

Raffa Wealth Management’s Qualified Plan due diligence process  
David Burgess, CFA, Senior Investment Manager

**Introduction:**

Raffa Wealth Management believes that the key to a successful qualified plan are the same concepts that drive investment returns for other investors in the market:

- The ability to identify the risks of an investment, and the commensurate returns that are expected from those risks.
- Finding the appropriate investment vehicles that are expected to deliver the returns of their asset class as efficiently and effectively as possible.
- Empowerment of participants to fully understand the various investment risks within their plans and how to use their plans to achieve their investment goals.

RWM’s due diligence process for qualified plans provides the plan sponsor with support in assuring that their plans are setup to maximize participant success by thoroughly reviewing, selecting, and monitoring the investment options available through your plan.

**Challenges:**

Evaluating investment vehicles is not as straight forward an exercise as it should be, given the Mutual Fund industry’s use of naming methodologies that do not always make the fund’s investment style transparent, and can make benchmarking the fund’s relative risk and performance difficult.

Additionally, mutual funds may change their investment focus over time, occasionally drifting from one investment style to another, making it more difficult to properly assign an appropriate measure of risk and performance. RWM reviews every fund available to the plan to determine its appropriate asset class. We review the fund’s current and historic asset allocation to determine the appropriate asset class for each fund. Funds are then grouped by these asset classes and benchmarked to determine their relative performance to the most appropriate index for their asset class. RWM also employs other criteria specific to each broad asset class in determining the fund’s risk profile, efficiency and effectiveness.

**Equity Classification Criteria:**

Our evaluation of equity based mutual funds begins with determining a fund’s asset class. The range of asset classes we define include:

Allocation Fund - US Emphasis	Allocation Fund – World	Regional Fund	Emerging Markets
Global - excluding US	International – Blend	International – Growth	International – Small
International – Value	Sector – Energy	Sector – Financial	Sector – Health
Sector - Real Estate	Sector – Technology	Sector – Utilities	Total US Market
Total US Market – Growth	Total US Market – Value	US Large Blend	US Large Growth
US Large Value	US Mid Blend	US Mid Growth	US Mid Value
US Small Blend	US Small Growth	US Small Value	World

RMW reviews several fund characteristics to determine the appropriate asset class of each fund, including:

- Average market capitalization of the fund’s holdings, to determine whether the fund emphasizes Large, Mid, or Small Cap companies
- Distribution of market capitalizations for firms to determine if the fund is focused on stocks of a particular size, or if the fund invests in stocks of various sized companies, with an emphasis on a particular market segment
- Average valuation of the fund’s holdings, to determine whether the fund emphasizes Growth, Value, or Average(Blend) companies based on the fund’s average Price to Book and Price to Earnings ratios
- Distribution of valuations for firms to determine if the fund is focused on stocks of a particular size, or if the fund invests in stocks of companies with various valuation levels, with an emphasis on a particular market segment
- Historical drift of the fund’s core holdings in relation to the market capitalization and valuation factors
- Geographic composite of the fund’s holdings, including a review a of the allocation to US Markets, Developed International Markets, and Emerging Markets

**Bond Classification Criteria:**

Our evaluation of bond based mutual funds begins with determining a fund’s asset class. The range of asset classes we define include:

High Quality – Intermediate	High Quality – Short	High Quality – Long
High Yield – Intermediate	High Yield – Short	High Yield – Long
International Govt – Intermediate	International Govt – Short	International Govt – Long
Medium Quality – Intermediate	Medium Quality – Short	Medium Quality – Long
Gouvernement – Intermediate	Gouvernement – Short	Gouvernement - Long
TIPS		

RMW reviews several fund characteristics to determine the appropriate asset class of each fund, including:

- Average maturity and duration of the fund’s holdings, to determine whether the fund emphasizes Short, Intermediate, or Long Term Bonds.
- Distribution of maturities and durations for bonds to determine if the fund is focused on bonds of a particular maturity, or if the fund invests in bonds of various maturity with an emphasis on a particular market segment
- Average credit quality of the fund’s holdings, to determine whether the fund emphasizes High Quality, Medium Quality, or High Yield bonds

- Distribution of ratings for bonds to determine if the fund is focused on bonds of a particular credit quality, or if the fund invests in bonds of various quality, with an emphasis on a particular market segment
- Historical drift of the fund’s core holdings in relation to the maturity, duration, and rating factors
- Geographic composite of the fund’s holdings, including a review a of the allocation to US Markets, Developed International Markets, and Emerging Markets

**Allocation Fund Evaluation Criteria:**

Our evaluation of allocation based mutual funds begins with determining a fund’s asset class. The range of asset classes we define include:

10/90 Allocation - US Emphasis	20/80 Allocation - US Emphasis	30/70 Allocation - US Emphasis
40/60 Allocation - US Emphasis	50/50 Allocation - US Emphasis	60/40 Allocation - US Emphasis
70/30 Allocation - US Emphasis	80/20 Allocation - US Emphasis	90/10 Allocation - US Emphasis
10/90 Allocation – World	20/80 Allocation – World	30/70 Allocation – World
40/60 Allocation – World	50/50 Allocation – World	60/40 Allocation – World
70/30 Allocation – World	80/20 Allocation – World	90/10 Allocation – World

RMW reviews several fund characteristics to determine the appropriate asset class of each fund, including:

- Allocation between stocks and bonds over time, and a review of the emphasis of the stocks and bonds based on previously outlined equity and bond criteria
- Geographic composite of the fund’s holdings, including a review a of the allocation to US Markets, Developed International Markets, and Emerging Markets
- Leverage employed within the portfolio

**Selection Process**

This review allows us to truly determine the risk and return profile of each fund. Frequently fund names provide guidance to participants as to the investment style of the fund; however, this review allows us to determine the most appropriate asset class for each fund, based on a more detailed review of the underlying fundamentals of each fund.

Once funds have been assigned the appropriate asset class based on these factors, RWM then reviews each fund within the asset class to determine which fund is the best fit to be included within the list of eligible investments for participants. Among the criteria reviewed to make this determination are:

- Historic performance is reviewed as far back as 15 years. RWM reviews this performance both in absolute terms as well as relative terms. We assign an appropriate benchmark to each asset class that provides a guideline for that particular asset class’s performance over that same time

frame, looking at the fund's relative performance to its benchmark and peers over the short and long term.

- Manager tenure is reviewed in conjunction with the Historic Performance data to determine if a recent change in management of the fund may invalidate some of the historic return data. For funds that have undergone a recent change in management, long term performance of the fund may not be as relevant a statistic as other factors that we review.
- Expense ratios are compared to the other funds within the asset class grouping. Funds with higher expense ratios have a higher likelihood of underperforming the asset class benchmark and may have a negative impact on the participant's return. These expense ratios are also compared in relation to the long term performance of the fund to determine if the expense ratio being charged has negatively impacted the fund's return in the past.
- The fund's diversification is reviewed to its peer group based on the number of securities held within the fund, as well the percentage of the fund that is represented by the ten largest holdings. Funds with higher diversification are expected to have less volatility of their returns and are less sensitive to the performance of any one underlying security held within the portfolio.
- Turnover within the fund is also reviewed. This number represents the percentage of the fund that is bought and sold in a given year. Turnover can range from below twenty percent to over two hundred percent. Funds with high turnover will incur higher trading costs that may deter from the fund's performance. Generally funds with lower turnover are expected to have higher performance as a result of lower transaction fees within the fund.
- RWM will also review the Morningstar rating of each fund. Morningstar scores funds using similar criteria as outlined below, as a result, Morningstar ratings are generally in line with the RWM's selection process.

## **Conclusion**

This approach lends itself to an objective decision making process. Funds that have either been grossly underperforming or possess characteristics that may hinder performance in the future are replaced. Once an investment has been selected it is monitored to ensure that it performs as expected. In addition, the criteria that lead to its selection are periodically reviewed and confirmed as consistent with the original screening process.

## **Sample**

**The pages that follow illustrate the result of a due diligence process. They show the funds that were eliminated from a qualified retirement plan and the funds that we selected as replacements.**

**Exhibit A - Funds Removed from the plan**

Fund Name	Asset Class	Rating	Tenure	Fees	Turnover	Performance	Diversification	Replacement
Global Bond Fund	International Government - LT	-	-	N	-	-	+	Capital World Bond Fund
International Opportunities Funds	Global ex US	N	N	-	-	-	N	International Equity Index Fund
All Cap Growth Fund	US Large Growth	-	N	N	-	-	N	The Growth Fund of America
U.S Large Cap Fund	US Large Growth	-	+	N	N	-	N	The Growth Fund of America
Large Cap Fund	US Large Blend	-	N	N	N	-	N	The Investment Company of America
Fundamental Value Fund	US Large Blend	-	N	N	+	-	N	The Investment Company of America
Optimized All Cap Fund	US Market	-	N	-	-	-	N	Total Stock Market Index Fund
Emerging Small Company Fund	US Small Growth	-	-	-	-	-	N	Small Cap Growth Index Fund
High Yield Fund	High Yield - Intermediate	-	N	N	N	-	+	U.S. High Yield Bond Fund
U.S. Government Securities Fund	Government - Short	-	N	N	N	N	N	US Government Securities Fund
Pacific Rim Trust	Region - Asia	-	-	-	N	-	N	Oppenheimer Developing Markets Fund
Income and Value Trust	Allocation 55/45 - US Emphasis	-	+	N	N	-	+	The Income Fund of America
Global Allocation Trust	Allocation 80/20 - US Emphasis	N	-	-	-	-	+	Lifestyle Fund Growth Portfolio
Health Sciences Fund	Sector - Health	+	+	-	N	N	N	T. Rowe Price Health Sciences
International Core Fund	International - Blend	N	N	-	N	N	N	EuroPacifica Growth Fund

**Exhibit B - Replacement Funds**

Fund Name	Asset Class	Rating	Tenure	Fees	Turnover	Performance	Diversification	New	Replacing
Capital World Bond Fund	International Govt - Long Term	+	+	N	N	-	+	Y	Global Bond Fund
International Equity Index Fund	Global ex US	N	N	+	+	N	+		International Opportunities Funds
The Growth Fund of America	US Large Growth	+	+	+	N	+	+		All Cap Growth Fund / U.S Large Cap Fund
The Investment Company of America	US Large Blend	+	+	N	N	+	N		Large Cap Fund / Fundamental Value Fund
Total Stock Market Index Fund	US Market	N	+	N	+	+	+		Optimized All Cap Fund
Small Cap Growth Index Fund	US Small Growth	+	N	+	N	+	+		Emerging Small Company Fund
U.S. High Yield Bond Fund	High Yield - Intermediate	+	N	N	N	+	+		High Yield Fund
US Government Securities Fund	Government - Short	+	+	+	N	+	+	Y	U.S. Government Securities Fund
Oppenheimer Developing Markets Fund	Emerging Markets	+	-	N	N	+	N	Y	Pacific Rim Trust
The Income Fund of America	Allocation 55/45 - US Emphasis	+	+	+	N	-	+	Y	Income and Value Trust
Lifestyle Fund Growth Portfolio	Allocation 70/30 - US Emphasis	+	N	N	N	-	N		Global Allocation Trust
T. Rowe Price Health Sciences	Sector - Health	+	+	N	N	+	N	Y	Health Sciences Fund
EuroPacifica Growth Fund	International Blend	+	+	+	+	+	N		International Core Fund