Fund Performance is Just the Beginning

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Many treasury professionals sit on their employer's 401(k) Retirement Plan Committee and share the responsibility of monitoring and reviewing their plan's investments. Most plans have investment advisors that provide the expertise in selecting, tracking, and replacing investment funds. As a member of the Committee and a fiduciary, it is also important for you to have a disciplined understanding of your advisor's due diligence and evaluation process for recommending investment funds for your retirement plan.

Evaluating performance is merely a first step in selecting a mutual fund.

The ever-expanding universe of available investment funds is making the task of selecting the proper funds for retirement plans increasingly difficult. With so many from which to choose, plan sponsors may be making choices for the wrong reasons.

Evaluating performance is merely a first step in selecting a mutual fund. Past performance is the primary basis of most fund evaluations, but is insufficient as the sole means of measurement. Morningstar and other third-party ratings rely heavily on historical performance against a peer group when rating funds.

Additionally, many sponsors make long-term decisions based on short-term performance. While this is one important feature to keep in mind, there are numerous other criteria to consider when building a 401(k) fund line-up.

As a quantitative measure, performance alone ignores the many important qualitative factors that will impact your plan over the long run. A fund's management team, investment style and risk level are even more important than pure performance.

Manager Turnover

It is important to know that the people who were making the investment decisions in the past will be the same people making the decisions in the future. When participants invest in a fund they are actually buying into the knowledge, experience and assumptions of the management team. In many cases, a fund's track record may have been generated by a manager that is no longer involved with the fund.

Knowing that investors are mindful of management changes, firms will claim that key investment professionals were simply a small part of a much larger team and attempt to reduce their perceived role in the investment decisions.

A management change does not mean that a fund should be automatically eliminated from consideration, it simply means that further research is required. The new manager should ideally have a minimum of three to five years of experience with expertise in the same asset class and sector for which he or she is taking over.

Investment Style and Style Drift

While it may be hard to ignore the infatuation with the high flyers, studies have shown that 95% of long-term performance is attributable to asset allocation. Selecting a fund that stays true to its intended style without migrating too far from its asset category is more important to a participant's portfolio than peer ranking. Value and growth styles shift in and out of favor over time.

Overlap reduces diversification and increases risk

Providing participants with a wide array of asset classes to allow proper diversification is key to the long-term success of their retirement strategy. As funds drift in style, their holdings may overlap other funds in the line-up, reducing diversification through increased correlation and effectively increasing risk. A 401(k) menu composed of funds that have a lot of overlap won't allow participants to create well diversified portfolios.

This makes monitoring style drift of paramount importance to plan fiduciaries. It is relatively easy for a fund to slip out of its style box and in most cases is unintentional. Style drift is most prevalent with small cap stock funds because as small cap companies mature, they drift into the mid-cap range and tend to move from growth to value.

A mid-cap value fund masquerading as a small cap growth fund won't provide the proper risk-reducing benefits of diversification.

Risk and Volatility

Volatility is a roller coaster ride that most plan sponsors and participants seek to avoid. The most common measure of volatility and risk is standard deviation which describes the amount the performance of a fund fluctuates in up and down markets. For the most part, participants are willing to forgo some upside potential if they are also protected from extremely poor results on the downside.

Other statistics that measure risk include Sharpe ratio, Beta, and R2. These figures describe the amount of risk taken per unit of return, the degree to which the funds' performance is correlated to the market and the rest of the plan line-up.

Fund concentration also plays an important role in volatility. Diversification tends to reduce volatility but a large allocation to a single stock or sector may deliver higher than average returns or larger than expected losses.

Investment Manager Compensation

The incentives for a fund manager must be in line with the strategy of the fund and the philosophy of the plan sponsor. Managers can be compensated in various ways, encouraging different types of behavior. Risk-taking to achieve high returns can lead to higher volatility than a manager that is compensated for consistent, methodical returns.

The structure of a manager's compensation can lead to style drift. A manager being compensated based on short-term results may turn to aggressive risk-taking as a means of boosting performance. This means that the fund may venture away from its stated style if that style is currently out of favor.

Fees and Revenue-Sharing

A critical fiduciary responsibility in fund selection is fully understanding the all-in fees and revenue-sharing arrangements for each fund.

This task is complicated by the need for fees to be "reasonable." Revenue-sharing arrangements are the primary components of "hidden" fees. These arrangements are different from fund to fund and impact participants directly. What might seem to be a "free" plan to the plan sponsor may in fact include funds in the highest-cost share class, shifting high costs of the plan and administration onto the participants.

Balancing the needs of the participants and the needs of the plan sponsor are key to establishing and understanding reasonable fees. Plan costs can be recaptured and used for the benefit of the plan participants. A balance should be struck between high and low-cost funds to deliver the appropriate services at a reasonable cost.

Delving Beneath Performance

It is clear that measuring performance is merely one small part of the investment fund evaluation process. As a fiduciary, it is imperative to perform both a quantitative and qualitative analysis.

Relying solely on historical performance is a one-dimensional approach to solving a multi-dimensional problem. While still a significant measure, style drift, manager compensation, risk and volatility, manager turnover, and fees are often times much more impactful. Properly evaluating these qualitative measures may take additional time and resources, but is a critical component of the fiduciary due diligence process.

Evaluating performance is just the first step in selecting a fund. Delving deeper, to discover how that performance was achieved will provide the critical insight necessary to make the right decisions for your plan and participants.