Investment policy statement

Elements of a clearly defined IPS for defined contribution plans

Russell Investments Research

Greg Coffey, CFA, Director, Institutional Investment Solutions

Today's increasingly complex investment and regulatory landscape places greater pressure on the plan sponsors and fiduciaries overseeing defined contribution plans. Fiduciaries are not only re-examining their current investment decision-making practices, they are also seeking to ensure that those practices allow for enough flexibility in implementation to maximize the likelihood of investment success, while protecting the plan sponsor from potential litigation. Central to the idea of a well-managed program, a clearly articulated investment policy statement (IPS) serves as the foundation of sound governance and a robust oversight process.

In this paper, we summarize the key elements of an IPS and discuss the ways by which "great" policy design can ultimately drive a successful defined contribution plan.

What is an investment policy statement?

An investment policy statement (IPS) is a plan-sponsor-specific document designed to provide oversight procedures that govern the investment-related activities of a defined contribution plan. Specifically, the IPS should address the objectives, investment structure and evaluation guidelines of the investment offerings within the plan. A well-rounded IPS should clearly delineate the responsibilities of all parties involved in the plan (e.g., the board of trustees; the investment committee; the investment advisor, which may be an outsourced CIO provider; and the recordkeeper).

ERISA does not mandate that a plan sponsor have an IPS; however, that doesn't mean it is not needed. In addition to providing guidance on plan management, should the plan ever be audited by the Department of Labor (DOL), one of the first documents the DOL will request is the IPS. Further, DOL Interpretive Bulletin 29 CFP 2509.94-2 specifically discusses the need for an IPS: *"…consistent with the fiduciary obligations set forth in ERISA Section 404(a)(1)(A) and (B). For purposes of this document, the term 'statement of investment policy' means a written statement that provides fiduciaries who are responsible for plan investments with guidelines or general instructions…."*

In summary, having an IPS is good practice, but fiduciaries must follow the contents of the IPS to the letter or risk a breach of fiduciary responsibility under ERISA. Therefore, it is also good practice to avoid directives and embed flexibility.

Constructing an IPS should be a dynamic process. While changes to the document should be infrequent, the IPS should be reviewed annually to ensure that all language and content reflect the plan sponsor's views and fulfill all regulatory requirements. During the initial design process, or periodic review, the plan sponsor should seek input from trusted investment advisors and an external counsel who can help identify additional risks and issues that may not be top-of-mind.

Drafting an IPS can also be an educational experience for investment fiduciaries. Working through issues in the design process can help identify weaknesses and gaps between actual and best practices, and between expectations and reality. The result should be a document that can be easily understood and executed by all relevant parties and that provides clarity in the case of questions regarding investment strategy. (For example, an investment manager change should not automatically necessitate an IPS revision.)

The IPS should be specific enough to provide meaningful guidance but flexible enough to follow while also accommodating for future economic, accounting and regulatory changes without exposing the plan to undue legal challenges. The IPS development process can be like walking a tight rope; fiduciaries must strike a balance between creating a useful document that demonstrates procedural prudence and managing litigation risk by not imposing an obligation on the plan fiduciaries to act in any particular way. To that end, plan sponsors should consider incorporating additional flexibility into the IPS by adding language to explicitly state that fiduciaries "may consider criteria not set forth in the IPS to make decisions that differ from those set forth in the IPS, and shall be free to deviate from the IPS as they deem appropriate in their sole discretion."

Vital elements of a "great" investment policy statement

What embodies a "great" IPS? A well-written investment policy statement is typically organized in sections that address these core areas:

1. Purpose and Scope
2. Plan Objectives
3. Definition of Duties
4. Investment Menu Framework
5. Monitoring and Evaluation
6. Participant Communications
7. Acknowledgement

When constructing an IPS, the adage of "less is more" is important to keep in mind. While it may seem like a good idea to write out a very detailed IPS, a high degree of detail can be a mistake. Detailed directives and overly prescriptive language often create an inflexible document that can make it difficult for the plan sponsor to follow or that can force unnecessary changes to the plan that may not benefit plan participants. An example could be frequent fund changes that result in performance chasing. As noted above, if the IPS isn't followed to the letter, it exposes the plan sponsor to legal risks due to their breach of fiduciary duty.

Section 1: Purpose and Scope

Typically, the first section in an IPS is "Purpose and Scope." This section provides an overview and sets the tone for the specific guidelines within the body of the document. It should broadly state the scope of the IPS, its intended purpose and the general objectives of the plan. If an entity has multiple defined contribution plans, listing out all plans that fall under the scope of the policy is important.

Section 2: Plan Objectives

All IPS documents should clearly articulate the objectives of the plan(s). Generally, this would include language such as, "The purpose of the 401k plan is to provide eligible employees with an opportunity to save for retirement." Often there may be a description stating that participant account balances will be composed of employee and employer contributions as well as earnings on those contributions.

Within this section, it is a good idea to acknowledge that different plan participants likely have different investment objectives, time horizons and risk tolerances. As a result, the plan will offer a range of investment options and different asset class exposures designed to span the risk and return spectrum.

From a legal perspective, in this section of the IPS, it is appropriate to state that plan participants bear the risk of investment results from the options they choose, along with the associated asset allocation. The plan sponsor does not take on this risk. While participants bear the investment risk, the plan sponsor has a fiduciary responsibility to ensure the plan is well managed and will act in the best interest of plan participants. The IPS should state that the plan will always be managed in compliance with ERISA and all other applicable laws and regulations.

This is also an appropriate place to communicate any plan objectives related to socially responsible investing, which is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions to manage risk better and generate sustainable, long-term returns.

Section 3: Definition of Duties

It is important for the IPS to clearly state the duties of all involved parties, so that they are aware and may effectively fulfill their obligations. At minimum, the parties listed should include:

Board of trustees

Typically, the board has the ultimate fiduciary responsibility for the plan's management. The board is responsible for ensuring that appropriate policies governing the management of the portfolio are in place, as well as implemented. Typically, the board delegates responsibilities to an investment committee for ongoing monitoring and implementation of the plan.

Investment committee

The investment committee (IC) is responsible for creating and implementing the investment policy. In addition, the IC is responsible for reviewing and approving plan structure, the investment choices offered and the investment strategy (i.e., hiring investment managers or an outsourced CIO provider to implement the strategy). The committee is responsible for monitoring performance on a regular basis to ensure compliance with the IPS. Additionally, it must ensure that the fees charged to plan participants are competitive and reasonable.

Outsourced CIO provider

Articulating the role of an outsourced CIO (OCIO) provider is critical. An OCIO provider assumes co-fiduciary responsibility along with the IC and can perform a wide range of duties, which depend on the delegated level of discretion (e.g., determining the investment menu, selecting managers, actively managing the portfolio, etc.). Generally, there is an investment management or services agreement between the plan sponsor and the OCIO provider. This agreement establishes the breadth and depth of the OCIO's investment management scope and level of fiduciary responsibility. Within the IPS, preference should be given to the following tasks:

- Meet regularly with the IC and provide the committee with materials reviewing the effectiveness of the plan's investment options and strategy as well as provide guidance
- Select specific investment vehicles to be offered to participants
- Notify the committee of any material changes to the organization, investment teams or investment process
- Invest plan assets in accordance with participant direction from the recordkeeper

The OCIO should provide a comprehensive solution that includes assuming the fiduciary liability for the selection of the underlying investment managers. It is important to be clear on where the responsibility for those relationships lies. Depending on the scope of services and level of discretion accorded to the outsourced provider and other parties, there may be additional roles to define.

Investment managers (optional)

The duty of investment managers is to implement the strategy for which their services have been retained. For example, a global equity manager would be responsible for investing in stocks across the breadth of the global opportunity set.

Trustee/recordkeeper

While the trustee and recordkeeper are often the same organization, sometimes these functions will be separate and the main responsibilities for each should be spelled out in the IPS. At a high level, some of the key responsibilities include:

- Maintain the plan and provide asset safe keeping
- Allocate and transfer the plan assets as directed by the plan participants
- Make payments from the plan to participants or beneficiaries as directed
- Provide a written accounting of all cash flow movement and market values
- Provide an annual 5500 reporting package
- Report performance of all investment options
- Provide statements to participants

Section 4: Investment Menu Structure

All investment policy statements should clearly articulate the investment objectives of the plan and outline the IC's philosophy in plan design. With plan participants having a wide range of investment objectives and differing circumstances, a robust plan design that covers the risk and reward spectrum is important. Policy language around the use of actively managed and/or passively managed investment offerings are typically included in this section. In addition, the defined contribution industry has seen a noticeable increase in "white labeling" investment options to streamline investment menus and help reduce participant confusion. If the white labeling of investments is utilized by the plan, that should be noted.

In recognition that participants possess varying degrees of investment sophistication and different investment preferences, this section should be used to describe the tiered investment menu structure. While participants can invest in more than a single tier, each tier is designed to allow for varying investment approaches. Descriptions of each tier should be included in the IPS.

Tier 1 (target date funds, target risk funds, managed accounts)

Tier 1 investments are often thought of by participants as the "do it for me" approach to investing. The participant may choose from a comprehensive, pre-mixed lifecycle fund that offers a complete and diversified portfolio based on age, anticipated date of retirement, or risk tolerance. In addition, a Tier 1 investment offering is often the default investment option for the plan and the IPS should reference its designation as the Qualified Default Investment Alternative (QDIA).

Tier 2 (active and/or passive core funds)

Tier 2 investments are appropriate for participants who may wish to construct their own investment portfolios. As part of this offering, the plan should make available a core menu of single asset class options or white label funds. Options in this tier should be diversifying among the varying asset classes with different return and risk characteristics. The broad asset classes made available to participants may change over time, but each investment option should be evaluated based on its appropriateness in a well-diversified portfolio.

Example of Tier 2 Investment Offerings

ASSET CLASS	BENCHMARK
U.S. Large Cap Equity	Russell 1000 Index
U.S. Small Cap Equity	Russell 2000 Index
Non-US. Equity (Developed and Emerging Markets)	MSCI ACWI ex-US Index
Core Fixed income	Bloomberg Barclays US Aggregate Bond Index
Stable Value	Citigroup 1 to 3 Month T Bill Index

Tier 3 (self-directed brokerage accounts)

This is recommended only when a plan utilizes self-directed brokerage accounts. These accounts provide participants with additional flexibility by picking investment options outside of the Tier 1 and Tier 2 investment menus. If Tier 3 investments are offered, language in this section should emphasize that the plan sponsor makes no judgement or attestation about the appropriateness or suitability of its inclusion in a participant's asset allocation strategy. The responsibility of monitoring and assessing the suitability of the investments in a Tier 3 option rests solely on the participant.

Investment advice/managed accounts

This section is recommended only if the plan offers investment advice (i.e., managed accounts). Managed accounts are an advisory service that participants may elect, which provides individualized asset allocation advice for a fee, generally utilizing funds from the existing plan's core menu. If managed accounts are offered, the language should convey that managed accounts are an optional service that participants have access to in addition to the investment offerings made available under the plan. The IPS should state that the managed account service is provided by a third-party service provider and indicate the name of the provider.

Section 5: Monitoring and Evaluation

Ongoing review of a plan's investment options is a critical step in the IPS process. Many plan sponsors have seen an increase in lawsuits brought by participants claiming improper management of their defined contribution plan. Having well-articulated guidelines for the IC to follow can be very helpful in a lawsuit or audit. While it is important to have a policy in place, it is equally important to ensure the policy is followed.

When evaluating the Tier 1 and Tier 2 menu performance, the IPS should clearly state which market benchmarks are to be used for each investment option and if applicable, which peer universe. Given the unpredictability of financial markets and varying lengths of market cycles, language in the IPS should acknowledge that short-term fluctuations in returns may cause variations in both absolute and benchmark relative performance. As a result, best practice would be for the IC to take a longer-term view in evaluating the performance of each investment option. The monitoring of results should include not only quantitative criteria, but qualitative inputs as well such as portfolio management process, investment professionals, etc. While the IC should review results on a frequent basis (e.g. quarterly), it should leave itself the flexibility to avoid unnecessarily replacing an investment option simply because benchmark relative performance has fallen below an index on a three- or five-year basis. Underperformance could simply be due to the investment style being out of favor with the market. While flexibility in the IC's evaluation is important, ensuring that reasons for an investment option's underperformance or overperformance is memorialized in the meeting minutes is imperative. In the future and most important, when in question, the plan sponsor can show a clear and thorough process in the monitoring and evaluation of the investment menu during plan audits or when participants claim plan mismanagement.

In addition to performance evaluation, the IC should also include guidelines with a focus on evaluating fees borne by plan participants such as recordkeeping and investment management fees. The IC should confirm on a regular basis that all costs associated with the management of the plan are reasonable. Investment management expense for each investment option should be competitive relative to respective peers considering portfolio characteristics, account size and investment style.

Section 6: Participant Communications

The IPS should contain a section outlining the plan sponsor's philosophy towards participant education. A well-designed defined contribution plan will not be able to live up to its full potential if participants are not educated on their benefits as well as options. It is important for plan sponsors to think about the nature and frequency of participant education.

Section 7: Acknowledgement

Typically, the last section in an IPS is the acknowledgement section, which is signed by an authorized individual from the plan sponsor with copies distributed to all parties. The acknowledgment statement can be as simple as: The committee considered and approved this Investment Policy Statement on XX date.

Conclusion

Having a well-defined and clearly articulated IPS is vital in today's challenging investment and regulatory landscape. The IPS fulfills a vital role in helping to lay the foundation of a plan sponsor's overall governance structure and ensuring that all fiduciaries achieve their obligations. Writing a "great" IPS is often an iterative process; it demands engagement and thoughtfulness from each fiduciary. Russell Investments strongly believes that such a level of care will result in an oversight protocol that is more integrated and better aligned with the needs of the plan sponsor and the beneficiaries of the plan.

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