

Modifying the Vista 401(k) Mutual Fund Portfolio

By: Michael H. Sheridan, Senior Consultant

May 2016

Prologue

FBMC Benefits Management formed the Vista 401(k) plan in the early 1980's when the IRS approved 401(k) plans as the only permissible retirement plan that could be included as an option in Section 125 Flexible Benefit Plans. These plans were known in those days as "Cafeteria Plans".

This inclusion opportunity ended for Vista after the 1986 Tax Reform legislation excluded public employers from offering 401(k) plans in the future but "grandfathered" existing plans.

Although we could not add new school districts after this legislation was enacted, we did have a solid basis of Florida School Board clients to evolve the plan into a viable multiple employer retirement plan that has steadily grown through the years.

There are currently about 200 million dollars in the plan and we believe that this total will continue to grow.

We have advocated changes to the plan composition over the years and always submit these recommendations to the Vista 401(k) Advisory Council for consideration. We have been fortunate to have well respected and knowledgeable school district representatives as members of the Advisory Council and our collective decisions regarding fund composition have well served our participants.

The positions that we collectively take have been communicated to plan participants as they happen and we use a Newsletter to share our investment philosophy and positioning.

We have operated under the specifics of an Investment Policy over the decades and review all change considerations only after comparing those proposals to the IP. The IP has turned out to be a good guide as to what to avoid in the ever changing investment world. The basis of our philosophy is that Vista is a retirement supplement and should be viewed as a conservative, non-speculative, plan that does not select investments that involve "chasing returns". That is, trying to outperform the market benchmarks by increasing risk in a manner disproportionate to the opportunity for gain.

Many investments over the years have been recommended for our consideration that, in retrospect, were ill considered speculations that did not work for anyone in the market when viewed after a several year period. I am very proud that we avoided all of them.

We have recognized practices in the investment business that we knew were not in the best interest of customers and avoided them and later were gratified when government regulators banned them. FBMC's reputation and industry knowledge about Vista have led to our ability to be treated with importance by various mutual fund companies and their advisors.

Plan Modification Philosophy

During the period leading up to market crash and the beginning of the Great Recession, we collectively made some modifications to the plan but they primarily were with regard to the companies offering the funds. We kept the type of funds, as measured by their Lipper designated categories, but replaced the companies underwriting them. We also added Target Date funds when the US Department of Labor, the primary rule maker for qualified retirement plans, designated them as the acceptable default option when a participant did not make a choice. Most of our Target Date participants have intentionally chosen them.

During the 2006-2009 period of the worst recent market performance, our funds mostly outperformed the market. We offered sufficient choices in bond and money market funds to give our participants a cushion as their values were subjected to decline. We also encouraged movement into the safest funds so the overall decline in plan values was less than other retirement plans that we monitored.

In 2010, we concluded that the market would begin a slow recovery. We knew that we should offer new funds that gave our participants the widest variety of choices because no one knew how the economic recovery would proceed and at what pace. By offering one fund in almost every Lipper Category and encouraging our participants to "diversify, diversify, diversify", most of them were able to take advantage of reasonable gains without the uncertainty of which market elements were going to be favored.

Now with worldwide economies slowing and modest upside opportunities expected, we feel that plan modifications are again necessary. As I wrote in the Newsletter earlier this year, we expect modest growth over the next five years with the USA leading all developed economies. Interest rates will gradually increase to reflect market dynamics. Companies will continue to make profits but reflect slower growth. Previously referred to as Emerging Markets, countries such as China and India will be considered to be developed markets and compete with the USA, Europe and Pacific Rim countries on a more or less equivalent basis. This means less speculation in foreign economies.

In this environment, we have recently suggested that we focus on funds from stable and mature fund companies that emphasize profitable dividend paying stocks in their portfolios. We would look to funds that prioritize companies in growing industries without consumer market or regulatory problems and underweight or avoid problem or shrinking industries.

Previously, to maximize diversity, we offered separate funds that each included holdings that emphasized Growth, Core and Value objectives. We also separated out bond funds into short, intermediate and long term durations because we could not predict the Federal Reserve's controlling intentions regarding interest rates.

We now see Fund companies abandoning the Core strategies and only emphasizing Growth and Value techniques and in many cases, simply merging them into one blended strategy.

A dynamic of merging, known in the fund industry as "blending", is that the reasons for separating small cap, mid and large cap are disappearing as long as the growth or value strategy is consistent. We still believe that there is safety in large cap funds because of their ability to sustain profits in changing markets and their ability to pay dividends. We also believe that mid and small cap companies and the funds that hold them, have diversification opportunities for gain as industries change and "little later becomes big". Growth becomes important again.

The Federal Reserve has committed to gradually increasing interest rates to reflect market demand. We know that these increases will reduce the value of long term bonds but will reflect modest returns for short and intermediate duration bonds. Therefore the need for separating funds into duration classes seems to be no longer of value. We expect the return to market dynamics for interest rate increases to take a few years.

In addition, many of our participants are concerned about the credit quality of bond issuers. We believe that the inclusion of a fund that meets the standard of being able to call itself a Government Bond fund was, and probably still is, a need.

Some of the bond funds have now focused on quality and overweight US Treasury bonds along with a modest inclusion of investment grade corporate or foreign bonds. We believe that these diverse funds, not generally available just a few years ago, are of value to Vista.

Our participants have embraced the great diversity of Target Date funds which change composition and weighting as we age and approach retirement. At the time we added such funds to Vista, there were few fund companies offering them and we selected the most sophisticated fund company's offerings. We now have many choices in the fund industry and mandates by US regulators led us to the conclusion that we must change fund companies in order to offer the lowest cost funds available, assuming that all other competencies exist, in order to meet and exceed new standards for default options.

The Evaluation Process

We had extensive interviews with every Vista fund company and with each of their managers for each fund in the portfolio over a two month period this year. We have had follow up interviews and written communications. We had come to some "what if" conclusions that turned out to be not practical or even available from the fund companies.

We have finally settled into a practical and reasonable set of recommendations that we are now proposing to the Advisory Council. These recommendations embrace the changes, or lack thereof, in our US and global economies in the manner stated earlier in this commentary.

The ten guiding principles or objectives that we have used in forming our recommendations are, offered in no special order:

1. The plan should reduce the number of funds that are offered in order to simplify the participant's decision making processes, without reducing diversification prospects. However, we will only select from the most experienced and largest fund companies.
2. Recognition that Index funds, passively managed, are performance equaling or exceeding actively managed funds which come with higher costs. This leads us to propose a one index fund policy plus one actively managed fund selection in each category.
3. When evaluating funds, we should place more emphasis on the fund's current dividend yield than we have done in the past.
4. Funds that are not achieving positive Alpha (the degree of extra gain that a fund achieves in excess of its benchmark's performance) are not desired.
5. Shorten our retrospective performance evaluation time periods to more of an emphasis on 1,3 and 5 year performance rather than 10 year or "since inception", because of the need to focus on where the world's economy is headed and to take advantage of newer funds offered by stable fund companies.
6. Move from using Lipper as the evaluation standard service to Morningstar to assume a new industry standard almost universally adopted in the past several years.

7. Accept that credit quality in bond funds is now fairly equal between some corporate funds and large stable governments, including the US.
8. Realize that some of the funds and/or fund companies that we have used have changed their investment styles or objectives in a manner that is no longer compatible with the standards that we require for inclusion in Vista.
9. Reject funds whose composition analysis reveals that they are chasing returns, and/or overweighting stock selection in companies with very high evaluations but little current earnings (and no dividends!) in order to separate themselves from other funds in their Morningstar categories and thereby increasing risks and sometimes repositioning their funds in a manner that is, in our opinion, not compatible with a retirement supplement plan. Growth stock funds can be the exception to this practice.
10. Reduce the total fund expenses for each fund, either by replacing it with some other fund or moving it to a different asset class offered by the same fund company, so that no fund has an asset management fee (total fund expenses) in excess of 1% a year. Coupled with the plan's "wrap fee" of ½% a year paid to FBMC, we continue to believe that Vista is one of the lowest cost multiple employer plans, which offers multiple fund companies, available anywhere.

Our conclusion objective or reality: FBMC must plan on significant expense in time and hard costs, plus the disruption to operations as well as to the plan participants. But, we need to make the changes necessary to bring about evolution in the plan to reflect a new economic environment and changes in fund composition.

The following pages will summarize our recommendations for each of the existing funds future inclusion in Vista and the reasoning behind the recommendations. The Advisory Council must approve these or other changes.

The funds are discussed in the order that they are listed on the Fund Performance Chart that we publish on a monthly basis. An updated chart for 4/30/2016 is included in this report on the next page for reference.

INTERNATIONAL:

American Funds; Capital World: This fund has changed style in a dramatic way in the past few years. It originally was supposed to select stocks from companies who were domiciled outside the US and who distributed their products on a global basis. They have changed so much that almost half of their portfolio is now made up from companies domiciled in North America and almost all those are from the USA.

This shift has made this fund redundant of the other Vista funds whose holdings are primarily US domestics. We do not want the duplication.

We will replace this fund and transfer all assets and future contributions (this process is called “mapping” or Map) into another American Fund offering which has been a Vista component for many years, American Funds; Europacific, in order to have a truly international/global fund.

American Funds; Europacific: Although most international funds took a beating last year due to unrest in global markets, this fund has been a decent fund since its inception in 1984. It has emphasized developed markets in Europe and on the Pacific Rim (Japan, Korea but not US). China and some other Asian countries economies have grown to the point where the stocks of their larger companies can now be included in the portfolio.

We recommend keeping this fund and adding the American Funds; Capital World to it.

SMALL CAP STOCK:

Fidelity; Small Cap Growth and Fidelity; Small Value: Both of these funds are reasonable but, as stated in our Objectives above, we do not see the need for separate funds that are only emphasizing one opportunity strategy within a single capitalization category. In addition, the asset management fees (costs) are higher than we are now trying to achieve throughout the portfolio (a maximum of 1.00% annual asset management fees or, preferably, less).

In addition; our experience with Vista participants indicates that many of them who are interested in either Small or Mid Cap funds are diversifying into them for the expectation of higher gains in exchange for what is thought to be greater volatility and greater risk than if they had only invested in Large Cap funds. Therefore, we conclude that having value or core funds in either the Small or Mid Cap sectors as our offering, somewhat runs contrary to the thinking behind using these sectors as “growth opportunities”.

We will Map these two funds into the existing T. Rowe Price; Small- Cap Stock fund. It has a much lower asset management fee and combines a strategy of investing in Growth with a lesser inclusion of Value categorized companies. This will eliminate the need for separate funds to cover this investment strategy spectrum. However; as discussed in my commentary below regarding the Large Cap Growth fund, we believe that participants want to have the opportunity for Growth in Small Cap funds and not necessarily core or value. They want funds that are focused on growth. They want a fund that owns the next Google or Facebook and want to capitalize on those beginning successes until they grow into mid cap size and eventually become a large cap and are no longer in this fund.

We will also add a new fund to the plan; Vanguard, Small Cap Index, VSMAX, to be consistent with our objective of giving participants a choice of one actively managed fund (T.Rowe Price; Small Cap Fund, mentioned above) plus one Index fund for participants who want small cap style diversity.

MID CAP STOCK:

American Century; Heritage: This mid cap growth fund has had mediocre performance over the past few years and is rated average to below average by Morningstar. Consistent with our small cap fund reasoning on participants wanting growth from their mid cap investments, not core or value, we will Map this fund to a new fund to be added to the plan, Fidelity; Growth Strategies (FDEGX), an actively managed fund which emphasizes growth stock holdings.

American Century: Mid Cap Value: This fund has had reasonable performance but includes only undervalued mid-sized company's stock and consistent with our stated strategy, we want to emphasize growth in our mid cap sector offering. Like the Heritage fund above, we will also Map this fund to Fidelity; Growth Strategies (FDEGX).

Vanguard; Mid Cap Index: This fund has had good performance at low cost and will continue as the Vista offering as the mid cap Index fund. By its nature, it will include growth, core and value mid-sized companies.

LARGE CAP STOCK:

American Funds; Investment Company of America: This is one of the oldest mutual funds in existence. Founded in 1934, they have had consistent performance as a conservative value fund with a blend of some mid and small cap companies and have some positions in core and growth strategies. The fund emphasizes dividend payments and fits our current positioning.

We cannot think of a better blend fund on a long term basis and will retain this fund.

American Century; Growth: Like so many other large cap growth funds, 2015 and early 2016 performance has been negative to flat.

We were reluctant to replace this fund because we have had good experience with it in the past. However, we have had it on our watch list for over two years because it has had mediocre performance. Its composition has become too similar to Core and even Value strategies rather than the Growth strategy that we believe is desired by our participants who want to invest in Growth.

We believe that most of our participants gravitate to Large Cap US domestic funds rather than small, mid or international funds so we have offered more funds in this category rather than just one passive/index fund plus one actively managed fund.

We have included a Core fund in this sector (Vanguard; Institutional Index—S&P 500), a large cap blend (American; ICA) and am recommending a dividend growth fund to replace the Equity Income and Income and Growth funds. Therefore, we are recommending that the growth strategy be offered through a fund that is completely focused on growth (but not speculation) and is composed of large cap stocks that are associated with this dynamic and not on conservative strategies and dividend yields.

T. Rowe Price; Blue Chip Growth (PABGX) is definitely a growth stock fund with almost 100% of its holding in large cap stock. To give you an idea of its strategy, the top five holdings, in order, are: Amazon, Alphabet (Google), Facebook and Priceline. The total portfolio has no energy sector holdings, only about 10% in financials, and almost 60% of the total is in three sectors; Consumer Cyclical, Healthcare and Technology. Although the average PE is 23.15, its Beta is only 1.10 which is surprisingly low considering how we might perceive its degree of volatility and risk. Morningstar awards the fund its highest rating, 5 stars. And, its cost is less than our current fund in this category.

I like this fund very much but I am too old to be investing in this type of growth. However, we need something for the younger participants to choose. I think this strategy should be sustainable over many years until young people are ready for retirement and can switch to more conservative funds. If they diversify in addition to this fund, they should be able to take advantage of changing times and economic shifts and protect themselves from long term investment adversity. We recommend that this fund replace American Century; Growth.

American Century; Income and Growth which is a large cap value fund has had mediocre performance in the past few years and is rated average by Morningstar. We prefer better than average as long as the risk is balanced with our goals. With the change to using Morningstar as our rating service, we have a dilemma in how having two funds in the same "Large Value" category, this American Century fund and the T. Rowe Price; Equity Income fund. We do not need two funds to occupy this category that are both using the same strategy, that are actively managed. In addition, our stated goals include emphasis on funds that seek inclusion of dividend paying stocks. This is not the emphasized strategy of either Income and Growth or Equity Income. Both of these current funds emphasize value purchases that they deem undervalued compared to the market, which seems to mean a lot of energy and bank stocks. Therefore, we will replace them with a new fund, T. Rowe Price: Dividend Growth (TADGX).

T. Rowe Price; Equity Income: I once said that this fund was in my imaginary Hall of Fame. I no longer feel that way. We had long discussions and debates with their management representatives and did not end up with a common outlook. Although their stock selections pay decent dividends, their emphasis is on value or, in my words, "getting a deal". As of year-end, this fund's price to earnings ratio was up to 19.55 which is, in my opinion, far away from getting a cheap price. I think they are overpaying for companies whose short and even long term prospects are questionable. Their top two holdings are Bank of America and Exxon Mobil, a bank and an oil company and these two stocks alone comprise almost 8.5% of their entire portfolio. Energy and Financial stocks comprise almost 40% of the entire fund. Do you think oil producers and banks are the companies of the future? Maybe banks will have a good recovery but only after a few years of normal interest rates. We can no longer recommend including this formerly wonderful fund in Vista. We will Map it to the aforementioned T. Rowe Price; Dividend Growth, along with the American Century; Income and Growth.

Vanguard; Institutional Index; this is our Standard and Poor's (S&P) index fund and it is about the lowest cost fund of its kind in the industry. It is our best representation of a non-actively managed fund and we will keep it in Vista. It has growth, core and value stocks in it.

BALANCED:

Vanguard; Balanced Index is a terrific combination 60% stock/ 40% bond index fund and I do not regret saying that if you could only own one fund, this should be it. It is our passively managed selection in this category and we should keep this low cost fund.

Vanguard; Wellesley is an actively managed conservative fund with a usual mix of around 40% stocks and 60% bonds and is a low cost well diversified option. We recommend keeping it.

Vanguard; Wellington is an actively managed conservative fund, somewhat of a mirror of the Wellesley fund, with different fund managers. It has a mix of around 60% stocks and 40% bonds. It is a low cost diversified option and we recommend keeping it.

MIXED ASSET CLASS TARGET DATE:

We have had the Fidelity group of funds on our watch list for a couple of years because of underperformance compared to peers and higher costs. This is a sensitive area of decision making because the target date funds and the Fidelity; Freedom Income fund, an all bond fund where the participants funds eventually are deposited as they reach the end of their “ glide path”. Maintaining these options is the fiduciary responsibility of plan managers and sponsors because the target funds are the default option if a participant cannot decide on plan options.

We finally have a better choice of a target date fund company from the American Funds group with better options, similar or superior features and lower costs. American has been offering mutual funds since the 1930's and has been part of the Vista family of funds for many years. We recommend mapping all assets and future contributions to this fund.

We are including a separate summary of the American Funds elsewhere in this Advisory Council report.

BOND :

American Century; Government Bond is a long time Vista option. Although some other funds, offered outside of our existing family of funds may have lower costs, this fund has consistently maintained the largest composition of truly “ US government” bonds.

Although the SEC allows funds to call themselves “ Government Bond” , they are allowed to invest up to 20% in non-government bonds. Unfortunately, many funds do invest in non-governments or Treasuries to “ chase returns”. Although almost all of the other funds we researched are prudent in the credit quality of their alternative bond investments, they deviated from what we perceive is the message to our participants that these would be “Government”, as in United States Government, funds.

Our long-ago direction from the Advisory Council was that we should include a Government bond fund in the plan and that it should include government bonds, not alternatives.

This fund has consistently followed that mandate with US Treasuries and various asset backed securities and mortgages that are credit guaranteed by the US government. It also has a good mix of various maturity dates and probably qualifies as, in the mix, an intermediate term fund with an average duration of 6.8 years. We recommend keeping it.

American Century; Inflation-Adjusted Bond, primarily invests in US Government Treasury Inflation Protected Securities (TIPS) and this is the only purpose that we desire in this fund. Many of its competitors add other similar bonds to their funds, sometimes overloading with foreign government issues, but this fund sticks to its objective in a reassuring way and we recommend keeping it in the plan.

PIMCO; Total Return; this fund was once the darling of large mixed composition bond funds but, in our opinion, has completely lost its way over the past couple of years.

They are not user friendly anymore and refuse to disclose the credit quality composition of their bond portfolio. This alone makes me want to replace them because every other bond fund that I have reviewed makes such disclosures.

In addition, their portfolio as of the analysis date, was only 28% in Government bonds, only 6% in corporate bonds and held 36% cash. We are not paying them a .71% annual asset management fee to park money in non-interest bearing cash.

There is nothing here that recommends keeping this fund and we recommend mapping it to a new fund that we wish to add to Vista: Fidelity Advisor; Total Bond Fund (FEPIX). This decision will terminate our relationship with the PIMCO family of funds.

We will maintain our relationship with all of the other fund families which collectively represent the largest segment of the mutual fund industry.

Vanguard; Short Term Treasury, Intermediate Term Treasury and Long-Term Treasury funds have served their narrow focus purpose well over the past several years. However, we have concluded that a mixed duration of US Government bonds in one fund in our plan is now a better idea as interest rates gradually rise and we need to let experienced fund managers determine the proper duration mix of the total.

We recommend mapping these three funds to the aforementioned American Century, Government Bond fund. We had hoped to keep all of these funds in the Vanguard family but all of this company's Treasury funds are duration limited and they do not have a fund that fits our purpose.

CASH/MONEY MARKET:

Changes in Federal Regulation compel all 401(k) plans to cease offering what was once a traditional Money Market fund and is now considered a "Retail" fund. We must map our existing fund to a "cash type" fund that guarantees that the share value is set at \$1.00 per share. The Vanguard; Prime Money Market fund has been in our plan for a long time because its cost was about the lowest we could find. However, Vanguard has had to revamp their money market funds to accommodate the new regulations. Vanguard offers the Federal Money Market Fund which is stable value and the most appropriate for a retirement plan. This fund's composition is entirely US government short term treasuries and has the highest credit risk status of any fund we can select.

We recommend adding the Federal Money Market Fund (VMFXX) to the plan and mapping the existing Money Market fund into it.

We have included a description of this fund and the reasons for making this change, elsewhere in this book.

NEW FUNDS TO BE ADDED TO THE PLAN:

I have already mentioned each of these funds in the review plan above. Following this review, Fact Sheets for each fund are included for Advisory Council review.

The new funds are:

Vanguard, Small Cap Index (VSMAX) is a small cap index fund

Fidelity; Growth Strategies (FDEGX) is a mid-cap growth strategy fund

T. Rowe Price; Blue Chip Growth (PABGX) is a large cap growth fund

T. Rowe Price; Dividend Growth (TADGX) is a conservative fund which emphasizes dividend paying stocks

American; Target Date Retirement (various quote symbols for each fund with ascending 5 year projected retirement year targets)

Fidelity; Total Bond (FEPIX) is a total bond fund similar to PIMCO; Total Return with a wide mix of types of bonds and durations but overall has a high credit rating composition.

Vanguard; Federal Money Market Fund (VMFXX) is the new money market fund mandated by new regulations.

(Revised 06.21.16)

