

The Proper Way to Evaluate 401(k) Investment Options

Michael B. Moskal

With the increased scrutiny given to investment evaluation procedures today, plan sponsors need to ensure that they take the proper steps when selecting and monitoring their plan investment options.

The bear stock market over the past two-and-a-half years, as well as corporate scandals (i.e., Enron), have put greater emphasis on making sure 401(k) plan sponsors properly select and evaluate plan investment options. There are five basic factors that should be considered when evaluating plan investment options:

Performance

Performance is the most common measure utilized by investors and plan sponsors in the assessment of investment options. One common mistake is to judge an investment by absolute rather than relative performance. For instance, the most important issue for plan sponsors is how each mutual fund option is performing within its category, not which category is performing better. Some plan sponsors ask, "Shouldn't I invest in the best performing category all the time?" The answer is "Sure, if we had a crystal ball and knew which category would perform the best every year." But we don't. Most plan participants invest their money in a diverse menu of funds. The key question is, "Are the individual funds good performers in their category?" Example 1 shows the absolute returns for two mutual funds for 2001.

Looking at the absolute returns of the two funds in Example 1, the Delaware Small-Cap Value A Fund is a better mutual fund. However, when judging a fund's performance within

Example 1

| Fund Name | 2001 Return ¹ |
|----------------------------------|--------------------------|
| Fidelity Advisor Equity Growth T | -18.19% |
| Delaware Small-Cap Value A | +11.22% |

1. Morningstar Mutual Funds, January 21, 2002.

a 401(k) plan, the fund's performance should be examined in comparison to its category or benchmark average. For mutual funds, the most popular companies that provide benchmark information are Morningstar Mutual Funds and Lipper Analytical Services. For the two funds in Example 1, we will use Morningstar's benchmark information.

Morningstar separately categorizes each mutual fund, then averages the returns for all funds in that category. This is called a "benchmark average." The Fidelity Advisor Equity Growth T Fund is in the large-cap growth category. Its benchmark average consists of 1,027 funds (Morningstar Mutual Funds, January 21, 2002). The Delaware Small-Cap Value A Fund is in the small-cap value category. This fund's benchmark average consists of 250 funds.

Example 2 shows these two funds versus their benchmark averages.

Benchmark average information

Example 2

| Fund Style ¹ | Fund Name ¹ /Benchmark | 2001 Return ¹ |
|-------------------------|--------------------------------------|--------------------------|
| Large-Cap Growth | Fidelity Advisor Equity Growth T | -18.19% |
| <i>Large-Cap Growth</i> | <i>Morningstar Benchmark Average</i> | <i>-23.63%</i> |
| Small-Cap Value | Delaware Small-Cap Value A | +11.22% |
| <i>Small-Cap Value</i> | <i>Morningstar Benchmark Average</i> | <i>+17.31%</i> |

1. Morningstar Mutual Funds, January 21, 2002.

produces quite a different result with respect to the funds' performance in 2001 than the results indicated by the funds' absolute returns for the year (Example 1).

While the Delaware Small-Cap Value A Fund had a positive return in 2001, the fund actually underperformed its benchmark by 6.09 percent, while the Fidelity Advisor Equity Growth T Fund outperformed its benchmark by 5.44 percent. The funds and their benchmarks should be part of a written investment monitoring system to be provided to the plan sponsor.

Risk

Risk is an important measure because it answers the question of how much risk the particular investment option experienced while generating its return. Standard deviation (SD) is used as the measure of risk for purposes of this article.

SD measures an investment's volatility (ups and downs) over a 36-month period as compared to the investment's average or mean return. It also provides expected high and low returns for that investment. One SD from the average return is accurate 67 percent of the time. An SD benchmark may also be used to evaluate whether an investment is more or less risky than the benchmark average.

Example 3 looks at the two funds previously referenced in Examples 1

and 2 and adds their standard deviations and compares them to their benchmark averages. Since SD is measured in a 36-month (3-year) time period, Example 3 shows the 3-year returns.

SD can be used in the following two ways:

The first is to look at the specific fund. The Fidelity Advisor Equity Growth T Fund will be used as an example in showing how SD works:

1. Add the SD number to the 3-year average return:

$$-0.44\% + 20.63\% = 20.19\%$$

20.19% is the high range of the average return for the past 3 years.

2. Subtract the SD number from the 3-year average return:

$$-0.44\% - 20.63\% = -21.07\%$$

-21.07% is the low range of the average return for the past 3 years.

3. We can conclude that the Fidelity Advisor Equity Growth T Fund has ranged in returns from a high of 20.19 percent and a low of -21.07 percent over the past 3 years on average.

4. The Delaware Small-Cap Value A Fund's range of returns would be a high of 24.95 percent and a low of -10.77 percent.

The second way to use SD is to compare each fund's SD to the benchmark SD. If the fund's SD is higher than the benchmark SD, the fund is taking above average risk. For the two example funds, the Fidelity Advisor Equity Growth T Fund is less risky than its benchmark average, while the Delaware Small-Cap Value A Fund is more risky than its average.

Style Purity

Style purity refers to the monitoring of an investment's stated objective. As a large-cap growth fund, the Fidelity Advisor Equity Growth T Fund has an objective of investing in stocks of larger companies that have above-average prospects for growth.

The Delaware Small-Cap Value A Fund has an objective of investing in stocks of smaller companies that are considered "cheap" by traditional stock valuation measurements (such as price-to-earnings ratios). A plan sponsor is obligated to monitor each investment style and notify plan participants of any changes from the investment's stated objective.

The Franklin Small-Mid Cap Growth Fund's 2001 decision to alter its investment philosophy is an example of a change in mutual fund investment style. For 1992 through 2001, the fund was considered to be a small-cap growth fund. In 2001, the fund announced that it would invest in more mid-sized (mid-cap stocks) rather than strictly small-cap stocks. Plan sponsors had to communicate this change to plan participants so those who initially elected to invest in the Franklin Fund as a small-cap growth fund could opt to either remain with it as a mid-cap growth fund option or transfer their funds to a true small-cap growth fund.

Fund Manager Expertise

Each mutual fund has a fund manager (managers are ultimately responsible for the success or failure of the fund). A plan sponsor should first know who all of the fund managers

are and make a determination as to the quality of the management. Factors such as manager experience and education should be considered. The warning signs to look out for are as follows:

- Frequent manager changes on a portfolio fund
- Manager experience and fund objective are not consistent (i.e., an experienced growth manager, managing a value fund)
- A manager deviating from his or her successful style (i.e., a manager successful in small-cap stocks beginning to buy large-cap stocks)

Table 1 incorporates the tenures and names of the managers of the two sample funds.

Expenses

After performance, fund expenses are the next likely priority in evaluating investments. In mutual fund analysis, we can compare a particular fund to the benchmark average expense.

Table 2 incorporates ratios of fund expenses to benchmark average expenses.

Other potential expenses that a plan sponsor should look out for are front- or rear-end loads on the mutual funds.

Conclusion

Let's conclude by evaluating the two funds in our example for each of the five measurement factors. As a reminder, conclusions are based on how each fund compared to its benchmark and are *not* based on direct comparisons of one fund to

| Example 3 | | | | |
|------------------|--|-------------|-----------------------|--------------------|
| Fund Style | Fund Name | 2001 Return | 3-Year Average Return | Standard Deviation |
| Large-Cap Growth | Fidelity Advisor Equity Growth T | -18.19% | -0.44% | 20.63% |
| Large-Cap Growth | Morningstar Large-Cap Growth Benchmark | -23.63% | -3.44% | 23.44% |
| Small-Cap Value | Delaware Small-Cap Value A | +11.22% | +7.09% | 17.86% |
| Small-Cap Value | Morningstar Small-Cap Value Benchmark | +17.31% | +13.02% | 18.67% |

Table 1

| Fund Style | Fund Name | 2001 Return | 3-Year Average Return | Standard Deviation | Fund Manager/Tenure |
|-------------------------|---|----------------|-----------------------|--------------------|-------------------------|
| Large-Cap Growth | Fidelity Advisor Equity Growth T | -18.19% | -0.44% | 20.63% | Jennifer Uhrig (1997) |
| <i>Large-Cap Growth</i> | <i>Morningstar Large-Cap Growth Benchmark</i> | <i>-23.63%</i> | <i>-3.44%</i> | <i>23.44%</i> | |
| Small-Cap Value | Delaware Small-Cap Value A | +11.22% | +7.09% | 17.86% | Christopher Beck (1997) |
| <i>Small-Cap Value</i> | <i>Morningstar Small-Cap Value Benchmark</i> | <i>+17.31%</i> | <i>+13.02%</i> | <i>18.67%</i> | |

the other.

- **Performance:** The Fidelity Advisor Equity Growth T Fund is the winner for this measurement factor. The fund outperformed its benchmark by 6.09 percent while the Delaware Small-Cap Value A Fund underperformed its benchmark by 5.44 percent.

- **Risk:** Both funds have experienced less risk than the average with lower SDs versus the benchmark. The Fidelity Advisor Equity Growth T Fund is 2.81 percentage points less risky than the average, while the Delaware Small-Cap Value A Fund is 0.81 percentage points less risky.

- **Style Purity:** Both funds are “as advertised.” A review of the Fidelity Advisor Equity Growth T Fund stock portfolio shows a high percentage of stock holdings (75 per-

cent) are large-cap growth oriented. The Delaware Small-Cap Value A Fund has approximately the same percentage of small-cap value holdings.

- **Fund Manager Expertise:** Both fund managers have been at the helm of their funds for over five years and possess extensive experience in implementing their fund styles.

- **Expenses:** The Fidelity Advisor Equity Growth T Fund is the winner in this measurement factor with an expense ratio that is 0.19 percent lower than its benchmark. The Delaware Small-Cap Value A Fund is 0.06 percent more expensive than its benchmark average.

Overall, as a plan sponsor, I would conclude that the Fidelity Advisor Equity Growth T Fund is a fund worth keeping in a plan’s

investment portfolio. The Delaware Small-Cap Value A Fund should be replaced with a different small-cap value fund option.

With the increased scrutiny given to investment evaluation procedures today, plan sponsors should take steps to ensure that they take the proper steps when selecting and monitoring their plan investment options. Proper monitoring will not only go a long way toward isolating plan sponsors from liability, but promises to offer plan participants better investment menus. *

Michael B. Moskal, RFP, is vice president of Investment Operations for Moskal Klein Incorporated and is president and CEO of Moskal Klein Securities Corporation (Cleveland). He is also a member of the Fiduciary Advisory Board for Nationwide Financial.

Table 2

| Fund Style | Fund Name | 2001 Return | 3-Year Average Return | Standard Deviation | Fund Manager/Tenure | Fund Expense Ratio |
|-------------------------|---|----------------|-----------------------|--------------------|-------------------------|--------------------|
| Large-Cap Growth | Fidelity Advisor Equity Growth T | -18.19% | -0.44% | 20.63% | Jennifer Uhrig (1977) | 1.26% |
| <i>Large-Cap Growth</i> | <i>Morningstar Large-Cap Growth Benchmark</i> | <i>-23.63%</i> | <i>-3.44%</i> | <i>23.44%</i> | <i>1.45%</i> | |
| Small-Cap Value | Delaware Small-Cap Value A | +11.22% | +7.09% | 17.86% | Christopher Beck (1997) | 1.58% |
| <i>Small-Cap Value</i> | <i>Morningstar Small-Cap Value Benchmark</i> | <i>+17.31%</i> | <i>+13.02%</i> | <i>18.67%</i> | <i>1.52%</i> | |