

Evaluating Investment Success:

Six Factors for Employee Benefit Plan Trustees

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Evaluating the investment success of an employee benefit plan does not begin and end with investment return. Using the six factors identified in this article, trustees can gain a deeper understanding of their plan's investment program.

One of the most important responsibilities of employee benefit plan trustees is to exercise discretionary control over plan assets. In this role, trustees serve as a fiduciary to the plan beneficiaries in the management and disposition of their money.

Since fiduciary duty represents the highest standard of care in law, it is important to get it right . . . but how do you know? How should trustees evaluate the success of an investment program? For many, investment success equates to investment return wherein the higher the return, the better. But what if investment returns are negative? Should the investment program be considered a failure if a plan may temporarily lose money in the market? Of course not! Investment return is only one metric used to evaluate plan success or failure.

As a fiduciary, evaluation begins with the Employee Retirement Income Security Act of 1974 (ERISA). ERISA identifies six primary fiduciary duties:

1. Loyalty to plan participants
2. Prudence in exercising responsibility
3. Diversification of assets (to minimize large losses)
4. Following plan documents
5. Avoiding prohibited transactions or conflicts of interest
6. Paying reasonable fees for plan expenses.¹

Although ERISA does not cover plans established or maintained by governmental entities, following ERISA as a best practice is generally advised since the Securities and Exchange Commission (SEC) has jurisdiction over all plans—public and private—and can enforce regulations for fiduciary behavior.

While investment returns get all the attention when it comes to evaluation, it is worth noting that generating the highest possible investment return is not a fiduciary duty under ERISA. (Read that again!) Rather, benefit plan fiduciaries have a duty to plan participants to ensure that the plan can pay the benefits promised; therefore, investment programs must generate returns necessary to meet their benefit obligations.

This article identifies six factors that trustees can use to evaluate the success of their investment program.

Evaluating Investment Return

Factor 1: Total Fund Return vs. the Discount Rate

Defined benefit (DB) retirement plans are unique in that they have a *discount rate* (assumption rate), which is the rate of return the plan is expected to achieve from its investments over time to meet its benefit obligations to current and future beneficiaries. For multiemployer plans, the plan actuary determines the discount rate, and for public plans, the discount rate is set by the trustees with input from the actuary. Corporate plans, whose discount rates are mandated by law, are not discussed in this article. DB plan discount rates for multiemployer and public plans currently range from 6.5% to 7.25% with a median of 6.75%, down from 7.5% just a few years ago.

Plans evaluate total fund performance annually at the plan's fiscal year end. While the stock market fluctuates, the discount rate remains fixed, thus making it nearly impossible for the total fund return to equal the discount rate at the end of a plan year.

Considering this, how should investment success be measured? It stands to reason that if the total fund return, net of fees, meets or exceeds the discount rate, that should be considered a success. But what if a plan with a 7.25% discount rate earned a positive return of only 5.5% for the plan year—Should that be deemed a failure? Not necessarily. Although the plan incurred an actuarial loss of 1.75%, it still generated a positive investment return, made money for plan beneficiaries and contributed to the total growth of assets. Determining success or failure based on achievement of the discount rate in a single year has limitations. While short-term returns may be of interest, long-term cumulative performance that includes actuarial gains, as well as losses, is a more reasonable measure.

takeaways

- Using a single metric to evaluate investment success of an investment program does not tell the complete story.
- Achieving the highest return possible is not a fiduciary duty under the Employee Retirement Income Security Act (ERISA).
- Peer universe rankings allow trustees to evaluate investment returns in all market environments, and benchmarking against a policy index can be a reasonable comparison for plans that utilize active management and have a low (or no) allocation to alternative investments.
- Plans with great investment returns but significant negative cash flows will likely run out of money to pay benefits.
- Trustees should maintain a long-term focus.

Factor 2: Total Fund Return vs. Peer Group

A second evaluation measure to help trustees better understand investment returns involves peer comparison, also referred to as *peer universe ranking*. Although every DB pension plan has unique cash flows and risk tolerance, the industry trend for discount rates tends to unite plans around a similar investment goal. All DB plan investments contain allocations to stocks and bonds and, in most cases, alternative investments, allowing for meaningful comparisons among returns. Gaining insight into how other plans performed under the same market conditions and time period provides perspective for trustees about the investment returns of their own plans independent of the discount rate.

A peer universe aggregates professionally managed investment portfolios with similar objectives to serve as a benchmark for performance. Investment consultants blindly report client returns to a database, allowing the performance of a single benefit plan to be measured and ranked against all members of the peer group.² For a universe to be relevant, it should contain a significant number of data points (portfolios) and draw from multiple sources—not just one consultant’s client returns. In addition, universe data should be consistent and avoid survivorship bias wherein “bad” returns stop being reported, thus skewing the universe to include only the best-performing plans.

Plan returns in a peer universe are quantified via statistical quartiles around the median return, which is the middle point at which exactly half of the data lies above and half below the central value.

Consider again the example of the plan with a 7.25% discount rate that returned 5.5% in a plan year, thus incurring a 1.75% actuarial loss. If that plan ranked above the median for the plan year, trustees could conclude that investment returns across the universe were low for that period, with most plans returning less than 5.5%. In this example, the above median rank indicates that despite an actuarial loss, the plan performed well compared with its peers under the same market conditions.

In contrast, if the same 5.5% return ranked below median for the plan year, it would indicate that the plan made a lower investment return than its peers and would be viewed differently. Furthermore, if a DB plan had a negative return of –3.25%, but ranked in the top percentile of the peer universe, it would indicate that the plan limited losses in a down

market, which is a fiduciary duty under ERISA. Return as an absolute measure tells one story, but combining it with the universe rank provides trustees with additional context to understand investment success or failure under all market conditions.

Trustees can use universe comparisons to better understand short-term returns but should rely and base decisions on longer term rankings. Consistently ranking above the median over a ten-year period or longer is a quantifiable measure of investment success for pension plans. (Note: Peer universe rankings would not be relevant for plans utilizing liability-driven investing and those with Special Financial Assistance (SFA) program assets.)

Factor 3: Total Fund Return vs. Policy Index

Plan universe returns are not publicly available, and investment consulting firms pay for services that provide this data. Since trustees must rely on their investment consultant to provide the information (which not all do), trustees understandably consider the total fund return relative to the policy index as the benchmark measure of success of their investment program. Unfortunately, this measure has limitations.

A policy index should reflect the target asset allocation of the plan as defined in the investment policy statement and is constructed using the “representative benchmark” for each investment at the (static) target percentage allocation specified in policy guidelines. Unfortunately, while most plans invest in private market (alternative) investments, most alternatives (e.g., private equity, private credit and infrastructure) lack a representative index. As a result, an index representing a different asset class, usually equities, is used as a proxy for the alternative allocation in the policy index. Not only does this misrepresent the return of the policy index, but it can also lead to false conclusions about the relative performance of the total fund versus the policy index, especially when public equities are significantly positive or negative.

The second limitation involves the valuations of alternative investments.

Publicly traded investments (stocks and bonds) are priced daily using time-weighted returns,³ but valuations of private market investments use dollar-weighted returns,⁴ resulting in a valuation lag of one to two quarters. As a result, the return of privates are carried at 0% change in value during that time yet measured against a fully valued

policy index. If public equities are up, the total fund return will naturally lag the policy index. If the public equities are down, the value-add of alternatives in the total fund return may be obscured.

Lastly, and perhaps the most significant, is the use of passive investment management. If a plan uses passive investments (indexing), the total fund return is less likely to outperform the policy index because the index fund cannot outperform itself! In fact, plans must pay fees—though low—to access index funds, while the actual index, used in the policy index, has no fees. Over time, that small differential in net-of-fee performance of a passively managed index fund will result in tracking error versus the policy index, resulting in total fund underperformance.

ERISA Fiduciary Standard

Since trustee-directed defined contribution (DC) plans and health and welfare funds do not have a discount rate, universe comparisons for these plans as well as other non-DB plans provide less relevant rankings. Trustees, under the guidance of ERISA, can consider additional evaluation measures such as paying reasonable fees, minimizing losses and ensuring that assets are available to pay benefits promised.

Factor 4: Paying Reasonable Fees

Fees are a necessary plan expense, and it is worth noting that all benefit payments are made from plan assets net of fees. ERISA does not mandate that trustees pay the lowest fee, but it does require trustees to pay reasonable fees for plan expenses. Investment management fees vary by asset class and are based on the sophistica-

TABLE I

Typical Investment Management Fees

Asset Class		Management Fees in Basis Points (bps)*		
		Range		
Stocks	U.S. Large Cap Equity	50 bps	to	65 bps
	U.S. Small/Mid Cap Equity	70 bps	to	80 bps
	International (Developed) Equity	75 bps	to	90 bps
	Emerging Markets Equity	75 bps	to	120 bps
Bonds	Investment Grade Bonds	20 bps	to	40 bps
	High-Yield Bonds	40 bps	to	60 bps
	Non-U.S. (Developed) Fixed Income	25 bps	to	45 bps
	Non-U.S. Emerging Markets Fixed Income	40 bps	to	80 bps
Cash	Cash	10 bps	to	20 bps
Alts**	Real Estate	90 bps	to	150 bps
	Hedge Funds	100 bps	to	200 bps
	Infrastructure	100 bps	to	175 bps
	Private Credit	90 bps	to	150 bps
	Private Equity	100 bps	to	200 bps

*A *basis point* is a standard unit of measurement used to indicate percentage changes in financial instruments. One basis point equals 1/100th of 1%, or 0.1% (0.0001 in decimal form). Investopedia.com.

**Alternatives may also charge an *incentive fee* (a general partner's share of the capital gains from an investment or fund, also referred to as *carried interest*) and apply *hurdle rates* (predetermined minimum level of return that must be achieved before earning an incentive fee, also referred to as *preferred return*). Investopedia.com.

Source: Investment Performance Services, LLC, research department.

tion of the investment. Table I provides general guidance for asset class fees for commonly used areas of active management.

Passive investments have lower fees than active management since no security selection is involved in making investment decisions. Fees for indexing typically range from one to five basis points but may be higher for asset classes like non-U.S. equities or

fixed income due to challenges in index replication.

Factor 5: Limiting Losses

Financial markets fluctuate, so it is natural that investment programs will periodically experience negative returns. As plan fiduciaries, trustees are tasked with ensuring that benefits are available for plan participants and, as per ERISA, trustees should

TABLE II

Impact of Negative Investment Returns

Year 1	Year 2
Return	Return Needed to Break Even
0%	0%
-5%	5%
-10%	11%
-15%	18%
-20%	25%

Source: Investment Performance Services, LLC, research department.

TABLE III

Impact of Negative Cash Flow on Investment Return for a \$100 Million Benefit Plan

Year 1 Return	Return Needed in Year 2 to Break Even				
	Cash Flow as Percentage of Beginning Assets				
	0%	-2.5%	-5%	-7.5%	-10%
0%	0%	5%	11%	16%	22%
-5%	5%	11%	17%	23%	29%
-10%	11%	17%	24%	30%	38%
-15%	18%	24%	31%	39%	47%
-20%	25%	32%	40%	48%	57%

Source: Investment Performance Services, LLC, research department.

diversify plan assets to limit investment losses.

Asset allocation drives return, and portfolio construction should be balanced to consider the risk⁵ of an asset class as well as the return.⁶

As illustrated in Table II, limiting losses is meaningful, since the magnitude of investment losses requires plans to achieve higher investment returns to simply break even.

Using diversification to construct an investment program that makes money on the upside while also protecting capital on the downside helps ensure long-term plan asset growth and viability. Like diversification, active management can help play a role in downside protection for a plan. When public markets decline, portfolio managers can make strategic decisions to help limit losses, unlike index funds which simply go down with the market.

Unfortunately, limiting losses is not nearly as exciting as making money,

so it can be an afterthought for many investors.

Factor 6: Managing Cash Flows

The purpose of an employee benefit plan is to pay benefits earned; thus, continued growth of plan assets is crucial. There are only two ways that benefit plans grow—contributions and investment return—and both can be negatively impacted by cash flows. Plans have either *positive cash flow*, which means contributions exceed disbursements, or *negative cash flow*, wherein more money is being paid out than is coming in.

Because negative cash flow erodes the asset base on which returns depend, thus impacting investment return and plan liabilities, a plan's percentage of negative cash flow (calculated by dividing the dollar amount of the negative cash flow by the total market value of assets) is measured by the plan actuary as well as the investment consultant each fiscal year.

Returning to the earlier example (Table II) of how investment losses in Year 1 can impact the return needed in Year 2, plans with negative cash flow require an even higher return in Year 2 following the loss in Year 1 to return to break even, as illustrated in Table III.

Table IV further illustrates how cash flows can magnify investment losses and dilute investment gains, thus impacting assets available to pay benefits.

Plan A—If a \$100 million plan with neutral net cash flow experienced a loss of -10% in Year 1, the plan would require an 11% gain in Year 2 to return to an asset level of \$100 million.

Plan B—Surprisingly, a plan with the same asset value and same -10% loss in Year 1, but with negative cash flow of -5%, would require a 24% return in Year 2 to return to \$100 million. That is more than double the investment return needed to break even!

TABLE IV

Impact of Negative Cash Flow on Total Fund Assets

Plan Growth of Assets	Plan A		Plan B		
	Neutral Cash Flow Fund		Negative Cash Flow Fund		
	Year 1	Year 2	Year 1	Year 2 (x)	Year 2 (y)
Beginning Assets	\$100 million	\$90 million	\$100 million	\$85 million	\$85 million
Net Cash Flows	N/A	N/A	\$5 million	\$5 million	\$5 million
Investment Returns	-10%	11%	-10%	11%	24%
Investment Returns	\$10 million	\$10 million	\$10 million	\$9,444,350	\$20 million
Ending Value	\$90 million	\$100 million	\$85 million	\$89,444,350	\$100 million

Source: Investment Performance Services, LLC, research department.

Assuming both plans have a discount rate of 7.25%, an 11% return would be considered good; however, after experiencing the same investment loss in Year 1 and the same 11% investment return in Year 2, they have dissimilar outcomes. The plan with negative cash flow has \$10.5 million less in market value compared with the neutral cash flow plan.

Since many DB plans are mature plans with negative cash flow, trustees must consider the long-term growth of assets a vital measure of success. A plan with consistently good returns but a declining asset base due to investment losses and negative cash flow will eventually run out of money to pay benefits despite the strong returns.

Conclusion

Because markets fluctuate, determining the success of an employee benefit plan should rely on longer term examination of annualized investment return and plan asset growth. Evaluation should also consider such factors as achievement of the discount rate, benchmarking returns, fees, losses and cash flow management.

Peer universe rankings are a useful benchmark that provides trustees the ability to evaluate the reasonableness of investment returns in up and down markets. For plans utilizing alternative investments, peer rankings should be

reserved for six months after the plan year end to ensure sufficient time for private assets to be valued for the plan and peer group. In addition, the policy index can provide relative insight into total plan performance but, depending on a plan's use of alternative and passive investments, limitations can apply.

While it is easy to get distracted by U.S. equity market returns over the past two years, trustees should maintain a long-term approach when evaluating their plan. Trustees should not expect their total plan return to be 25% just because the S&P 500 returned 25% in 2024. Clear measures of success include achievement of the discount rate (net of fees) over the long term, consistently ranking above the median in the peer universe over time and ongoing plan asset growth. ⑥

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bio



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Endnotes

1. *Meeting Your Fiduciary Responsibilities*. U.S. Department of Labor, Employee Benefits Security Administration.
2. "Comparison Universe: Meaning, Pros and Cons." Investopedia.com.
3. *Time-weighted return* is a measure of investment performance that calculates the compound growth rate of an investment over a specified period, without considering the timing and size of cash flows. Investopedia.com.
4. *Dollar-weighted return* is a measure of investment performance that accounts for the size and timing of cash flows. Also referred to as internal rate of return (IRR). Investopedia.com.
5. Horizon Actuarial publishes an annual *Survey of Capital Market Assumptions* that contains detailed analysis of the expected risk and return of asset classes.
6. Risk, as measured by standard deviation, considers the volatility of returns wherein the higher the standard deviation, the wider the range of returns on the upside and the downside. Investopedia.com.