Everybody Makes Mistakes: What We Found in a Review of Over 50 Investment Policy Statements

"I make mistakes; I'll be the second to admit it." – Jean Kerr, playwright and apparent mistake-maker

Developing, maintaining, and following an investment policy statement (IPS) is a foundational component of fiduciary process. An IPS serves as a touchstone, guidepost, and guardrail for an investment committee, and it's vital to the prudent and consistent performance of fiduciary duties. Despite their importance, investment policies are often treated simply as a box to check, where errors are initially made and then allowed to linger on in the absence of serious regular reviews.

We recently completed a review of a client's IPS, which covers multiple plans and over $3 billion in assets. As part of the process, we thought we'd incorporate a novel approach: we added a peer review, including the investment policy statements of over 50 governmental and higher education plans for comparison. Looking at that volume of policies at once generated a unique perspective that was enlightening and, in some cases, alarming. We thought we'd pass along the most prevalent missteps we found.

THE MOST COMMON MISTAKES WE FOUND

While there were many excellent policy statements (including, thankfully, our client's), nearly all exhibited at least a few issues, and most contained more. The bulk of errors fell under these broad groups:

Spelling and Grammar Mistakes

We'll start with the easiest problem to solve. You won't get sued over bad spelling, but spelling and grammatical errors reflect poorly on you, your committee, and, potentially, your entire institution. Remember that the audience for an IPS can extend well beyond your committee. Policy statements are commonly viewed as documents that plans must provide to participants upon request, and basic errors will not inspire confidence. If you're facing an ERISA suit and trying to avoid discovery, handing over a policy statement rife with spelling mistakes probably isn't the best way to convince a judge that you're carefully monitoring anything.

After the same eyes review multiple revisions of a document, errors can slip through the cracks. Fortunately, it's a problem that's easy to avoid. Using an editing app like Grammarly can expose spelling and grammatical errors and may help you improve readability. Even better, finding a colleague who is a talented editor can add a dimension to your review well beyond apps and spell-check.

(Note that if you look at your policy after you read this and find a bunch of simple errors, don't feel too bad. The most egregious spelling and grammar offender we came across was a university.)

Not preventing conflicts with other plan documents

A key consideration when composing an investment policy is the avoidance of conflicts with the plan document, which governs a retirement plan's operation and administration. At best, a conflict can create confusion; at worst, it may create fiduciary exposure. While you should take significant care to ensure that the IPS and other documents coordinate, we suggest adding a primacy statement to the IPS that clarifies its subordinate place in the governing hierarchy. A passage such as "In the case of a conflict between the IPS and the plan document, the plan document will be considered the controlling document" makes it plain that the plan document serves the governing record, avoiding confusion and resolving any unintended conflict.

Assuming all readers will have sophisticated investment or plan knowledge

An investment policy should serve as a practical guide for every investment committee member, whether a CFO who has been on the committee for a decade or a new hire with two years of HR experience. The best approach is to compose an IPS that any reasonably competent party can understand. An investment policy should be worded such that an unrelated party who is unfamiliar with the plan and has only basic investment knowledge (like a judge, for example) could read the IPS and clearly understand the purpose of the document, the objectives of the plan, and the concepts and processes used to develop, maintain, and monitor the plan's investment structure.

An IPS should be free from internal jargon, acronyms, or vague references to specific internal processes. From an investment perspective, forgo the inclusion of specific statistics and, instead, use the concepts to which those statistics apply. For example, volatility takes the place of standard deviation; risk-adjusted return replaces information ratio, etc. (this also provides an investment committee with necessary flexibility, which we'll address in a moment).

Note that we don't mean to understate the importance of committee members having sufficient plan and investment knowledge to fulfill their duties. Every committee should have a formal onboarding process that ensures that new members are acquainted with not just the plan and investment policy but also associated fiduciary and investment concepts and methods.

Including specific schedules

One frequent faux pas we encountered was the use of unnecessarily specific language that could create an obligation that a committee may have difficulty fulfilling.

For example, if your IPS states that the investment committee will meet once per quarter, your committee has to meet once per quarter. In extreme situations, this can become an issue for even the most diligent committee. This became apparent at the beginning of the coronavirus pandemic when regular priorities suddenly faced tremendous disruption as companies scrambled to adapt to the emergency. It's likely that more than one organization postponed or even skipped a Q1 2020 investment review.

Even in more normal times, organizations face scheduling challenges. For example, between summer vacation schedules and September catch-up, it may become difficult to schedule a review during the third quarter.

Overly specific schedules should be avoided in policy statements and left to calendars. More pliable language such as "four times a year" or "periodically, not less than annually" allows a committee to demonstrate prudent fiduciary behavior by maintaining a regular meeting schedule outside of the IPS but provides flexibility when the need arises. Provided your committee can demonstrate that it has met regularly, your fiduciary documentation will be intact. After all, it isn't an intention to schedule meetings that exhibits your diligence; it's proof that meetings actually occurred.

Making unrealistic or unprovable statements

Allowing inaccurate or unprovable statements in an IPS impugns the diligence and capability of an investment committee. Any phrase that looks like a "claim" should be examined with a skeptical eye.

One IPS we read claimed that guaranteed or fixed account funds, as an asset class, presented virtually no downside risk to investors. We had several technical issues with the passage. However, the main reason we didn't like it was our concern over how a participant could interpret the statement. While this IPS was easily accessible on the internet, we'll repeat that policy statements are commonly viewed as documents that plans must provide to participants upon request. How would a participant read that passage? Most likely, "I can't lose money." Is that an accurate statement about fixed accounts? It's unlikely that an insurance company would make that claim.

Questionable statements are often more inconspicuous and casually made. We came across several overstatements along the lines of "the purpose of the plan is to prepare participants for a successful retirement." Not a grandiose claim on its face but probably inaccurate (the sponsor is offering the plan to *help* participants prepare *themselves* for retirement, and it will likely only be part of a successful preparation).

We've found that a helpful tactic to eliminate questionable statements is to have a colleague play devil's advocate and challenge claim-like statements in an exaggerated fashion. Though this may seem unreasonable, it usually results in a reworked phrase without a reduction in impact or meaning.

Overstating the role of a committee

A key purpose of an investment policy is to describe the responsibilities of the various parties involved. Maintaining accuracy in these descriptions is important; seemingly innocuous overstatements don't provide any benefit and could come back to haunt you.

We found that some policies used terms like "manage" or "supervise" to describe the investment committee's role relative to a vendor. While committees select providers to whom they delegate tasks and monitor the performance of those providers, implying a supervisory or managerial relationship significantly overstates the scope of a committee's activities. In another example, a few policies used the phrase "constantly monitor" relative to the plan's investments. Four meetings a year (or twelve, for that matter) hardly qualifies as constant.

A healthy tactic to avoid these overstatements is to think of the IPS as a contract you're making with a challenging client, where you know you'll be on the hook for every tiny thing you promise. Not only do you need to be careful about what you sign up to do, but you also need to use clear, accurate, and measured language to describe each activity. Pay special attention to extreme words like "constant," "every," or "all," and active words such as "manage" or "supervise." You'll easily find language that's less likely to cause a breach and more accurately defines the committee's role.

Not clearly assigning responsibilities

The assignment of responsibilities is a core purpose of an IPS, but it was another area where the policies we reviewed often lacked. Here, clarity is vital.

In some cases, two different parties were assigned responsibility for what could be read as either two unique tasks or a single task described slightly differently in two places. In other examples, confusion came when an IPS described duties at such a high level that responsibilities appeared to overlap, leaving multiple parties on the hook and unsure of exactly who is to do precisely what. There were several instances where, despite having read passages relating to responsibilities three or four times, my partner and I each had different understandings of who bore responsibility for specific tasks. If two people who combine for over forty years of investment and retirement plan experience read your IPS and can't figure out who is responsible for doing what, you likely have a problem.

A third-party editor may be helpful. Your reviewer should be able to read your IPS and, in basic terms, tell you who has responsibility for what. If they're confused, it may be time to consider a rewrite.

Omitting an important responsibility

The omission of responsibilities can be problematic, as well. A common example came from a number of plans that offered self-directed brokerage accounts (SDBAs). In nearly all cases, brokerage account providers select the investments to offer through SDBAs - not a plan fiduciary (fiduciaries may elect to limit the types of investments offered, e.g., only mutual funds, but that's a separate matter). Nevertheless, many of the policies of plans offering brokerage didn't explicitly declare SDBA investment selection as a responsibility of the brokerage provider. Combined with the historical gray area of SDBAs under ERISA, this could imply that a committee has assumed responsibility for investment selection within the SDBA. We advocate that an IPS clearly assign the brokerage provider the responsibility for investment selection within SDBAs (provided that's the case).

Including too much specificity or precision

We found many instances where overly precise language could result in the "handcuffing" of a committee. Often, this came in the description of investment selection or termination provisions. We saw phrases that prescribed that an investment option be replaced upon failure to meet specific performance criteria (e.g., if returns fell in the bottom quartile of peers over some period). Such an exacting requirement may impinge on the flexibility of a committee to make investment decisions based on the relationship of prevailing market conditions to an individual investment strategy. A committee may be forced either to replace a perfectly prudent investment option at exactly the wrong time or risk non-compliance with their own IPS. Rigid "if-then" statements should be avoided since *if* your IPS says you need to do something and you don't, *then* you have a problem.

In a more benign situation, the mandated use of specific investment statistics or benchmarks may limit a committee's ability to examine investments in the way it believes most appropriate. A committee should maintain the flexibility to use measures that offer the best insight into each investment option, recognizing that those measures may differ by investment and change over time due to conditions or innovation. For example, a committee may migrate from the Sharpe Ratio to the Sortino Ratio or determine that the Russell 3000 is a more appropriate gauge of performance for a specific investment than the S&P 500. By indicating that a committee will measure investment performance using the statistics, benchmarks, and peer groups "it deems appropriate," the committee retains autonomy to determine its most prudent course.

Naming specific Employees or Investments

Building off the last entry, many policy statements included the names of specific employees or vendors (generally in the Responsibilities section). Employees may leave, and vendors may be replaced. While it may not represent a technical inaccuracy, using specific, proper names creates a potential point of failure and necessitates an additional process to ensure that all parties are kept current. A better approach is to assign responsibilities by role or, better yet, group. You'll eliminate the need to change your investment policy simply because a committee member has been promoted while retaining sufficient clarity and flexibility.

For the same reason, authors should avoid referencing specific benchmark or investment names. Including a list of investments or benchmarks within an IPS provides no benefit (since that information can be kept elsewhere) and requires more onerous diligence to keep the IPS up to date outside of a regular review cycle. We ran across several references to the Barclay's US Aggregate Bond Index. Unfortunately, the name of that index changed back in 2021 (it's now the Bloomberg US Aggregate Bond Index). We even found one publicly available IPS that referenced the

Lehman Brothers Aggregate Bond Index, the name by which the index was known fourteen years and two name changes ago.

Over-reliance on a template policy

The last mistake we'll reference doesn't appear often, but it's glaring when it does.

While it's common to use a template IPS provided by a vendor, such as a law firm, consultant, or recordkeeper, in the early formulation of an investment policy, customization to the particular needs and circumstances of each plan and plan sponsor is mandatory. We saw cases (admittedly, very few) where we could tell the source from which a sponsor's IPS originated. If we can do that, there's a good chance it isn't as plan-specific, and therefore effective, as it should be. As with some of the other errors we've discussed, it may not get you sued, but reliance on a shortcut could shortchange your committee and plan participants.

WHY MISTAKES HAPPEN

Looking beyond unsophisticated or rote advice, we see a few root causes of the mistakes we've discussed:

Lack of a Holistic Approach

As investment policies mature, there are two approaches to making changes. The first is a bolt-on approach, where edits are casually made as needed, without consideration of the IPS as a whole. The second is a holistic approach, which requires a bit more diligence and involves regular reviews of an entire policy statement. While the bolt-on method saves time in the short term, it can result in a Frankenstein's monster of a document that lacks necessary clarity and cohesion and may hold greater potential for unintended conflicts. Our review frequently saw the bolt-on approach in evidence (in one instance, with different fonts!). We advocate for an annual investment policy statement review.

Lack of Objective Review

The longer you look at a document, the less noticeable errors tend to become. It's natural to fall into the trap of subconsciously "filling in the blanks," reading what you intended to write rather than what you've actually written. Alternately, you can miss errors by being distracted by pressing priorities or lulled into performing only a cursory review of a mature document. An objective review by a third party may spot inconsistency or lack of clarity that is no longer evident to the writer.

Lack of Resources or Appropriate Prioritization

For most of the fiduciaries tasked with creating and maintaining investment policies, acting as an investment committee member is a minor component of their job, at least in terms of hours allocated. Once outside the committee room, competing duties may become more pressing, especially when a plan seems to be doing just fine. While there's frequently a shortage of hours and a surplus of distractions, committee members should remember that fiduciary duty is among the highest standards of care imposed by law, and fiduciaries are held <u>personally</u> liable for their diligence. Investment policy statements, as one the most important tools available to plan fiduciaries, deserve an appropriate level of attention.

OUR PERSPECTIVE

It is understood (and we're repeating ourselves) that investment policy statements are foundational components of fiduciary process. As such, they should be carefully composed and maintained. An IPS should be seen as an investment itself that, when adequately funded with time and attention, may not only lead to greater efficiency (of the committee) and a better product (the plan) but could be the key to considerable savings (the dismissal of a suit before discovery) in the long run.

The bulk of the mistakes we saw in our review would have been just as easy to fix as they were to make. A regular, serious review process can eliminate all of the common errors we've discussed and yield a better investment policy statement upon which fiduciaries can rely.

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