

**TACTICAL ASSET ALLOCATION & ERISA PLANS:
Best Practices for Finding the Right Strategy for Plan Participants**

**Part One of Two:
Part Two on Investments Is Exclusive To CFDD '13 Registrants**

A White Paper By

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I. Introduction – Plan Fiduciaries and Tactical Asset Allocation

Looking for ways to stabilize returns and manage downside risk, plan sponsor and investment advisor interest in Tactical Asset Allocation (“TAA”) strategies has increased. This was initially driven by the 2008 financial crisis, where diversification of asset classes did not provide participants with downside protection. Equity market valuations, a changing interest rate environment and a better understanding of participant risk tolerance further increased interest in TAA. Given today’s investment dynamics - heightened risk for equities as well as bonds - astute investment advisors are increasingly questioning the prudence of modern portfolio theory. The DOL’s recent Tips for ERISA Plan Fiduciaries may also have catalyzed the desire for more oversight through custom solutions.

In contrast to the passive approach adopted in strategic asset allocation (“SAA”) strategies, TAA contemplates dynamic changes that are actively made to a portfolio’s allocations based on current market conditions. 401(k) plans and other similar plans with participant-directed investments (“Plans”) often include target-date or target-risk investment options (“Asset Allocation Investments”) utilizing a TAA strategy of some kind.

Plan fiduciaries face unique challenges when evaluating the actual benefits of TAA as a whole, as well as different TAA strategies. These challenges require additional due diligence on the part of plan fiduciaries overseeing the investment choices offered to their participants, which often include Asset Allocation Investments. Given the fact that Asset Allocation Investments are also routinely used as default investments, Plan fiduciaries should take the time to investigate the prudence of selecting an Asset Allocation Investment with a TAA strategy, and develop a considered approach for evaluating the varying advantages and disadvantages of different types of TAA strategies.

In this white paper, we will provide an analytical framework that is intended to assist Plan fiduciaries in their assessment of TAA investment strategies. This analysis will include a discussion of the legal standards and core principles that govern how Plan fiduciaries should evaluate TAA, as well as suggested “best practices” for evaluating an Asset Allocation Investment’s particular TAA strategy.

II. Fiduciary Considerations Applicable To TAA Strategies

One of the fiduciary challenges to accurately evaluating TAA strategies is the complexity and diversity of TAA strategies that are available to Plan investors. Some TAA investment advisers (“TAA Advisers”) make “systematic” asset allocation changes based on quantitative models, whereas other TAA Advisers make “discretionary” changes based on both quantitative and qualitative factors. Furthermore, some TAA Advisers are focused on enhancing the portfolio’s returns to generate “alpha,” whereas other TAA Advisers are committed to providing downside risk management even at the cost of reducing the portfolio’s upside potential.

In many instances, the TAA strategies are actually SAA strategies with a tactical overlay, where the TAA Adviser temporarily underweights or overweights certain asset categories but seeks to return the portfolio to its strategic asset mix when desired short-term objectives have been achieved. “Core-satellite” asset allocation strategies are a variation on this theme, where the core strategic holdings in the portfolio are passively managed in accordance with a SAA strategy (without a tactical overlay) and only the remaining satellite holdings in the portfolio are actively managed using TAA (*i.e.*, SAA with a tactical overlay). However, it is also possible for TAA strategies to feature dynamic asset allocations that are not anchored by any “neutral” strategic allocations.

A broad spectrum of approaches also exists with regard to the frequency of tactical allocation changes, as well as the magnitude of such changes. Some TAA strategies contemplate tactical changes on a relatively infrequent basis (*e.g.*, once per year), while others may involve tactical changes on a substantially more frequent basis (*e.g.*, multiple changes per quarter). Certain Asset Allocation Investments with TAA strategies include tight constraints on the tactical deviations from the portfolio’s

strategic asset allocations, while certain TAA Adviser's have a broad and unconstrained discretion to make large-scale swings in the portfolio's asset allocations.

III. TAA vs. Market Timing

The U.S. Department of Labor (the "DOL") generally disfavors "market timing," or at least the type of undisciplined market timing conducted by unsophisticated Plan participants. The DOL has specifically noted that "[i]nvestors often buy and sell in response to short-term past returns, and suffer as a result," and that "[a]mong inferior strategies, it is likely that active trading aimed at timing the market generates more adverse results".¹ Some critics may analogize TAA to "market timing," a loaded term with negative connotations in certain contexts.² And certain TAA strategies that contemplate large-scale and frequent swings in portfolio allocations, if exaggerated and taken to their extreme, would be especially susceptible to this type of criticism.

In light of this ongoing debate on whether TAA should be viewed as a form of market timing, for purposes of this paper, we would like to highlight the fact that recognized TAA strategies can and should be distinguished from the types of high-risk trading strategies which may be utilized by undisciplined and unsophisticated market timers. Legitimate TAA strategies are analytically disciplined and based upon objective measures, such as capital market data, macroeconomic conditions, governmental policies, investor sentiment and other quantitative and qualitative factors. Thus, it is important for Plan fiduciaries to confirm that the TAA Adviser for an Asset Allocation Investment has the appropriate investment skill and expertise to manage an investment portfolio successfully. In addition to being able to evaluate a TAA Adviser's qualifications as well as the ongoing performance of the TAA strategy, Plan fiduciaries also need to have a clear understanding of the fiduciary standards that should be used to evaluate a particular TAA strategy.

IV. Core Fiduciary Standards for Plan Investments

The fiduciary standards that govern a Plan fiduciary's evaluation of any Plan investment, including Asset Allocation Investments with TAA strategies, are set forth under Section 404(a) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). These standards include the fiduciary duty of prudence, which generally requires Plan fiduciaries to act with the care, skill, prudence and diligence that a prudent person familiar with such matters would use. Under the interpretive regulations issued by the DOL at 29 CFR 2550.404a-1 (the "Investment Regulations"), to satisfy this duty of prudence, the Plan fiduciary must give "appropriate consideration" to those facts and circumstances that the Plan fiduciary knows or should know are relevant and act accordingly. In light of this standard, the duty of prudence is often characterized as a procedural duty, one that focuses on the information gathered and reviewed by the Plan fiduciary in connection with its investment decision.

The fiduciary standards under ERISA Section 404(a) also include a duty of investment diversification, which requires the Plan fiduciary to diversify the investment portfolio "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." The Investment Regulations further specify that when the Plan fiduciary is giving appropriate consideration to the relevant facts and circumstances, it must include a determination that the particular investment is reasonably designed "as part of the portfolio" to further the purposes of the Plan, taking into consideration the risk of loss and the opportunity for gain. The Plan fiduciary must also consider the composition of the portfolio as a whole with regard to diversification. As highlighted in the Investment

¹ Preamble to DOL's final regulations on participant investment advice at 29 CFR 2550.408g-2.

² In certain negative contexts, "market timing" has been said to bear a closer resemblance to gambling, than to a legitimate investment strategy. However, some advocates of TAA have characterized it as a form of "market timing" in a positive sense, using the term in acknowledgment of the fact that TAA Advisers may make opportunistic allocation changes based on current market conditions and short-term forecasts.

Regulations, when making investment decisions, the Plan fiduciary must consider both the duty of prudence and the diversification requirement under ERISA.

If an Asset Allocation Investment is utilized as a default investment, certain fiduciary protections are available to the Plan sponsor and other fiduciaries if the Asset Allocation Investment is able to satisfy the various requirements for a qualified default investment alternative ("QDIA"). The DOL regulations at 29 CFR 2550.404c-5 (the "QDIA Regulations") governing these QDIA requirements, explicitly provide that the Asset Allocation Investment's underlying portfolio must satisfy the diversification requirement under ERISA. The QDIA Regulations also require the Asset Allocation Investment to apply "generally accepted investment theories." If the Asset Allocation Investment is a balanced default investment for participants, the QDIA Regulations also require its portfolio allocations to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures that is consistent with the target level of risk for the participants of the Plan as a whole. Similarly, if the Asset Allocation Investment is a target-date default investment for participants, the QDIA Regulations require the portfolio's asset allocations and associated risk levels to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures that become more conservative over time as participants get older.³ The changes in a target-date portfolio's asset allocations, which become more conservative over time, are customarily referred to as the "glide path."

It should be noted that the core fiduciary standards set forth in the Investment Regulations and QDIA Regulations, as well as the related case law interpreting the relevant fiduciary duties under ERISA, are grounded in "modern portfolio theory."⁴ Although this investment term refers to a widely accepted body of academic work, we would like to acknowledge that modern portfolio theory is not without its critics.⁵ However, as applied by the DOL and the courts, this term is intended to refer to a broad and basic set of well-recognized investment principles. In clarifying how "generally accepted investment theories" should be consistent with modern portfolio theory, the DOL has explained that modern portfolio theory recognizes "the relationship between risk and return, the historic returns of different asset classes, and the importance of diversification."⁶ As summarized in a notable court ruling under ERISA, modern portfolio theory stands for the basic proposition that "the prudence of selecting a particular investment [should] be viewed in light of its contribution to the risk and return of the entire portfolio, and not in light of its individual risk."⁷ Thus, even though a risky investment could be viewed unfavorably on a stand-alone basis, it may nevertheless be viewed favorably for ERISA purposes when the risky investment is made in connection with the creation of a diversified portfolio.

V. Applying Core Fiduciary Standards to TAA Strategies

Generally, the core fiduciary standards under ERISA are intended to be flexible, permitting a broad range of investment strategies and also allowing for academic advances and changes in the techniques used by investment experts. DOL Advisory Opinion 2006-08A provides that, within the framework of ERISA's prudence and diversification requirements, Plan fiduciaries have "broad discretion" in defining investment strategies appropriate to their Plans and "[w]hether any particular investment

³ It must be noted, however, that the Department of Labor guidance explicitly provides that an investment product with no fixed income exposure cannot qualify as a permanent QDIA, nor can an investment product with no equity exposure (Field Assistance Bulletin 2008-03, Q/A-14 (April 29, 2008)).

⁴ See, e.g., DiFelice v. U.S. Airways, Inc., 497 F.3d 410 (4th Cir. 2007) ("[M]odern portfolio theory has been adopted by the investment community and, for purposes of ERISA, by the [DOL]."); and Laborers Nat'l Pension Fund v. N. Trust Quantitative Advisors, 173 F.3d 313 (5th Cir. 1999) ("In general, the [DOL] regulations provide that the fiduciary shall be required to act as a prudent investment manager under the modern portfolio theory.").

⁵ For example, critics of modern portfolio theory have taken issue with its association with the "efficient markets hypothesis" and other related investment theories. They have also taken issue with certain assumptions that are made under modern portfolio theory, including the extent to which volatility can be used to measure risk.

⁶ Preamble to ERISA Interpretive Bulletin 96-1 ("IB 96-1"). The term "generally accepted investment theories" was first used by the DOL in IB 96-1, which provide safe harbor guidance on non-fiduciary investment education.

⁷ DiFelice v. U.S. Airways, Inc., 436 F. Supp. 2d 756, 786 (E.D. Va. 2006) *aff'd* 497 F.3d 410 (4th Cir. 2007).

strategy is prudent with respect to a particular plan will depend on all the facts and circumstances involved.”⁸ When the DOL was asked by commentators to provide more specific guidance with respect to which investment practices would be consistent with its regulatory requirement for “generally accepted investment theories,” the DOL declined to do so, citing that it was “concerned that attempting to provide further clarification or additional specificity in this area may have potentially significant unintended consequences – such as limiting advisers’ ability to select, apply or make further innovations in participant-oriented investment advice.”⁹

Thus, the core fiduciary standards under ERISA do not rigidly approve or disapprove of any specific type of TAA investment strategy. However, as discussed above, the TAA Adviser’s investment techniques must be grounded in modern portfolio theory and any tactical changes made to its portfolio of investments must be based on investment theories that are generally accepted by the investment community. For this reason, when evaluating a TAA strategy, Plan fiduciaries should gather information concerning the TAA strategy to assess whether the TAA Adviser’s investment theories are generally accepted. As discussed above, unlike the kind of undisciplined market timing activity disfavored by the DOL, legitimate TAA strategies should be analytically disciplined and based upon objective measures. Plan fiduciaries may wish to consider performing enhanced due diligence on any TAA Adviser that utilizes frequent tactical allocation changes (e.g., multiple changes per quarter), and confirming that each tactical change is being made in a disciplined manner in accordance with its investment theories.

Under the Investment Regulations, Plan fiduciaries must give appropriate consideration to those facts and circumstances that the Plan fiduciary should know are relevant and act accordingly. Depending on the legal form of an Asset Allocation Fund, its TAA Adviser may not necessarily be a fiduciary to the Plan.¹⁰ However, from the perspective of a Plan sponsor responsible for prudently selecting the Plan’s investments, it would be a “best practice” to ensure that the TAA Adviser is in fact giving “appropriate consideration” to all relevant facts and circumstances (even if technically speaking it is not a fiduciary to the Plan). Thus, when evaluating a TAA Adviser’s investment strategy, Plan sponsors should gather information concerning the objective measures that are being given appropriate consideration by the TAA Adviser for purposes of its tactical changes made to the Asset Allocation Investment’s portfolio. In general, a TAA Adviser should prudently consider a wide variety of objective measures. As discussed above, the factors taken into account by the TAA Adviser may include capital market data, macroeconomic conditions, governmental policies and other quantitative and qualitative factors. Plan fiduciaries may also wish to consider gathering information on the extent to which the TAA Adviser, when making tactical changes, gives appropriate consideration to the fact that retired participants, as applicable, are taking current distributions from the Asset Allocation Investment. Such consideration would presumably limit the extent to which the TAA Adviser is willing to make tactical changes that substantially increase the risk of the portfolio in light of the current financial needs of retirees.

Asset Allocation Investments customarily utilize some kind of SAA strategy to comply with the QDIA Regulations, which specifically require portfolio allocations to be maintained in accordance with certain requirements. As discussed above, if the Asset Allocation Investment is a balanced QDIA, its portfolio allocations must reflect asset allocations that provide long-term appreciation and capital preservation, consistent with the target risk-level for Plan participants as a whole. If it is a target-date QDIA, its portfolio allocations must provide varying degrees of long-term appreciation and capital preservation, becoming more conservative as participants get older. In order to ensure these requirements are satisfied, Plan fiduciaries should ensure that the Asset Allocation Investment utilizes a

⁸ DOL Advisory Opinion 2006-08A was issued in response to a fiduciary’s request for guidance on the prudence of utilizing a liability-driven investment (LDI) strategy for a defined benefit plan’s investment portfolio.

⁹ Preamble to DOL’s final regulations on participant investment advice at 29 CFR 2550.408g-2. Although these commentators were seeking guidance on the DOL’s participant investment advice regulations, we note that these regulations have the same “generally accepted investment theories” requirement included in the QDIA Regulations.

¹⁰ Under the DOL’s “plan assets” regulations, the investment manager for a Plan’s investment fund is generally a fiduciary to such Plan, subject to certain regulatory exclusions. For example, if the investment fund is an operating company or a mutual fund, the investment manager would not be a fiduciary to the Plan investing in such fund.

SAA strategy (for balanced or glide path allocations) with a tactical overlay that is subject to reasonable tactical constraints and complies with the regulatory mandate to achieve long-term appreciation and to preserve capital. Thus, a TAA strategy that utilized frequent trading to achieve substantial short-term gains with an associated risk of incurring substantial short-term losses, would be inconsistent with the requirements of the QDIA Regulations.

The diversification requirements under ERISA and the QDIA Regulations generally require the Asset Allocation Investment's portfolio to be diversified so as to minimize the risk of large losses. Consistent with the Investment Regulations, Plan fiduciaries should also consider the composition of the portfolio as a whole with regard to diversification. Accordingly, when evaluating a TAA Adviser's investment strategy, it would be important for Plan fiduciaries to gather information concerning the extent to which tactical allocation changes may cause the Asset Allocation Investment's portfolio to become less diversified. A TAA strategy should be consistent with ERISA's duty to minimize the risk of large losses, and tactical changes should never increase portfolio risk beyond the acceptable range. Plan fiduciaries should also bear in mind that asset allocations that ensure a high level of diversification to reduce the portfolio's risk, consistent with modern portfolio theory, may have lower returns.

VI. Investment Expertise of TAA Advisers

In light of the fact that legitimate TAA strategies should be analytically disciplined and grounded in generally accepted investment theories, it is critical for the TAA Adviser (and outsourced service providers, such as tactical overlay professionals, if any) to have the requisite level of investment expertise. For example, a qualified TAA Adviser should have the ability to analyze capital market data and all of the other objective measures that should be given appropriate consideration in accordance with generally accepted investment theories. Plan fiduciaries should be confident that their TAA Advisers do not bear any resemblance to the kind of undisciplined and unsophisticated market timers disfavored by the DOL. When evaluating TAA Advisers, the professional qualifications, the specific TAA-related expertise and experience should all be considered. Plan fiduciaries should keep in mind that TAA is a specialized area and that an investment adviser's general investment management experience or expertise in security selection may not necessarily mean that the investment adviser is qualified to serve as a TAA Adviser for the benefit of Plan participants.

VII. Special Fiduciary Consideration for TAA Strategy's Investment Goals

Given the broad diversity of strategies that may be categorized as TAA, it is critical for Plan fiduciaries to consider a TAA strategy's particular investment goals. This understanding is necessary for Plan fiduciaries to understand whether a particular TAA strategy is appropriate as part of an Asset Allocation Investment offered to the Plan's participants, and it is also necessary for monitoring purposes in order to evaluate the TAA Adviser's success at achieving its investment goals. We have identified four different strategies below for discussion purposes, in order to highlight how TAA strategies may differ from one another in terms of their investment goals. There is no universal agreement on the nomenclature for the various types of TAA strategies that are currently available or how they should be categorized.¹¹ Our labels and descriptions of the various strategies below are for discussion purposes only, and the various strategies listed below are not intended to be exhaustive.

A. Passive Rebalancing (Without TAA)

Before moving on to any specific TAA strategies, we believe it would be helpful to analyze the investment goals of passive rebalancing strategies, which are commonly used by Asset Allocation Investments without a TAA strategy. With passive rebalancing, the investment adviser customarily uses

¹¹ We note that others may label, group and describe the various TAA strategies in a different manner. We further note that any discussion in this White Paper concerning changes in allocation is meant to be interpreted broadly to include, by way of example and not limitation, allocations, asset classes, location (domestic, international), and the ability to go to cash.

SAA to establish target allocations, and it rebalances the portfolio back to its target allocations on either a periodic basis (*e.g.*, quarterly) or when the allocations for any asset category exceeds a tolerance band (*e.g.*, plus or minus 5% of target allocation percentage). The primary investment goal in passive rebalancing is to maintain the portfolio's target allocations and the associated level of risk. For example, if a portfolio's percentage allocation to U.S. equities were to fall during a "bear" equities market, typically, a passive rebalancing strategy would require the purchase of additional U.S. equities to return the portfolio to its target allocations and associated risk level. Without rebalancing, the portfolio's actual allocations and associated risk level would otherwise drift. As an ancillary objective, passive rebalancing may also enhance a portfolio's return in certain market environments.¹²

B. Downside Risk Management (Preservation Asset Allocation)

There has been a great deal of interest expressed by Plan fiduciaries in TAA strategies designed to provide downside protection. A class of TAA-related strategies, which some refer to as "preservation asset allocation" ("PAA"), has the investment goal of providing downside risk management. PAA typically involves setting a minimum or floor value for the portfolio, and managing its risk so that its current value does not dip below the floor value.¹³ The tactical changes under a PAA strategy are not based on a change in capital market expectations. PAA-based tactical changes are often explained as being made based on the assumption that the investor's risk tolerance decreases as the investor's wealth (*i.e.*, portfolio value) decreases.

One popular form of PAA is known as constant proportion portfolio insurance ("CPPI"), which provides for allocations between the portfolio's risky asset classes and its riskless asset class (*e.g.*, cash equivalents, Treasury securities) taking into account the portfolio's "cushion" or the excess of the portfolio's current value over its floor value. For example, if the portfolio's cushion declines during a bear equities market, typically, a CPPI strategy would require an increase in the portfolio's allocation to the riskless asset class, and a corresponding decrease in the allocations to the risky asset classes. Under a PAA strategy, the tactical allocation changes typically run in the opposite direction of those under a passive rebalancing strategy. For example, while passive rebalancing would require increasing allocations to equities during a bear market, PAA would require decreasing such allocations.

C. "Fine-Tuning" the Portfolio

Unlike PAA strategies where tactical allocation changes are made based on changes in wealth, other types of TAA strategies involve tactical allocation changes based on changes in capital market expectations. Many TAA Advisers make such changes with the investment goal of "fine tuning" their portfolios, where their longer-term investment strategies are refined and adjusted to reflect current market conditions and ongoing trends. For example, target allocations under a TAA strategy could be fine-tuned to reflect a market cycle during which an asset category is likely to deliver below- or above-average returns.¹⁴ For example, during a bear market for U.S. equities, a TAA Adviser may fine-tune its portfolio by underweighting its allocation to U.S. equities (relative to the neutral allocation determined by SAA) during a relevant phase of the market cycle. Although TAA Advisers that fine-tune their portfolios may respond somewhat differently to the same set of market conditions, in many instances, tactical allocation changes that are designed to fine-tune a portfolio will run in the same direction as those under an PAA strategy (*e.g.*, decreasing allocations to equities during a bear market).

¹² Passive rebalancing is typically expected to enhance the portfolio's returns when investment prices fluctuate but ultimately revert to their long-term averages. However, this passive strategy may underperform during rising markets.

¹³ An IAA strategy typically cannot guarantee that the portfolio's current value will not fall below its floor value in all possible scenarios.

¹⁴ Short-term market cycles may span a few years, but "secular" market cycles driven by large-scale national and global events may span decades.

D. “Contrarian-Like” Tactics

Certain TAA strategies employ contrarian-like tactics, which are functionally similar to “contrarian” investing in that they attempt to time the market by buying after market declines and selling after market rises. The investment goal of contrarian-like tactics is to enhance portfolio returns above those that would otherwise be achieved by SAA alone. Contrarian-like tactics typically assume that asset categories with below- or above-average returns will eventually revert to their long-term averages. Thus, contrarian tactical changes typically will follow the same direction as those made under a passive rebalancing strategy. For example, if a portfolio’s allocation to U.S. equities were to fall during a bear market, both contrarian-like tactics and passive rebalancing would require the purchase of additional U.S. equities. Of course, a TAA Adviser using contrarian-like tactics may strive to make such purchase at the end of (rather than during) the bear market cycle, and the amount purchased may be significantly greater than that which would otherwise be purchased for passive rebalancing purposes.

Some TAA Advisers may find contrarian-like tactics to be incompatible with PAA strategies and TAA fine-tuning strategies on the grounds that contrarian tactical changes would run in the opposite direction of allocation changes under the other strategies (*e.g.*, contrarian-like tactics would increase allocations to equities during a bear market, unlike an PAA strategy). However, other TAA Advisers may attempt to use contrarian-like tactics in combination with such strategies. For example, a TAA Adviser may fine-tune asset allocations by underweighting equities during a bear market, and then attempt to use contrarian-like tactics at the end of the bear market cycle by suddenly overweighting equities.

Among the TAA strategies discussed above, contrarian-like tactics may be the TAA strategy-type that is most akin to market timing in that it is based upon identifying “inflection points” or directional changes in the markets. However, as discussed above, recognized TAA strategies are distinguishable from the kind of undisciplined market timing disfavored by the DOL in that legitimate TAA strategies are analytically disciplined and based upon objective measures. For this reason, when evaluating TAA strategies, Plan fiduciaries may wish to consider performing enhanced due diligence for any TAA Adviser that utilizes contrarian-like tactics based upon identifying “inflection points” and directional changes in the markets, and gathering relevant information on the potential risk of loss associated with such tactics (*e.g.*, any constraints on tactical deviations from target allocations).

VIII. Required Disclosures and Documentation Under ERISA

A. For Plan Fiduciaries

As discussed above, the fiduciary duty of prudence under ERISA is often characterized as a procedural duty, focusing on the information gathered and reviewed by the Plan fiduciary in connection with its investment decision. When considering prospective Asset Allocation Investments (either with or without TAA strategies) for their Plans, Plan fiduciaries should gather all relevant information concerning the Asset Allocation Investment’s investment strategy. Under ERISA Section 408(b)(2) and the related regulations (the “408(b)(2) Regulations”), the Plan’s recordkeeping platform is obligated to provide the Plan sponsor with comprehensive investment-related and fee disclosures for each of the Plan’s designated investment alternatives (“DIAs”).¹⁵ This disclosure requirement for DIAs is typically satisfied through the delivery of fund prospectuses, fund fact cards and other similar disclosure documents.¹⁶ Therefore, Plan fiduciaries should review the required disclosures for DIAs under the 408(b)(2) Regulations to gather relevant information concerning the Plan’s current or prospective Asset Allocation Investment, including any TAA strategy used for the Asset Allocation Investment. Additionally, if the TAA Adviser is an investment adviser registered under the Investment Advisers Act of 1940 or applicable state law, Plan fiduciaries may obtain other relevant information concerning the TAA Adviser’s investment

¹⁵ The required disclosures for DIAs would be in addition to the fee-related disclosures that the Plan’s recordkeeping platform would have to provide under the 408(b)(2) Regulations with respect to its own recordkeeping services.

¹⁶ In the case of bank collective investment funds (“CIFs”), this disclosure requirement may be satisfied through the CIF participation agreement or CIF fact cards.

processes and methods through its ADV brochure. ADV brochures are publicly available on the SEC's Investment Adviser Public Disclosure website.¹⁷

Unfortunately, the performance information included in these materials may not provide Plan fiduciaries sufficient information to evaluate the success of a TAA strategy, since an Asset Allocation Investment's favorable performance may be wholly due to other factors (*e.g.*, performance of individual asset categories, impact of SAA). To determine whether the TAA Adviser's tactical allocation changes have added value, Plan fiduciaries should consider engaging a financial advisor or consultant who can help them evaluate the TAA strategy (*e.g.*, tactical transparency, accountability, attribution analysis, returns-based performance analysis, etc.).

B. For Plan Participants

Under the DOL's participant disclosure regulations ("404a-5 Regulations"), the Plan sponsor has a fiduciary duty to furnish annual investment-related disclosures concerning each of the Plan's DIAs to participants in the form of a comparative chart.¹⁸ Similarly, the QDIA Regulations also require the Plan sponsor to provide investment-related disclosures concerning the Plan's default investment to participants. Under both sets of regulations (404a-5 Regulations and QDIA Regulations), the required disclosure must be "written in a manner calculated to be understood by the average plan participant" (the "Average Participant Standard"). Thus, if the Plan's Asset Allocation Investment is a DIA and a QDIA, the relevant disclosures must be provided to participants in a format that satisfies the Average Participant Standard. Although general information concerning the Asset Allocation Investment would need to be furnished, neither the 404a-5 Regulations nor the QDIA Regulations expressly require any specific disclosures to be made concerning any TAA strategy utilized by the Asset Allocation Investment. However, to ensure compliance with the Average Participant Standard, Plan fiduciaries should consider including a brief description of the TAA strategy and its associated risks in the required DIA and QDIA disclosures to help ensure that such disclosures can be understood by the Plan's "average" participant.

IX. Best Practices for Plan Fiduciaries Evaluating TAA Strategies

Using the legal analysis and recommendations included in this paper, we have developed a checklist of suggested "best practices" and key considerations for Plan fiduciaries evaluating Asset Allocation Investments with TAA strategies. These best practices and key considerations are set forth in the attached Appendix A, and this checklist is intended to provide a conceptual framework to help Plan fiduciaries gather all relevant information for their review and to assist them in the organization of their fiduciary considerations. In addition to being used by Plan fiduciaries when selecting Asset Allocation investments for their respective Plans, the checklist may also be used for purposes of monitoring Asset Allocation Investments on an ongoing basis and replacing them as necessary.

X. Conclusions

Plan fiduciaries face unique challenges when evaluating Asset Allocation Investments with TAA strategies, especially in light of the complex and diverse range of TAA strategies that are available to Plan investors. The fiduciary standards under ERISA impose a duty of prudence and a diversification requirement, and the QDIA Regulations additionally require Asset Allocation Investments to apply "generally accepted investment theories" and to provide required levels of long-term appreciation and capital preservation. The attached Appendix A provides a list of suggested best practices and key considerations for Plan fiduciaries evaluating Asset Allocation Investments with TAA strategies. Following these best practices can help Plan fiduciaries find the right strategy for their participants and discharge their duties prudently in compliance with ERISA's fiduciary standards.

¹⁷ The SEC website is found at http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx.

¹⁸ The 404a-5 Regulations also require quarterly and annual fee disclosures for participants. Certain other information must be made available on an internet website or made available upon request to participants.

APPENDIX A
Checklist of Best Practices and Key Considerations for
Asset Allocation Investments with Tactical Asset Allocation (TAA) Strategies

Fiduciary Rule	Best Practices and Key Considerations
QDIA	1. <u>Generally Accepted Investment Theories</u> . Plan fiduciaries should gather information concerning the TAA strategy to assess whether the TAA Adviser's investment theories are generally accepted.
	2. <u>Tactical Constraints</u> . Plan fiduciaries should ensure that the Asset Allocation Investment has a strategic asset allocation (SAA) with a tactical overlay subject to reasonable constraints, ensuring that tactical changes comply with the regulatory mandate to achieve long-term appreciation and preserve capital.
Diversification	3. <u>TAA's Impact on Diversification</u> . Plan fiduciaries should gather information concerning the extent to which tactical changes may cause the Asset Allocation Investment's portfolio to become less diversified.
Prudence	4. <u>Frequency of Changes</u> . Plan fiduciaries should perform enhanced due diligence on a TAA Adviser that utilizes frequent tactical allocation changes (e.g., multiple changes per quarter), and confirm that each tactical change is being made in a disciplined manner in accordance with its investment theories.
	5. <u>Factors Given Appropriate Consideration</u> . Plan fiduciaries should gather information concerning the objective measures (e.g., capital market data, governmental policies) that are being given appropriate consideration by the TAA Adviser for purposes of its tactical changes.
	6. <u>Retired Participants</u> . Plan fiduciaries should gather information on the extent to which the TAA Adviser gives appropriate consideration when making tactical changes to the fact that retired participants, as applicable, are taking current distributions from the Asset Allocation Investment.
	7. <u>Expertise and Experience</u> . Plan fiduciaries should consider the professional qualifications of the TAA Adviser (and outsourced service providers, such as technical overlay professionals, if any) as well as its specific TAA-related expertise and experience.
	8. <u>Identifying Investment Goals</u> . Given the broad diversity of TAA strategies, Plan fiduciaries should gather and consider information concerning a TAA strategy's particular investment goals (e.g., downside risk management, fine-tuning portfolio allocations or contrarian-like tactics).
	9. <u>Contrarian-Like Tactics</u> . Plan fiduciaries should perform enhanced due diligence for any TAA Adviser that utilizes contrarian-like tactics (based upon identifying "inflection points" and directional changes in the markets as described in Section VII.D) and gather information on the potential risk of loss associated with such tactics (e.g., any constraints on tactical deviations from target allocations).
Documents and Information	10. <u>Plan-Level Disclosures</u> . Plan fiduciaries should review the disclosures provided by the Plan recordkeeper under the 408(b)(2) Regulations for designated investment alternatives (DIAs), as well as the TAA Adviser's ADV brochure (assuming the TAA Adviser is a registered investment adviser) to gather relevant information concerning the TAA Adviser and its TAA strategy.
	11. <u>TAA Performance Monitoring</u> . To determine whether the TAA Adviser's tactical allocation changes have added value, Plan fiduciaries should consider engaging a financial advisor or consultant who can help them evaluate the TAA strategy (e.g., tactical transparency, accountability, attribution analysis, returns-based performance analysis, etc.).
Participant Disclosures	12. <u>Average Participant Standard</u> . Plan fiduciaries should consider including a brief description of the TAA strategy and its associated risks in the required DIA and QDIA disclosures for participants to help ensure that such disclosures can be understood by the Plan's "average" participant as required under DOL rules.

IMPORTANT INFORMATION

The **Wagner Law Group** has prepared this white paper on behalf of the Center for Due Diligence (CFDD), which is intended for employers sponsoring retirement plans that are subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), as well as the financial professionals and other advisors who work with plan sponsors. Future legislative or regulatory developments may significantly impact the matters discussed in this paper. This white paper is intended for general informational purposes only, and it does not constitute legal, tax or investment advice on the part of The Wagner Law Group, the CFDD or their respective affiliates.

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