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Investment Categorization

Introduction

The goal of designing a participant-directed investment menu should be to provide enough diversification of roles to allow participants, physician-executives and trustees to make an appropriate trade-off between risk and return, without having so many roles as to create participant confusion. Ultimately, the burden on plan fiduciaries to adequately educate employees is largely driven by the investment decisions we require them to make in the plan, with more choices necessitating a greater understanding of the fundamental differences between and appropriate role for each choice. The logical questions that arise when selecting options on a menu are:

1. Are there clear differences among the options?
2. Are differentiating characteristics inherent to the option or potentially fleeting?
3. Are the differences among options easily communicated to and understood by the typical plan participant?
4. Most importantly, if participants are given choice among these different options, can the decisions they make reasonably be expected to result in an appropriate long-term investment program?

This white-paper will examine several different ways of categorizing investment options and discuss their usefulness in an average participant's efforts to build a long-term investment program with an appropriate risk/return trade-off. We will specifically examine the problems associated with manager style classifications (e.g., "growth" versus "value" or "growth & income" versus "growth", etc.), with the general conclusion that style categories fail to pass the test of the four basic questions listed above.

Overview

Listed below are relevant topics we will cover regarding investment categorization.

- Investment Categorization Today
  - Asset Class, Style, Size, Sectors…
- Style Categories: Growth & Value
  - Problems with Stock Universe Categorization
  - Problems with Manager Universe Categorization
  - Conclusions
- Investment Reality - There are fundamental differences among manager investment philosophies, but style categories oversimplify these differences.
- Fiduciary Burden – Appropriate Allocation Strategies, Participant Education, Monitoring Compliance with Style.

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Investment Categorization Today

At the most fundamental level, assets can be identified as simply as ownership of a company's equity (i.e., stocks) or ownership of promised interest and principal payments (i.e., bonds). These basic security types can be divided into sub asset classes, including bonds of different maturity (e.g., short-term, long-term, etc.) or different sector (e.g., corporate, government, etc.), stocks with different locations around the world for their corporate headquarters, etc. Let's consider ways of further sub-classifying stocks and bonds. Typical investment categories include the following:

- ***Bond Sub-Classes*** **–** Bonds have their own unique categorizations. Bonds are grouped by type of issuer or "sector" (Treasury, agency, municipal, corporate), by maturity (short, intermediate, long), and by quality (from "investment grade" to "junk"). Each of these sub categories has a somewhat unique set of characteristics, with changes in a security's classification over time only coming from credit quality (i.e., as bond ratings change) and maturity (i.e., as bonds move towards the date of principal repayment).

- ***Equity/Bond Geographic Focus*** – Technically, country of domicile dictates whether an investment is considered domestic to the U.S. or whether it is international. Often, securities in a particular region of the world will have common sources of risk that can be distinct from other regions. While this too seems straightforward initially, considering the multi-national focus of companies these days, an investor can have significant foreign business or market exposure by investing in companies like GM, Ford, Hewlett Packard, or Coca-Cola.

- ***Equity Size: Market Capitalization*** **–** Small, mid, and large are the typical classifications here. Small cap usually refers to stocks with a market capitalization of between $0 and $1 billion, mid cap is usually between $1 and $5 billion in market capitalization, and large cap often includes those stocks with a market capitalization above $5 billion. Even with relatively defined borders, the S&P, Russell, and Wilshire cross these lines when defining the constituents of their small, mid and large cap indexes. Size can also be defined on a relative basis. According to Mobius,* the Scientific Monitoring and Ranking Technologies (S.M.A.R.T) index is constructed by, "sorting Compustat securities in descending order based on market capitalization. The top 60% are funneled into the Large Cap style indexes, the bottom 5% belong to the Small Cap style indexes, and the remaining 35% comprise the Middle Cap style indexes." The conclusion is that, while these universes appear distinct, it is rare that the industry agrees on one universal classification by something even as simple as size.

- ***Equity Style: Growth and Value*** **–** This classification method attempts to distinguish between stocks or manager philosophies based upon the financial characteristics of the investments. As an example, a stock may be considered either "growth" or "value" based on a given set of valuation measures (e.g., price-to-earnings, price-to-book value, dividend yield, etc.). Likewise, a manager may be considered "growth" or "value" based upon the valuation measures of the stocks in the manager's portfolio. Specific problems associated with this methodology are discussed in detail in the following sections**.**

- ***Equity Sectors*** **–** Stocks are often separated by the primary business of the underlying company. This has the potential to be a relatively descriptive classification approach, although the significant level of detail can sometimes mask the problems of classifying companies with businesses in multiple industries. As an example of the level of detail, the Dow Jones Global Industry Groups divide stocks into nine major groups with 78 sub categories below that. The major groups include:

  1. ***Basic Materials***
  2. ***Independent***
  3. ***Consumer Cyclical***
  4. ***Consumer Non-Cyclical***
  5. ***Energy***
  6. ***Financial***
  7. ***Industrial***
  8. ***Technology***
  9. ***Utilities***

Style Categories: Growth & Value

Problems with Stock Categorization

Beyond the problem associated with the shear number of categories that now exist, the issue of how individual investments are actually defined is subject to qualitative judgement and interpretation. Recent debates surrounding the relative performance of growth and value investments have largely neglected discussing key foundational issues associated with the identification and use of such classifications. Identifying stocks with simplistic "growth" and "value" labels can be misleading. Let's take a look at some popularly held misconceptions.

True or False?

- You can classify all stocks as either growth or value.
- At one point in time, a stock is classified as either growth ***or*** value.
- If a stock is classified, it will maintain that classification forever.
- There is a generally accepted and consistently applied method for classifying stocks as either growth or value.

All of the above statements are false. If this is the case, then it is easy to understand why using a label like growth or value to describe the investment style of an investment manager can be misleading as well. Let's look at how the seemly straightforward concept of growth and value is, in actuality, difficult to define.

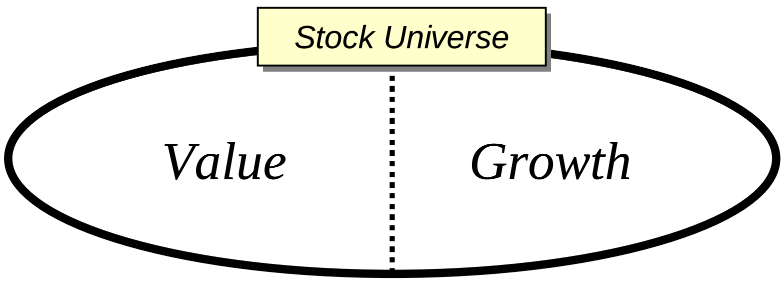
Valuation “Continuum”

Low Valuation | High Valuation

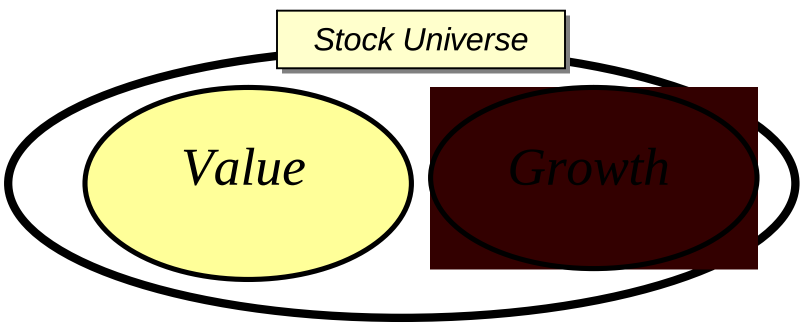
Value
Price driven investors who look for undervalued stocks by focusing on issues with low price/earnings ratios and/or above-average dividend yields as indicators of value.

Growth
Look for companies that have exhibited above average growth in the past and/or have not experienced historical above average growth but are expected to do so in the future. Characterized by high price/earnings ratios and little or no dividends.

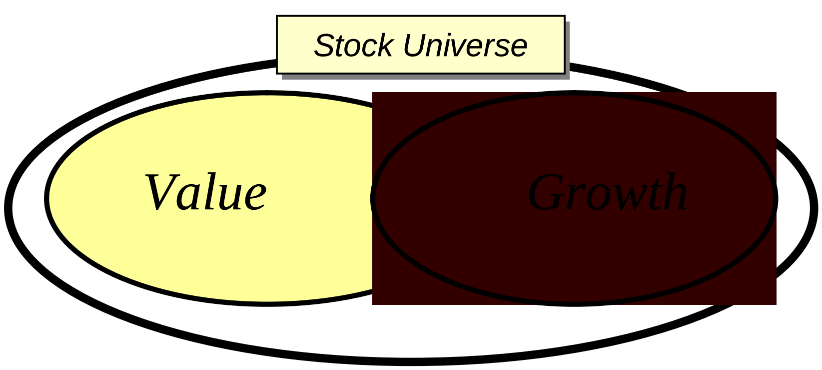
That seems easy enough. Then we should be able to classify the universe of stocks into one of two buckets like this:



Unfortunately, the determination of growth and value is not that simple. On some occasions, some stocks aren’t classified as either. That leaves us with the following partition between value and growth <u>at best</u>:



However, this model also fails to account for the fact that some stocks are considered both growth and value, because low valuation levels by one measure (e.g., price-to-book) does not guarantee low valuations in another (e.g., price-to-earnings). That leaves us with the following diagram:



Simply stated, stocks can not be accurately separated into "growth" and "value" categories. For illustrative purposes, the different methods used by four organizations to categorize "growth" and "value" are shown below.

Prudential Securities, Inc.

Prudential Securities, Inc. (PSI) sorts the U.S. Compustat securities in descending order of market capitalization and forms three universes, large-cap, mid-cap, and small-cap. The stocks in the top 15% of market capitalization make up the large-cap universe, the 10%-25% encompass the mid-cap, and the small-cap comprises the 20%-50% of stocks. The value indexes are constructed from each universe and based on two fundamental characteristics: low normalized price/earnings ratio and high dividend yields. A stock is included in the value index if its normalized P/E is in the fortieth percentile (40%) of its universe. If a stock's dividend is high enough to be in the top fortieth percentile (40%) of the **large-cap** universe (regardless if the stock is large-cap, mid-cap, or small-cap), then that stock is also included in its appropriate value index. The growth indexes include securities from each universe that meet three out of four qualifying factors: the stock's "I/B/E/S long-term earnings growth estimate" must be greater than the universe's mean, the "last-three-year top-line growth rate" must be greater than 10%, the stock's debt must be "less than 35% of market capitalization," and/or the stock's dividend payout ratio must be less than 20% (Brown et al.). As expected, some stocks meet both the value and the growth's standards, thus these stocks are placed in both indexes. Also, some securities meet neither of the style indexes standards (these are called "orphans"), and these stocks are omitted from the value and the growth indexes. Therefore, these style indexes are neither mutually exclusive nor are they exhaustive. The PSI style indexes are rebalanced semi-annually every June and December.

Russell Index Construction

The Russell indexes branch from the Russell 3000, which is composed of the U.S. securities that have the largest market capitalization. The largest 1000 of those 3000 make up Russell's large cap index, the Russell 1000, and the smallest 2000 generate Russell's small cap index, the Russell 2000. In the past, the Russell 1000 bifurcated into value and growth exclusively according to each company's book-to-price ratio and projected growth mean. However, as of June 1995, Russell's large cap style indexes are constructed using the same methodology as the small cap style indexes. Each security is assigned a ranking based on adjusted book-to-price ratio and I/B/E/S projected long-term growth mean. Two breakpoints are determined by the "cumulative available market capitalization" (*Russell*) creating three sections. Those securities in the lower section are deemed 100% growth; those in the upper section are classified as 100% value. The remaining securities that fall in the middle section are given a probability weighting based on which part of the security's market value is considered growth and which part is value. These stocks are partitioned such that if a certain percentage of the stock is included in the value index, then the remaining percentage will be in the growth index. As a result, the sum of the two style index's market cap will equal that of the Russell 1000 or Russell 2000, but the number of companies will be greater. Since overlap occurs in these style indexes, they are not considered mutually exclusive. Rebalancing, or "reconstitution" occurs every June.

Wilshire Index Construction

Wilshire's Large Company Universe, the Top 750, is generated from the Wilshire 5000, and the Next 1750 index is Wilshire's Small Company Universe. Each universes style index is created according to certain characteristics. Key factors for the value indexes are "price/earnings ratio, price-to-book, and yield". For the growth indexes, key elements "include sales growth, return on equity, and dividend payout" (*Wilshire*). Overlap occurs rarely in these style indexes, so they can be considered mutually exclusive. But they are not exhaustive because not every stock is placed in either style index. The large cap and small cap indexes are rebalanced every June, while the style indexes are recreated quarterly.

S.M.A.R.T. Index Construction

Scientific Monitoring and Ranking Technologies (S.M.A.R.T) index construction begins every quarter by sorting Compustat securities in descending order based on their market capitalization. The top 60% are funneled into the Large Cap style indexes, the bottom 5% belong to the Small Cap style indexes, and the remaining 35% comprise the Middle Cap style indexes. Each group is then sorted in ascending order according to a proprietary ranking system that combines dividend yield and price-to-earnings ratio. The securities are divided into three style indexes based on their location in the ranking system: the top 40% become the Growth Index, the bottom 40% become the Value Index, and the remaining 20% establish the Core Index, exclusively, so there is no overlap. Since the Growth and Value style indexes do not encompass every stock, these indexes are not exhaustive in this study. If all nine S.M.A.R.T. indexes are used, they will cover all of the market and thus be exhaustive.

If stocks can not be clearly separated into fundamentally distinct and stable universes of growth and value, should we expect a given manager to invest exclusively in any one of these universes no matter how well "growth/earnings momentum" or "value/fundamental" describes their basic investment philosophy?

Problems with Manager Categorization

Why is it so difficult to make a distinction as simple as growth manager versus value manager? As noted above, there is no universally accepted set of criteria to differentiate a growth stock from a value stock. Since stocks can not be accurately separated into "growth" and "value" categories, it is easy to understand why using a growth or value label to describe the investment style of an investment manager can be misleading. Even so, consultants and investment database providers use these asset classification methods as a basis for creating innumerable investment manager universes that attempt to measure and contrast manager performance. An example of the breadth of categorization is provided here:

- Morningstar has over 40 distinct "Morningstar Categories", over 35 "Prospectus Objectives", 9 style/size combinations for stocks and 9 quality/maturity categories for bonds.
- Mobius calculates 82 distinct universe categories.
- Nelson's, "…rank's the 'Top' institutional investment managers by performance results in each of ***200*** categories."

A sampling of the output is shown below.

M-Search® Investment Manager Database, Release 1999.1 Universe Criteria

The Möbius universe criteria are divided into three separate tables. Table 1 lists criteria for Möbius domestic equity universes that are created using returns-based style analysis. Table 2 on page 5 lists criteria for Möbius mid cap universes, which are created using fundamental criteria. Table 3 on page 6 lists criteria for all other Möbius universes.

Table 1. Criteria and Values for Möbius Domestic Equity Universes

Universe Name	Index	Criteria	Value	Number of Firms	Number of Pro-cesses	Number of Return Sets	Total Assets in $Millions Firm	Total Assets in $Millions Vehicle
Broad Equity		Return	Current Quarter - At least -99	785	1,824	2,170	9,803,380	3,308,582
Broad Equity Conservative	R3000	Beta	Not more than 0.927	300	382	433	6,267,772	899,187
Broad Equity Core	R3000	Beta	At least 0.927, not more than 1.197	470	728	861	8,385,127	1,889,651
Broad Equity Aggressive	R3000	Beta	At least 1.197	256	374	432	6,377,679	447,876
Broad Large Cap	R1000	Index Wtg. - Large Cap Index-Relative Tracking Error	At least 50 Not more than 7.0	456	704	858	8,788,982	2,456,989
Broad Large Cap Conservative	R1000	Index Wtg. - Large Cap Index-Relative Tracking Error Beta	At least 50 Not more than 7.0 Not more than 0.921	156	189	215	4,153,731	673,399
Broad Large Cap Core	R1000	Index Wtg. - Large Cap Index-Relative Tracking Error Beta	At least 50 Not more than 7.0 At least 0.921, not more than 1.089	269	375	431	6,876,123	1,509,786
Broad Large Cap Aggressive	R1000	Index Wtg. - Large Cap Index-Relative Tracking Error Beta	At least 50 Not more than 7.0 At least 1.089	156	182	212	4,640,920	419,179
Pure Large Cap	R1000	Index Wtg. - Large Cap Index-Relative Tracking Error	At least 75 Not more than 7.0	383	572	688	8,485,024	2,297,056
Pure Large Cap Conservative	R1000	Index Wtg. - Large Cap Index-Relative Tracking Error Beta	At least 75 Not more than 7.0 Not more than 0.918	128	153	173	3,778,636	570,299
Pure Large Cap Core	R1000	Index Wtg. - Large Cap Index-Relative Tracking Error Beta	At least 75 Not more than 7.0 At least 0.918, not more than 1.080	221	297	345	6,581,333	1,427,511
Pure Large Cap Aggressive	R1000	Index Wtg. - Large Cap Index-Relative Tracking Error Beta	At least 75 Not more than 7.0 At least 1.080	128	149	171	4,462,748	387,338
Broad Large Cap Value	R1000V	Index Wtg. - Large Cap Value Index-Relative Tracking Error	At least 50 Not more than 7.0	242	341	409	6,994,011	1,037,974
Broad Large Cap Value Conservative	R1000V	Index Wtg. - Large Cap Value Index-Relative Tracking Error Beta	At least 50 Not more than 7.0 Not more than 0.888	75	93	103	2,520,742	306,121
Broad Large Cap Value Core	R1000V	Index Wtg. - Large Cap Value Index-Relative Tracking Error Beta	At least 50 Not more than 7.0 At least 0.888, not more than 1.085	152	184	205	5,150,404	630,792

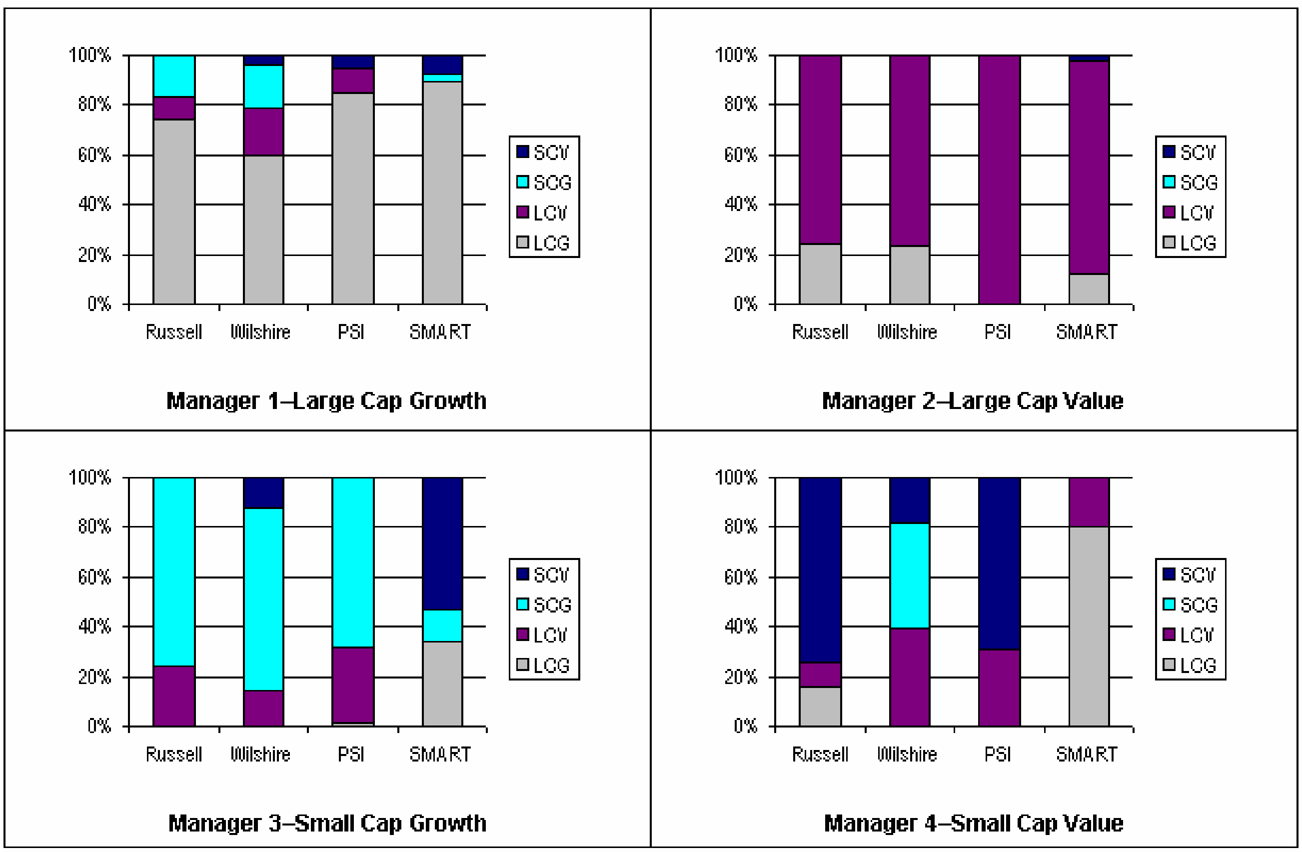
As could be expected, each service provider produces unique results. However, although the output is unique, these vendors use similar labels to identify the manager styles they track. The table below illustrates this outcome.

Figure 1. Results of Analyses of Sample Managers

Manager	Vendor	Large Cap Growth	Large Cap Value	Small Cap Growth	Small Cap Value	Tracking Error	R^2
Manager 1–Large Cap Growth	Russell	74.19%	9.09%	16.72%	0.00%	5.41	0.92
	Wilshire	60.10%	19.05%	16.95%	3.90%	5.53	0.91
	PSI	84.59%	9.77%	0.00%	5.64%	4.90	0.93
	SMART	89.65%	0.00%	3.05%	7.30%	5.39	0.93
Manager 2–Large Cap Value	Russell	24.17%	75.83%	0.00%	0.00%	4.54	0.87
	Wilshire	23.14%	76.86%	0.00%	0.00%	5.01	0.86
	PSI	0.00%	100.00%	0.00%	0.00%	3.59	0.92
	SMART	11.90%	85.52%	0.00%	2.58%	3.82	0.91
Manager 3–Small Cap Growth	Russell	0.00%	24.06%	75.94%	0.00%	5.13	0.95
	Wilshire	0.00%	14.57%	72.98%	12.45%	5.51	0.94
	PSI	1.47%	30.23%	68.29%	0.00%	5.64	0.94
	SMART	33.81%	0.00%	13.36%	52.84%	8.01	0.87
Manager 4–Small Cap Value	Russell	15.96%	9.83%	0.00%	74.20%	4.28	0.94
	Wilshire	0.00%	39.05%	43.12%	17.83%	8.35	0.77
	PSI	0.00%	31.06%	0.00%	68.94%	4.80	0.93
	SMART	22.02%	0.00%	0.00%	77.98%	4.86	0.92

Source: MSearch software, Copyright 1995-1999 Mobius Group, Inc.

Figure 2. Graph of Manager Analyses



Key: SCV=Small Cap Value, SCG=Small Cap Growth, LCV=Large Cap Value, LCG=Large Cap Growth.

Conclusions

Clearly, the most fundamental classification of investments is the basic asset class (i.e., stock, bond or cash). Once we move beyond that, we create a certain level of ambiguity. On the one hand, separation of bonds by credit quality, maturity, sector and geography will tend to create reasonable distinctions and dividing equity investments by geography, market capitalization and economic sector results in a certain amount of uniqueness to the resulting groups of stocks. However, separation of stocks by style has problems all of its own, because valuation measures can be frequently contradictory (e.g., a high price-to-book value, but a low price-to-earnings ratio) and is constantly changing. As will be discussed further in the following sections, classification by style is not necessarily inherent to the stock (i.e., criteria established in Question # 2 in the Introduction) and, therefore, may not have the stability necessary to build a long-term investment program around it.

How pervasive is investment categorization in the investment industry? Simply stated, it has been a foundation for the products of several companies, with each having their own approach to the definitions used to categorize investments and, in turn, managers. These investment database providers use these asset classification methods as a basis for categorizing investment manager approaches and to create manager universes. The theory behind such detailed manager categories is that the basic universe of securities within which any given manager invests is stable and clearly classifiable, so the manager's approach can be classified in the same manner. The categories established by most of these databases cover <u>all</u> of the different types of categories discussed above, from basic asset classes to economic industry/sector focus of the manager or mutual fund. Most of the criteria used today to categorize stocks, and as a result, the managers who invest in those stocks, focus on valuation measures such as price-to-earnings or price-to-book value ratios. However, a beaten down cyclical stock that no self-respecting growth/momentum oriented manager would purchase may have a high price-to-earnings ratio (i.e., from low earnings) or a high price-to-book value (i.e., from asset write-offs). Likewise, "value managers" are not the only ones to own low valuation stocks that have improving earnings growth momentum.

The second problem is that managers are often misclassified or they purposefully "game" the categorization of their own process in order to appear more competitive. As an example, if a manager that typically looks for relatively strong earnings/price momentum is lagging in a period when "growth" managers are out-performing, the rank of the manager can be improved simply by claiming a "value" approach. These issues are well covered in an academic article titled "Mutual Fund Misclassification: Evidence Based On Style Analysis" (Financial Analysts Journal, Fall 1997). Morningstar's "style box" classification of mutual funds by size and style of the current portfolio highlight this problem for any given fund by showing how their portfolio has changed its classification annually. This leads to the fiduciary issues regarding selection and monitoring of options on a participant-directed menu: If a manager is still using the same basic investment philosophy and disciplines, but their "style" category has changed according to the ratings service, should you have to fire them? As we will discuss in greater detail in the last section of the paper, the answer is probably "yes" when the plan's menu has been defined in narrow style categories. Thus, the burden of monitoring and the cost of manager turnover are an inevitable part of narrow style based definitions in a plan.

In total, the terms "growth" and "value" are typically a gross over generalization of what may be a well thought out and relatively complex investment process or philosophy. Since there is no way to unambiguously establish either performance or stock holdings as clearly growth or value, these problems persist in the industry.

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Investment Realities

While style categories are typically over-generalizations, there are basic differences among manager approaches. These basic differences are best categorized by the concept of "momentum" (i.e., buying a good situation with the view that the trend will continue) and "fundamental" (i.e., buying an investment at a specified price irrespective of trends). While some managers use a combination of these disciplines, there are fundamental differences in the conditions under which an investment will appear "attractive" to each type of manager. Likewise, these different approaches may be "in-favor" or "out of favor" over indeterminate, sometimes long periods of time. However, commentaries produced within these time periods typically forget this phenomenon and give statistical support that empirically shows the out-performance of one over the other. Here is just such an example from 1995 (i.e., following an extended period of "value" out-performance):

> "Because nearly any definition of value can be used to outperform the S&P 500 Index, Calderwell concludes that superior information is a commodity. He evaluates the empirical evidence showing that value has a positive bias versus growth – on average, about 300 basis points out-performance and a larger bias for small-capitalization stocks. The value edge differs somewhat by size, index vendor, time horizon, and universe used, but it is enduring and is deliverable with lower levels of risk than the returns associated with the growth style."
>
> *Steve Calderwood, Chairman and CEO, Trinity Investment Management Corporation**

Once again, it is interesting to look historically how this has played out. By the mid-year of 1999, it was far more challenging to find a value manager who had beaten the S&P 500 on a consistent basis over the typical 1, 3, and 5 year rolling time frames. In this more recent environment, the managers that focused on momentum of earnings and price appreciation left more fundamental-based managers behind on a relative basis. The S&P 500, which has been driven by the earnings and price momentum of the largest 30-50 stocks, shows similar strength.

Thus, when selecting investment options for a participant-direct retirement plan, we can not ignore that there are fundamental differences among manager philosophies that may have an impact on relative performance over any given time period. If we use managers of one particular style, it must be done with the understanding that performance may lag over the short-to-intermediate term ***even if the manager is exceptional over a full range of market environments***. Likewise, if we break each category by narrow style-based roles, then we have the difficult task of properly educating participants and monitoring for strict adherence to what have become generally arbitrary definitions.

If we go back to our original four questions, we can conclude that there are differences among managers (i.e., "yes" to Question #1), but the answers to the other questions are more troubling. Specifically, the "growth" or "value" categories are not inherent to each manager and, therefore, may be fleeting. Likewise, we must consider how easily participants can understand the distinctions between "growth" and "value" and how we expect these options to be used in a prudent, long-term investment program. These issues are discussed in the remaining section of the paper.

* "Value and Growth in Equity Investing: An Overview", Jan R Squires, CFA, Professor of Finance, Southwest Missouri State University, *ICFA Continuing Education: Value and Growth Styles in Equity Investing*, 1995, no. 5.

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Fiduciary Burden

All this adds up to additional fiduciary concerns for the plan sponsor. Can the typical participant understand growth and value as concepts when even the experts can not agree on their definitions? The use of style based menus for self-directed plans bring this issue to the forefront. What about investment strategy? What choices are we expecting the participant to make when offering growth and value styles for one basic asset class role? Finally, beyond the responsibility to provide effective education, what other fiduciary issues are associated with style categorization for a participant-directed investment menu?

Consider whether the differences among manager styles can be effectively communicated to the average participant. Because the general style categories of "growth" and "value" are not well defined, we are expecting the participant to understand how the manager is making investments in a fundamental manner and the differences in risk/return characteristics of these alternative approaches. This exercise is difficult for investment professionals and trustees, so it will be even more unlikely to be properly understood by an average participant.

Let's assume for the moment that there is an effective means for understanding the different risk and return characteristics of two managers investing in what is ultimately the same basic asset class. When allowing the choice of these two differing approaches, what decision can the participant make? There are four possibilities:

1. Select the single manager whose investment philosophy makes the most sense overall to the participant;
2. Time the decision of when to move from one management philosophy to another;
3. Split the allocation between the two managers; or,
4. Give up from confusion and do not participate in the plan.

We have already discussed the difficulty of the first choice, so let's consider the second possibility. This decision is an extremely risky choice that typically leads to poor or even catastrophic performance. Why? Timing decisions such as this are typically based upon recent past performance, which is cyclical in nature. In essence, investors generally chase after yesterday's returns and invest in funds after their period of strong relative performance. The strong flows into S&P 500 Index funds and growth/momentum firms of today were preceded by flows into value/fundamentally-oriented investment firms a few years ago. In fact, a Journal of Investing academic article in the Summer of 1998 ("Mutual Fund Performance: A Question of Style") found that mutual funds *changing* their investment style had the worst performance of any style individually.

The next choice is to split the allocation between growth and value. While this approach may mean that the participant will not under-perform significantly when any one style is out-of-favor, it also means that the participant will generally never out-perform either. However, by combining two halves of the same basic universe within an asset class, it is likely that the basic performance of the asset class will result (i.e., index-like returns). Since the participant is paying the higher expenses of active, value-added mutual funds, the end result is likely to be index-like returns less the significantly greater fees and consistent under-performance over the long-term.

While there may be participants who can handle the investment process, the previous discussion illustrates why it remains an open question whether educational efforts and typical menu choices provided by plan fiduciaries will be adequate from a regulatory and legal standpoint. However, while it is unreasonable for participants to select the single best manager, it is reasonable for trustees to choose managers by defining investment policy and objectives that focus on characteristics like broad asset classes. By creating an investment menu that removes soft, overlapping, and largely qualitative distinctions such as style, plan sponsors can take a significant step toward mitigating the potential for participant confusion that inevitably could lead to litigation.

THE END

Resources: