From "Fantastic" Fund to Fantastic Fund Lineup

Putting the 2016 Fantastic Fund List to Good Use

In our October 2016 article, "The Makings of a Fantastic Fund", we shared the 2016 Fantastic Fund List, an annual report compiled by Morningstar's Director of Mutual Fund Research, Russel Kinnel, as well as the stringent criteria used to seek out what Kinnel considers the best of the best in the fund universe. While Kinnel's screening process is very stringent and can help Plan Sponsors to identify the best of the individual funds available, more evaluation is needed to construct a "fantastic" fund lineup.

Constructing a Fantastic Fund Lineup

As a Fiduciary, Plan Sponsors have a duty to prudently select and monitor the investment options made available to Participants. What should Plan Sponsors consider when constructing their plan's fund lineup?

Consider an IPS

An Investment Policy Statement (IPS) is a written document that formally details a Plan's decision making and monitoring processes for investments. Plans are not required to have an IPS; however, when constructed properly, an IPS has practical advantages such as clarified investment objectives and a structure for fund evaluation.

Understand the advantages and disadvantages of an IPS for your Plan in *Is an Investment Policy Statement right for you?*

Diversification is Key

Did you know that, under ERISA, a Fiduciary is required to diversify the investments of a Plan as to minimize the risk of large losses? Proper diversification of the Plan's investment alternatives will allow participants to better diversify their individual portfolios. Diversification of fund alternatives includes covering multiple asset classes, categories, and sizes, as well as finding a good balance between stock and bond allocation. The number of funds available is also to be considered. Research has shown that between 15 and 20 alternatives allows for proper diversification while avoiding decision paralysis.

Learn more in our featured article, *Diversification*.

Passive versus Active…or Both?

The opportunity for market outperformance has long encouraged investors to take advantage of professionally, actively managed funds. On the other hand, the low fees associated with passively managed funds also attract investors. The question is whether the potential returns of active management are high enough to offset the additional expense. However, a combination of both strategies by asset class may be the most advantageous for the long-term investor.

Get the details on combining the best of both strategies in *Active vs. Passive Management*.

Keep Expenses Reasonable

The initial test in Kinnel's screening process for the Fantastic Fund list excludes funds outside of the cheapest quintile, meaning the fund's expenses must be in lowest 20% when compared to the rest of the fund universe.

Among the duties of a Fiduciary is the duty to ensure that all Plan related costs are necessary and reasonable for the services provided. In addition to monitoring the performance of fund alternatives, Sponsors must also monitor investment expenses. The DOL provides a comprehensive guide on understanding investment fees and other plan expenses and the requirements for presenting fee information to Participants. This resource can be found on the DOL website.

Past Performance

While past performance is not indicative of future returns, a history of strong, positive performance compared to an appropriate benchmark is a good sign that the fund is well-managed. As Kinnel alludes in his screening process, it is important to look at past performance for the current manager's tenure with the fund. Generally, performance can be viewed in year-to-date, 1-year, 3-year, 5-year, and 10-year segments as well as annual returns. Annual returns for certain years can help you analyze how a fund might handle times of market decline. For example, a fund's performance in 2000, 2001, 2002, and 2008 will show how it has fared in bear markets while returns in 2003 and 2009 will show how the fund rallied during recovery.[1]

The Bottom Line

Plan Sponsors have a tall order to fill when it comes to building a fund lineup for their Plan. Following a prudent process and analyzing specific criteria will help Plan Sponsors to fulfill their duty and ensure they are providing a "fantastic" fund lineup for their Participants.

[1] Zoll, Adam. How Much Should You Care About Past Performance? Our Experts Weigh In. Morningstar. 07 August 2013.