hooker & holcombe

Our 401(k) investments are on the watch list. Now what?

Approach, review, document, and decide

As a member of your company's retirement plan committee, if you have recently been informed that one or more of your company's retirement plan investments are on the watch list, don't panic. This is an opportunity for due diligence and possibly to enhance the plan's performance.

Approach

As a thoughtful plan fiduciary, your company's retirement plan probably had a process in place when you originally selected the investments offered. Whether working with an advisor, hiring an investment fiduciary, and/or leaning on the support of your recordkeeper, some guiding forces probably helped you create the list of investment options.

Additionally, you probably have heard the term, Investment Policy Statement (IPS). It is the governing document that helps plan fiduciaries evaluate their investment choices and outline a path of reasonableness for performance. IPS's have a range of methodology criteria; and while IPS's are not technically required by ERISA, they could be the first document that most DOL auditors request when auditing your plan. Therefore, it's a best practice to have one – and follow it.

Review

Once your retirement plan's investment methodology is in place (IPS), it's time to regularly compare your investment offerings against their criteria. This often includes:

- Investment performance against the peer group
- 1, 3, and 5 year rates of return
- Manager tenure
- Expense ratio

These are just a few of the common comparison criteria.

Now that you are objectively evaluating the plan's funds, it's time to review how they are performing compared to your IPS criteria and the peer group. This process provides a reasonable apples-to-apples style comparison. For example, if your plan offers a large cap growth fund, does it make sense to compare that fund against short-term bond funds? Probably not, right? This would be an apples to oranges comparison. Rather, you'd want to line up and compare all funds in the same investment category (Large Cap Growth Funds).

To evaluate and aggregate investment information, many plan sponsors ask for the help of professional investment advisors. These advisors generally subscribe to screening, monitoring, and scoring software that catalogs and evaluates over 50,000 investment offerings.

Once you have aggregate data about the funds in the same category, you can review your IPS and start to document your thought process.

Document

With the investments evaluated and often times scored based on the peer category and IPS criteria, it's pertinent to start evaluating the results. When a fund is underperforming, it generally means it's time for your retirement plan committee to consider placing that fund on the watch list. Occasionally, a fund may be placed on watch for non-performance reasons such as changes in management or style drift.

What is a watch list? Simply stated, it is a list of investment offerings that do not meet certain aspects of the investment criteria outlined in your company's investment policy statement.

Once a fund goes on the watch list, you guessed it, you should watch it. As the Department of Labor states, "The primary responsibility of fiduciaries is to run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses."[1] This includes oversight of the plan investments and a continual obligation to monitor them, so eventually they will provide a retirement benefit to your plan participants and their beneficiaries.

As a best practice after a fund goes on the watch list, committees should decide how long is reasonably appropriate for that fund to be on watch. This is where documentation is important. Nowhere in ERSIA does it state a defined period of time. Rather, it is up to prudent fiduciaries to determine the horizon – and, of course, to document all thoughts considered.

Decide

In the long term, responsible plan fiduciaries will make decisions. They are usually binary decisions that include either:

- Keeping the investment offering within the plan and on the watch list, or
- Removing the fund in question

Whatever decision is made, it is mission critical to document **why** it was made, **how** it was made (investment reports, history, meeting meetings) and **what** are the next steps.

In short, if an investment offering is going to stay within the plan and on the watch list, a prudent fiduciary process is to follow it with documentation.

Also, keep in mind that funds can have periods of underperformance and be placed on the watch list; then as market cycles change, those funds may meet screening criteria and can be removed and placed back into the good graces of the IPS and screening methodology. In effect, the fund will have regained its status and is no longer on the watch list.

On the other hand, if the decision is made to replace the fund, a prudent due diligence process should take place to find appropriate fund(s) that meet the IPS and scoring methodology (again, many times this process is supported by an investment advisory professional with access to investment analytics and the vast universe of fund offerings). Once the new fund is selected, it's best to connect with your recordkeeper to understand the replacement process. It usually entails a notice to plan participants and a mapping period.

When a fund is placed on the watch list, it's not the end of the world. It means that plan fiduciaries need to watch the fund and discuss if the fund's methodology still meets its intended objective. As market cycles ebb and flow, certain investment management styles will come in and out of favor. Investment funds will see periods of meeting criteria and not meeting criteria – this may be due to normal market fluctuation.

What is most important as an ERISA plan fiduciary is to remember to act in the best interest of the plan, your participants, and their beneficiaries at all times. Your documentation of **why**, **how**, and **what** your actions are should be front and center in your plan's fiduciary process, because the goal of a company- sponsored retirement is to ultimately provide a meaningful retirement benefit to employees.

[1] U.S. Department of Labor. "Fiduciary Responsibilities." April 18, 2019