Selecting and Monitoring Investment Options in a DC Retirement Plan

by Jill Taylor Smith
Selecting and monitoring investment options are included in a plan sponsor’s duties in setting up and maintaining a defined contribution retirement plan. This article is from a chapter in the newly published International Foundation book *Employee Benefits in Canada, Fourth Edition*. 

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An important component of the setup and maintenance of a defined contribution (DC) retirement plan is the selection and monitoring of the investment options offered to plan members.

Selecting Investment Options

There is no legislative guidance in Canada that plan sponsors can turn to when trying to decide which investment options to offer plan members. Historically, many Canadian plan sponsors have looked to the United States and requirements under the Employee Retirement Income Security Act (ERISA) of 1974 for direction on best practices. With the release of the Capital Accumulation Plan (CAP) Guidelines by the Joint Forum of Financial Market Regulators (Joint Forum) in 2004, Canadian plan sponsors, service providers and members now have a clearer path as to their roles and responsibilities. While the CAP Guidelines aren’t law, they do set the industry standard in terms of expected processes and administration.

ERISA frees plan sponsors from fiduciary responsibility if a plan gives effective and meaningful control over investment decisions to plan members. Since having the power to select one’s investments is meaningless if there is an inadequate range of investment alternatives available, ERISA stipulates that sponsors seeking fiduciary exemption must provide members a broad range of investment alternatives. ERISA goes further by stipulating the options must provide members an opportunity to affect materially their potential return and degree of risk and an opportunity to diversify to minimize the risk of large losses. At a minimum, ERISA requires sponsors to provide at least three categories of investment.

More specifically, the CAP Guidelines note “the degree of diversification and liquidity, and the level of risk associated with the investment options are particularly relevant for capital accumulation plans that are established for retirement purposes.”

The majority of investments offered to plan members are investment funds. The CAP Guidelines provide further considerations for plan sponsors selecting these investment vehicles as an option for plan members. In particular, plan sponsors should consider:

- Attributes of the funds such as investment objectives, investment strategies, investment risks, the manager(s) and historical performance
- Whether the fund(s) selected
- The degree of diversification among fund options.

...
provide CAP members with options that are diversified in styles and objectives.3

When selecting investment options and product providers, sponsors and their advisors must assess options objectively. For example, choosing funds with the highest potential return and not considering a vendor’s stability or investment terms (e.g., fees) could get sponsors in trouble. Similarly, relying solely on professional advisors or credit and bond rating agencies may also be insufficient to fulfill a sponsor’s duties. As stated in the oft-quoted passage from Donovan v. Cunningham, a significant case for DC plans in Canada:

An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool and, like all tools, is useful only if used properly . . . fiduciaries need not become experts . . . they are entitled to rely on the expertise of others. However, as the source of the information upon which the expert's opinions are based, the fiduciaries are responsible for ensuring the information is complete and up-to-date.4

The collapse of Confederation Life in 1994 illustrates the peril that exists when a sponsor places all plan funds in an investment vehicle at one institution on the belief the institution is secure and does not warn plan participants of the risk associated with a failure to diversify. Despite a general awareness that the company was in trouble as a result of its overexposure in real estate investments, some plan sponsors did not reduce their plan exposure in the company. They relied almost entirely on the continued good ratings given to Confederation Life by credible bond and credit rating agencies. Although not legally tested, this kind of reliance on independent experts may constitute a breach of a sponsor’s duties to participants to independently select and monitor investment choices—particularly when it can be established that there was good cause for concern.

**Default Funds**

When choosing the investment options to offer plan members in a DC scheme, a default fund must be identified. This is the investment option where the contributions of plan members who have not made an investment selection are directed. In the United States, the selection of a plan's default fund was addressed in the Pension Protection Act (PPA) of 2006, which extended safe harbour provisions to sponsors that chose investment vehicles labeled “Qualified Default Investment Alternatives (QDIAs).” The two most common QDIAs are target-date and balanced funds.

With one exception, Canada currently has no safe harbour provisions for plan sponsors. In fact, the Joint Forum has indicated that it is not practical to consider a safe harbour in the context of its guidelines. In 2014, Alberta became the first Canadian jurisdiction to introduce a safe harbour provision in its pension regulations. Specifically, the new regulations state that the default investment option for DC plans that allow members to make investment decisions should be either a balanced fund or a portfolio of investments that takes into account a member's age.5 Given the lack of legislation around safe harbours, many plan sponsors have typically looked to the PPA and the identified QDIAs as best practices for default options—The new Alberta rules provide another source of guidance.

**BIO**

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Takeaways

- Defined contribution (DC) plans should offer a sufficient range of investment options to allow risk diversification, including, but not limited to, investment funds, guaranteed investment certificates, annuity contracts and employer securities.
- Plan sponsors are obligated to monitor investment options to ensure they continue to be appropriate.
- A written investment policy that guides the selection and monitoring of Registered Pension Plan investments, including DC plans, is generally required by Canadian legislation.
- A well-designed investment policy statement contains the following elements: statements of purpose and responsibilities; investment objectives, goals and guidelines; asset mix; limitations and restrictions; investment performance review and evaluation; and communication.
- Investment policy statements should be reviewed at least once annually.

Monitoring Investment Options

Once a plan sponsor has selected the investment options to be offered through a plan, the sponsor has an obligation to monitor these options to ensure they continue to be appropriate investment options for plan members. U.S. law is well-developed on the fiduciary obligation of pension plan administrators to prudently select and monitor investments, investment managers and consultants and other plan agents.

Investment Policy Statements

Since the Ontario Pension Benefits Act requires "care, diligence and skill" be applied in the investment decision-making process, it is presumptuous to think this requirement can be met without succinctly written directives. Similar language appears in pension legislation across Canada.

The establishment of a written investment policy and goals for Registered Pension Plans (RPPs)—including DC plans—is generally required by the Canadian legislation governing these plans. The investment policy guides the selection and monitoring of RPP investments. Logically, all types of capital accumulation plans should adopt investment policy statements as well.

A written investment policy is essential to achieving a mutual understanding between the plan fiduciaries and the investment professionals serving the plans. The absence of this understanding is the most significant reason investment objectives are not met.

Essentially, an investment policy statement is the overall game plan from which all investment strategies and their implementation evolve. The policy and evolving strategies must respond to the objectives of the plan sponsor and participants as well as economic realities.

A well-designed investment policy statement should be established for every DC plan and contain the following elements, among others.

- **Statement of purpose.** This statement provides background information relating to the plan and the sponsor, including the name and type of plan, the purpose for which the plan was established, and participant demographics. Factors relating to the sponsor that may have an impact on the plan may be included, such as the sponsor's industry, profitability and sensitivity to the economy and business cycles. In addition, specific needs or characteristics of the plan should be included, such as the source(s) of contributions.

- **Statement of responsibilities.** This is where the parties associated with a plan are identified along with the functions, responsibilities and activities of each with respect to managing plan assets. Parties include, without limitation:
  - Fiduciaries ultimately responsible for the plan, its investment policy and policy implementation
  - Fiduciaries may include a board of trustees, administrative committee and investment policy committee.
  - Investment manager(s) responsible for day-to-day management of assets, including the selection of securities and the timing of purchases and sales
  - A master custodian responsible for the safekeeping of securities, collection, disbursements and periodic accounting statements
  - Investment consultant(s) that assist(s) the plan sponsor to develop investment policy and objectives and to monitor the performance of the plan and its investment managers
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—The recordkeeper is typically delegated many of the responsibilities of the master custodian listed above but may also be delegated responsibilities for maintaining member records and overseeing investment managers.

• **Investment objectives.** A sponsor’s return expectations, sensitivity to risk and time horizon are described here. Investment objectives and goals should be realistic and appropriate given plan needs.

• **Investment goals.** Specific numeric targets should be stated that measure whether investment objectives have been met. These goals may be expressed as an absolute return target relative to a market index, a minimum required dollar amount or an income yield.

• **Investment guidelines.** These provide the framework within which investments are made. They may contain language pertaining to proxy voting, liquidity needs, trading and execution guidelines, social responsibility in investing, etc.

• **Asset mix.** It is here that the asset classes approved for investment with a maximum and minimum range for each asset category are stated. The asset mix policy and acceptable ranges should represent a long-term view. Rapid and significant market movements may cause a plan’s actual asset mix to fall outside the policy range, but any divergence should be short term in nature.

• **Limitations and restrictions.** This is the place for addressing quality ratings, diversification, selection criteria and restricted investments.

• **Investment performance review and evaluation.** State the basis for measuring and evaluating investment manager performance. Measurement includes the performance results for individual managers, asset class performance and total plan performance. Each should be compared against appropriate benchmarks on a regular basis.

• **Communication.** An integral part of the management process, this section addresses the need for regular and continued communication between all parties associated with the plan (e.g., the plan sponsor, members, investment managers and consultants). Reporting requirements and the frequency of plan review meetings should be stated here. Communication with the investment consultant may be addressed in this section as well.

While the elements just listed should be included in all investment policy statements, plan sponsors should be aware that when a plan invests in pooled funds (as is the case with most DC plans), elements such as asset mix policy and investment limits and restrictions are often governed by the investment policy statement of the pooled funds. This is particularly relevant for capital accumulation plans since the primary offering to plan members is a range of investment funds.

The depth or brevity of the investment policy statement varies from plan to plan. The language should provide meaningful guidance in the management of plan assets but not be so overly restrictive that it is not possible to make changes with economic fluctuations such as those that occur in business and investment markets. This policy statement should be reviewed at least once each year and confirmed or amended to reflect any change in circumstances. This provides an opportunity for plan fiduciaries to review with a fresh eye the plan structure, manager lineup and investment portfolio.

**Endnotes**

2. Ibid.
3. Ibid.
6. Ontario Pension Benefits Act, R.S.O. 1990, s. 22 (1).