Numbers and Judgment - A Partnership for Fund Evaluation

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Fiduciary committees are swamped with issues to evaluate on behalf of plan participants; Secure 2.0, financial wellness and retirement income are a few that come to mind. But fiduciaries cannot ignore the plan's foundations - the investments - that are the bedrock of plan design.

Investments available in defined contribution plan menus are selected by fiduciaries to give participants the ability to choose investments appropriate to their circumstances. Because participants can only choose from the options available in the plan menu and the quality of the investment lineup available in the plan will **directly impact** their retirement income, **setting** and **maintaining** the plan investment menu are **critical fiduciary responsibilities**.

When an investment fails to meet established due diligence criteria and performance expectations, fiduciaries must decide whether it is best to retain or replace that investment.[1]

What are the issues that should be addressed in the execution of these fiduciary responsibilities? Are there bright lines that committees must observe or a combination of quantitative and qualitative criteria that should be required for fiduciary vigilance? Can recent fee litigation cases provide any additional guidance?

For this survey, we will define plan investments as actively managed funds, the evaluation of which is more challenging than that required for index funds.

The Big Picture

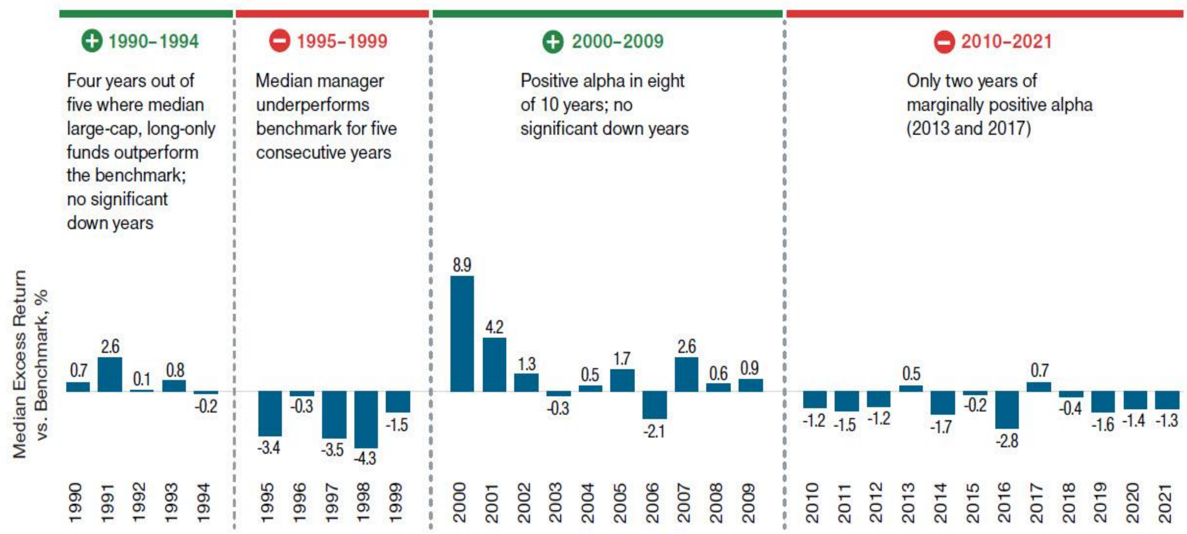
Fiduciaries need to start with understanding the "big picture." In 2022, the S&P 500 and Bloomberg Barclays' Aggregate **both** experienced negative returns for the first time ever in the 46-year history of the Aggregate Index. The Fed raised interest rates seven times in a belated attempt to bring inflation under control, as prices soared 9.1 % through mid-June, the highest annual increase since 1981.[2,3]

[1]Dimensional Fiduciary Resource Guide, Dimensional Fund Advisors. December 2020.
[2]Fiducient Advisors, Fourth Quarter Executive Summary. December 2022.
[3]United States Bureau of Labor Statistics: The Economics Daily, September 2022.

Clearly, the macroeconomic and market environments have changed from a “Goldilocks” period of slow but steady growth, low inflation and low interest rates to a new and uncertain stage, something already being reflected in the higher market volatility and more differentiated sector returns seen over the past year. This is where history can provide some guidance in the form of clearly observable performance trends during previous economic cycles.[4]

Active vs. Passive Performance During Different U.S. Market Cycles

(Fig. 1) Median excess return of actively managed U.S. large-cap funds vs. benchmark



Past performance is not a reliable indicator of future performance.

Data shown include all U.S.-domiciled, domestic-focused, long-only, large cap, actively managed equity funds (US Large Cap Growth, US Large Cap Core and US Large Cap Value universes) as defined by eVestment Alliance, LLC. Historical data include funds that are no longer active, either through closure, or merger with another fund. Returns are shown net of fees (managers providing gross only fees are excluded) and compared against each fund's reported benchmark. Sources: eVestment Alliance, LLC, and Goldman Sachs Global Investment Research (see Additional Disclosures).

Source: T. Rowe Price. September 2022.

The market cycles identified above occurred either during periods of economic expansion (1995-1999; 2010-2021) or economic recession (1990-1994; 2000-2009), producing widely different relative results for actively managed large cap value, core and growth funds. Note that actively managed funds had stronger and more frequently observed positive relative returns during recessionary periods.[5]

[4]Market Turbulence Puts Active Management in the Spotlight, T. Rowe Price Insights, December 2022.
[5]Market Turbulence Puts Active Management in the Spotlight, T. Rowe Price Insights, December 2022.

As evidenced in the chart above, certain economic and market environments may be more favorable for actively managed funds.[6] The Independent Directors Council, which advises independent directors of publicly registered mutual funds, offers the following insight on the importance of the "big picture" in evaluating fund results:

"The board and (fund) adviser might discuss the market environments in which the fund would be expected to outperform its benchmarks and those in which it might trail, as well as how the fund would be expected to perform in rising or falling markets (i.e., expectations for "upside capture" and "downside protection"). They also might discuss the appropriate market cycle over which to evaluate the performance of the portfolio."[7]

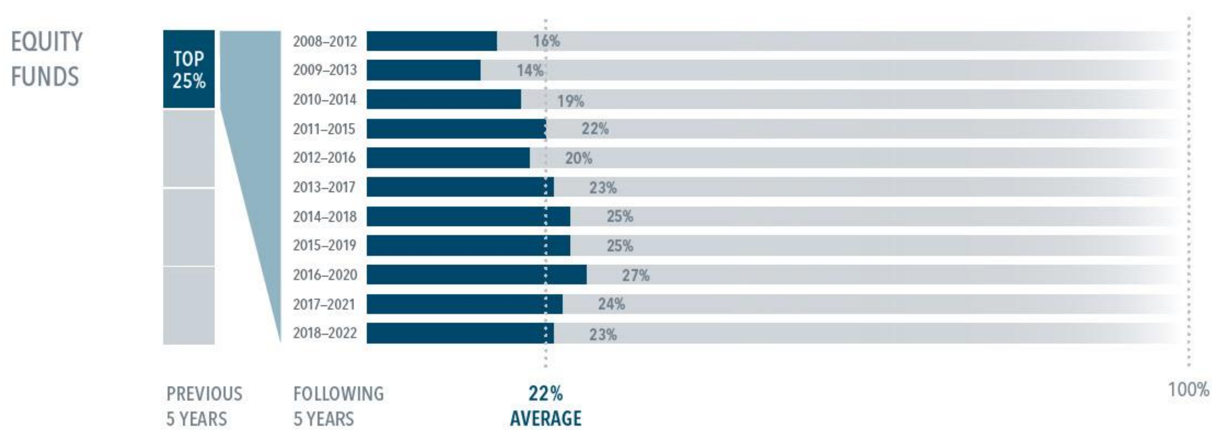
Evaluating Performance - Not as Easy as It Appears

All fiduciaries want actively managed funds that outperform benchmarks and peers. But even considering the "big picture", fiduciaries are often faced with situations when consistent, long-term performers hit rough patches.

What should be done? Or NOT done?

A Fund's Past Performance Is Not Enough to Predict Future Results

Percentage of funds that were top-quartile performers in consecutive five-year periods



[6] Investment Performance Oversight by Fund Boards, Independent Directors Council, October 2013.
[7] Investment Performance Oversight by Fund Boards, Independent Directors Council; October 2013.

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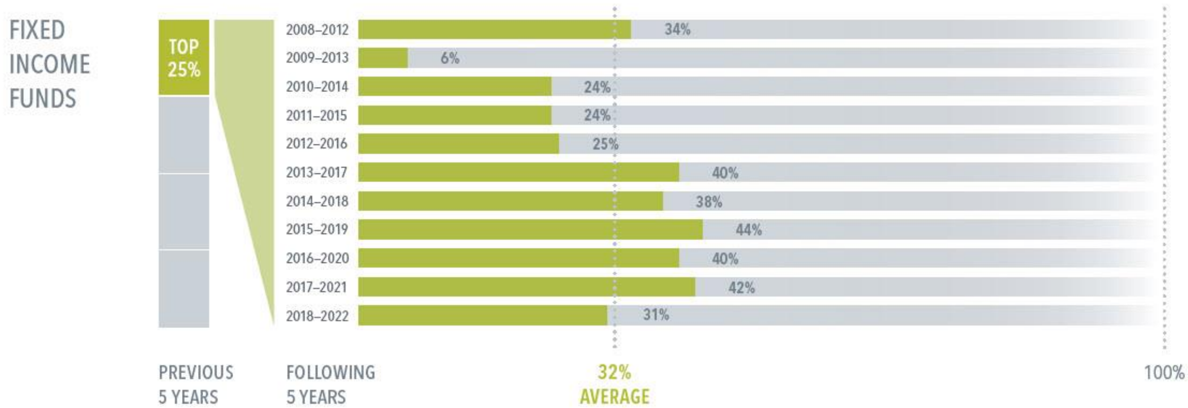


At the end of each year, US-domiciled funds are sorted within their category based on their five-year total return. The tables show the percentage of funds in the top quartile of five-year performance that ranked in the top quartile of performance over the following five years. Example in upper chart (2018–2022): For equity funds ranked in the top quartile of performance in their category in the previous period (2013–2017), only 23% also ranked in the top quartile in the subsequent period (2018–2022). Past performance does not indicate future performance and there is a possibility of a loss.

Source: The Fund Landscape 2023: A Study of US-Domiciled Mutual Fund and Exchange-Traded Fund Performance: Dimensional Fund Advisors, March 2023.

The charts above illustrate the significant challenge of using simple historical data to evaluate manager skill. Some fund managers might be better than others, but historical track records alone may not provide enough insight. Stock and bond returns contain a lot of noise, and impressive track records may result from good luck. The assumption that strong past performance will continue often proves faulty, leaving many investors disappointed.[8]

So based on this analysis, should fiduciaries replace a long-term strong performer soon after it begins to falter? And what other evaluative criteria should be considered besides extrapolating past performance?

Patience and Perspective

While the previous chart focused on how rare it is for top-performing funds to deliver performance at the highest level over successive longer term time periods, we need to observe performance over short to intermediate term time horizons and how that creates challenges for fiduciaries evaluating what to do about an underperformer.

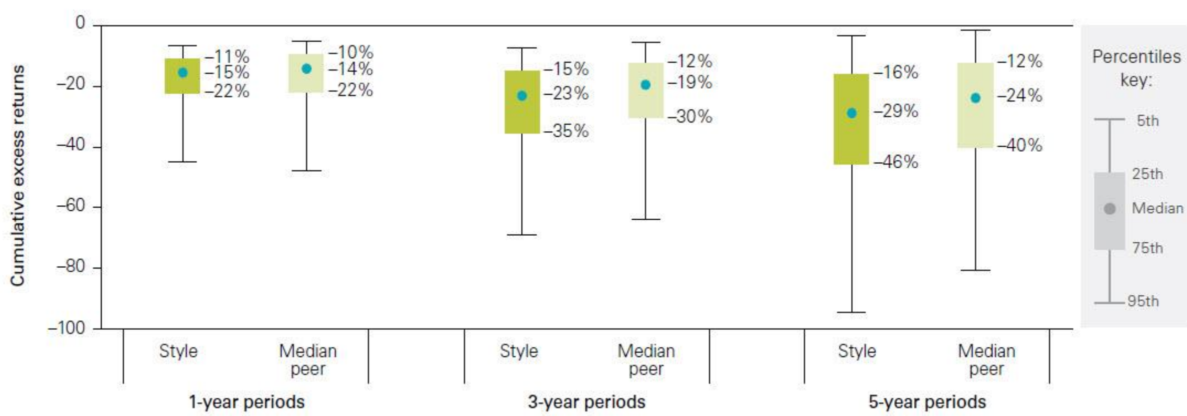
[8] The Fund Landscape 2023: A Study of US-Domiciled Mutual Fund and Exchange-Traded Fund Performance: Dimensional Fund Advisors, March 2023.

In a paper published in 2020 focused on equity funds, Vanguard screened actively managed domestic and international developed and emerging markets funds via Morningstar's database with at least ten years of performance history and at least ten holdings that had outperformed their style benchmarks net of fees during the 1995-2019 study period. The resulting screen consisted of 1,173 funds with an average life of 19 years.[9]

Vanguard found that 837 out of the 1,173 funds, or about 70% of the outperforming funds, underperformed their style benchmarks between 40% and 60% of all **one-year evaluation periods**. The percentage of the time periods for which outperforming funds underperform their style and peer benchmarks decreases as the evaluation period lengthens (three and five years).[10]

When funds underperformed, what were the amounts and ranges of underperformance over one-, three- and five-year periods?

The magnitudes of the worst one-, three-, and five-year excess returns across the individual funds show a wide range of underperformance[11]



Notes: We evaluated all U.S.-domiciled, Morningstar nine-style-box U.S. active equity, emerging markets, and developed market foreign funds with a minimum of ten years of performance data over the period from January 1, 1995, to December 31, 2019, relative to their style benchmark and identified all net outperforming funds. For each group, we calculated overlapping one-, three-, and five-year performance for each year of the period and measured it relative to the relevant style benchmark and median peer returns over the same period. The data presented are each outperforming fund's worst performance over the various aggregated time periods, with the 5th-, 25th-, 50th-, 75th- and 95th-percentile fund returns shown. Although there were statistically significant differences between the means of the categories, these differences were economically insignificant. Therefore, all style boxes were aggregated.

Sources: Vanguard calculations as of May 2020, based on data from Morningstar, Inc.

Past performance does not indicate future performance and there is a possibility of a loss.

[9]Patience with active performance cyclicality: It's harder than you think, Vanguard Research, Vanguard, October 2020.
[10]Patience with active performance cyclicality: It's harder than you think, Vanguard Research, Vanguard, October 2020.
[11]Patience with active performance cyclicality: It's harder than you think, Vanguard Research, Vanguard, October 2020.

As reflected in the chart above, patience and perspective are critical for fiduciaries who are charged with evaluating funds that can have significant declines in short term performance despite superior long-term historical results.

What About Fixed Income?

Using similar methodology Vanguard created a database of 693 actively managed fixed income funds from seven Morningstar fixed income categories. Performance comparisons used the style benchmark comparison as was done in the equity study. And while long-term outperforming fixed income funds did experience stretches of under-performance on a one-, three- and five-year basis, they were less frequent and less severe.[12]

So where are we in our fund evaluation survey? We have learned that the big picture can have an impact for active managers across value, blend and growth styles and that even the "best" long-term performers can go through challenging shorter periods of very poor performance. **It appears that success in traditional active investing requires both a conviction that a manager will outperform in the future and the active risk tolerance to stay invested through the underperforming or drawdown periods.**[13]

Are there other evaluative criteria that fiduciaries can access that will result in bolstering that conviction while practicing well-informed "active risk tolerance"?

Expenses Matter

The most frequently cited criterion by academics and active fund managers is that lower costs and expenses play a significant role in improving the chances for active management to add value over the long term.

As an example, in its study of U.S. domiciled mutual and exchange traded fund performance, Dimensional Fund Advisors found a meaningful difference in survival and outperformance of funds that had the lowest quartile of expense ratios relative to peers for both equity and fixed income over 10-, 15- and 20-year periods ending December 31, 2022.[14]

[12] Some patience required: Outperformance in active fixed income, Vanguard, July 2021.
[13] Patience with active performance cyclicality: It's harder than you think, Vanguard Research, Vanguard, October 2020.
[14] The Fund Landscape 2023: A Study of US-Domiciled Mutual Fund and Exchange-Traded Fund Performance: Dimensional Fund Advisors, March 2023.

Other Evaluative Criteria

Other evaluative criteria cited by active managers includes high manager/high firm ownership, low turnover, high active share and low downside capture.[15]

Fiducient Advisors' research suggests adding qualitative perspectives to the evaluation process via answers to the following questions:[16]

- *Has the portfolio manager changed the fund's process, investment constraints or style?*
- *Does the process remain consistent despite near-term performance challenges?*
- *Has the manager's competitive advantage decayed because of changing market dynamics?*
- *Have there been any material personnel or organizational changes?*

Fee Litigation Cases

Recent court decisions point to fiduciaries having significant flexibility, but not a lot of actionable, concrete guidance when evaluating fund options. In *Hughes vs. Northwestern*, the Supreme Court reaffirmed its decision in *Tibble vs. Edison* that fiduciaries have an ongoing duty to monitor investments and remove imprudent ones within a reasonable time. The Court went on to say that there are a **range of reasonable decisions** a fiduciary can make without violating the duty of prudence.[17]

Closing Thoughts

We have surveyed big picture economic market data, long-term historical fund performance and identified other measurement criteria available to fiduciaries. It is evident there are no rules of thumb/bright lines to ease the burden of using both quantitative tools and qualitative judgment and perspectives to conduct ongoing fund evaluation.

[15]Think no one can beat the index? Think again. The Capital Advantage, Capital Group, 2023 and Understanding the Case for Active Management, Dodge & Cox, October 2016.
[16]The Next Chapter in the Active Passive Debate, Fiducient Advisors, April 2023.
[17]Legal Landscape Update, Thompson Hine, March 2022.

A disciplined, patient and consistent oversight process applied by well-informed fiduciaries continues to provide the best opportunity for Plan Sponsors to create and maintain an investment menu that includes competitive, actively managed funds.

To facilitate the oversight process, committees should strongly consider the following:

Fund Evaluation Checklist

- Establish a shared committee culture where all can agree on the framework for ongoing fund evaluation.
- Obtain the advice of a financial advisor who has long-term experience in the selection and use of quantitative and qualitative criteria in its fund research and monitoring process.
- Consider adopting a 3(38) fund evaluation process that delegates fund selection and termination decisions to the financial advisor.
- With the assistance of ERISA counsel and a financial advisor, create an investment policy statement that provides quantitative guidance and qualitative decision flexibility for committees on fund evaluation.
- For committees that already use an investment policy statement, conduct an annual review which is critical to address changes in plan design and/or the fiduciary landscape.

About the Author

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Dick services institutional clients by providing counsel and guidance on portfolio design, asset allocation, manager selection, investment policy statements and overall performance monitoring.

Prior to joining the firm in 2021, he was a Vice President/Investment Strategist for Fidelity Investments' Workplace Investing organization. Dick's industry experience also includes serving as a Director for BMO Nesbitt Burns, the investment banking division of the Bank of Montreal. He earned a BA with Honors in Economics from Trinity College and his MBA from the University of Virginia's Darden School of Business. Dick is a member of the Board of Trustees and Head of the Investment Committee for the University Liggett School as well as an active member of the Alumni Board for the Darden School of Business. He is a Chartered Financial Analyst (CFA) charterholder, a Certified Financial Planner (CFP®) and a Chartered Alternative Investment Analyst (CAIA®). Dick is a lifelong pianist – contemporary standards, a World War II and economic history enthusiast and a golfer with a passion for links courses.

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