Funds for Participant Direction

Mutual Fund Selection Process

Broad Range of Styles

The central principle of building a menu of funds for participant direction, called the **Designated Funds**, is to provide for a broad range of investments with varying risk and return characteristics that will allow for participants to grow their accounts while reducing risk through diversification.

While the range of styles included in the Designated Fund list should include at least one equity, bond and stable fund, most plans offer various sub-styles (i.e. small cap, foreign) of each of these core investment types to create an opportunity to enjoy further diversification within each style. Often index funds in many categories will be offered to satisfy the interests of participants that prefer low cost, passive approaches. Just how broad and specialized a Designated Fund list becomes should be matched to the investment sophistication level of the participant group.

Art & Science: Qualitative and Quantitative Analysis

Once the styles of the funds to be part of the Designated Funds are chosen, the actual funds need to be prudently selected and monitored. CecilCo employs a rigorous mutual fund selection and monitoring process that initially screens, evaluates and selects suitable candidates based on our insights into the fund managers and fund families with the highest efficiency, stewardship and style adherence reputations - a focus on the “Five Pillars” above.

Quantitative Transparency

CecilCo seeks transparency into the suitability of a fund by using robust Modern Portfolio Theory (MPT) quantitative measurements from sources such as Morningstar®, Wilshire Associates and the Nationwide Fiduciary Series. We convert a fund scores into a “Batting Average” to simplify the illustration of the status among its peers. *Please see the attached chart describing the six primary evaluation measurements that make up the Batting Average.*

Qualitative Depth

CecilCo offers depth in qualitative analysis through evaluating those essential factors or “Warning Signs” we believe reveal potential risks to a funds ability to outperform in the future. *Please see the attached chart indicating the ten Warning Signs we use in monitoring a fund.*

Although it is difficult to predict the future performance of any fund, CecilCo believes that with our disciplined process we can identify active managers and funds that are likely to outperform over the long term.

The six evaluation measures and a brief explanation are listed below:

Batting Average: Status Among Peers:
Based on Peer Group Percentile Rank for Each Measure

Measure	What it Measures	How it is Measured
Short-term Evaluation Measures		
Expense Ratio	Reasonable Expenses	Analysis of the most recent total expense ratio. Funds with lower expense ratios versus the peer group have higher batting averages.
Sharpe Ratio	Risk-adjusted Return	Trailing 36-month average excess return (above T-bills) over variability. Funds with higher Sharpe ratios versus the peer group have higher batting averages.
Intermediate-term Evaluation		
Trailing Performance	Performance (Total Return)	Trailing total returns for three, five and 10 years, tilted to more recent performance. Funds with higher trailing performance versus the peer group have higher batting averages.
Rolling Information Ratio	Manager Achievement	36 rolling 36-month average excess returns (above market index) over variability. Funds with higher information ratios versus the peer group have higher batting averages.
Long-term Evaluation		
Performance Consistency	Performance Consistency (Total Return)	Rolling 12-month total returns over the last 10 years. Funds with consistently higher returns than their peer group have higher batting averages.
Rolling Selection Return	Manager Skill	84 rolling 36-month average excess returns (above style benchmark). Funds with high selection returns versus the peer group have higher batting averages.

Below Batting Average .100 — .250 — Above Batting Average .400

WARNING SIGNS: WILL THE FUND CONTINUE TO OUTPERFORM ITS PEERS?

The batting average is the primary indicator of whether the fund passes the IPS criteria. However, additional information is provided in the form of warning signs to help indicate if the fund will continue to outperform its peers. Generally, when selecting between two similar funds with similar batting averages, the plan fiduciary may wish to choose the fund with fewer warning signs. Warning signs are indicated on the Nationwide Financial Fiduciary Series[SM] reports with a ⚠. A ✔ indicates the fund passes a particular warning sign. The following fund screening criteria (fund warning signs) are evaluated and monitored to reveal potential risks and provide relevant information to assist plan fiduciaries in making prudent investment decisions.

Warning Signs

High operating expenses (equity, bond, hybrid)	A warning sign indicates the fund's expenses are above the peer group average
High portfolio turnover (equity):	A warning sign indicates the fund's portfolio turnover is higher than 90% of its peer group's portfolio turnover. High portfolio turnover indicates frequent trading and could lead to increased transaction costs for the fund
High performance volatility (equity, bond, hybrid):	A warning sign indicates the fund's three-year standard deviation of returns (risk) is higher than 90% of its peer group
High individual holding concentration (equity, hybrid):	A warning sign indicates the fund holds more than 10% in one security, or more than 50% in the top 10 holdings, or less than 40 total holdings, which may raise concerns about the fund's diversification
High economic sector concentration (equity, hybrid):	A warning sign indicates the fund holds more than the greater of 25% of assets or 1.5 times its peer group average in any one sector
Low style purity (equity):	A warning sign indicates that the fund's performance has varied significantly from the performance of its peer group's benchmark index. If the fund does not follow its stated style it may be difficult to use in an asset allocation program
Low asset base (equity, bond, hybrid):	A warning sign indicates that the fund has less than $50 million in assets
Low manager tenure (equity, bond, hybrid):	A warning sign indicates that the fund manager's tenure is less than one year
High duration bet (bond, hybrid):	A warning sign indicates the fund's duration is more than 1.5 years longer or shorter than its peer group. Duration can be looked at as the payback period for a fund's bond holdings — the average bond maturity adjusted for interest payments
Low credit quality average (bond, hybrid):	A warning sign indicates that the current S&P average bond credit rating is less than single A

Core Fund Review

Selection & Monitoring

Certain plan fiduciaries are considered investment fiduciaries. These are the people who select and monitor the investment options offered to the participants.

Investment fiduciaries

Certain plan fiduciaries are considered investment fiduciaries. These are the people who select and monitor the investment options offered to the participants. If the employer's board of directors appoints a committee or officers to select and monitor the investments, the directors are responsible for prudently selecting and monitoring the investment fiduciaries. In cases where the responsibility for selecting the investments is not assigned to a specific committee or officers, it remains with the employer. In that case, the investment fiduciaries are the officers who select the investments for the plan.

Investment fiduciary activities include:

- Determining the range of investment options and selecting the specific options
- Designating the person who will make the decisions about plan investments
- Selecting the investment provider

As a fiduciary, your job is to establish the investment policy, decide on the positions (asset classes) to be filled and then select the investments for the participants. The committee must select a combination of investment funds that have the potential to perform well individually and that fit together properly as a team. Committee members must seek outside assistance if they lack the education and experience to confidently perform this duty. As mentioned previously, outside professionals must be prudently selected and monitored. Again, the importance of "procedural prudence" must be emphasized. Fiduciaries have the duty to investigate and document their work when selecting and monitoring investments and service providers.

Choosing an investment provider

The duty to prudently select and monitor the funds in your plan means that, at some point in the future, you may, or probably will, need to remove one or more under-performing funds. An investment package with investment options from only one management company or that offers limited availability of funds from outside providers may cause problems with fund selection and monitoring. Because investment management companies often follow the same investment philosophies for all their funds, many of the mutual funds managed by the same company may concentrate in the same stocks, making it difficult to achieve appropriate diversification.

Additionally, if providers force plans to choose a certain number of their own proprietary funds, it may be difficult for the fiduciaries to fulfill their duties to monitor the plan investments because a suitable replacement may not be available if a fund underperforms. Fiduciaries should determine whether the investment package offers a sufficient number and variety of choices so that if an investment option (e.g., a small-cap value fund) were to underperform, it could be replaced by another qualified fund of the same type.

Duty to select and monitor investments

Although many plan fiduciaries seek ERISA Section 404(c) protection, it's important to note that the preamble to the final 404(c) regulations states:

"The act of designating investment alternatives is a fiduciary function to which the limitation on liability provided by section 404(c) is not applicable."

In other words, plan fiduciaries retain the responsibility for selecting and monitoring the investment options made available to participants, even if the plan intends to comply with ERISA Section 404(c). See the ERISA 404(c) section of the fiduciary overview and the ERISA 404(c) *Checklist* and 404(c) *Q&A Brochure* in the fiduciary tools provided with this guide for more information.

Three key investment decisions

There are three key investment decisions fiduciaries must make when selecting investment options for a 401(k) or other participants-directed plan:

1. Each individual investment option must be carefully selected. After researching the possible funds to offer in the plan, the fiduciaries should believe each investment option chosen will perform well relative to its peer group.
2. The group of funds available in the plan must cover a broad range. ERISA Section 404(c) regulations define a broad range as:

"A broad range of options where a participant has a reasonable opportunity to materially affect the potential risk and return … at any point within the range normally appropriate for the participant."

Many investment professionals believe that to cover the broad range requirement, the plan should consider having investments in at least the following investment categories:

Stable value investment such as a guaranteed investment contract (GIC) or money market fund; because the value of the securities held by stable value funds will fluctuate, there is the risk that an investor will lose money investing in stable value funds

U.S. government or corporate bonds; while the fund invests primarily in securities of the U.S. Government and its agencies, the fund's value is not guaranteed by these entities

Large-cap U.S. equities. Invest in the largest 5% of companies in the market; these are larger, more established, profitable and well-known companies

Mid/small-cap U.S. Equities; small-cap stocks have higher risks than stocks of larger, more established companies and have significant short-term price volatility; small company funds involve increased risk and volatility

International or global equities; international investing involves additional risks, including: currency fluctuations, political instability and foreign regulations

3. The investment options individually and as a whole must be appropriate for the particular workforce. Employees must understand the investment options so they can invest successfully for retirement. Ensuring that the investment options are suitable for employees involves providing the right investments, communication and education.

Participants are entitled to have prudently selected investment options available to them. This means that the committee must assess the needs of the participants and choose funds that meet those needs.

The process of selecting the plan's investment options is similar. The committee needs to choose funds to fill different investment categories, from cash to bonds to domestic and international equities: funds with stocks of large and small companies and funds with growth and value styles. The objective is to offer quality funds that work together as a winning team to give participants a range of choices that allows them to customize their investments to help meet their individual needs.

Asset allocation funds and models

Because participants vary widely in their investment knowledge, determining the right combination of plan funds can be a difficult task. That's why it might be a good idea to include asset allocation funds or models for those participants who do not have the knowledge or desire to allocate assets on their own.

Offering asset allocation funds or model and educational materials to participants also helps satisfy ERISA's requirement that the investments be suitable for the participants. Many investment education programs include a questionnaire to help participants determine their investor profiles. Asset allocation does not guarantee a profit or protect against loss in a declining market. However, with this information, participants can choose the appropriate asset allocation model based on their risk tolerance and investment time horizon. The use of asset allocation does not guarantee returns or insulate investors from potential losses.