Framework for investment policy statement

Overview

An investment policy statement (IPS) is a written document that provides plan fiduciaries with a framework for plan investment decisions. A well-defined IPS can support fiduciaries in meeting their obligations and mitigating fiduciary risk by helping provide consistency of decision-making and stability when investment committee members change. Maintaining an IPS designed to further the purposes of the retirement plan is consistent with the fiduciary obligations set forth under the Employee Retirement Income Security Act of 1974 (ERISA).

This document is intended to guide plan sponsors in drafting their IPS by providing questions the plan sponsor may consider addressing in their IPS and sample IPS language for each section. In this document are examples of the core components to consider in an IPS and thought leadership on the purpose for each component. It's important that each plan sponsor tailor its IPS to meet the unique needs of its participant population.

This document is not intended to contain, and should not be construed as, legal or tax advice. Further, nothing in it constitutes investment advice and may not be relied upon as such. Should you have any questions regarding adherence to the law or tax considerations, please consult your legal counsel or tax advisor. Vanguard recommends that a plan sponsor have a qualified attorney review its IPS prior to execution.

Contents

Purpose of an investment policy statement

The IPS is intended to define the Plan's investment objectives and establishes guidelines and general instructions so that these objectives can be met in a prudent manner. The plan fiduciaries may consider stating the following intentions with their policy:

- Provide a mechanism to establish and review the Plan's investment objectives.
- Identify those individuals/functions within the Company with responsibility for selecting and reviewing the Plan's investments.
- Designate the investment options available to participants with a clear understanding of the role each investment option performs.
- Establish the procedures and identify the criteria that may be considered when selecting and monitoring the funds and evaluating the funds' continued appropriateness.
- Provide a single document to ensure that the fiduciary investment and monitoring responsibilities of the Plan are met.

Sample IPS language:

The purpose of this Policy is to provide the Investment Committee, established and appointed by the Company, with guidance in discharging its fiduciary responsibilities of overseeing the investment guidelines described in this Policy.

Plan sponsor:	Sample client
Type of plan:	Plan type
Plan IRS tax identification:	Plan tax ID
Effective date of IPS:	MM/DD/YYYY

Once an IPS is created, the Committee must adhere to it unless it's imprudent to do so. Any departure from the IPS should be documented, including the reason why.

The Committee should consider scheduling a regular review of the IPS to ensure that it continues to reflect the Plan's objectives and meets the needs of their participants, making any necessary modifications to the IPS as necessary.

Section A: Plan and company data

This section should describe the purpose and objectives of your plan, including a clear definition of success. Under Department of Labor (DOL) regulations, plan fiduciaries should select investments "reasonably designed . . . to further the purpose of the Plan, taking into consideration the risk of loss and opportunity for gain (or other returns) . . ."

Originally intended for defined benefit (DB) plans but extended to DC plans, the DOL directs plan fiduciaries to take into account the diversification of plan assets, the Plan's liquidity and current income needs, and the projected rate of return on the portfolio relative to the Plan's funding objectives.

With regards to DC plans, each participant's objective is to accumulate adequate savings for retirement, regardless of whether the Plan is serving as a stand-alone retirement plan or a supplement to another retirement plan.

Some plans may choose to have a secondary objective, such as promoting employee ownership through company stock.

To address the considerations above, plan fiduciaries may consider the following questions:

1. What is the retirement plan's name and type?

____

Name

____

Plan type

2. The Plan functions as:
   - ☐ A stand-alone retirement plan
   - ☐ A supplement to another retirement plan(s)

3. The objectives of the Plan are to (check all that apply):
   - ☐ Provide competitive, diversified investment options that allow participants to accumulate retirement savings over the long term.
   - ☐ Provide a means for participants to supplement benefits provided by the ____________ Plan.
   - ☐ Comply with Section 404 (c) Department of Labor guidelines.
   - ☐ Acquire a long-term ownership position in __________________ (name of company) through purchase of shares in the __________________ Company Stock Fund.
   - ☐ Other: ____

Sample IPS language:

XYZ Company, Inc. (the "Company") sponsors one defined contribution plan named the XYZ 401(k) Retirement Savings Plan (the "Plan") to provide eligible employees, as defined in the Plan, with the opportunity to save for retirement on a tax-deferred basis and receive contributions from the Company. The Plan is qualified under section 401(a) of the Internal Revenue Code and is operated in compliance with the Employee Retirement Income Security Act ("ERISA") of 1974, as amended.

Explanation of Section 404(c)

ERISA section 404(c) provides that when a participant in a DC plan exercises control over the assets in his or her individual account, the Plan's fiduciaries will generally be relieved of liability under ERISA for losses resulting from the participant's exercise of that control.

The Plan must meet several requirements necessary to qualify as a section 404(c) plan. The Plan must offer participants a broad range of investment options consisting of at least three core investment alternatives, each of which is diversified and each with materially different risk-and-return characteristics. Participants must have the right to change their investments (i.e., exchange investment funds or change contribution allocations) at least once within any three-month period. Since DC plan fiduciaries may find that some participants abuse their daily trading privileges by engaging in market-timing, the DOL has stated that imposing appropriate trading restrictions does not interfere with 404(c) compliance.

Participant disclosure requirements under 404(c) have been replaced by participant fee disclosure rules under DOL Regulation section 2550.404a-5, which applies to all participant-directed plans, regardless of whether the plan sponsor intends that the Plan satisfy ERISA section 404(c). However, plan fiduciaries must follow all of the requirements of the participant fee disclosure regulations to qualify for 404(c) protection.

If the Plan is 404(c) compliant, the plan fiduciary may seek to include language in the IPS about how to maintain compliance. The intention to be 404(c)-compliant must also be included in the Summary Plan Description (SPD) provided to participants.

Sample IPS language:

The Plan is a participant-directed individual account plan that is intended to constitute a plan described in section 404(c) of ERISA and Department of Labor Regulations section 2550.404c-1, which means that the Plan's fiduciaries may be relieved of liability for any losses that are the result of investment instructions given by a participant or beneficiary.

Given the Plan's intent to comply with section 404(c) of ERISA, the Plan will provide a broad range of investment choices to reflect the different investment preferences and risk tolerances common among participants in retirement savings plans. Additionally, participants will be given the flexibility to alter their investment choices and the direction of existing and future contributions.

The Plan will also provide participants with access to current investment information along with education materials and/or programs designed to compare investment options by risk-and-return characteristics in order to make informed investment decisions.

Section B: Investment strategy and policy

Part I: Investment strategy

ERISA embraces a modern portfolio view and recognizes the benefits of diversification as an effective method for managing investment risk. What matters is not the individual risk of a specific investment but how the entire portfolio seeks to manage risk and return.

Because risk-and-return characteristics are strongly influenced by a portfolio's asset allocation, it is important for plan fiduciaries to determine the overall asset allocation for the Plan's investments.

Given the defined contribution plan is participant-directed, plan fiduciaries should offer a broad range of investment options covering multiple investment categories and asset classes so that participants can devise portfolios with risk-and-return characteristics based on their own risk preferences. To comply with 404(c) regulations, a plan sponsor only needs to offer a minimum of three diversified options with materially different risk-and-return characteristics. However, in our experience, plan sponsors offer an average of 18 funds[1] in a balanced array of investment options covering four major investment categories: equity funds, bond funds, balanced or life-cycle funds, and money market or stable-value options. A small number of plan sponsors may offer greater choices, perhaps through a brokerage window.

It is important to document the Plan's investment strategy in light of the demographics and investment experience of the participant population.

Key considerations in structuring the investment options are:

- Each fund should be an appropriate building block to forming a reasoned and diversified portfolio.
- Each fund should be relatively low cost and broadly diversified within its area of focus.[2]
- Each fund should capture asset-class returns (i.e., returns should be consistent with the fund's area of focus).
- Each fund's investment strategy should be readily understood and easy to communicate.

Sample IPS language:

Considering the varied attitudes, goals, expectations, investment time horizons, and risk tolerance levels of the Plan's participants, the Plan will offer a broad array of investment options that allow participants to build portfolios consistent with their individual preferences and objectives.

Thus, the well-diversified investment options the Plan will offer include choices among the three primary asset classes (cash, bonds, and stocks).

Within stocks, the Plan may offer additional opportunities to diversify by style (growth and value), size (large capitalization and small capitalization) and region (U.S. and international).

1 Vanguard, *How America Saves 2017*.

2 To better understand the importance of cost and diversification, please reference *Vanguard's Principles for Investing Success*.

Part II: Investment categories and options ("tiers")

Plan fiduciaries should also consider designing their investment menus in concert with their participant education and advice programs. This design and the explanation behind the structure and purpose of each tier may be captured in the investment policy statement.

Plans may be structured with one or more investment categories (or "tiers") to meet the needs and preferences of plan participants and to facilitate the Plan's participant education program. Tiering investment options is not an investment strategy or recommendation in itself. Rather, it is a way to organize the presentation of the Plan's investment options for participants based on participants' desired level of engagement in managing their accounts, as described further in the chart below.

Plan fiduciaries may consider the following questions:

1. For educational purposes, is the plan lineup communicated to participants using a "tiered" approach?

   ☐ Yes

   ☐ No

2. Investment categories (check all that apply):

   ☐ Single-fund solutions: To provide an array of pre-mixed, well-diversified portfolios from which the participant can choose a professionally managed asset allocation option to meet his or her distinct asset allocation target.

   ☐ Core funds: Straightforward portfolio building blocks for participants who want to build a portfolio consistent with their independent objectives, risk tolerance, and views on the market. Funds will be selected to offer choices among the three primary asset classes (cash, bonds, and stocks).

   The investment approach for the Core funds will be one of the following:

   - All index portfolios.
   - All actively managed portfolios.
   - A combination of index and active portfolios.

   ☐ Supplemental funds: To offer a wider range of investment options that may be appropriate for more sophisticated or experienced investors.

Vanguard has considered a few plan design frameworks that plan sponsors may find suitable given their investment objectives.[3]

A basic framework for structuring a tiered plan lineup

	Tiering options	Critical elements	Option: A	Option: B	Option: C
Tier I	Single-fund solution	Appropriate QDIA for all investors in a plan.	Target-date fund (TDF): index or active.	Target-risk fund.	Balanced fund: index or active.
Tier II	Building blocks: broadly diversified options	Straightforward portfolio building blocks.	Underlying TDF funds.	Core index.	Active/index mix.
Tier III	Supplemental choices	Broaden access to investment options.	Supplemental styles.	Supplemental asset classes.	Brokerage window.

Notes: QDIA = qualified default investment alternative.

Source: Vanguard.

3 To learn more about plan design frameworks, see: Frank Chism, Kelly N. McShane, Stephen P. Utkus, 2016, *Constructing a defined contribution investment lineup: Four best practices*, Vanguard Research, institutional.vanguard.com.

Part III: Default investments

A plan fiduciary may select a default investment option for contributions belonging to participants who do not provide investment directions. The plan fiduciary may choose to describe the purpose and designation of the qualified default investment alternative (QDIA) and its adherence to section 404(c) in the investment policy statement.

Sample IPS language:

The Committee will establish a default fund to allocate contributions to the Plan when a participant fails to make an investment selection for elective contributions or employer contributions, or when a participant is automatically enrolled in the Plan. In selecting a default fund, the Committee intends that such selection will comply with Department of Labor section 2550.404c-5 as a qualified default investment alternative ("QDIA").

The Committee will select a default fund or funds and invest Plan assets for which participants have not provided investment instructions in accordance with section 404(c)(5) of ERISA. Accordingly, the Committee is not required to invest in "safe" assets that protect principal, and the law permits fiduciaries to invest in assets that may experience short-term losses in pursuit of long-term returns.

In order to determine the appropriate default fund, the Committee will:

- Evaluate the objectives of the Plan.
- Determine which investment principles underlie the notion of a "prudent investor" as defined by ERISA.
- Select a fund or funds consistent with the prudent investor analysis and that meet the regulatory requirements for a QDIA.
- Document the decision-making process and conclusions.
- Monitor the fund or funds periodically to ensure that they continue to satisfy the requirements to be treated as qualified default investment alternatives.

Considerations for default options

Plans with target-date funds may also include the following: The Committee will select a series of investment funds that are diversified so as to minimize the risk of large losses. Such funds will provide varying degrees of long-term appreciation and capital preservation through exposure to a mix of equity and fixed-income investments that vary based on the participant's age, target retirement date, or life expectancy. Such funds are expected to change their asset allocations over time with the objective of becoming more conservative over time.

Plans with goals-based (aggressive, moderate, conservative) funds may include the following: The Committee will select a group of static-allocation funds as the default funds. The Committee will analyze and monitor employee demographics to determine the appropriateness of the fund based on participant age breakpoints, risk characteristics, and investment strategies. Such funds will provide varying degrees of long-term appreciation and capital preservation through exposure to a static mix of equity and fixed-income investments consistent with a target level of risk appropriate for participants of the Plan as a whole.

Plans with balanced funds may include the following: The Committee will select an investment fund that is diversified so as to minimize the risk of large losses. Such a fund will be designed to provide long-term appreciation and capital preservation through exposure to a mix of equity and fixed-income investments consistent with a target level of risk generally appropriate for participants of the Plan as a whole.

Plans with investment management services (e.g., managed accounts) may include the following: The Committee will select an investment management service under which an investment manager allocates the assets of each participant's individual account in available investments under the Plan based on the participant's age, target retirement date, or life expectancy.

Part IV: Selecting and monitoring diversified investment options

A fundamental responsibility of plan fiduciaries of a participant-directed DC plan is to select, monitor, and, if necessary, terminate investment options for the Plan. This means having a disciplined process for investment selection and evaluation, and documenting the process in the IPS. Without such a strategy, plan fiduciaries risk overreacting to the latest performance trends, either positive or negative. Committees may consider describing their process and the criteria used in monitoring managers in their documentation, as well as the approach committees will take should they consider eliminating investments from the Plan.

Evaluation of investment options incorporates four key elements:

- Evaluating the manager's team and organization.
- Understanding the philosophy that guides the manager's firm.
- Understanding the firm's investment process in managing the option and its consistency over time.
- Analyzing performance, risk, and suitability for a retirement plan over time in light of the firm's philosophy and process.

On an ongoing basis, committees should evaluate whether investment options are achieving the goals set for them within the Plan's investment strategy in light of economic and market developments and the impact to their selected investments. Investment performance should be reviewed regularly relative to the benchmark and peer group as defined by the plan fiduciary. If fiduciaries don't have the proper expertise to select and monitor plan investments, they should seek external experts to help.

Please contact your Vanguard representative to learn how Vanguard's Defined Contribution Advisory Services can partner with plan sponsors in providing resources and investment support.

Sample IPS language:

The Investment Policy Statement will reflect the following:

The selection of investment options for the Plan will be performed in a manner consistent with generally accepted standards of fiduciary responsibility. The Plan's investment options will be selected and monitored with the skill, care, and diligence of a prudent person acting in such capacity and in accordance with ERISA and other applicable laws. All determinations undertaken on behalf of the Plan will be for the sole benefit of the participants and beneficiaries in the Plan.

The Committee will monitor the investment options and will add, remove, or change investment options (or investment managers, if applicable) as may be appropriate. The Committee considers a number of qualitative and quantitative factors when selecting and monitoring any investment option. The Committee will focus its evaluation on long-term issues related to the management of the fund, both qualitative and quantitative. No single factor will determine whether an investment option should be added, retained, or eliminated; however, certain factors may carry more weight in the Committee's final analysis.

Qualitative factors may include fundamental changes in a fund manager's investment philosophy, organizational structure (e.g., manager tenure), and financial condition (including any significant changes in total assets under management).

Quantitative factors may include adherence to fund objectives, performance, and expenses, as detailed below. With regard to performance evaluation, the Committee will continually monitor the funds' benchmarks and peer groups to ensure that they are the most appropriate for comparison purposes.

Quantitative measures for consideration:

- Performance consistency. Has the fund generally outperformed the fiduciary designated benchmark and peer group over a specified time horizon? What specific criteria will the Committee consider to evaluate performance? What are the reasons for underperformance and are they acceptable?
- Style consistency. Has the manager demonstrated consistency in style for the fund's stated investment area over a specified time horizon? For passive funds, have the funds demonstrated low tracking error relative to their stated benchmark?
- Risk/risk-adjusted returns. Has the performance been reasonable given the risk metrics of the fund over a specified time horizon? Is the risk of the fund suitable for a retirement plan given the participant population?
- Expense ratio. Is the expense ratio reasonable relative to the fund's peers and given its performance record?

Qualitative measures for consideration:

- Management stability. Does the fund management have adequate investment experience, and has there been stability with the manager(s) of the fund? Is there management turnover, or regulatory action or litigation, at the firm level?
- Consistent philosophy and process. Have their investment philosophy, strategy, and process of implementing them remained steady over time?

Example benchmark and peer-group table:

Category/style	Fund	Benchmark	Peer group
Large-Cap Blend Equity Fund	XYZ 500 Index Fund	S&P 500 Index	Large-Cap core funds average

Part V: Role of company stock fund

Fiduciaries who offer company stock as part of the defined contribution plan may consider including a section describing the company stock policy, including any restrictions on contributions to company stock, in the IPS. Many aspects of the Plan's company stock holdings may be dictated by other documents (e.g., the plan or trust document), but to the extent the controlling plan documents permit, the IPS should describe the reasons for the inclusion of company stock and any limits on company stock holdings (or, conversely, the reasons why no caps on company stock holdings are deemed necessary).

Monitoring of XYZ., Inc. company stock

The Committee should consider evaluating the relative performance of the Company Stock Fund on a quarterly basis against one or more broad market indexes (e.g., CRSP U.S. Total Market Index, S&P 500 Index, or MSCI US Broad Market Index) or its relevant peer groups. The Committee may also use other means of evaluating the performance of its stock as it deems necessary.

Sample IPS language:

XYZ, Inc. Company Stock is unique among the Plan's investment options in that it invests solely in the company stock shares of a single company, XYZ, Inc. Investment in a single security poses both company-specific and industry/sector risks for participants. The value of the stock can be greatly affected by issues that arise within XYZ, Inc., or within its industry. Therefore, it is much more difficult to anticipate the risk characteristics of this option versus the diversified fund options available in the Plan. However, the Committee does believe that the investment option is a suitable investment for participants within the Plan providing it remains prudent.

The Committee believes that XYZ, Inc. Company Stock Fund as an investment option provides participants with a means of accumulating an ownership position in the Company in a tax-efficient and convenient way. Due to the risks discussed above, the Committee believes that ownership of the Company Stock Fund should be part of a well-diversified retirement savings program.

The Committee will provide investment guidelines to participants to encourage appropriate portfolio diversification. These guidelines will be prepared by the Plan's administrator in order to assist participants when making or changing their investment selections. They will discuss the unique risks associated with a single stock.

If the fiduciaries designate their company stock as the default investment:

To ensure that participants share in the ownership of the Company, all Company contributions are initially invested in XYZ, Inc. Company Stock and may be transferred to any of the other investment options at any time at the employee's direction.

For more information about DC plan best practices, see:

Frank Chism, Kelly N. McShane, Stephen P. Utkus, 2016, *Constructing a defined contribution investment lineup: Four best practices,* Vanguard Research, institutional.vanguard.com.

For more information about plan fiduciary best practices, see:

August 2016, *Best practices for plan fiduciaries*, Vanguard Research, institutional.vanguard.com.

DCIPSTFW 062017