

INVESTMENT OPTION SELECTION & MONITORING: WHY IS PROCESS IMPORTANT?

BY SARAH PARKER, AIF®, SENIOR MANAGING DIRECTOR

The role of a plan sponsor charged by the Department of Labor (DOL) includes the selection, monitoring, and implementation of investment managers within a Defined Contribution Plan. There are many factors to consider when documenting, selecting, monitoring, and terminating an investment manager.

We have seen many prospective plan sponsors provide us pages of printouts from Morningstar.com as evidence of their investment manager due diligence and documentation. Would the DOL accept this level of due diligence? How much due diligence do we believe a plan sponsor should complete? The short answers in our opinion are: “no” and “a significant amount.”

Due diligence and documentation are exceedingly important to ensure that you have the right investment manager for your plan participants.

Below we discuss the following:

- DOL’s Position and Prudence
- Clearstead’s Philosophy
- Plan Sponsor Documentation

DOL’S POSITION AND PRUDENCE

The DOL’s position, which is consistent with case law, is that the decision-making process leading up to the challenged act is reviewed to determine whether an ERISA fiduciary’s investment was prudent. After an investment decision has been made, the plan fiduciary has a duty to review and monitor the investment. Prudence, by definition, is acting with or showing care and thought for the future. To successfully conduct prudent decision-making on investment managers, it is our opinion that working with a firm with expertise in the field (i.e., an independent investment consultant such as Clearstead) be retained.

CLEARSTEAD’S INVESTMENT RESEARCH DEPARTMENT AND PROCESS

Clearstead has a rigorous process, honed over thirty years, for conducting due diligence on investment managers and monitoring investment performance. Investment research is coordinated by our Head of Research and is conducted by our eight-person dedicated analyst team, each of whom specializes in a particular asset class or type. Our analysts are objective – the firm does not receive any compensation from investment managers – and we are interested only in finding high-quality investment managers and vehicles for client portfolios.

Our process involves more than performance analysis alone; we believe the qualitative aspects of investment management firms are the major determinants of long-term success. Our due diligence process winnows a large universe of opportunities to a few that can be introduced to plan sponsors.

Analysts conduct quantitative and qualitative research on managers, including on-site meetings, conference calls, questionnaires. Our six “P” framework (outlined on the next page) guides our research and helps identify high-quality managers within asset classes. Getting beyond the numbers to evaluate the qualitative aspects of investment management firms is essential. This skill has been developed through years of experience and is implemented through a honed process.



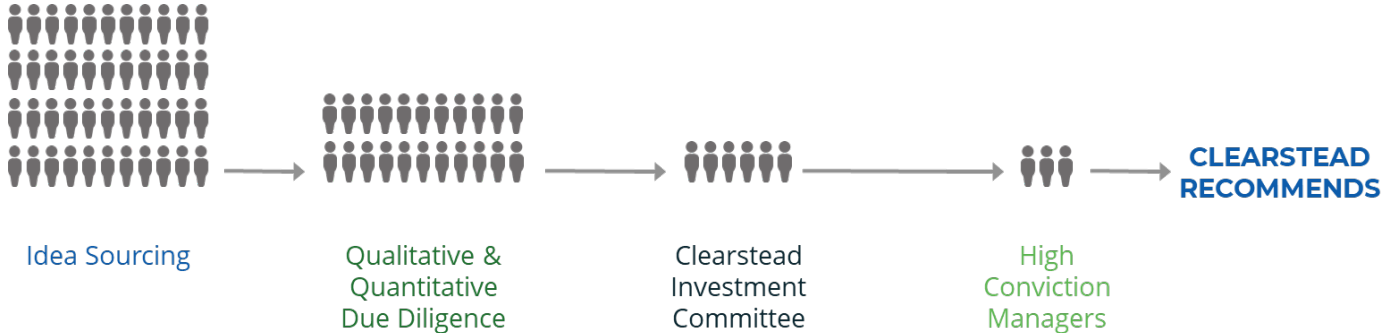
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CLEARSTEAD'S SIX "P" FRAMEWORK

- **Parent:** The beliefs, values, and behaviors that differentiate one organization from another that will produce the results that are best for our clients.
- **People:** The most successful firms create an environment where talented professionals can achieve results that are good for the client, the firm, and themselves.
- **Proess:** A disciplined, enduring investment process that can be repeated by successive generations of managers or investment teams and raises confidence in the expected returns.
- **Portfolio:** Portfolios need to be constructed, managed, and reviewed in a manner that is consistent with high fiduciary standards.
- **Principles:** Incorporating the principles of responsible investing into portfolio decisions may better align the client with the broader objectives of society.
- **Performance:** Investment results are a reflection of the firms ability to stated long-term objectives over long periods.

Analysts then produce a report that is presented to the Clearstead Investment Committee (CIC), who must approve the manager before it can be recommended or implemented in a client plan.



Once a manager has been vetted and approved by the CIC, analysts monitor both its investment performance and the rationale for offering the manager. This occurs through ongoing quarterly due diligence following the same research principles. Our research team sends due diligence questionnaires, conducts interviews, and produces a manager write-up (Figure 1).

The write-up includes an overview of any changes to the team, process, portfolio, parent company, or performance attribution. Manager results are reviewed monthly at CIC meetings and daily results are distributed to the full consulting team. If an unfavorable attribute arises with a manager, Clearstead's Research team will immediately make a recommendation to the CIC for termination across the firm.

Conducting a prudent level of due diligence is a skill that our firm and analysts have developed over many years. The process must be repeatable and focus on qualitative and quantitative attributes of an investment manager.

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MANAGER NAME OCTOBER 29, 2020

Portfolio Managers: **Team Managed** RATING – HIGH CONVICTION

PARENT

MANAGER was founded in XXXX and is headquartered in City, State. The firm is 100% employee-owned by XX shareholders.

Quarterly Updates:

- MANAGER's AUM is \$XX billion. The firm does not report quarterly flows.

PEOPLE

The MANAGER Committee manages the portfolio and consists of XX senior investment professionals. The average Committee member possesses XX years of experience at MANAGER. Key individuals include NAME and NAME. The Investment Policy Committee also receives support from XX investment professionals on the analyst team.

Quarterly Updates:

- No major changes.

PROCESS

MANAGER is a classic value investor seeking to purchase attractive businesses with margins of safety. The investment process begins with fundamental research performed by the research team. The team meets regularly with company management, analyzes financial reports, and interviews competitors to develop a detailed assessment of a business and its prospects. The team builds a five-year model with pessimistic scenarios reflected to determine a company's intrinsic value. The team presents its findings to the Investment Policy Committee, which thoroughly vets the company's merits as an individual investment and determines its role in the overall portfolio.

Quarterly Updates:

- No major changes.

PORTFOLIO

The Fund typically invests in companies that, in MANAGER'S opinion, appear to be temporarily undervalued by the stock market but have a favorable outlook for long-term growth. The Fund focuses on the underlying financial condition and prospects of individual companies, including future earnings, cash flows, and dividends. Other factors such as financial strength, economic conditions, competitive advantages, and management competence factor into

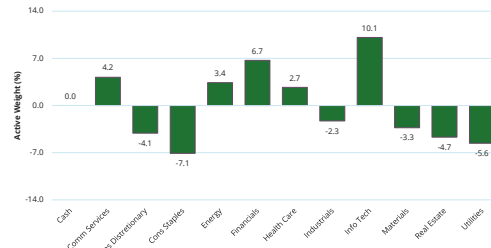
MANAGER NAME

the process of selecting individual securities. Sector weightings result from bottom-up stock selection and can vary significantly from those of the benchmark.

Quarterly Updates:

- Strategy AUM is \$XX billion. The firm does not report quarterly flows.
- The Fund continues to be overweight Financials but has also built up a substantial overweight in Info Tech. The team is significantly underweight defensive areas like Consumer Staples, Real Estate, and Utilities amid unappealing valuations.

Active Positioning:



PRINCIPLES

MANAGER is a signatory to the UN Principles for Responsible Investment. The team integrates ESG research into its process on an investment-by-investment basis given its focus on bottom-up stock selection. It weighs valuation against risks and opportunities for each company and ESG components often factor into the risk component for each company.

Quarterly Updates:

- No major changes.

Figure 1

DOCUMENTATION

A Plan Sponsor should retain all records of due diligence completed by the Investment Consultant. This includes meeting material and any supporting documentation, meeting minutes, and any notes of changes or implementation to the recordkeeper. Included in this material should be information on fees, fee benchmarking, and any changes to overall fee structures from implementing a manager change. All changes made should also follow the client's Investment Policy Statement.

This level of documentation would likely serve as evidence of prudent due diligence on a plan's investment options, according to the DOL's position.

In conclusion, if you need assistance in understanding the process or level of diligence required for defined contribution plans, please do not hesitate to reach out to Clearstead. We are happy to discuss our due diligence process and documentation best practices.

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Performance data shown represents past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.