Investment Menu **Handbook**

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How to get started

1. **Recognize that there is not a one-size-fits-all approach.** There is not one ideal menu that is appropriate for everyone. You need to determine what's most appropriate for your participants.

2. **Know what your average participant looks like.** What's your average participant's age, tenure, salary, balance, and deferral rate?

3. **Know if the two types of participants exist within your organization**, the do-it-for-me and the do-it-myself participant. The do-it-for-me participant wants someone else to make investment decisions for them. They don't have the interest, time, or knowledge to feel comfortable in making decisions on their own. We typically find that about 80% of participants are in this camp. On the other hand, the do-it-myself participant wants to have a diversified menu of funds so that they can build a portfolio that's right for them.

4. **Understand the differences between the available options** for the do-it-for-me participant and decide which is most appropriate for your participants.

5. **Understand the various categories of funds** and determine which is most appropriate for the do-it-myself participant. Keep in mind that ERISA only requires 3 funds with different risk/return profiles be offered to participants and on average, participants generally use only a small handful of funds.

6. **Know the difference between index and non-index** funds and to what extent the two are appropriate for your participants.

7. **Document your rationale** and revisit periodically.

Available options

Understand the differences between the available options for the do-it-for-me participant and decide which is most appropriate for your participants.

The two types of "easy" options for these participants include risk based and target date funds. It's generally not appropriate to offer both because that causes an additional decision for a participant that is looking for a simple approach.

Risk based funds

These are balanced funds that have a set mix of stocks and bonds. Typically, a suite of funds is offered to participants such as a Conservative fund, Moderate fund, Growth fund and an Aggressive fund, all of which have a different allocation or mix of stocks and bonds.

Advantage:
These funds take into consideration not only the participants' expected retirement date but also their overall risk tolerance.

Disadvantage:
A participant has to move from one fund to another as they approach retirement and want a more conservative allocation.

Target date funds

These are balanced funds that have a changing mix of stocks and bonds. This mix automatically becomes more conservative over time, which is referred to as the fund's glide path. Generally a suite of funds is offered in terms of years, or "vintages". Examples include a 2030 fund, 2035 fund, 2040 fund etc.

Advantage:
These funds are easy to select as the participant choses the fund that aligns with their expected year of retirement. These funds automatically become more conservative over time so, theoretically participants can set-it-and-forget-it.

Disadvantage:
These funds are designed for the average risk taker, which might not be appropriate for all. Participants might not be aware of the asset allocation and subsequently the risk associated with the fund.

In determining which is most appropriate for your participants, consider:

- Advantages and disadvantages of both
- Glide path of the target date fund
- Underlying diversification of the funds
- Costs
- Initial and ongoing education program (What's the plan for reaching out to participants in the risk based funds to encourage moving funds if a different allocation is appropriate and how easy can you make it for participants to initiate a fund change.)
- Participant's past experience with these funds

Fund Categories

Do-it-myself participants need to have access to a variety of funds so that they can build a properly diversified portfolio. However, the menu shouldn't be too large which could cause confusion or inaction.

The following represent thoughts and points for consideration for the most popular categories found within defined contribution retirement plans. It's important as you weigh each and determine which is most appropriate for your participants, to document that rationale as a part of your prudent process.

Money market or stable value

Generally you can offer one or the other, not both. That's because stable value funds generally do not allow competing investments with a duration of less than 3 years.

Both money market and stable value funds are viewed by participants to be safe. Generally, money market funds offer the lowest long term returns because they carry the least amount of risk due to their conservative short term investments. Stable value funds can offer higher returns but come with additional risk. Stable value funds are not priced to market. To offer higher returns, they invest in longer term bonds. To maintain a stable value, an insurance wrapper is in place to "guarantee" the value. These funds are only as sound as the insurance company offering the wrapper. It shouldn't be assumed that participants can't lose money with these funds. Generally, if a plan sponsor wants to remove the stable value fund from the lineup (whether looking to replace with another fund or because of a move in record-keepers), the provider won't initiate a move unless given 12 months advance notice.

Understand the various categories of funds and determine which is most appropriate for the do-it-myself participant.

Fixed income

The committee should know their philosophy regarding fixed income, which will help guide the types of fixed income funds offered to participants. Generally, lower credit quality funds and funds with higher durations experience more volatility than higher quality and shorter duration funds. If fixed income is being offered to help participants dampen their equity volatility, it needs to be decided how much additional risk should be taken with fixed income funds and to what extent long term and high yield is appropriate.

High yield is one of the more controversial funds in the fixed income space. While these types of funds might offer attractive longer term returns, they often act more equity like and might not offer the stability your participants are looking for when they need it the most. Consider the first half of 2020 during the pandemic when the equity markets were down substantially. During this time, participants welcomed positive fixed income returns. However had you invested in high yield, you would have experienced losses that were similar to the equity markets.

Major index	1/1/20 - 6/30/20
Bloomberg Barclays Aggregate Bond Index	6.14%
Bloomberg Barclays U.S. Corp High Yield Index	-3.80%
S&P 500 Index	-3.08%

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Domestic Equity

The domestic equity category is divided into nine Morningstar style boxes:

Large Value	Large Blend	Large Growth
Mid Value	Mid Blend	Mid Growth
Small Value	Small Blend	Small Growth

When it comes to offering participants a diversified menu, that doesn't mean that you need to offer a fund in each of the nine boxes. Why? Most funds span several of the boxes despite being categorized in just one. Take for instance the Vanguard S&P 500 Index fund (as of 6/30/20). The numbers below total 100% and show the weighting in each of the nine style boxes.

	VALUE	BLEND	GROWTH
Large	29%	30%	29%
Mid	5%	5%	2%
Small	0%	0%	0%

While the fund is categorized as large blend and the largest weighting is indeed in the large blend bucket, the fund offers exposure to both large growth and value in addition to mid cap exposure. If participants are looking for broad diversification and market like exposure, offering a total market fund or a large blend, mid blend, and small blend fund may be sufficient. Anything more would allow participants to overweight by size or style. You need to consider if participants really understand the style boxes and how to combine various funds to get the diversification they are looking for.

Balanced Funds

Balanced funds invest in a mix of stocks and bonds. In this case, we are excluding risk based and target date funds, which are offered in a suite. Here we are talking about a stand-alone balanced fund.

One of the most important decisions an investor can make is the split between stocks and bonds. This dictates the overall risk of the portfolio as well as expected long term return. Balanced funds often have a target mix but usually provide the manager great flexibility around that target. What role do these funds play for the do-it-myself participant? With an ever changing mix, how's the participant going to know how this fund fits into their overall portfolio? If offered, consider the education plan so these funds don't cause confusion or get participants off-track.

International Equity Funds

The international equity markets consist of both developed and emerging markets. The international markets comprise about 45% of the entire global market. Emerging markets then comprise about 20% of the international markets, which is a substantial weighting. In order to create a truly diversified and market-like portfolio, participants should have access to the international sector, which include both developed and emerging markets.

Decisions to think about include offering one total international fund where participants have access to both segments of the international markets but can't control the mix between the two or separate funds that focus individually on developed and emerging markets. In addition to determining how many funds are appropriate, as in the domestic equity area, also consider if a blend fund is sufficient or do participants need the ability to overweight style and size?

Global Equity Funds

Similar to balanced funds, global equity funds are comprised of a mix of investments that include both domestic and international equity. While the fund likely has a target between the two, the manager can have great flexibility. Therefore, for the do-it-myself participant, where control of the portfolio's overall diversification is important, are these funds necessary? Or is the participant best served by offering domestic and international funds and the ability to control the mix between the two?

Sector Funds

These are funds that focus on a certain area or sector of the market. Examples include healthcare, technology, and real estate to name a few. These funds typically carry higher expenses and additional risk due to their undiversified nature. If these funds are offered in the lineup, you need to be able to document why they are appropriate for your participants, why participants have the ability to determine how these riskier, more expensive funds fit into their overall portfolio, and why it's appropriate to allow participants to overweight a very specific area of the market.

Self-Directed Brokerage Accounts

Perhaps viewed as the ultimate option in participant choice, self-directed brokerage accounts offer participants the ability to open their own account and invest in securities outside of the investment menu. Plan sponsors may have the ability to limit the percent of their account that can be invested in this brokerage account and the ability to limit the types of investments offered under that account. Plan sponsors should check with their record-keeper to review their options. Remember that if you offer self-directed brokerage accounts, they need to be made available to all participants, not just a select few.

Index & Non-Index

Index funds are designed to track a certain segment of the market. For instance, an S&P 500 Index fund tracks the S&P 500 Index. Index funds are generally broadly diversified, holding all or most of the securities in the index and they generally have lower cost structures than non-index funds due to the lack of management involvement and fewer research costs.

Non-index funds are funds that seek excess returns over a benchmark or segment of the market. They attempt to outperform through security selection and market timing. These funds generally have higher costs due to their additional trading, management, and research costs. Since no one has a crystal ball, sometimes these managers get it right and sometimes they don't. Studies show that over longer periods of time, it gets harder and harder for these non-index managers to outperform the index due to their higher costs.

In terms of risk, index funds carry market risk, non-index funds carry both market risk and manager risk.

SNAPSHOT OF ADDITIONAL DIFFERENCES

Type of Management	Index	Non-Index
Example	Fidelity S&P 500 Index Fund	Parnassus Core Equity Fund
Expense Ratio	0.015%	0.87%
Expected Short-Term Return	Benchmark return	Can vary widely above/below benchmark
Expected Long-Term Range of Returns	Benchmark return	Can vary widely above/below benchmark. Over long-term, due to higher expenses, it can be difficult to beat benchmark.
Expected Volatility from Benchmark	None Because of operating costs, the fund should lag benchmark index by a small amount	High Volatility can be minimal or large over benchmark
Expected Morningstar Ratings[1]	2-4 stars	1-5 stars
Expected Category Rankings[2]	Usually 2nd or 3rd Quartiles	Any of the 4 Quartiles
Number of Holdings	Reflects what's included in benchmark index (Approx. 500)	Relatively few thus allowing for large bets on individual securities (Approx. 40)
Security Selection	Hold stocks included in or sampled from the benchmark index	Picks stocks based on criteria; usually trades in and out of stocks regularly and therefore has high turnover
Derivative Use[3]	Very low	Possibly moderate as managers attempt to add additional return over the benchmark
Goal	Capture benchmark returns over all time frames	Beat the benchmark
Frequency of CSIA's Changes on the Approved List of Investments	Not expected unless another fund company lowers their expense structure	Every 2-4 years as fund managers/ process/performance changes

It's important that fiduciaries discuss the extent of index and non-index funds that are appropriate for participants. At a minimum, does it make sense to offer participants index funds so that if they want to build an all index or market like portfolio they could? This would equate to an index core including fixed income, domestic equity and international equity.

Beyond that core, you can build the menu out as appropriate. Do additional index funds make sense in the value and growth areas? Are non-index funds appropriate and if so, in what areas?

This index and non-index discussion also applies to the do-it-for-me participant. Once you have determined if a risk based or target date approach makes the most sense, you need to ensure that the composition of those funds is aligned with the style that is most appropriate for participants. It may not make sense to offer an index core approach to the do-it-myself participant yet offer the less sophisticated do-it-for-me investor a suite of funds that are all non-index. If you do, be sure to know why and properly document that decision.

Know the difference between index and non-index funds and to what extent the two are appropriate for your participants.

DOCUMENT YOUR RATIONALE AND REVISIT PERIODICALLY

Plan sponsors seem to be in a routine of reviewing the actual funds in the lineup and comparing their fees and performance to peers and benchmark. However, there doesn't seem to be enough discussion around the menu as a whole and why certain funds are offered and not others. As your fiduciaries work through the outline above, the decisions will form the framework for your fund lineup. Document this framework as a way to showcase your prudent process, provide clarity over the existing lineup and to help ensure continuity over the years as committee members change. It's a good idea to have this high level review and conversation at least every few years.

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