Chapter 8

Statement of Investment Policy

Sample Statement of Investment Policy

Objectives and Risk

We, the fiduciaries to the retirement plan, regard risk as the possibility of failing to achieve objectives. Accordingly, the purpose of this statement is to document our goals and how we plan to achieve them. The objectives and risks of the selected target date fund are:

1. Deliver at least accumulated contributions plus inflation at the target date. Strive to achieve this objective with high conviction (i.e., low risk).
2. Grow assets as much as possible without jeopardizing the primary preservation objective. We would like a high probability of achieving this objective when the horizon (term to target date) is long, but will sacrifice growth for safety as the target date nears.

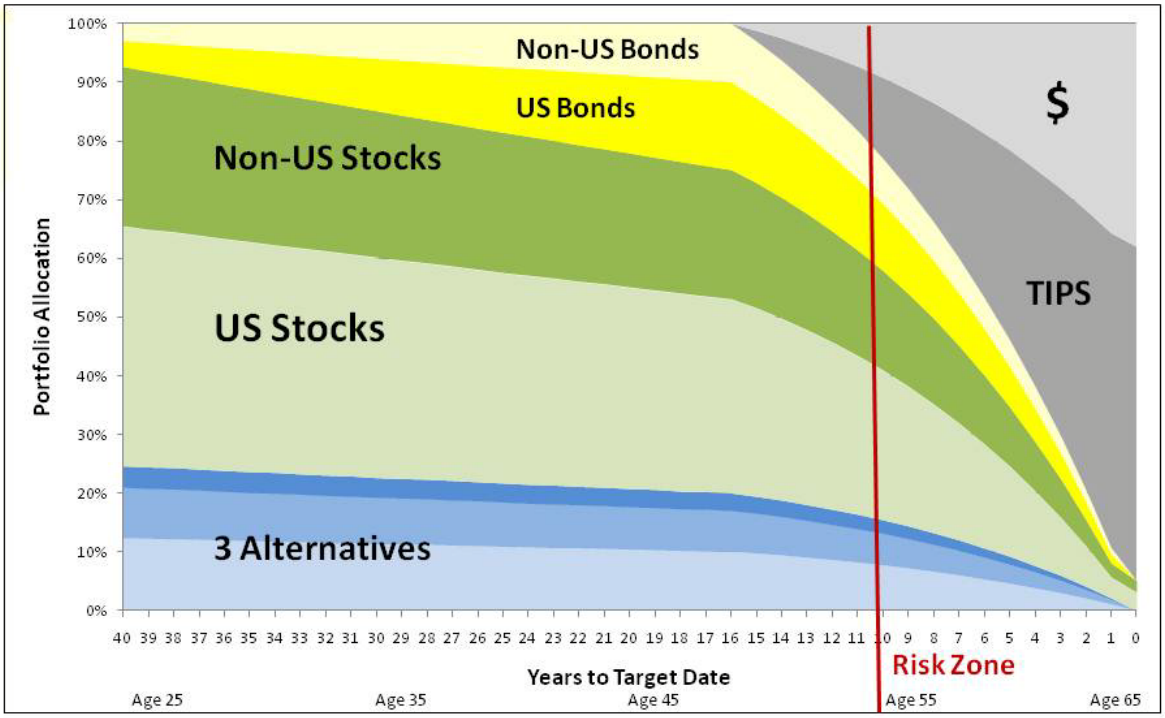
Policies

The policies for achieving these objectives employ a 2-asset growth-preservation separation principle. In the early years, a very broadly diversified growth portfolio serves to increase wealth, but then about 15 years from target date the fund employs Liability-Driven Investing (LDI) principles to defend, moving monies aside into a "Reserve" lock-box of TIPS and Treasuries.

Glide Path

The glide path controls risk through time and is designed to emphasize growth in the early years and then move to defend fairly quickly as the target date nears. The following graph and table describe this path. As shown in the graph, there is a "Risk Zone" that starts 10 years prior to the target date during which account balances are at their highest and lifestyles are at stake. The SEC and DOL understand this. The focus of

their hearings and proposals has always been on risk near the target date. There is no fiduciary upside to taking risk during this critical period.



Selected Target Date Fund Asset Allocations

Years to Target	Equity	Alternatives	Bonds	TIPS and T-bills
0	5	0	0	95
10	42	15	20	23
20	57	21	22	0
30	63	23	14	0
40	68	25	7	0

Architecture and Expenses

Our target date fund is entirely open architecture, meaning no proprietary funds are employed. Furthermore, most of the underlying funds are broadly diversified and

passive, which lowers costs. The high-water mark on underlying fund expenses occurs at about 15 years to target and is less than 30 basis points. When management fees, custody, administration and other associated costs are added in, the all-in costs are generally less than 50 basis points.

Experience and Credentials of the Fund Provider

John Doe is the designer and developer of the selected target date fund. John has 35 years of experience in investment program design and investment policy setting. He earned an MS in Applied Mathematics with Honors from the University of Illinois and an MBA in Finance from the University of Chicago.

Performance Expectations and Reporting

In normal (positive) stock market environments, we expect near-dated funds to lag in performance relative to the industry, as represented by the Morningstar Target Date Index for To Funds. This is the opportunity cost of emphasizing safety near the target date. Regarding all funds the usual risk-reward trade-offs will apply, so we expect that the reward-to-risk ratios of the funds will dominate those of the industry at all target dates. We also expect that over a full market cycle the longer-dated funds will dominate the industry on both a return basis and a reward-to-risk basis because of the broader diversification employed by the funds.

Performance will be reported quarterly to fund participants. The fund is benchmarked against the BrightScope On-Target Indexes® (OTI).

Legal Guidance

The primary principle to observe in investing other people's money is to establish investment policy. The DOL virtually mandates an investment policy for achieving objectives. The investment policy statement (IPS) is the keystone of compliance with fiduciary responsibilities. An investment policy without supporting written documentation is a

penguin—it will not fly. The only way that a prudent fiduciary can meet his obligations is to clearly set down a well-thought-out investment policy statement for achieving appropriate objectives consistent with the fund's documents and instruments. Only then will the fiduciary be able to defend all future actions relating to the investment of those funds, assuming they are consistent with the policy.

The minimum requirements for a statement of investment policy include:

- A statement of objectives
- The method for selection, monitoring, evaluating, retaining, and firing investment managers
- Policies for achieving objectives, for supervising investment performance, and for making this information available to participants and beneficiaries

Managers have to consider the investment policy statement, which includes guidelines for investing, appropriate courses of action, and portfolio monitoring. The process clearly implies the usage of an investment management consultant.

Unfortunately, I estimate that 80 percent of smaller plans (less than $3 million) do not have written investment objectives and policies.

Ethical Perspective

In Chapter 3 we addressed the vulnerability of the unsophisticated plan participant, because most assets in TDFs are there by default. TDF assets belong to the unsophisticated. Once again the physician analogy is helpful here. The most fundamental ethical principles for a physician are found in the Hippocratic Oath: Make a habit of two things: to help, or at least, do no harm.

While this obligation is just a brief few words, the underlying ethical principles are significant and relate directly to the fiduciary responsibility of plan sponsors. The two principles are beneficence and non-maleficence. The principle of beneficence is an affirmative obligation to do good and is summarized as acting in ways that promote the

well-being of others. The principle of non-maleficence is a negative obligation to "do no harm," to act in ways that do not cause harm to others.

A plan sponsor could apply these principles to any ethical decision if they act in ways that enhance a participant's opportunity for a secure retirement income; and do not act in ways that diminish a participant's opportunity for a secure retirement income.

We might consider enhancing a participant's opportunity for a secure retirement income as investment growth. And not diminishing a participant's opportunity for a secure retirement income as, at least, maintaining the buying power of a participant's assets.