Morningstar Fiduciary Services

forward-thinking fiduciary solutions

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Since 1984, Morningstar, Inc. has been driven by a single mission: to help investors reach their financial goals. This mission motivates us to use our proprietary research and independent perspective to deliver innovative solutions that help people better meet their retirement goals.

Agenda

- The Fiduciary Landscape
- Outsourcing Fiduciary Services
- Perception vs. Best Practices
- Q&A

The Fiduciary Landscape

Who Qualifies as a Fiduciary?

- Exercises discretion over a plan
  Selecting vendors, being a member of an investment committee
- Renders investment advice for a fee
- Has discretionary authority over a plan

  Approving loans, distributions, submits money to be invested

Your Fiduciary Responsibilities

- Act in sole interest of participants
- Ensure fees are reasonable
- Seek help in selecting managers and administrating the plan
- Diversify investments
- Follow plan documents

Source: Section 3(21) of ERISA

Fiduciaries are in the Hot Seat

Common scenarios leading to EBSA enforcement action

Imprudent Investments for many different reasons

Fiduciaries who don't know and /or don't fulfill their duties – many fiduciaries did not know they were fiduciaries!

Employee Benefits Security Administration (EBSA) 2016 Stats:

2,002 Civil Investigations	1,356 cases resulted in monetary results for plans or other corrective action
333 Criminal Investigations	led to the indictment of 96 individuals – including plan officials, corporate officers, and service providers

Source: http://www.dol.gov/ebsa/

Fiduciaries are in the Hot Seat

Key Cases:

Donovan vs Cunningham

"A pure heart and an empty head are no defense" - Lack of knowledge is not an excuse

LaRue vs DeWolff

Participants can sue for decisions that resulted in a loss in their account

Kayes vs Pacific Lumber Co

A fiduciary's personal assets are at risk

Avon Beauty Products & RadioShack

The plan fiduciaries should have implemented a freeze on purchases of shares in the Avon stock fund – Undisclosed mishandling of company stock

Tibble vs. Edison

Plan Sponsors have a duty to monitor and maintain their investment menu.
"Under trust law, a trustee has a continuing duty to monitor trust investments and remove imprudent ones. This continuing duty exists separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset."

The Reason Fiduciary Blind Spots Exist

1. **Many Plan Sponsors and the Individuals Serving on Plan Committees (a.k.a. Plan Fiduciaries)**

    - Don't realize they are THE Fiduciary for their plan
    - Aren't aware of the extent of their personal financial liability
    - Underestimate the full scope of their fiduciary responsibilities
    - Don't understand the true nature of the legal relationship with their plan's service providers

2. **Financial industry has, in some cases, created complex and opaque business models and fee structures**

3. **Lack of in-house fiduciary compliance and governance expertise**

4. **They are too busy running their business…..**

Risks of Fiduciary Liability

- Legal and financial penalties for the corporation
- Trustees’ personal assets are exposed to financial penalty
- Governmental enforcement and civil litigation
- Liability for acts and omissions
- Regardless of whether these errors result from one’s own actions or the actions of others

Most Plan Sponsors get sued for what they don’t do, not for what they do.

Outsourcing Fiduciary Services

Don't Be Average… Offer A Better Plan Design

Aim to achieve four main principles:

Provide broad market exposure with appropriate complexity:

- Someone building a portfolio out of the funds in a plan's lineup should be able to build an efficient portfolio that is diversified and has limited overlap between investments.

Emphasize core, diversified options:

- Strive for a line-up that is balanced from an asset class perspective in a ratio that roughly approximates the balance that a typical portfolio would have (in fact, since many participants allocate an equal amount to each fund, this is more than just a theoretical underpinning).
- Balance growth and value stocks.
- Reasonable ratio of: Equity to Fixed-Income funds (with more Equity funds); Domestic to Foreign funds (with more Domestic funds); Large Cap to SMID funds (with more large-cap funds).
- If an naïve investor were put an equal amount in each fund in our lineup, his portfolio would be reasonably diversified and balanced
- Offer do-it-for-me solutions

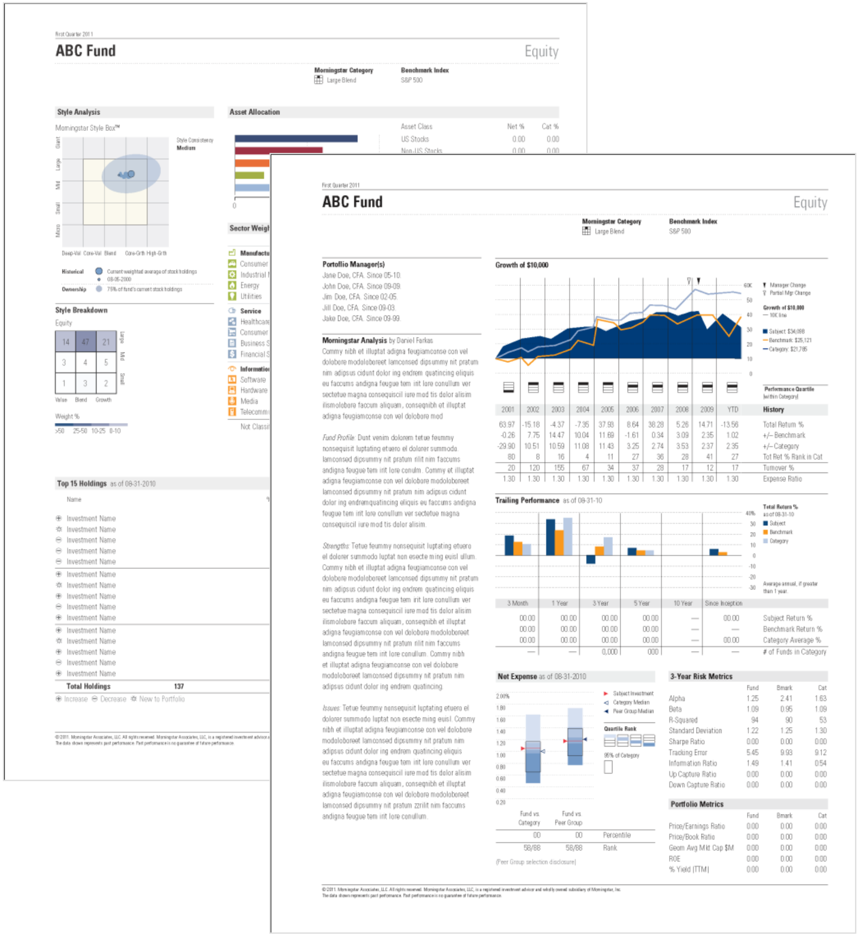
Make It Manageable:

- Research has shown that participation declines when lineups get crowded with too many options. This seems to really take effect at around 25 options.

Offer active and passive investments:

- Build portfolios that allow participants with either mindset (active or passive) to build sound portfolios

- Fiduciary support (Plan Level)
  - ERISA - 3(21) & 3(38)
- Investment selection and monitoring
- IPS construction
- Comprehensive reporting
- Provides indemnification



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Investment Fiduciary Types

ERISA 3(21)(A)(ii) vs. 3(38)

A 3(21) investment fiduciary is any person who is a fiduciary to the plan per the definition in Section 3 of the ERISA code.

Retirement plan sponsors can outsource some fiduciary responsibilities under Section 3(21) to a paid professional who provides investment recommendations to the plan sponsor/trustee. The plan sponsor/trustee retains ultimate decision-making authority for the investments and may accept or reject the recommendations. Both the plan sponsor and the independent advisor have some fiduciary responsibility.

The 38th definition in the act **(ERISA Section 3(38)) is the definition of investment manager.** An investment manager is a special type of fiduciary, one who has been specifically appointed to have full discretionary authority and control to make the actual investment decisions. The manager may select, monitor, remove and replace the investment options offered under the plan. Only certain types of financial institutions may be appointed as a 3(38) investment manager. The 3(38) must be a **registered investment adviser, bank or insurance company** and **must acknowledge its fiduciary status in writing**. It is important that service agreements be carefully drafted to provide for both the appointment of a 3(38) and for the acknowledgement of fiduciary status.

Investment Fiduciary Types

ERISA 3(21)(A)(ii) vs. 3(38)

Once properly appointed, the 3(38) investment manager has full fiduciary responsibility for its investment decisions, subject to the terms of the plan documents and its investment policy statement. The plan sponsor and all other plan fiduciaries are relieved of all fiduciary responsibility for the investment decisions made by the investment manager. The plan sponsor does have a continuing responsibility to monitor whether the investment manager is actually performing the services but need not second guess its investment decisions.*

* Source: National Institute of Pension Administrators Website

Typical Service Options from Investment Fiduciaries

Plan Sponsor using 3(21)(A)(ii) Provider

1. **Plan Sponsor** selects provider
2. **Plan Sponsor** determines Plan Profile
3. **Plan Sponsor** and 3(21) provider determine what categories to offer in the plan
4. 3(21) provider prepares a select list of funds for each category.
5. **Plan Sponsor** selects "Best" fund in each category.
6. **Plan Sponsor** Implements Menu
7. 3(21) provider prepares reports as needed
8. 3(21) provider monitors menu and notifies plan sponsor if changes are needed.
9. **Plan Sponsor** implements needed fund changes
10. 3(21) provider acknowledges position in writing

Profile | **Category** | **Fund Menu** | **Monitor**

Plan Sponsor using 3(38) provider

1. **Plan Sponsor** selects provider
2. **Plan Sponsor** determines plan profile
3. 3(38) provider builds the lineup
3. 3(38) provider monitors the lineup
4. 3(38) provider prepares reports as needed
5. 3(38) provider implements line-up changes
6. 3(38) provider acknowledges fiduciary position in writing

Profile | **Lineup** | **Monitor**

MORNINGSTAR®

Morningstar Investment Management LLC Investment Selection Process

1. Investment Universe
2. Quantitative Screens
3. Qualitative Analysis
4. Category-level Lineups
5. Fund Specific Lineups

Morningstar Investment Management LLC Investment Selection Process

Quantitative Analysis

Gather data points that help define the investment.
Provide the starting point to our analysis.

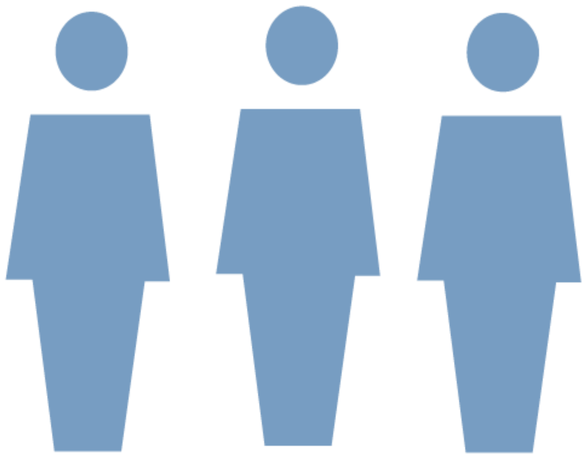
Quantitative Measures

- Fees
- Management tenure
- Style consistency
- Asset exposure
- Holding concentration
- Turnover
- Fund size
- Performance
- Risk
- Alpha

Morningstar Investment Management LLC Investment Selection Process

Qualitative Analysis

Attempt to understand the people involved and decision-making process. Helps to build proper expectations.



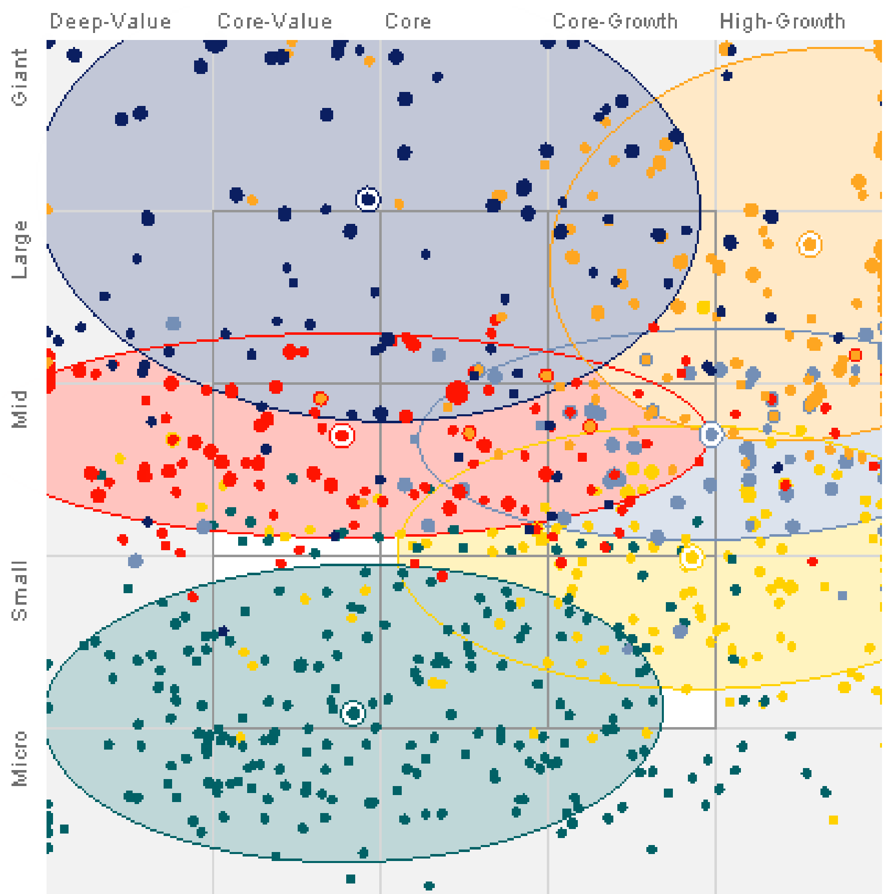
Qualitative Analysis

- People, process, parent, price, performance
- Style nuances
- Identify skill/capabilities
- Source of investment ideas
- Actions in previous market environments
- Asset size and growth
- Manager ownership
- Process repeatability
- Performance attribution

Morningstar Investment Management LLC Investment Selection Process

Evaluation of Fit

Distinct roles, Limit overlap



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Factors

- Common holdings
- Active Share
- Sector weights
- Correlation
- Style
- Firm

The Landscape For Outsourced Fiduciary Services

- Perception vs. Best Practices
- How can I design a better plan?

Perception…	Filter Test	Morningstar Investment Management Commentary	
A Larger Fund Line-Up is better	Why Would You Want a Larger Line-Up?	- Having more funds does not necessarily lead to better or more diverse options.	
Ability to Hold Outside Funds	Doesn't That Defeat The Purpose of a Co-Fiduciary?	- Mr./Mrs. Plan Sponsor: You want us as a co-Fiduciary for the specific purpose of investment selection and monitoring but you still want your favorite funds in the line-up? - A Brokerage Window can allow for access to additional funds.	
A Person with a Computer Can Prudently Select Funds	What Does Your Process & Team Look Like?	- Does the fiduciary simply screen funds based on past performance? - Sales & Service Support.	
Hiring a 3(21) vs. 3(38) investment fiduciary is automatically a better solution	Similar?	- Look at where the fiduciary team started and where they are now. - Longevity. - What responsibilities does the plan sponsor wish to retain? - With Either Service get your agreement in writing	

How can I design a better plan?…

Service Item		Morningstar Investment Management LLC	
Workforce Profiles	.	Plan characteristics that assist the advisor and plan sponsor in selecting the proper profile. Profiles help determine how many categories are appropriate for a plan.	
Performance Reporting		**- Factsheets on every fund.** **- Quarterly Reports.** **- Investment Memos.** **- Annual Plan Review.**	
Service Support?		- Field Representative available to answer questions and explain their process.	

An Independent Fiduciary can assist with Plan Menu Construction and/or Participant Portfolio Construction

Fiduciary Services
Plan lineup construction, monitoring, and management and investment manager as defined in section 3(21)(A)(ii) or 3(38).

The Independent Fiduciary accepts a Fiduciary Position in writing.

Managed Accounts
Personalized, professional investment management and ongoing portfolio oversight that helps put participants on the path to reaching their retirement goals.

The Independent Fiduciary accepts a Fiduciary Position in writing.

The Advisor and Plan Sponsor maintain the responsibility to monitor the independent fiduciary.

What should Customized Advisory Services for Each Participant offer?

Customized Retirement Goal Setting

Each individual participant is different. Slight nuances to individual circumstances can lead to vastly different retirement investing strategies.

Savings Rate Recommendations

Asset allocation and fund selection are a part of the larger story.

Retirement Age Recommendations

Allows participant to determine what age may allow for them to reach their retirement goals.

Asset Class Guidance

Support

Education, counseling, and support.

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Methodology Matters

Strategic Asset Allocation

Seeks to capture diversification benefits among asset classes over the long run.

Fund Selection

Seeks to add value through selecting funds

Risk Management

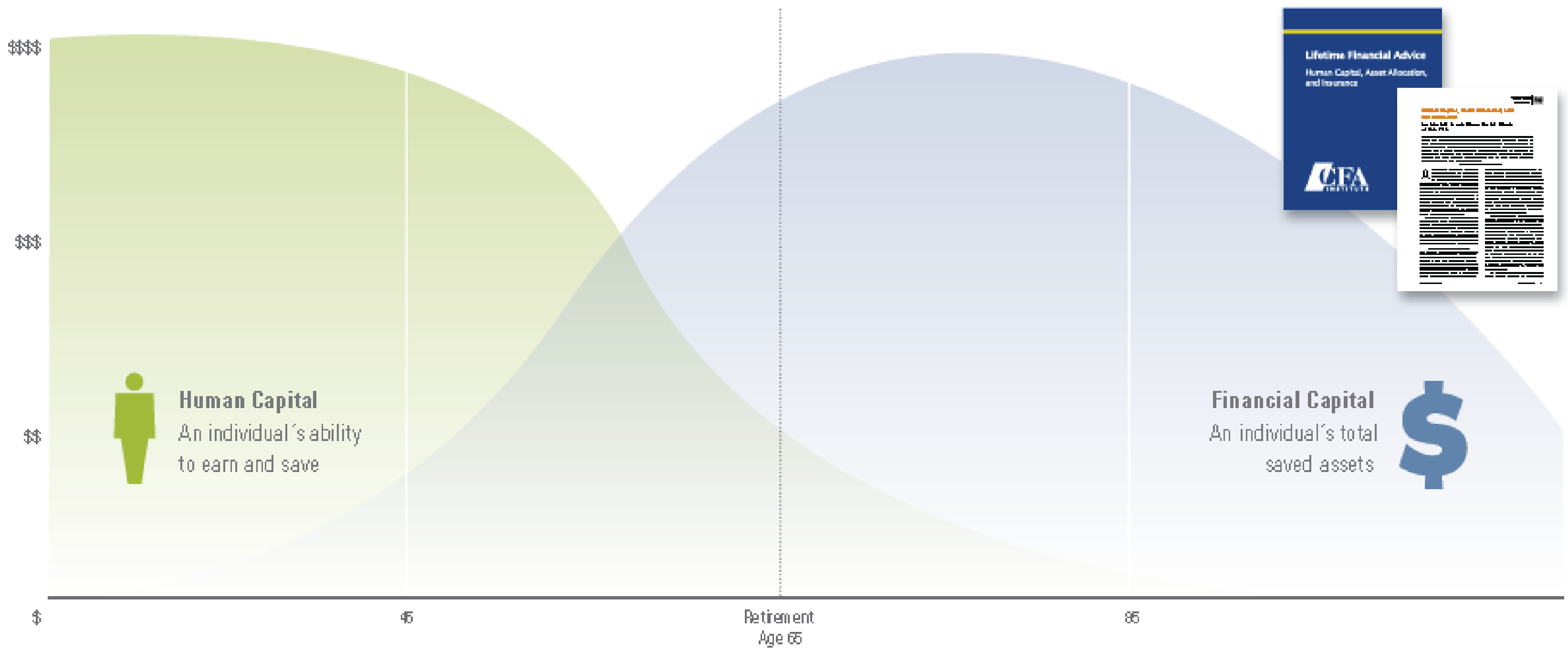
Seeks to eliminate emotional decision making and control active risk relative to the long-term strategic asset allocation with customized allocations.

Ongoing Monitoring and Management

Seeks to adjust portfolios to account for changes to human capital and financial capital.

Managed Accounts
The True Total Wealth Picture

Stocks, bonds, and other tradable assets have traditionally been used when constructing an asset allocation, but consider a bigger picture of an investor’s total worth and earning potential.



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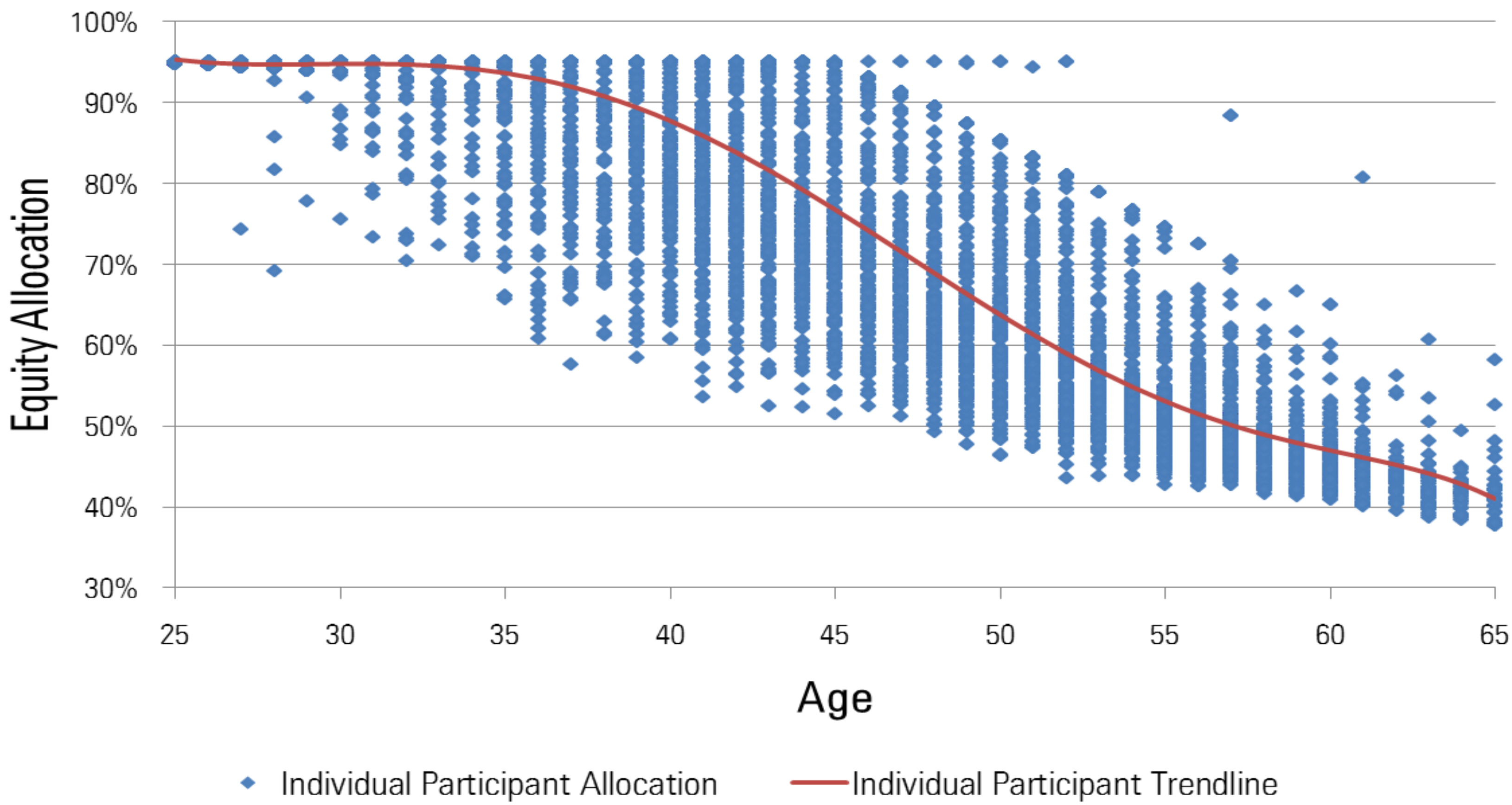
Managed Accounts
Personalized Portfolios

Comparison of a typical target-date fund allocation with typical allocation for a managed account user, leveraging only basic data available via the recordkeeper.



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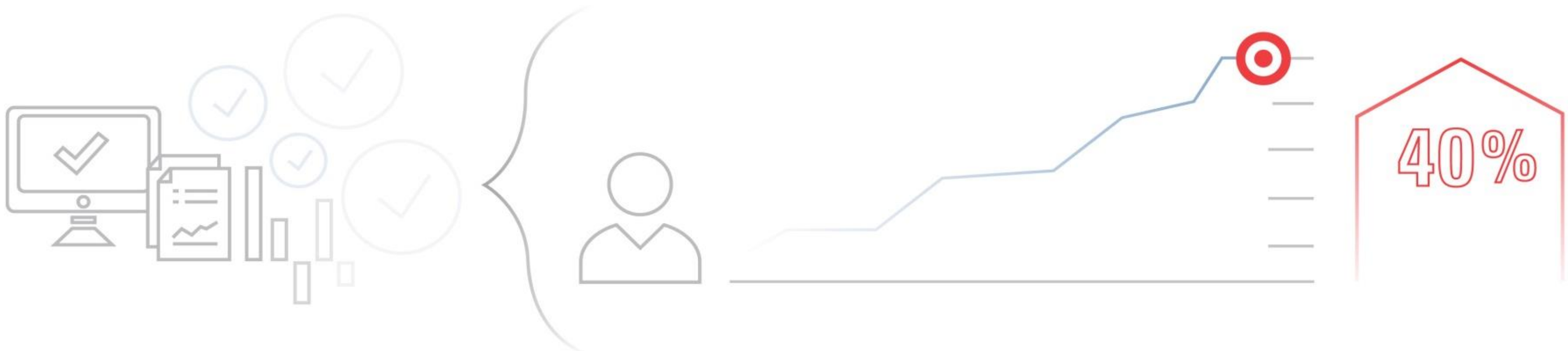
The Impact of Managed Accounts: More Wealth in Retirement



More Wealth in Retirement

A 25-year-old participant could have almost 40% more retirement income from an advice and managed accounts service with an annual fee of 0.40%. Also, there is an 89% chance that a 25-year-old using the program will have greater retirement wealth.

This figure represents the likelihood that a participant could potentially have more wealth at retirement by using Morningstar Retirement Manager. This analysis is based on 58,444 participants who used the Morningstar Retirement Manager service between the dates of January 2006 and February 2014. For each participant in this universe, the hypothetical future one-year performance using the participant's portfolio prior to and after using Morningstar Retirement Manager is calculated. The difference between these results was then projected forward to the participant's assumed retirement at age 65, including an annual fee of 0.4%. Participants were categorized based on their age upon first using Morningstar Retirement Manager, and the ratio of participants in each age category who had better results after using Morningstar Retirement Manager to the total number of participants in that category was calculated to arrive at the aggregate likelihood value. For example, the analysis shows that an average 25-year-old using Morningstar Retirement Manager has an 89% likelihood of having more wealth at retirement compared to an average 25-year-old who did not use the service. The likelihood amount varies by age, and tends to decrease with the age the participant first uses the Morningstar Retirement Manager service, i.e., a 45-year-old has an 80% likelihood and a 60-year-old has a 56% likelihood of having more wealth at retirement. Additionally, the likelihood of more wealth at retirement increases as the management fee decreases; conversely, decreases as the management fee increases.

Q&A