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A Sponsors' Guide for Reading an Investment Report

By: Constantine Mulligan, Brandon Diersch, Melanie Lambie, Chris McNulty, Rose Murtaugh, and Hannah Schriner

This guide is intended to give PSCA's Investment Committeean overview of some of the terms they may see when reviewing investments offered in their defined contribution plan(s).

Investment Option Types

This section describes different types of investments that may be offered in the plan, including the defining characteristics and the relevant investment criteria that should be evaluated. Understanding the difference between the types of investments is important in determining the applicable performance metrics, as well as understanding how to establish benchmarks and peer groups for comparison.

EQUITY

- **U.S.:** Ownership in U.S. companies.
- **International:** Ownership in non-U.S. companies that participate in a developed market.
- **Global:** Ownership in companies across the globe with no regional restrictions.
- **Emerging Markets:** Ownership in companies that participate in an economy that is beginning to develop but is not stable enough to be considered fully developed.

FIXED INCOME

- **Core:** Diversified fixed income strategy that invests across government bonds, securitized securities like mortgages and asset backed securities, and investment grade credit (corporate bonds).
- **Core Plus:** Similar to Core with additional allocations to alternative fixed income securities such as high yield, emerging market bonds, and bank loans for increased return potential.
- **Short-Term Bond Fund:** Fixed income strategy that invests in securities that have shorter time to maturity (1– 3 years) and lower durations (less than 3 years). This strategy typically has less interest rate risk than the Core or Core Plus strategies.
- **U.S.:** Debt holders of U.S. companies.
- **Foreign:** Debt holders of Non-U.S. companies.

CASH OR CAPITAL PRESERVATION

- **Money Market:** A high-credit quality, ultra-short duration fund (usually securities with maturities of 90 days or less) that is designed to provide stability (i.e., not lose value, only appreciate).
- **Stable Value:** A special type of investment that provides short-to-intermediate, investment grade bond fund returns, designed to provide stability (i.e., not lose value, only appreciate). There are several types of stable value funds including guaranteed investment contracts (often referred to as "GICs,") separate account stable value contracts, and collective investment trusts (which may or may not use synthetically constructed stable value contracts).

ALTERNATIVES

Asset types that do not fit into the conventional Equity/Fixed Income/ Cash categories.

Categorization of Investment Option Types

This section addresses more granular classifications of the investment option types listed above. Often investment options are further subdivided by the way they invest and the types of securities or individual investments traded within a fund. This is important because it also helps the understanding of the applicable performance metrics and how to establish benchmarks and peer groups for comparison.

MARKET CAPITALIZATION (MARKET CAP)

The aggregate market value of a publicly traded company's outstanding shares.

- **Small-Cap:** Smaller companies, normally with an aggregate value from $300 million to $2 billion.
- **Mid-Cap:** Mid-size companies, normally with an aggregate value of between $2 and $10 billion.
- **Large-Cap:** Large companies, normally with an aggregate value of more than $10 billion.

STYLE

- **Value:** Stocks with a price that appears low relative to a company's financial performance; may have a higher-than-market dividend yield.
- **Growth:** Stocks that are anticipated to grow at a rate above the average growth for the market; typically, growth stocks do not pay dividends. If growth expectations are not met growth stocks can see large drops in share price.
- **Blend:** Inclusive of both value and growth stocks.

Performance Metrics

This section describes the different metrics used to measure an investment's performance. Understanding if an investment has performed well relative to its benchmark or peer group is important because it gives a plan sponsor an indication whether an investment should be monitored more closely or any other action taken.

INVESTMENT OPTION RETURNS

The actual investment returns of the investment (i.e., money made or lost on an investment over a period of time).

- **Gross of Fees:** Performance presented before fees are considered, thereby overstating the actual, final performance return reflected in participants' accounts.
- **Net of Fees:** Return of the investment after fees are paid.
- **Annualized:** A method of expressing returns as an equal annual amount over the same period of time. For example, an investment could have had the following yearly returns; 3%, 7%, 5%, 12%, 1%. Another investment could have yearly returns of 4%, 6%, 5%, 6%, 7%. However, the annualized return for both investments would be 5.5% per year throughout the 5-year period. This method allows for easy comparison of returns across different investments during the same time period.
- **Trailing:** A method of expressing returns over a historical time period. For example, a 12-month trailing return of 3 percent means that during the last 12 months (not necessarily a calendar year,) the investment returned 3 percent.
- **Rolling:** A method of expressing a return for a certain time interval successively over a much longer time period. For example, if you wanted to look at 12-month returns for an investment, during the last three years, progressed monthly, you could show a 12-month return for January through December of year one, then show a 12-month return for February of year one through January of year two, and then March of year one through February of year two, and so on. This method allows for an analysis of returns that takes out the "point in time" bias (i.e., the idea that if an investment recently had a good month of performance, it would skew the analysis).
- Excess: Returns in excess of a benchmark. For example, if an investment returns 10 percent and its benchmark returns 8 percent, the investment had a 2 percent excess return.
- Risk Adjusted: A method of adjusting a return metric for the given level of risk that the investment has exhibited. For example, if two investments have a 10 percent return over a one-year period, but the first investment has exhibited a higher level of risk than the second one, the second investment will have a higher risk-adjusted return than the first one.

RISK AND VOLATILITY

There are many types of risk. Risk represents an event that could impair the ability to achieve an objective.

Volatility represents pricing variability which could lead to lower returns, or returns that are impaired at a given point in time (i.e., if you own an investment with high volatility, there is a chance that the price will move up and down drastically, and might be at a low point if and when you need to sell the investment).

- **Beta:** Measures of an investment's volatility as it relates to a benchmark (normally an index). This metric gives a measure of "market risk" for a given market. This metric is expressed as a coefficient. For example, an investment with a beta of 1.1 means that in general, it has a 10 percent higher correlated volatility than the benchmark. So, in this example, if the benchmark was up 10 percent, we could expect (with some level of confidence) that the investment would be up 11 percent.
- **Alpha:** Measures of an investment's risk-adjusted excess return as it relates to its benchmark. The return of the investment is adjusted by the beta of the investment to the benchmark, and then netted from the benchmark returns. For example, if an investment with a beta of 1.0 had a return of 10 percent and the benchmark of the investment had a return of 8 percent, then the investment's alpha would be 2 percent. This is because with a beta of 1.0, the investment should have the same return as the index (this is the beta-adjustment) and since it had a return that was higher than 8 percent, any excess return would be considered alpha (this is the excess return process).
- **Standard Deviation:** The standard deviation is a statistic that measures the dispersion of a dataset relative to its average, or how spread out the numbers are to the average. In portfolio theory, the past performance of securities is used to determine the range of possible future performances and a probability is attached to each performance. The standard deviation of performance can then be calculated for each security and for the portfolio as a whole. The greater the degree of dispersion, the greater the risk.
- **Sharpe Ratio:** This is a risk-adjusted return metric that adjusts a level of return by the level of volatility (as measured by standard deviation). For example, if two investments had the same return, but the first investment exhibited lower volatility (standard deviation) than it would have a higher Sharpe ratio than the second investment.

COMPARISONS

- **Benchmark:** A fund used to measure the performance of an investment strategy to the market. A benchmark is often an index and should be representative of the investable universe of securities for the given strategy. An example of a benchmark for U.S. Large Cap investment strategies would be the S&P 500 index.
- **Style Purity:** Measures how similar an investment is to a benchmark. There are many ways to assess style purity, but often it is done at a holdings level (what's in the portfolio and how similar it is to the benchmark) or a returns-based level (how close are the returns of the investment to the benchmark over time).
- **R Squared:** Measures the style purity or the variance of the return of an investment relative to a benchmark. This tells us how close or "pure" the investment is relative to a benchmark over time. This metric is expressed as a coefficient. For example, an investment with an R Squared of .85 could be relative to an investment with the same benchmark and an R Squared of .75 could be said to be more "style pure."
- **Peer Group:** A group of investment strategies with similar objectives and investable securities. Measures the performance of an investment manager to alternate investment managers of similar strategies. This could be viewed as the universe of similar strategies that could be included in a plan's investment line-up. Peer group performance can help a plan sponsor assess how well an investment strategy is performing relative to alternative investment managers within the same asset class.
- **Peer Ranking:** A standardized way of ranking performance within a peer group. The fund with the best performance is ranked "1" and the fund with the lowest performance is ranked "100". The remaining observations are placed equal distance from one another on the rating scale. The lower the ranking, the better as compared to peers.

ADDITIONAL TERMS

- **Up-Market and Down-Market Capture:** The ratio of return that an investment strategy performed relative to its benchmark during periods when the index has risen for the up-market capture (fallen for down-market capture).

For example, if an investment strategy is up 8 percent and its benchmark is up 10 percent during the same time period, then its up-market capture would be 80 percent (8/10).

- **Return Correlation:** The relationship between the returns on investments. A negative return correlation between two investments means that on average, when investment A has a positive return, investment B will have a negative return.
- **Dividend Yield:** For equities or fund investments, the rate of annual dividends expressed as a percentage of market value. It is obtained by dividing the dividends by the current market price of the security.
- **Earnings Yield:** For equities, the earnings per share expressed as a percentage of market value.
- **Coupon Income (Average Coupon):** For fixed income investments, the annual coupon payments of a bond divided by the par value (value of a single share).
- **Current Yield:** The annual coupon payments of a bond divided by the market price.
- **Maturity:** The date on which a loan, bond, mortgage, or other debt security becomes due and is to be paid off.
- **Duration:** Measures the price sensitivity of a bond or fixed income portfolio to interest rate changes. Bond prices move inversely to interest rates. The higher the duration, the more sensitive to interest rate changes.

Other

This section describes other relevant criteria, characteristics, and terms that may be found in an investment monitoring report.

QDIA

The "Qualified Default Investment Alternative" is a default investment type established in the Pension Protection Act of 2006 giving sponsors of ERISA individual account balance retirement plans a safe harbor to default participants into that do not make an investment election (or are automatically enrolled). QDIAs can be target date funds, balanced funds, or managed accounts.

PASSIVELY MANAGED

Implies no active selection of securities being made. These strategies have the objective of tracking their Benchmark. For example, if there are 500 companies in the S&P 500, a passive strategy would hold all 500 stocks with the same weights to each.

ACTIVELY MANAGED

Implies that there is an active allocation and security selection taking place to position the strategy differently than the benchmark. These allocation decisions can include qualitative factors made by portfolio managers or quantitative factors driven by models. For example, there are 500 companies in the S&P 500 and a U.S. equity manager selects only 200 of them for inclusion in the portfolio because they believe those 200 companies represent better investment opportunities than the other 300. Expense ratios are typically higher for actively managed investment options than they are for passively managed investment options.

GLIDEPATH

Refers to the asset allocation mix of a target date fund based on the number of years to the target; allocations can vary depending on the fund manager, and asset mix at the target dates can vary as some fund managers assume investors hold the funds throughout retirement.

SELF-DIRECTED BROKERAGE

A brokerage window is designed to allow participants to select investments outside of the core investment line-up while staying within the plan and receiving the associated tax benefits.

Depending on the plan, these windows can allow investments in mutual funds, ETFs, individual stocks, bonds, and derivatives. It is important to note that the participant, and not the plan sponsor, is taking fiduciary responsibility for investment selections within the brokerage window.

EXPENSE RATIO

Total investment management and administrative expenses to manage the investments, expressed as a percentage of net asset value of the fund. Expense ratios can vary based on the share class and plans can benefit by seeking to the lowest expense ratio share class.

ADMINISTRATION FEES

Fees charged to a plan by recordkeepers and others; fees can be explicit (e.g., a specific dollar charge for every participant or as a percentage of plan assets) or be charged indirectly via revenue sharing funds (see below).

REVENUE SHARE

Compensation plan recordkeepers and service providers receive from mutual funds in exchange for assuming part of the mutual fund company's administrative functions. Revenue share is typically used to offset administrative fees, or credited back to participants invested in the fund generating the revenue. Revenue share is not standard across all mutual funds, so it may lead to an inequity in fees paid if they are used to offset administrative fees (i.e., some plan participants may pay a higher share of a plan's administrative fees than other participants relative to their account size).

MANAGER TENURE

The length of time an investment manager has been running an investment fund; some plans seek stability in this area.

PORTFOLIO TURNOVER

Ratio in which assets in a fund are bought and sold; a ratio of 25 percent for an equity fund means that stocks are held for an average of four years.

PORTFOLIO CONCENTRATION

(Top 10 Holdings)

Reflects the value of the top 10 holdings to the overall holdings of the fund; funds with higher percentages are more concentrated and will be more volatile, and typically have higher beta ratios.

TRAILING PRICE TO EARNINGS (P/E) RATIO

A popular measure of relative stock value, calculated by dividing the current stock price by the latest four quarters of reported earnings per share.

FORWARD P/E RATIO

Similar measure as P/E except that it uses earnings per share expectations for the future four quarters.

Conclusion

The above terms in this guide are intended to cover the primary areas plan sponsors will see as they assess the performance of investments offered by their plan(s). Investments can be held in different vehicles such as a mutual funds (pooled funds invested in various asset classes for a group of individuals or entities and registered with the SEC,) separate accounts (funds invested in various asset classes for a specific individual or entity), and commingled funds (funds from several investors are combined into one fund). There are benefits to separate accounts and commingled funds: especially from an expense standpoint. However, assessing performance for separate accounts and commingled funds may be more challenging as return disclosures are not always publicly available.

Important Disclosures

This article was written by PSCA Investment Committee members: Brandon Diersch, Senior Portfolio Manager, Microsoft; Melanie Lambie, Human Resources Generalist, Vizo Financial Corporate Credit Union; Chris McNulty, EVP, CFO & Treasurer, GNY Insurance Companies; Constantine Mulligan, Managing Partner, Director of Research, Cerity Partners; Rose Murtaugh, Associate Director, Pensions, Navistar, Inc.; and Hannah Schriner, Investment Consultant, Meketa Investment Group, Inc.

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