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I. Introduction

Investment Policy Statements
Many plan sponsors have asked what they are, why they need one and how to put one together. That’s where this booklet is intended to help. This easy-to-use guidebook was created for retirement plan sponsors faced with the task of not only creating an investment policy, but also with monitoring the investment options in the future.

To assist plan sponsors with the creation of an investment policy statement, this booklet covers the essentials of what information should be included in the document and why. Specifically, it will explain what an investment policy statement is and why it can be helpful for the plan and the plan sponsor. Additionally it will highlight the basic components of a typical investment policy statement which are:

• Providing the objectives and purposes of the investment policy statement
• Assessing the needs of the plan’s participants
• Creating guidelines for how investment options are selected, and
• Establishing procedures for monitoring the investment policy on a continuous basis

A. What is an Investment Policy Statement?
The primary purpose of an investment policy statement is to outline the process that a plan’s sponsor intends to use in selecting and monitoring investments within the company’s retirement plan. Although a great deal of thought must go into creating a prudent investment policy, the investment policy statement (IPS) itself need not be a complex and overly detailed document.

The IPS should, in a clear and understandable manner, outline all of the issues and criteria used in creating a prudent investment philosophy. Additionally, it should serve as an essential tool or a roadmap for a plan sponsor in overseeing the investment policy on an ongoing basis.

Once an investment policy is created, there is still additional ongoing work. It is the responsibility of the plan sponsor to implement and oversee the investment policy based on the roadmap provided by the investment policy statement. By continually comparing the plan to the original goals and assumptions laid out within the investment policy statement, the plan sponsor can be assured that the goals of the plan are fulfilled.

Additionally, the investment policy will be modified whenever there are significant changes in plan demographics. For instance, corporate changes, such as takeovers or mergers, warrant a review of the investment policy to ensure that participants’ needs are still properly addressed.

B. The Need for an Investment Policy Statement
There are a number of reasons for developing a written investment policy statement, and they include:

• The IPS serves as a guide for evaluating and monitoring the overall investment portfolio and the individual investment options. Clearly written guidelines can help the plan sponsor maintain a long-term investment philosophy and manage the plan in the best interest of the participants.

• The IPS provides documentation of the procedures and decisions made in selecting and monitoring a plan’s investment options. It also serves to place in writing a plan sponsor’s compliance with regulations relating to corporate retirement plans (mainly the Employee Retirement Income Security Act, or ERISA for short). The enactment of ERISA in 1974 codified plan fiduciaries’ liability for breaches in prudence and diversification standards.

• The IPS reassures plan sponsors and plan participants that their investment contributions are invested in a prudently constructed retirement plan that is continually being overseen in their best interests.
II. Preparing the Investment Policy Statement

Much preparation and forethought must go into the IPS. The plan sponsor must envision the entire process to follow in establishing and monitoring the investment policy and its investment options. Only then can the process and goals be outlined in writing in the form of an IPS.

The following highlights four key areas plan sponsors should address in creating an effective investment policy statement.

Establishing the Objectives of the Investment Policy Statement

A. It is important to define the purposes of the IPS (i.e., what do you want the plan to accomplish for both the plan sponsor and plan participant) before designing the investment policy and selecting appropriate investment options. Although the main purpose of the retirement plan is to provide a framework for participants to accumulate retirement savings and plan for their retirement, there may be other goals and purposes. Understanding all of the purposes of the plan will help the retirement plan sponsor make decisions that are in the best interest of the participants. Additional purposes for an IPS includes:

• To operate the plan in compliance with Department of Labor regulations issued pursuant to ERISA Section 404(c). This is often an important objective of plan sponsors because it may provide protection for plan fiduciaries from liability for participant-directed investment decisions. To comply with these regulations, a retirement plan must offer at least three core investment options with materially different risk and return profiles to participants. Participants then must be allowed to change their selections on at least a quarterly basis. Additionally, plan sponsors must provide notices of 404(c) compliance, necessary information and education that would allow participants to make informed investment decisions.

• To attract and retain outstanding employees. An attractive 401(k) plan is a valuable company benefit and provides an extra incentive for employees to stay with the company.

• To encourage a high overall participation rate and consistent saving habits. Achieving healthy participation among lower-paid employees is challenging because they often feel they are less able to afford having part of their paychecks deferred into the retirement plan.

• To obtain plan services and investment options at reasonable costs. Because investment expenses can significantly affect performance, the IPS should direct the plan sponsor to consider total investment-related costs, together with other factors, when selecting the investment options.

B. Assessing the Needs of the Plan Participants

Every plan must be maintained and administered for the benefit of its participants. To create an investment policy that is aligned with the needs of its employees, plan sponsors should attempt to:

1. Understand the investment time horizon and risk tolerance of the plan participants.

Knowing the range of employees’ ages in the plan can help guide the investment process. Any investment option lineup has to be broad enough to satisfy the diversification needs of all participants, from the most aggressive investors to the most conservative ones. However, a plan whose workforce is mature (and as a result has a shorter investment time horizon) could include more conservative investment options. Alternatively, a plan with a younger workforce could include more aggressive investment options.
Consider the employee base’s level of investment sophistication and education.
A less-sophisticated employee base may not be equipped to tolerate the risks of aggressive investment options or to choose among a large number of investment options. A more sophisticated workforce may want a more robust investment option lineup that includes a wide range of risk and return characteristics.

The guidebook discusses later why it’s important to stay alert and monitor changes in your employee base’s key demographics.

C. The Investment Selection Process

1. Selecting asset categories for the plan.
   Once you have identified all of the relevant characteristics of your employee base and set the long-term investment objectives of the plan (see steps 1 and 2 Assessing the Needs of Plan Participants), the appropriate asset categories should start to become apparent.

   At a minimum, every plan should start with an understanding of ERISA Section 404(c) which mandates the inclusion of at least three different types of investment options with different risk/return characteristics. Although at least three asset categories must be included, most plans choose to include additional asset categories to enhance diversification.

   In addition to the employee workforce characteristics discussed above, other factors the plan sponsor should consider in selecting additional asset categories include:

   • How much employer-sponsored education and communication will be made available to the participants
   • The current allocation of employee assets in an existing employee-directed plan
   • Employee preferences for certain types of investment options, such as socially-responsible offerings
   • Selecting investment options within asset categories

2. Once the appropriate asset categories for the plan have been identified, the plan sponsor needs to select investment options to represent those asset categories. This part of the IPS underscores the prudent process that will be followed in choosing and monitoring the investments. Plan sponsors may want to consider the following criteria when selecting investment options.

   • A minimum performance record. The investment option and investment manager should have a reasonable performance record, typically a minimum of three years. If an investment manager were new to an investment option, he or she would be considered to have a minimum performance record if he or she managed a similar investment option for a minimum of three years.

   • The investment option’s historical returns relative to its peers’. The investment option’s returns should be competitive with its peers’ over trailing performance periods.

   • The amount of risk taken to achieve those returns. The investment option should not take on more risk than its average peers to achieve the same level of returns.

   • The consistency of the investment option’s returns. The investment performance should be relatively consistent over time. Excessive underperformance often reflects something inherent in the investment option’s style that leads to unpredictable performance. In addition, investments that are prone to frequent periods of underperformance are most likely to cause participant dissatisfaction.

   • The investment manager’s tenure. The investment manager should have long-enough tenure with the Investment Company so that the investment option’s past performance is relevant.
• **The consistency of the investment option’s investment style.** The investment style should be fairly consistent over time. A reasonable level of style purity is necessary so participants can rely on the investment options to fill their expected diversification roles within the plan.

• **The investment option’s expenses.** The investment option should have reasonable expenses. High-expense investment options must work harder over time than their lower-expense peers to achieve similar returns and risk profiles.

• **Overall lineup of investments.** The investment options available to participants should cover a wide range of return and risk objectives and provide enough diversification.

• **Any factors that would make the investment option inappropriate.** A bloated asset base, excessive sector or position concentration, etc. may render the investment option inappropriate for the retirement plan.

Although all of the above considerations may prove valuable in establishing a process for selecting investment options, there are no specific requirements that a fiduciary must follow. In general, **ERISA** does not dictate how investment selections should be made, but it does insist that they be made with the skill, care, and diligence of a prudent investor.

**D. The Investment Monitoring Process**

1. **Implementing decisions and monitoring the investment policy and investment options.** The plan sponsor’s responsibility does not end after the investment options have been selected. The plan sponsor should regularly review the investment policy as long as the retirement plan is in existence. The IPS should direct the plan sponsor to continually monitor:

   • **Participants’ needs:** The plan sponsor should watch for any significant changes in the company’s employee workforce due to aging, mergers and acquisitions, layoffs, or rapid growth. In addition, the plan sponsor should pay attention to the response of the retirement plan among employees, the effectiveness of communications, trends in contributions and distributions and asset allocation by employees.

   • **Investment performance:** The plan sponsor must oversee the investments to ensure they perform as expected. Factors utilized for monitoring the investment options should be consistent with the factors utilized in initially selecting the investment options. Equal effort should be expended watching the investments as in selecting them.

2. **Providing education and retirement-planning materials to plan participants.** Each participant must build a portfolio that is consistent with his/her risk tolerance and retirement goals. To help plan participants, the plan sponsor should encourage long-term planning and education materials that cover such areas as:

   • **Establishing retirement goals.** Participants should be shown how their investment choices would likely affect the amount of money they have at retirement.

   • **Building a diversified portfolio.** Educational materials should emphasize the importance of a diversified portfolio of investments. Diversification is a better method to control risk in a portfolio than simply selecting the most conservative investment options. The educational materials should cover diversification across and within asset categories.
III. Conclusion

While creating an IPS may seem like a daunting task, it is important to keep in mind that this guidebook attempts to cover all of the basics needed to give ample background for preparing the IPS. It doesn't need to be long and complex. It can be written at a general rather than highly detailed level while still adequately covering each of the necessary requirements.

The goal should be to create a streamlined document that's easy to read and provide usable, practical guidance to the plan sponsor. As long as each area outlined in this guidebook is addressed adequately, the IPS can serve as a useful guide for the plan sponsor and solid documentation of the prudent process the plan sponsor has followed in creating its retirement-plan investment option lineup.

IV. Key Terms

**ERISA:** Stands for Employee Retirement Income Security Act. The law was established in 1974 to govern most private pensions and benefit plans. Its regulations cover plan participation requirements, communication to participants, reporting to the federal government, and a variety of rules designed to safeguard any funds that are set aside to pay benefits in the future.

**ERISA Section 404(c):** Generally speaking, the plan should provide at least three core investment choices for participants that have materially different risk and return characteristics. The participant must be provided sufficient information about all investment options and must be allowed to change his/her investment choices at least quarterly.

**Fiduciary:** Under ERISA, a fiduciary is a person who exercises any discretionary authority over the management of the plan and its assets, or renders investment advice for a fee or other form of compensation, or has any discretionary responsibility in the administration of the plan.

**Investment Style:** The investment style of the investment options plays a crucial role in diversification. In general, investment style is defined by market capitalization (large to small) and valuation (value to growth).

**Valuation**

**Growth:** Growth companies have high earnings-growth expectations, trade at high price multiples, and are generally riskier investments.

**Value:** Value companies typically have lower growth rates, trade at low price multiples, and are generally less risky.

**Market Capitalization**

**Large:** Large companies, with their more established and diversified revenue streams, are generally less risky. For example, AT&T, IBM and General Electric would all be classified as large-cap companies.

**Small:** Small companies are typically younger or less established, have small or narrow revenue streams and are generally riskier. For example, Actel, Sun Bancorp, and Bluestone Software would all be considered small-cap.
Credit Quality

High Quality: Bonds that have a credit rating of AAA and AA are categorized as high quality. For example, U.S. government securities are considered AAA.

Medium Quality: Bonds that have a credit rating of less than AA but greater than or equal to BBB are considered medium quality.

Low Quality: Bonds that have a credit rating of below BBB are categorized as low quality. For example, high-yield or junk bonds carry low-quality credit rating.

Duration (a measure of interest-rate sensitivity, expressed in years and not to be confused with bond maturity)

Long Term: Bond funds with durations of more than 6 years are long-term.

Intermediate Term: Bond funds with durations of more than 3.5 years and less than 6 years are considered intermediate term.

Short Term: Bond funds with durations of 3.5 years or less are short-term.

Investment Policy Statement: Provides guidelines for the retirement plan sponsor in determining appropriate asset categories and investment options for the plan and its participants. The investment policy decisions should be based on the plan demographics, associated risk tolerances, saving and investing time horizons, and other participant needs, such as preference for certain investment options.

Socially Responsible Investments: Investments that may make investing decisions based on such issues as environmental responsibilities, human rights, or religious views. These investments often also avoid investing in companies that are involved in promoting alcohol, tobacco, gambling, or weapons.
The following sample IPS can be used as a template.

**Sample Investment Policy Statement**

### Plan Information

- **Plan Sponsor:** [Plan Sponsor]
- **Plan Name:** [Plan Name]
- **Type of Plan:** [401(k)]
- **Current assets:** [$1,000,000 (12/31/1999 balance)]
- **Plan adoption date:** [January 1, 2000]
- **Plan Year:** [January 1 to December 31]
- **Plan sponsor committee:**
  - Chief Executive Officer, Plan Sponsor
  - Chief Financial Officer, Plan Sponsor
  - Human Resources Officer, Plan Sponsor
- **Plan Administrator:** [Employer or Mr./Mrs. ABC]

### Plan Purpose

[Plan Sponsor’s] retirement plan was established [date effective] to provide a retirement savings program for the employees of [Plan Sponsor]. The plan is intended to operate in accordance with all applicable state and federal laws, and the provisions of Department of Labor regulations issued pursuant to ERISA Section 404(c). All decisions regarding investment options, administrative issues, and communication efforts must be made for the exclusive purpose of benefiting the Plan participants.

The plan sponsor will select and monitor the investment options to support the following goals:

- **Promote and maximize retirement savings accumulation by Plan participants**
- **Provide Plan participants with a wide range of asset categories and investment options designed to meet their retirement goals and investment objectives**
- **Outline how the asset categories and investment options are selected**
- **Encourage a high overall participation rate and consistent saving habits**
- **Attract and retain outstanding employees at [plan sponsor]**
- **Obtain investment options at reasonable costs**
Participant Characteristics
While plan participants are ultimately responsible for their own investment decisions, the plan sponsor must strive to provide a suitable range of investment options, allowing participants to invest in accordance with their own retirement goals, risk tolerances and saving/investing time horizons.

Because of the broad range of ages and investment knowledge, the plan sponsor will select a diverse number of investment options that would allow most participants to select investment options that meet individual risk tolerances.

or

Given the participants’ overall long time horizon and reasonable level of investment sophistication, the investment policy should include several suitably aggressive investment options; however, the core investment options must include relatively conservative investment options suitable to mainstream investors and those nearing or during retirement.

or

Given the participants’ relatively short time horizon and/or moderate to low level of investment sophistication, the investment policy will emphasize more conservative investments, such as blue-chip stock funds and high-grade bond funds.

Selection of Asset Categories
The plan intends to comply with ERISA Section 404(c) and it will provide, at a minimum, three investment options that have materially different risk and return profiles. To provide further diversification, the plan sponsor will select a broad array of investment categories to accommodate a wide range of risk/return preferences among plan participants, subject to the demographic considerations above.

Selection of Investment Options
In addition to the above criteria, the plan sponsor will consider the following criteria in selecting the plan’s investment options:

- **A minimum performance record.** The investment option and investment manager must have a reasonable performance record, typically a minimum of three years. If an investment manager is new to an investment option, he or she would be considered to have a minimum performance record if he or she had managed a similar investment option for a minimum of three years.

- **The investment option’s historical return relative to its peers.** The investment option should have relatively superior return to its peers over the trailing performance periods.

- **The amount of risk taken to achieve those return.** The investment option should have lower risk compared to its peers if the similar returns are achieved.

- **The consistency of the investment option’s return.** The investment’s performance should be relatively consistent over time. Excessive underperformance often reflects something inherent in the investment option’s style that leads to unpredictable performance. In addition, investments that are prone to frequent periods of underperformance are most likely to cause participant dissatisfaction.

- **The investment manager’s tenure.** The investment manager should have a reasonable tenure with the investment to ensure that its past performance is attributed to the particular manager or management team.
• **The consistency of the investment option’s investment style.** The offering’s investment style should be fairly consistent over time. A reasonable level of style purity is necessary so participants can rely on the investments to fill their expected diversification roles within the plan.

• **The investment option’s expenses.** The investment option should have reasonable expenses. High-expense investment options must work harder over time than their lower-expense peers to achieve similar returns and risk profiles.

• **Overall lineup of investment options.** The investment options available to participants should cover a wide range of return and risk objectives and provide enough diversification.

• **Any factors that would make an investment option inappropriate.** A bloated asset base, excessive sector or position concentration, etc. may render the investment option inappropriate for the retirement plan.

**Monitoring of Investment Policy and Investment Performance**

The plan sponsor will review the overall investment policy and monitor each investment option on a [semi-annual] basis. Specifically, the plan sponsor will examine the investment options’ risk-adjusted performance, risks, style consistency, performance consistency, expenses and portfolio characteristics.

Other factors will be considered as well, such as manager changes, asset growth and size, and nuances of or changes in investment styles. Investment options that stray from their investment style, experience management/organizational changes, or have relative declines in either their performance or risk rankings, may be recommended for removal. Alternatively the investment option could be placed on a “watch list” for future monitoring until a definitive decision can be made.

**Participant Education and Communication**

The plan sponsor will educate and assist participants in making informed investment decisions that are appropriate for their retirement goals. Additionally, the plan sponsor will provide communication and education materials to participants on a periodic basis. The plan sponsor will also provide summary pages for the investment options within the investment policy.

**Conclusion**

This Investment Policy Statement should be reviewed [annually] for necessary modification resulting from changes in plan demographics, key management, administrative issues, etc.

This Investment Policy Statement shall remain in effect until revised or amended by the plan sponsor.