fiduciary is strongly encouraged to follow the time-proven maxim of doing what one does best and delegating (when trust documents permit) the rest to professionals.

Whether investment decisions are delegated to professionals (strongly encouraged) or retained by the fiduciary, the fiduciary should demonstrate that a due diligence process was followed in selecting each investment option.

Suggested Due Diligence

1. Performance relative to peer group
2. Performance relative to assumed risk
3. Inception date of product
4. Correlation to specified index
5. Assets under management
6. Holdings consistent with style
7. Expense ratios or fees
8. Stability of the organization.

Practice No. 4.2

The fiduciary is following applicable "Safe Harbor" provisions (when elected)

Safe harbor rules are voluntary, but when adopted, the fiduciary's liabilities associated with the management of the portfolio's assets may be reduced. If investment decisions are being managed by a committee and/or by an investment advisor, then there are five generally recognized provisions to the *safe harbor rules:*

1. Use prudent experts to make the investment decisions.
2. Demonstrate that the prudent expert was selected by following a due diligence process.
3. Give the prudent expert discretion over the assets.
4. Have the prudent expert acknowledge their co-fiduciary status.
5. Monitor the activities of the prudent expert to ensure that the expert is performing the agreed upon tasks. [See also *Practice Nos. 5.1 – 5.5*.]

When investment decisions are participant-directed, as often is the case for defined contribution plans [401(k) plans], then there are *additional* provisions.

1. Plan participants must be notified that the plan sponsor intends to constitute a 404(c) plan.
2. Participants must be provided at least three different investment options.
3. Participants must receive information and education on the different investment options.
4. Participants must be provided the opportunity to change their investment strategy/allocation with a frequency that is appropriate in light of market volatility.

Substantiating Code, Regulations, and Case Law for Practice No. 4.2:

Employee Retirement Income Security Act of 1974 [ERISA]
§402(c)(3); §404(a) and (c); §405(d)(1)

Regulations
29 C.F.R. §2550.404a-1; 29 C.F.R. §2550.404a-1(b)(1) and (2)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q); Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2; DOL Miscellaneous Document, 4/13/98 – Study of 401(k) Plan Fees and Expenses; Fed. Reg., Vol. 44, p. 37255

Uniform Prudent Investor Act [UPIA]
§9(a); §9(c)

Management of Public Employee Retirement Systems Act [MPERS]
§6(b); §6(d)

Practices Associated with Step 4

Implement Investment Policy

Practice No. 4.3

Investment vehicles are appropriate for the portfolio size

The primary focus of this *Practice* is the implementation of the investment strategy with appropriate investment vehicles; specifically the proper use of mutual funds and separate account managers. A challenging question for most fiduciaries is: *At what point should there be a migration from mutual funds to separate account managers?* It is important for the fiduciary to be familiar with both mutual funds and separate account managers, for no one implementation structure is right for *all* occasions.

Substantiating Code, Regulations, and Case Law for Practice No. 4.3:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B); §404(a)(1)(C)

Regulations
29 C.F.R. §2550.404c-1(b)(3)(i)(C)

Case Law
Metzler v. Graham, 112 F.3d 207, 20 E.B.C. 2857 (5th Cir. 1997); *Marshall v. Glass/Metal Ass'n and Glaziers and Glassworkers Pension Plan*, 507 F. Supp. 378 (D.Hawaii 1980); *GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc.*, 10 E.B.C. 2290 (S.D.Ga. 1989); *aff'd*, 895 F.2d 729 (11th Cir. 1990); *Leigh v. Engle*, 858 F.2d 361, 10 E.B.C. 1041 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078, 109 S.Ct. 1528, 103 L.Ed.2d 833 (1989)

Other
H.R. Report No. 1280, 93rd Congress, 2d Sess. (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Uniform Prudent Investor Act [UPIA]
§2(a); §3; §3 Comments

Management of Public Employee Retirement Systems Act [MPERS]
§7(3); §8(a)(1)

Contrasting Money Manager Structures

No one structure is "right" for all occasions.

Mutual Funds

1. Greater liquidity – ease in entering and exiting.
2. Requires smaller dollar amounts to open accounts.
3. Ease in putting cash to work while money is in transition.
4. Greater degree of diversification.
5. Ease in meeting asset allocation and rebalancing guidelines.
6. Ease in due diligence with data bases.
7. Ease in implementing international portfolios in countries that have stiff registration and tax laws.
8. Information is required to be audited.
9. Greater cash-flows may meet disbursement requirements in lieu of liquidating positions.
10. Fees may be netted from distributions, reducing taxable income by equivalent amount.

Separate Accounts

1. Can be funded with securities-in-kind – assets with low or preferred tax basis.
2. Eliminates phantom tax consequences associated with funds.
3. Permits for year-end tax harvesting.
4. Easier to ascertain which securities are in the portfolio.
5. Ease in reducing total fees as account size grows.
6. Brokerage can be directed for soft dollar or commission recapture programs.
7. Manager can be given specific securities guidelines – SRI.
8. Management fees may be deductible (subject to 2% minimum threshold) as part of the investor's miscellaneous itemized deductions.

Industry Best Practice

At the retail level, the custodian typically is a brokerage firm. Most securities are held in street name, with the assets commingled with those of the brokerage firm. To protect the assets, brokerage firms obtain insurance from the Securities Investor Protection Corporation (SIPC).

Most institutional investors choose to use trust companies as custodians. The primary benefit is that the assets are held in a separate account, and are not commingled with other assets of the institution.

Practice No. 4.4

A due diligence process is followed in selecting service providers, including the custodian

Custodial selection is a very important fiduciary function. Most fiduciaries abdicate the decision to a vendor, advisor, or money manager. Yet, as with other prudent practices, there are a number of important decisions that need to be managed.

The role of the custodian is to: (1) Hold securities for safekeeping; (2) Report on holdings and transactions; (3) Collect interest and dividends; and, (4) If required, effect trades.

Substantiating Code, Regulations, and Case Law for Practice No. 4.4:

Employee Retirement Income Security Act of 1974 [ERISA]
§402(a)(1); §402(b)(2); §404(a)(1)(B)

Other
Interpretive Bulletin 96-1, 29 C.F.R. §2509.96-1; DOL Information Letter, Qualified Plan Services (7/28/98); DOL Information Letter, Service Employee's International Union (2/19/98)

Uniform Prudent Investor Act [UPIA]
§2(a); §7; §7 Comments; §9(a) (1), (2) and (3)

Management of Public Employee Retirement Systems Act [MPERS]
§6(a) and (b)(1) and (2); §7

Monitor and Supervise

Practice No. 5.1

Periodic reports compare investment performance against an appropriate index, peer group, and IPS objectives

The monitoring function extends beyond a strict examination of performance; by definition, monitoring occurs across all policy and procedural issues previously addressed in this handbook. The ongoing review, analysis, and monitoring of investment decision-makers, and/or money managers, is just as important as the due diligence implemented during the manager selection process.

In keeping with the duty of prudence, a fiduciary appointing a money manager must determine the frequency of the reviews necessary, taking into account such factors as: (1) the general economic conditions then prevailing; (2) the size of the portfolio; (3) the investment strategies employed; (4) the investment objectives sought; and, (5) the volatility of the investments selected.

Substantiating Code, Regulations, and Case Law for Practice No. 5.1:

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(c)(3)

Case Law
Leigh v. Engle, 727 F.2d 113 , 4 E.B.C. 2702(7th Cir. 1984);
Atwood v. Burlington Indus. Equity, Inc., 18 E.B.C. 2009 (M.D.N.C. 1994)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q);
Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2

Uniform Prudent Investor Act [UPIA]
§2(a); §9(a) (1 – 3)

Management of Public Employee Retirement Systems Act [MPERS]
§6(a) and (b)(1 – 3); §6 Comments; §6(d); §8(b)

Industry Best Practice

The fiduciary should establish performance objectives for each investment decision-maker, and/or money manager, and record the same in the investment policy statement. Investment performance should be evaluated in terms of an appropriate market index, and the relevant peer group.

The investment policy statement also should describe the actions to be taken when an investment decision-maker fails to meet the established criteria. [See also *Practice No. 3.5*.] The fiduciary should acknowledge that fluctuating rates of return characterize the securities markets, and may cause variations in performance. The fiduciary should evaluate performance from a long-term perspective, ordinarily defined as two-to-three years.

There often will be times when a money manager is beginning to exhibit shortfalls in the defined performance objectives but, in the opinion of the fiduciary, does not warrant termination. In such situations, the fiduciary should establish in the investment policy statement specific *Watchlist* procedures. The decision to retain or terminate a manager cannot be made by a formula. It is the fiduciary's confidence in the money manager's ability to perform in the future that ultimately determines the retention of a money manager.

Industry Best Practice

In addition to the quantitative review of the investment decision-maker, [See also *Practice No. 5.1*.] periodic reviews of the qualitative performance and/or organizational changes to the investment manager should be made at reasonable intervals. On a periodic basis [quarterly] the fiduciary should review whether each investment decision-maker continues to meet the performance objectives, specifically:

- The manager's adherence to the guidelines established by the investment policy statement.
- Material changes in the manager's organization, investment philosophy, and/or personnel.
- Any legal, SEC, and/or other regulatory agency proceedings that may affect the manager.

Practice No. 5.2

Periodic reviews are made of qualitative and/or organizational changes of investment decision-makers

The fiduciary has a continuing duty to exercise reasonable care, skill, and caution in monitoring the performance of investment decision-makers, particularly when investment duties have been delegated to a money manager. The fiduciary's review of a money manager must be based on more than recent investment performance results, for all professional money managers will experience periods of poor performance. Fiduciaries also should not be lulled into rethinking their manager lineup simply because of the reported success of other managers.

Substantiating Code, Regulations, and Case Law for Practice No. 5.2:

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(c)(3); §404(a)(1)(B)

Regulations
29 C.F.R. §2550.408b-2(d); 29 C.F.R. §2550.408c-2

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8; Booklet: A Look at 401(k) Plan Fees, U.S. Department of Labor, Pension and Welfare Benefits Administration

Uniform Prudent Investor Act [UPIA]
§2(a); §7; §9(a)

Management of Public Employee Retirement Systems Act [MPERS]
§6(a) and (b)(1 - 3); §7(5)

Practices Associated with Step 5

Monitor and Supervise

Practice No. 5.3

Control procedures are in place to periodically review policies for best execution, soft dollars, and proxy voting

The fiduciary has a responsibility to control and account for investment expenses – that the expenses are prudent and are applied in the best interests of the investor, participant (in the case of a retirement plan), or beneficiary (in the case of a private trust, foundation, or endowment). The fiduciary, therefore, must monitor that:

Best execution practices are followed in securities transactions. The fiduciary has an ongoing responsibility to determine that the investment decision-maker is seeking *best execution* in trading the portfolio's securities. In seeking *best execution*, money managers are required to *shop* their trades with various brokerage firms, taking into consideration: (1) commission costs; (2) an analysis of the actual execution price of the security; and, (3) the quality and reliability (timing) of the trade.

Soft dollars are expended only for brokerage and research for the benefit of the investment program, and are reasonable in relation to the value of such services. *Soft dollars* represent the excess in commission costs; the difference between what a brokerage firm charges for a trade versus the brokerage firm's actual costs. The failure of the fiduciary to monitor *soft dollars* may subject the investment program to expenditures which yield no benefit, itself a fiduciary breach.

Proxies are voted in a manner most likely to preserve or enhance the value of the subject stock. The fiduciary can either retain the power to vote the proxies, or instruct the money manager to vote on behalf of the fiduciary.

Substantiating Code, Regulations, and Case Law for Practice No. 5.3:

Employee Retirement Income Security Act of 1974 [ERISA]
§3(38); §402(c)(3); §403(a)(1) and (2); §404(a)(1)(A) and (B)

Case Law
Herman v. NationsBank Trust Co., (Georgia), 126 F.3d 1354, 21 E.B.C. 2061 (11th Cir. 1997), *reh'g denied*, 135 F.3d 1409 (11th Cir.), *cert. denied*, 525 U.S. 816, 19S.Ct. 54, 142 L.Ed.2d 42 (1998)

Other
Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q); Interpretive Bulletin 94-2, 29 C.F.R. §2509.94-2(1); DOL Prohibited Transaction Exemption 75-1, Interim Exemption, 40 Fed. Reg. 5201 (Feb. 4, 1975); DOL Information Letter, Prescott Asset Management (1/17/92) (fn. 1); DOL Information Letter, Refco, Inc. (2/13/89); ERISA Technical Release 86-1 (May 22, 1986)

Uniform Prudent Investor Act [UPIA]
§2(a); §2(d); §7; §9(a)

Management of Public Employee Retirement Systems Act [MPERS]
§6(2) and (3); §7(5); §8(a)(3)

Industry Best Practice

Typically, only the largest of fiduciary portfolios elect to take responsibility for voting their proxies. The majority of fiduciaries delegate that responsibility to the money manager via instructions in the investment policy statement. [See also *Practice No. 3.2*.]

Industry Best Practice

Money manager fees vary widely, depending on the asset class to be managed, the size of the account, and whether the funds are to be managed separately or placed into a commingled or mutual fund. Fees usually are charged in terms of basis points (100 basis points = 1.0%) and are applied to the market value of the portfolio at the end/beginning of a calendar quarter. Fees often decline with increasing asset size.

Practice No. 5.4

Fees for investment management are consistent with agreements and with the law

The fiduciary's responsibility in connection with the payment of fees is to determine: (1) whether the fees can be paid from portfolio assets [See also *Practice No. 1.1*.]; and (2) whether the fees are reasonable in light of the services to be provided. [See also *Practice No. 1.4*.] Accordingly, the fiduciary must negotiate all forms of compensation to be paid for investment management to ensure that the aggregate (and individual components) is reasonable compensation for the services rendered.

Substantiating Code, Regulations, and Case Law for Practice No. 5.4:

Employee Retirement Income Security Act of 1974 [ERISA]
§3(14)(B); §404(a)(1)(A), (B) and (D); §406(a)

Regulations
29 C.F.R. §2550.408(b)(2)

Other
Booklet: A Look at 401(k) Plan Fees, U.S. Department of Labor, Pension and Welfare Benefits Administration; DOL Advisory Opinion Letter (7/28/98) 1998 WL 1638072; DOL Advisory Opinion Letter 89-28A (9/25/89) 1989 WL 435076; Interpretive Bulletin 75-8, 29 C.F.R. §2509.75-8 (FR-17Q)

Uniform Prudent Investor Act [UPIA]
§2(a); §7 and Comments; §9 Comments

Management of Public Employee Retirement Systems Act [MPERS]
§7(2) and (5); §7 Comments

Practice No. 5.5

"Finder's fees," 12b-1 fees, or other forms of compensation that have been paid for asset placement are appropriately applied, utilized, and documented

The fiduciary has a duty to account for all dollars spent on investment management services, whether those dollars are paid directly from the account or through *soft dollars*, 12b-1 fees, or other fee-sharing arrangements. In addition, the fiduciary has the responsibility to identify those parties that have been compensated from the fees, and to apply a *reasonableness* test to the amount of compensation received by any party.

In the case of an *all-inclusive fee* (sometimes referred to as a bundled or wrap fee) investment product the fiduciary should investigate how the various service vendors associated with each component of the *all-inclusive fee* are compensated to ensure that no one vendor is receiving unreasonable compensation, and to compare the costs of the same services on an *a la carte* basis.

Substantiating Code, Regulations, and Case Law for Practice No. 5.5:

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(A) and (B);§406(a)(1); §406(b)(1); §406(b)(3)

Case Law
Brock v. Robbins, 830 F.2d 640, 8 E.B.C. 2489 (7th Cir. 1987)

Other
DOL Advisory Opinion Letter 97-15A; DOL Advisory Opinion Letter 97-16A (5/22/97)

Uniform Prudent Investor Act [UPIA]
§2(a); §7; §7 Comments

Case Law
Matter of Derek W. Bryant, 188 Misc. 2d 462, 729 NYS 2d 309 (6/21/01)

Other
McKinneys EPTL11-2.3(d)

Management of Public Employee Retirement Systems Act [MPERS]
§6(b)(2) and (3); §7(2) and (5)

Industry Best Practice

In the case of defined contribution plans, it is customary to offer investment options that carry 12b-1 fees. The 12b-1 fees often are used to offset the plan's record-keeping and administrative costs. For a new plan with few assets, such an arrangement is, ordinarily, beneficial for the participants.

However, as the assets grow, the fiduciary should periodically determine whether it is more advantageous to pay for the record-keeping and administrative costs on an *a la carte* basis, switching to mutual funds that have a lower expense ratio, and reducing the overall expenses of the investment program.

Conclusion

The *Practices* identified in this handbook prescribe a timeless and flexible process for the successful management of investment decisions. Once familiar with the *Practices*, the fiduciary will understand that no new investment product or technique will be good or bad *per se*, nor will it be valuable simply because it worked for other fiduciaries. Furthermore, the *Practices* will help the fiduciary understand which new investment strategies, products, and techniques fit into their priorities, and which do not.

The intelligent and prudent management of investment decisions requires the fiduciary to maintain a rational, disciplined investment program. The mind-boggling array of investment choices coupled with *market noise* from Wall Street understandably can result in financial paralysis from information overload. Fiduciaries clearly need a framework for making investment decisions that allows them to consider developing investment trends, and to thoughtfully navigate the possibilities.

Glossary of Terms

This glossary was compiled from the following sources.

Eugene B. Burroughs, CFA, ***Investment Terminology (Revised Edition)***, International Foundation of Employee Benefit Plans, Inc., 1993.

John Downes and Jordan Elliot Goodman, ***Dictionary of Finance and Investment Terms (Third Edition)***, Barron's Educational Series, Inc.

John W. Guy, ***How to Invest Someone Else's Money***, Irwin Professional Publishing, Burr Ridge, Illinois.

Donald B. Trone, William R. Allbright, and Philip R. Taylor, ***The Management of Investment Decisions***, Irwin Professional Publishing, Burr Ridge, Illinois, 1995.

Donald B. Trone, William R. Allbright, and Philip R. Taylor, ***Procedural Prudence for Fiduciaries***, self-published, 1997.

AIMR Performance Presentation Standards: These standards, effective January 1, 1993, are designed to promote full disclosure and fair representation in the reporting of investment results in order to provide uniformity in comparing manager results. These standards include ethical principles, and apply to all organizations serving investment management functions. Compliance is verified at two levels: Level 1 and Level 2. (Level 2 is a more comprehensive verification process). Specific information regarding these standards can be obtained by calling **AIMR** at (804) 980-3547.

Alpha: This statistic measures a portfolio's return in excess of the market return adjusted for risk. It is a measure of the manager's contribution to performance with reference to security selection. A positive alpha indicates that a portfolio was positively rewarded for the residual risk, which was taken for that level of market exposure.

Asset Allocation: The process of determining the optimal allocation of a fund's portfolio among broad asset classes.

Basis Point: One hundredth of a percent (100 Basis Points = 1%).

Best Execution: This is formally defined as the difference between the execution price (the price at which a security is actually bought or sold) and the "fair market price," which involves calculating opportunity costs by examining the security price immediately after the trade is placed. Best execution occurs when the trade involves no lost opportunity cost; for example, when there is no increase in the price of a security shortly after it is sold.

Beta: A statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security in comparison to a market index. The beta value measures the expected change in return per one percent change in the return on the market. Thus, a portfolio with a beta of 1.1 would move 10% more than the market.

Cash Sweep Accounts: A money market fund into which all new contributions, stock dividend income, and bond interest income is placed ("swept") for a certain period of time. At regular intervals, or when rebalancing is necessary, this cash is invested in assets in line with the asset allocation stipulated in the IPS.

Commingled Fund: An investment fund that is similar to a mutual fund in that investors purchase and redeem units that represent ownership in a pool of securities. Commingled funds usually are offered through a bank-administered plan allowing for broader and more efficient investing.

Commission Recapture: An agreement by which a plan Fiduciary earns credits based upon the amount of brokerage commissions paid. These credits can be used for services that will benefit the plan such as consulting services, custodian fees, or hardware and software expenses.

Correlation Coefficient: Correlation measures the degree to which two variables are associated. Correlation is a commonly used tool for constructing a well-diversified portfolio. Traditionally, equities and fixed-income asset returns have not moved closely together. The asset returns are not strongly correlated. A balanced fund with equities and fixed-income assets represents a diversified portfolio that attempts to take advantage of the low correlation between the two asset classes.

Defined Benefit Plan: A type of employee benefit plan in which employees know (through a formula) what they will receive upon retirement or after a specified number of years of employment with an employer. The employer is obligated to contribute funds into the defined benefit plan based on an actuarially determined obligation that takes into consideration the age of the workforce, their length of service and the investment earnings that are projected to be achieved from the funds contributed. Defined Benefit Plans are over funded if the present value of the future payment obligations to employees is less than the current value of the assets in the Plan. It is underfunded if the obligations exceed the current value of these Plan assets. The **Pension Benefit Guaranty Corporation** insures a specified amount of these future pension benefit payments on a per employee basis.

Defined Contribution Plan: A type of employee benefit plan in which the employer (Fiduciary) makes annual contributions (usually discretionary in amount or possibly based on a percentage of the profits of the company, e.g., **Profit Sharing Plan**) into the plan for the ultimate payment to employees at retirement. Each employee's account value will be determined by the contribution made, and the earnings achieved (usually a vesting percentage – 20% per year after one year of service).

Directed Brokerage: Circumstances in which a board of trustees or other fiduciary requests that the investment manager direct trades to a particular broker so that the commissions generated can be used for specific services or resources. See **Soft Dollars**.

Dollar-Weighted Rate of Return: Method of performance measurement that calculates returns based on the cash flows of a security or portfolio. A dollar-weighted return applies a discounted cash flow approach to obtain the return for a period. The discount rate that equates the cash inflow at the end of the period plus any net cash flows within the period with the initial outflow is the dollar-weighted rate of return. This return also is referred to as the Internal Rate of Return (IRR).

Economically-Targeted Investment (ETI): Investments where the goal is to target a certain economic activity, sector, or area in order to produce corollary benefits in addition to the main objective of earning a competitive risk-adjusted rate of return.

End Point Sensitivity: The performance of a manager/fund may vary depending on which ending time periods are used to analyze performance. Therefore, it is important to look at performance for a number of market cycles or time periods to gain an accurate assessment of the manager/fund's performance.

Equal Weighted: In a portfolio setting, this is a composite of a manager's return for accounts managed that gives equal consideration to each portfolio's return without regard to size of the portfolio. Compare to **Size-Weighted Return**. In index context, equal weighted means each stock is given equal consideration to the index return without regard to market capitalization. The Value Line Index is an example of an equal weighted index.

Equilibrium Spending Rate: Specific to foundations and endowments, the "spending rate" which offsets inflation and additional cost increases.

9.0%	–	3.5%	–	1.5%	=	4%
(return)		(inflation)		(cost increases)		(equilibrium spending rate)

ERISA: The Employee Retirement Income Security Act is a 1974 law governing the operation of most private pension and benefit plans. The law eased pension eligibility rules, set up the **Pension Benefit Guaranty Corporation**, and established guidelines for the management of pension funds.

Fiduciary: Indicates the relationship of trust and confidence where one person (the Fiduciary) holds or controls property for the benefit of another person. For example, the relationship between a trustee and the beneficiaries of the trust.

> Any person who (1) exercises any discretionary authority or control over the management of a plan or the management or disposition of its assets, (2) renders investment advice for a fee or other compensation with respect to the funds or property of a plan, or has the authority to do so, or (3) has any discretionary authority or responsibility in the administration of a plan.

Funding-Support Ratio: The *funding-support ratio* (the fraction of the budget supported by the fund) is the key strategic variable used by experienced committees to track and manage contributions to an institution's or recipient's annual budget. Although increasing the spending rate increases the fund's current contribution to the overall budget, more spending obviously means less reinvestment, a smaller growth rate and, all other things being equal, a lower funding support ratio in the future.

Geometric Return: A method of calculating returns which links portfolio results on a quarterly or monthly basis. This method is best illustrated by an example, and a comparison to **Arithmetic Returns**, which does not utilize a time link. Suppose a $100 portfolio returned +25% in the first quarter (ending value is $125) but lost 20% in the second quarter (ending value is $100). Over the two quarters the return was 0% – this is the geometric return. However, the arithmetic calculation would simply average the two returns: (+25%)(.5) + (-20%)(.5) = +2.5%.

Liquidity Risk: The risk that there will be insufficient cash to meet the fund's disbursement and expense requirements.

Market Capitalization: A common stock's current price multiplied by the number of shares outstanding. It is the measure of a company's total value on a stock exchange.

Market Timing: A form of **Active Management** that moves funds between asset classes based on short-term expectations of movements in the capital markets. (Not recommended as a prudent process.) It is very difficult to improve investment performance by attempting to forecast market peaks and troughs. A forecasting accuracy of at least 71% is required to outperform a buy and hold strategy.

Market-Weighted: Typically used in an index composite. The stocks in the index are weighted based on the total **Market Capitalization** of the issue. Thus, more consideration is given to the index's return for higher market capitalized issues than smaller market capitalized issues.

Money Markets: Financial markets in which financial assets with a maturity of less than one year are traded. Money market funds also refer to open-end mutual funds that invest in low-risk, highly liquid, short-term financial instruments and whose net asset value is kept stable at $1 per share. The average portfolio maturity is 30 to 60 days.

Profit Sharing Plan: Retirement plan that receives contributions as a percentage of the company's profits. See **Defined Contribution Plan**.

Proxy Voting: A written authorization given by a shareholder to someone else to vote his or her shares at a stockholders annual or special meeting called to elect directors or for some other corporate purpose.

Real Estate Investment Trust (REIT): An investment fund whose objective is to hold real estate-related assets, either through mortgages, construction and development loans, or equity interests.

Residual Risk: Residual risk is the unsystematic, firm-specific, (or "diversifiable") risk of a security or portfolio. It is the portion of the total risk of a security or portfolio that is unique to the security or portfolio itself and is not related to the overall market. The residual risk in a portfolio can be decreased by including assets that do not have similar unique risk characteristics. For example, a company that relies heavily on oil would have the unique risk associated with a sudden cut in the supply of oil. A company that supplies oil would benefit from a cut in another company's supply of oil. A combination of the two assets helps to cancel out the unique risk of the supply of oil. The level of residual risk in a portfolio is a reflection of the "bets" which the manager places in a particular industry or security class sector. Diversification of a portfolio can reduce or eliminate the residual risk of a portfolio.

Risk-Adjusted Return: The return on an asset, or portfolio, modified to explicitly account for the risk of the asset or portfolio.

Risk-Free Rate of Return: The return on 90-day Treasury Bills. This is used as a proxy for no risk due to its zero default risk issuance, minimal "interest rate" risk and high marketability. The term is really a misnomer since nothing is free of risk. It is utilized since certain economic models require a "risk-free" point of departure. See **Sharpe Ratio**.

R-squared (R^2): Formally called the coefficient of determination, this measures the overall strength or "explanatory power" of a statistical relationship. In general, a higher R^2 means a stronger statistical relationship between the variables that have been estimated, and therefore more confidence in using the estimation for decision-making. Primarily used to determine the appropriateness of a given index in evaluating a manager's performance.

Safe Harbor Rules: A series of guidelines which when in full compliance *may* limit a fiduciary's liabilities.

Sharpe Ratio: This statistic is a commonly used measure of risk-adjusted return. It is calculated by subtracting the **Risk-Free Return** (usually 3-Month Treasury Bill) from the portfolio return and dividing the resulting "excess return" by the portfolio's total risk level (standard deviation). The result is a measure of return gained per unit of total risk taken. The Sharpe Ratio can be used to compare the relative performance of managers. If two managers have the same level of risk but different levels of excess return, the manager with the higher Sharpe Ratio would be preferable. The Sharpe Ratio is most helpful when comparing managers with both different returns and different levels of risk. In this case, the Sharpe Ratio provides a per-unit measure of the two managers that enables a comparison.

Socially-Targeted Investment or Socially Responsible Investment (SRI): An investment that is undertaken based upon social, rather than purely financial, guidelines. See also **Economically-Targeted Investment**.

Soft Dollars: The portion of a plan's commissions expense incurred in the buying and selling of securities that is allocated through a **Directed Brokerage** arrangement for the purpose of acquiring goods or services for the benefit of the plan. In many soft dollar arrangements, the payment scheme is effected through a brokerage affiliate of the consultant. Broker-consultants servicing smaller plans receive commissions directly from the counseled account. Other soft dollar schemes are effected through brokerages that, while acting as the clearing/transfer agent, also serve as the conduit for the payment of fees between the primary parties to the directed fee arrangement.

Standard Deviation A statistical measure of portfolio risk. It reflects the average deviation of the observations from their sample mean. Standard deviation is used as an estimate of risk since it measures how wide the range of returns typically is. The wider the typical range of returns, the higher the standard deviation of returns, and the higher the portfolio risk. If returns were normally distributed (i.e., has a bell-shaped curve distribution) then approximately two-thirds of the returns would occur within plus or minus one standard deviation from the sample mean.

Glossary of Terms

Strategic Asset Allocation: Rebalancing back to the normal mix at specified time intervals (quarterly) or when established tolerance bands are violated (±5%).

Tactical Asset Allocation: The "first cousin" to **Market Timing** because it uses certain "indicators" to make adjustments in the proportions of portfolio invested in three asset classes – stocks, bonds, and cash.

Time-Weighted Rate of Return: Method of performance measurement that strips the effect of cash flows on investment performance by calculating sub-period before and after a cash flow and averaging these sub-period returns. Because dollars invested do not depend on the investment manager's choice, it is inappropriate to weight returns within a period by dollars.

Trading Costs: Behind investment management fees, trading accounts for the second highest cost of plan administration. Trading costs are usually quoted in cents per share. As of the date of this publication, median institutional trading costs range from 5 to 7 cents per share.

90-Day U.S. Treasury Bill: The 90-Day T-Bill provides a measure of riskless return. The rate of return is the average interest rate available in the beginning of each month for a T-Bill maturing in 90 days.

Variance: Variance is a statistical measure that indicates the spread of values within a set of outcomes around a calculated average. For example, the range of daily prices for a stock will have a variance over a time period that reflects the amount that the stock price varies from the average, or mean price of the stock over the time period. Variance is useful as a risk statistic because it gives an indication of how much the value of a portfolio might fluctuate up or down from the average value over a given time.

GUIDE TO INVESTMENT FIDUCIARY PRACTICES

Step One:
Analyze Current Position

1.1 Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements.
1.2 Fiduciaries are aware of their duties and responsibilities.
1.3 Fiduciaries and parties in interest are not involved in self-dealing.
1.4 Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.
1.5 There is documentation to show timing and distribution of cash flows and the payment of liabilities.
1.6 Assets are within the jurisdiction of U.S. courts, and are protected from theft and embezzlement.

Step Two:
Diversify – Allocate Portfolio

2.1 A risk level has been identified.
2.2 An expected, modeled return to meet investment objectives has been identified.
2.3 An investment time horizon has been identified.
2.4 Selected asset classes are consistent with the identified risk, return, and time horizon.
2.5 The number of asset classes is consistent with portfolio size.

Step Three:
Formalize Investment Policy

3.1 There is detail to implement a specific investment strategy.
3.2 The IPS defines duties and responsibilities of all parties involved.
3.3 The IPS defines diversification and rebalancing guidelines.
3.4 The IPS defines due diligence criteria for selecting investment options.
3.5 The IPS defines monitoring criteria for investment options and service vendors.
3.6 The IPS defines procedures for controlling and accounting for investment expenses.
3.7 The IPS defines appropriately structured, socially responsible investment strategies (when applicable).

Step Four:
Implement Investment Policy

4.1 The investment strategy is implemented in compliance with the required level of prudence.
4.2 The fiduciary is following applicable "Safe Harbor" provisions (when elected).
4.3 Investment vehicles are appropriate for the portfolio size.
4.4 A due diligence process is followed in selecting service providers, including the custodian.

Step Five:
Monitor and Supervise

5.1 Periodic reports compare investment performance against appropriate index, peer group, and IPS objectives.
5.2 Periodic reviews are made of qualitative and/or organizational changes of investment decision makers.
5.3 Control procedures are in place to periodically review policies for best execution, soft dollars, and proxy voting.
5.4 Fees for investment management are consistent with agreements and the law.
5.5 "Finders' fees," 12b-1 fees, or other forms of compensation that may have been paid for asset placement, are appropriately applied, utilized, and documented.

UNIFORM FIDUCIARY STANDARDS OF CARE	Step 1 Analyze	Step 2 Diversify	Step 3 Formalize	Step 4 Implement	Step 5 Monitor
1. Know standards, laws, and trust provisions.	1.1 – 1.6	1.5	3.1, 3.2, 3.7	1.1, 4.2	1.5, 5.1, 5.2
2. Diversify assets to specific risk/return profile of client.	1.1, 1.5	2.1 – 2.5	3.1, 3.3	4.1	3.3, 5.1
3. Prepare investment policy statement.	1.1, 1.5, 3.1, 3.2	3.3	3.1 – 3.7	4.1 – 4.4	3.5 – 3.7, 5.1
4. Use "prudent experts" (money managers) and document due diligence.	1.2, 4.1, 4.2	4.1	3.1, 3.2, 3.4	4.1 – 4.4	5.1 – 5.3
5. Control and account for investment expenses.	4.3, 5.4, 5.5	2.5	3.1, 3.6	4.3, 4.4, 5.3 – 5.5	5.3 – 5.5
6. Monitor the activities of "prudent experts."	1.4, 5.1	3.3, 5.1 – 5.3	3.1, 3.5 – 3.7	5.1 – 5.4	5.1 – 5.5
7. Avoid conflicts of interest and prohibited transactions.	1.1, 1.3, 1.4, 1.6	1.6	3.2, 3.7	1.3	5.5

Mission of the Foundation for Fiduciary Studies

To develop and promote the *Practices* that define a prudent process for investment fiduciaries.

Fiduciary Code of Conduct

If you're going to do it –
Do it right.

■ ■ ■

As you manage investment decisions:
Document the process;
Hire competent professionals; Monitor results; and
Always remember you have been entrusted with someone else's money.

■ ■ ■

Never invest in something you don't understand or is difficult to value. Know what you're paying for –
Don't hire the fox to count the chickens.

■ ■ ■

Understand that, when everyone is talking about making a killing –
The market already is dead.

■ ■ ■

Cautiously approach investments that promise superior results. Believe in the statement –
The past is no indication of future performance.

■ ■ ■

Relish the opportunity to be a steward of sound investment practices for, in the end, it's *procedural prudence*, not performance, that counts.

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