Reducing Fiduciary Risk

The tumultuous stock market is increasing pressure on retirement-plan sponsors and fiduciaries to address investment risks and to take step to build a shield to protect them from unnecessary litigation.

By Anthony Agbay

The global markets' plunge and record volatility began at the beginning of August and has picked up greater acceleration since then. It not only rattled the confidence of 401(k) participants but also increased the liability risk faced by retirement-plan committees and other plan fiduciaries.

Plan participants are reeling as the global markets digest a litany of recent developments including the two-day Federal Reserve meeting last month, increased fears of a Greek default and investors forced to stomach a huge correction in various stock indices.

As Warren Buffet said, "You see who's swimming naked when the tide goes out." Well, don't look now, but the tide is moving.

Employees, as plan participants directing their investments, don't seem to complain about risk (or may not even know they are taking much) when the markets are going up. It is a correction, a bear market or a change in the lunar tides that exposes the risks.

When investors are making money, they tend to take the bulk of the credit -- it's human nature. However, when they lose money, many look to point fingers and place blame on others.

The "others" in this case are the plan fiduciaries.

Section 404(c) of the Employee Retirement Income Security Act provides plan sponsors and other fiduciaries with liability protections on participant-directed retirement plans, such as a 401(k), if the plan satisfies the conditions in the 404(c) regulations.

To gain relief afforded under section 404(c), fiduciaries should incorporate a defined investment-review and monitoring process to analyze and evaluate the investment criteria and success of plan investments. Looking at performance alone is not enough; there needs to be a distinct methodology to look behind the numbers for the real truths and hidden problems.

Needed: An Investment-Policy Scorecard and Statement

One practice is to use an investment scorecard analyzing core investment attributes to determine the appropriateness of every plan investment. If a fund does not meet these minimum standards, they are excluded from future plans and removed from current plans.

In addition, the scorecard becomes a guide in choosing funds for the investment platform.

This should be outlined clearly in the investment-policy statement. The IPS is a living document guiding the committee, adviser and other fiduciaries in a prudent, written and organized template. Without it, it is nearly impossible for a fiduciary to support its actions in the investment-monitoring process.

Moreover, it helps build a shield around fiduciaries by fulfilling the responsibility and prudence standards required by ERISA sections 404(a)(I)(A) and (B).

However, having an investment-policy statement is not enough. Many committees and consultants have an IPS, but often they violate its parameters. In most cases, not adhering to an IPS is more of a breach than not having one at all.

The IPS should be quantitative and should eliminate most if not all the qualitative factors that give too much wiggle room for plan administrators to stack the deck in order to create favorable but fabricated outcomes.

There are many plan administrators offering to provide plan sponsors with a review process that is skewed heavily with qualitative metrics. Many of these vendors offer proprietary or "sub-advised funds." If so, they have an inherent conflict of interest because their revenue will be diminished if they recommend the removal of their funds by replacing them with investments from competing companies.

Next Steps

Fiduciaries and business owners already take on enough risk elsewhere. In an environment that allows government protection by following a series of procedures and practicing due diligence, it makes no sense to place fiduciaries at added risk.

Plan sponsors should review their investment-policy statement for a quantitative approach to investment monitoring. A good rule of thumb is: If you can explain to a novice the criteria of "how and when" a fund is placed on a watch list, removed or replaced, your work is done.

The formula should be simple: for example, a scorecard of each investment based on distinct and unique criteria, including peer group comparisons of:

* Fees;

* Risk-adjusted performance;

* Performance consistency; and

* Fund manager value-add.

Every quarter, the figures are formulated and the outcome is clear: A fund passes or fails. The removal of qualitative factors to skew the decision makes the process more meaningful and effective.

The worst investments decisions are based on emotions. Removing emotion from the equation provides added protection from risk for plan fiduciaries, whatever external factors might make the markets swoon.

Anthony Agbay is president of The Agbay Group, a Troy, Mich.-based division of Leonard & Co. He is an independent retirement-plan consultant specializing in fiduciary oversight strategies and retirement-plan evaluation. He can be reached at 877-302-401k or info@agbaygroup.com.

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