Four Forgotten Principles

Good Morning,

I'm Herb Whitehouse. Lets quickly go through what it means to be a successful defined contribution investment fiduciary.

Today, there are significant new tools available to the DC fiduciary; and these new tools are helping to create a new paradigm that involves four forgotten principles of investment fiduciary success.

These four principles are:

1. The formal clarifying of investment needs, aims and objectives;
2. A focus on the portfolio;
3. Investment management delegation; and
4. The measurement and monitoring of portfolio performance.

Before discussing these four implementation principles, Lets first discuss ERISA's overall fiduciary standard. This standard requires fiduciaries to act solely in the best interest of participants; and to act with the care, skill, prudence, and diligence, that a prudent person ***familiar with what it means to be a fiduciary***, would use for a similar plan with similar aims.

Now ERISA really sets the stage for talking about what experienced fiduciaries actually do. In order to provide better clarity here, I discuss these four principles as commonly understood and commonly applied by the more experienced elder brother of our fiduciary -- namely, the Defined Benefit fiduciary.

I do this as a matter of heuristics; but also because the DC fiduciary practice is both less developed **and harder** than DB fiduciary practice. It is harder because DC fiduciary success comes only with the connecting of participants to efficient portfolios that meet individual needs. This step is not required of the DB fiduciary. Therefore, an initial discussion of DB practice is a great way to establish clarity about these four forgotten principles before introducing the added complexities of Defined Contribution practice.

The first principle is the clarification of needs, aims and objectives. ERISA calls this **establishing a funding policy**; and it is a requirement for both DB and DC plans. Without this policy there is no frame of reference for the next principle…

...**A focus on the portfolio.** Here we can discuss sophisticated asset liability modeling, including my own experience in developing a stochastic model for evaluating alternative portfolios against the likely range short and long term expense, contribution, and funding ratios for each alternative policy.

But this audience will appreciate the general idea by one simple example. Risk is the invariable tradeoff accepted for increased returns -- **with one exception – the portfolio!**

Imagine a few highly correlated investments in a simple portfolio. Replacing one of these investments with a more volatile investment – and with a higher expected return -- can not only increase the overall expected portfolio return, but also reduce portfolio risk and volatility. How?

…and this is the only free lunch in the investment world – by replacing a highly correlated investment – one that moves up when the other investments move up and down when they move down – with an investment that tends to **reduce overall portfolio volatility because its ups and downs are less in sync with the other investments.**

The bottom line is that every DB fiduciary wants an efficient portfolio-- at whatever level of risk is the best fit for plan needs and objectives.

The third principle is the delegation of investment management. It is rare that a DB fiduciary will not either use a discretionary trustee or delegate to investment managers that each formally acknowledge that it accepts fiduciary responsibility.

The fourth principle is portfolio performance measurement and monitoring. While the performance of each asset class, as well as the performance of individual managers, is looked at in a DB plan, the key is measuring the performance of the overall portfolio.

This quick sketch provides a very clear picture of how these four principles are interconnected in the practice of our Elder brother.

> **The establishing of funding policy needs and objectives; a focus on the portfolio and its relation to those needs and objectives; delegation of *portfolio investment management; and finally, portfolio performance measurement.***

With this background, the following discussion of what a DC fiduciary typically does becomes much more revealing.

The DC fiduciary typically handles the first principle by setting the plan's and objective as offering a menu of investment options that will allow each participant to create his or her own portfolio – one suitable for his or her individual needs. The responsibility for defining and understanding the needs or objectives of the individual participant is left to the participant.

With respect to the second principle, the DC fiduciary again will often assign responsibility for creating an appropriate efficient portfolio to the participant.

When it comes to the third principle, there is often no investment delegation by the DC fiduciary. DC fiduciaries select mutual funds. And the mutual fund does not accept fiduciary responsibility. Responsibility for creating portfolios might be given to individual participants, but unlike what happens in the DB fiduciary world, the **responsibility for selecting the investments that make up these portfolios remains firmly with the DC fiduciary**.

And, of course, there is little or no portfolio performance measurement. Participants may be failing in their investments even as each mutual fund offered to participants is performing nicely. The DC fiduciary may not even know whether participants are using efficient portfolios.

In short, these four principles of successful fiduciary investment practice can truly be described as forgotten principles in the practice paradigm of many DC fiduciaries. Of course, there is now a growing recognition that fiduciary success requires more than the mouthing of a funding policy that the fiduciary knows will be ineffective. Fiduciary prudence is inherently incompatible with pretending that participants can actually, on their own, design and manage designed portfolios to meet their individual participant investment needs. To the extent that an efficient portfolio is, as every defined benefit fiduciary recognizes, an important tool for achieving investment objectives, the 401 (k) fiduciary can not prudently fail to monitor and measure the efficiency of participant portfolios.

Many DC fiduciaries already offer participants assistance in understanding and clarifying their individual needs and objectives. Others have taken the next step by connecting this assistance to efficient portfolios that can fill those needs, either as managed accounts, some level of investment advice, or as "model" portfolios offered to participants in core plan options. The approaches and level of participant support vary, but the practice standard is clearly changing. What is more, progress toward the goal of connecting participants with efficient portfolios can be measured, just as the performance of these portfolios can be measured.

Lets briefly recall the four central principles discussed at the beginning of this talk:

1. The formal clarifying of investment needs, aims and objectives;
2. A focus on the portfolio;
3. Investment management delegation; and
4. The measurement and monitoring of portfolio performance –

Understanding how these four forgotten fiduciary principles relate to emerging fiduciary practice standards is creating a powerful new paradigm built around acknowledging the truth about the place of the portfolio in participant success. The portfolio has a central place in modern investment practice; and neither individual participants nor lay fiduciary committees are competent to design and manage these portfolios.

And so, the new paradigm involves both increased participant services and reduced fiduciary liability. It recognizes the imperative of portfolio design and management; but also the limitations of both participants and lay fiduciary committees in designing and managing these portfolios.