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Plan investment selection and monitoring

Can emphasis on short-term results generate best-in-class fund lineups?

Few employee benefit programs receive more scrutiny today than 401(k) retirement plans, as legislators and regulators continue to seek ways to protect plan participants and improve their retirement savings outcomes. As fiduciaries, however, many plan sponsors feel ill-equipped or unprepared to comply with their obligations, especially when it comes to the task of selecting and monitoring plan investments.

To make this task easier, some 401(k) service providers have developed proprietary processes to help sponsors select and monitor plan funds.

The question is: Can a process be considered prudent if it bases fund selection on short-term investment results and largely ignores vital qualitative factors for long-term investors?

Top-quartile funds lagged benchmarks in at least three consecutive years over a 10-year period

Investment consulting firm DiMeo Schneider identified funds (by investment category) that had been in the top quartile over the past 10 years — funds that any plans would value.

It concluded that nearly 85% of those top-quartile funds (across all categories) delivered investment results below their respective benchmarks for at least one three-year period — 12 consecutive quarters — during that same 10-year period. (*See chart above.*)

Top quartile funds have lagged over shorter periods

Category*	Number of 10-year top-quartile funds	Percent of 10-year top-quartile funds below median for a …	
		three-year period	**five-year** period
Large-cap core	79	81%	61%
Mid-cap core	20	85	75
Small-cap core	29	76	41
International core	27	67	33
Intermediate bonds	56	88	64
Across all categories	502	85%	62%

* Only funds with 10-year records (as of 12/31/2009) in the Morningstar mutual fund database.

Source: *The Next Chapter in the Active Versus Passive Debate* (2010 update), an analysis of active management performance, persistency and efficacy. DiMeo Schneider & Associates, LLC.

Short-term focus could destroy long-term value

Investment consulting firm Cambridge Associates analyzed 92 retirement plans. Between 1996 and 2001, those plans had removed 652 funds and added 907 funds.

The study found that funds that were replaced due to poor short-term results lagged their benchmarks by 1.70 percentage points over the three-year period prior to their replacement — which led to the decision to replace them.

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However, those same funds ended up outpacing their benchmarks by 6.60 percentage points over the three-year period after replacement, as illustrated by the chart to the right. In summary, the study found that "the decision to switch [funds], often on the basis of short-term criteria, usually resulted in the destruction of value."

Chasing returns produces disappointing future returns

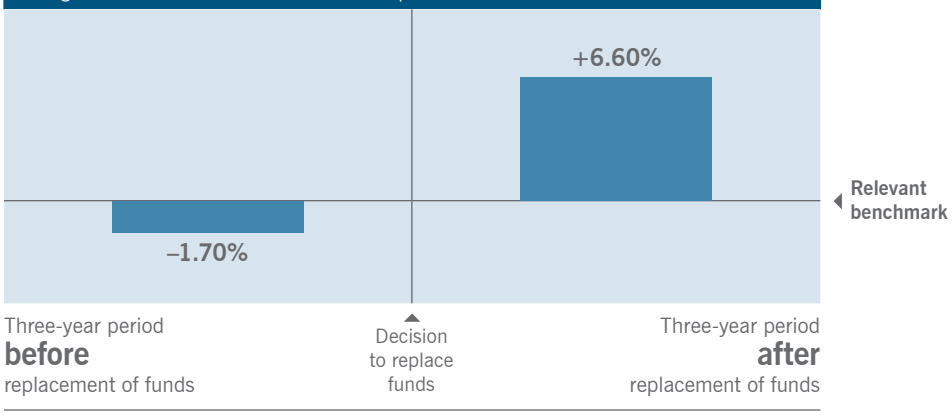
A research team led by Robert Ferguson, Jason Greene, and Carl Moss (*Chasing Performance Is a Dangerous Game*, 2009) concludes that a careful examination of almost any plan sponsor's fund replacement process "is likely to reveal that there is a substantial component of performance chasing."

The researchers say that chasing is sometimes obvious, such as "when a policy requires replacement of a fund that shows negative results after only three years."

They conclude: "No matter the form that performance chasing takes, it tends to produce future relative returns that are disappointing compared to expectations. Historical investment performance alone is not an effective basis for identifying a good manager among a group of bad managers."

This doesn't mean that historical results aren't useful, the study continued. "Rather, it means that it must be combined efficiently with other information."

"Chasing returns usually destroyed value"
Average annualized returns above benchmark (alpha)



Source: *Manager Hiring and Firing*, Cambridge Associates LLC, 2003.

"Historical investment performance alone is not an effective basis for identifying a good manager among a group of bad managers."

Does chasing returns *institutionalize* sell low/buy high?

Consider this example: Between 1999 and 2009, one 401(k) provider replaced more than half of the funds in its pool of best-in-class funds with different funds, newly touted as the same.

In other words, by eliminating funds that trailed their benchmarks for one to three years and then having participants reinvest in replacement funds — which delivered above-average results over the prior one to three years — a fund provider could be inadvertently forcing participants to sell low and buy high.

Prudence demands more

Research confirms that even the best long-term funds can lag over the short term. This fact should be acknowledged by any prudent selection and monitoring process, which should always serve the plan's and participants' best interests.

And, generally, those interests are best served by a process that focuses on considerably longer periods of time — at least 10 years and, when practical, 20 or more.

Figures shown are past results and are not predictive of results in future periods.
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