DEFINED CONTRIBUTION (DC):
Security Quality Matters When Choosing Equity Managers

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INTRODUCTION

Downside performance protection, better long-term return, and lower long-term risk – three objectives all investors seek for their investment managers vs. their appropriate benchmarks. What if an investor could significantly increase the odds of achieving these objectives? For defined contribution (DC) participants, this could improve retirement readiness and mitigate participant account impairment risk (selling low / buying high). For DC plan sponsors, this could mitigate fiduciary liability exposure.

In similar fashion, one could expect that an investment strategy that consistently holds higher quality stocks would tend to out-perform their style-appropriate benchmark and peer group when market losses are significant.

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With respect to equity managers, history shows that focusing on security quality, when selecting and monitoring DC investments, can increase the odds of achieving these objectives. This paper explores the concept and its positive impact on both the plan sponsor and participant.

The definitions of security quality vary widely. For this discussion, we define quality as the financial strength of the underlying companies in an equity portfolio. For example, a portfolio holding stocks that consistently exhibit stronger-than-market (relative to style-appropriate benchmark) profit margins, earnings growth, and cash-flow growth with lower-than-market leverage are defined as higher quality. Companies with the opposite relative characteristics (weaker margins, earnings growth, cash-flow growth; higher leverage) are defined as lower quality.

DOWNSIDE PERFORMANCE PROTECTION

Higher quality companies tend to out-perform lower quality companies in times of market stress. We illustrate this concept by measuring Russell US Stability® Index performance, by capitalization range (large, mid, small), for all negative calendar year periods since 1997 (see dark blue bars in Exhibits 1.0 - 1.2 at right) – Russell Stability® Index performance dates to July 1996.

Similar to dividing a Russell Index into value and growth, the Stability® Index divides into defensive and dynamic – Defensive® represents companies in the broad Index that exhibit lower leverage (debt/equity) and volatility (earnings, total return) with higher profitability (ROA) - implied to be higher quality; Dynamic® represents companies that exhibit higher leverage and volatility with lower profitability - implied to be lower quality.

In all negative calendar year periods (4 large-cap; 5 mid-cap; 6 small-cap) Russell's Defensive® Index (higher quality) significantly out-performed Russell's Dynamic® Index (lower quality).

PERFORMANCE (%)

EXHIBIT 1.0: US LARGE-CAP EQUITIES (negative calendar years since 1997)

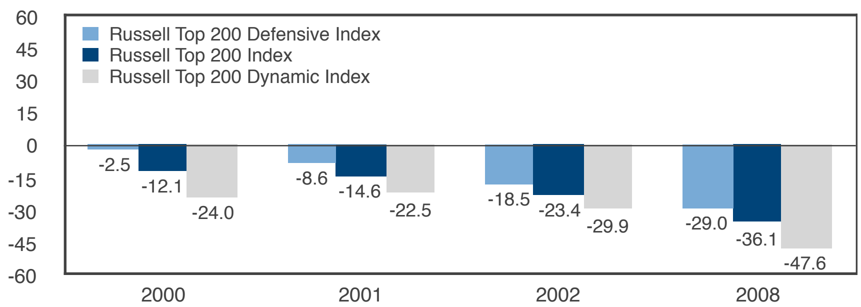


EXHIBIT 1.1: US MID-CAP EQUITIES (negative calendar years since 1997)

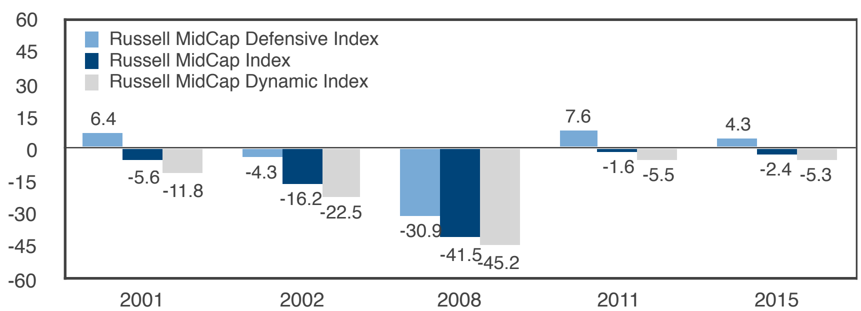
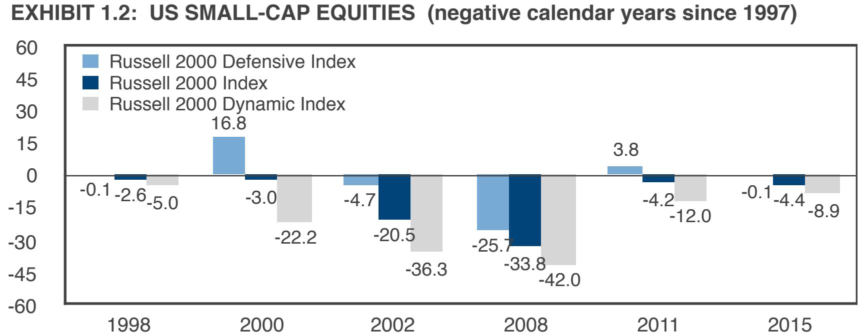


EXHIBIT 1.2: US SMALL-CAP EQUITIES (negative calendar years since 1997)



Russell Stability Indexes® - Morningstar Direct

The indexes measure a portion of the market based on the sensitivity to economic cycles, credit cycles, and market volatility, referred to as stability.

Stability, as defined by Russell, is measured at the company level in terms of volatility (earnings, total return), leverage (debt/equity), and return on assets. The more stable half of the index is called the Defensive® Index and the less stable half is called the Dynamic® Index.

Gosselin Consulting Group utilizes these indexes as one example of security quality differentiation. We define the defensive companies as higher quality and dynamic companies as lower quality.

Why is Downside Performance Protection Important?

For Participants: A significant "absolute" loss in a time of market stress can notably impair a participant's account balance, in some cases on a permanent basis. Participants may choose to (1) stop contributing, thus sacrificing the advantage of dollar-cost averaging or (2) re-allocate their assets out of equities (to cash or fixed income), thus negating any potential recovery. The frequency of these actions likely increase as absolute losses grow larger. To avoid this phenomenon, it makes sense to offer higher quality holdings-biased investment managers (vs. market-like or lower quality) as their historical losses are smaller.

For Plan Sponsors: A significant "relative (vs. benchmark)" loss in a time of market stress can notably increase a sponsor's fiduciary liability exposure. We believe sponsors face greater fiduciary risk when an investment significantly under-performs its benchmark in periods of market stress vs. periods of market exuberance. As an example, most participants would be satisfied with a 25% gain even if the market rose 35% in the same period. Most participants, however, would be dissatisfied with a loss of 35% in a period when the benchmark fell 25%. Not only are participants more apt to take notice of relative returns, but one may question the suitability of the option for a DC plan – thus increasing sponsor fiduciary liability exposure.

BETTER LONG-TERM RETURN; LOWER LONG-TERM RISK

We acknowledge that higher quality strategies tend to lag their benchmarks in times of market exuberance. That, however, does not detract from the long-term benefit of owning these portfolios.

In summary, we believe that conventional wisdom – the greater one's risk, the greater one's potential for return over long periods of time – does not hold true across the quality spectrum.

In fact, higher quality stocks have out-performed lower quality stocks (and the overall market) over the long-term. Furthermore, this has been achieved with significantly less risk. Exhibits 2.0 and 2.1 illustrate this phenomenon.

Once again, we utilize the Russell US Stability Index, by capitalization range, whose return streams are backdated to July 1996. This provides us with a 21 year period in which to analyze the long-term risk and return impact of quality investing.

As depicted in Exhibit 2.0, higher quality stocks out-performed lower quality stocks (and the overall market) at significantly reduced risk levels across large-, mid-, and small-cap. Higher quality stocks plotted in the desirable north (more return) and west (less risk) position (relative to their benchmark).

The most dramatic benefit existed within US small-cap where higher quality stocks nearly doubled the return (+99%) of lower quality stocks and reduced risk by 40% (see Exhibit 2.1 for data). The return premium in US large- and mid-cap, +19% and +16% respectively, was more moderate yet was achieved with similarly low relative risk levels (-36%).

It's also worth noting that these numbers were achieved despite the unique economic environment of the past 10 years – Historically low interest rates favored lower quality companies (cheap financing environment). Long-term, we believe stock prices move based on underlying company fundamentals instead.

EXHIBIT 2.0: US EQUITIES - RISK-RETURN
7/1/1996 - 6/30/2017

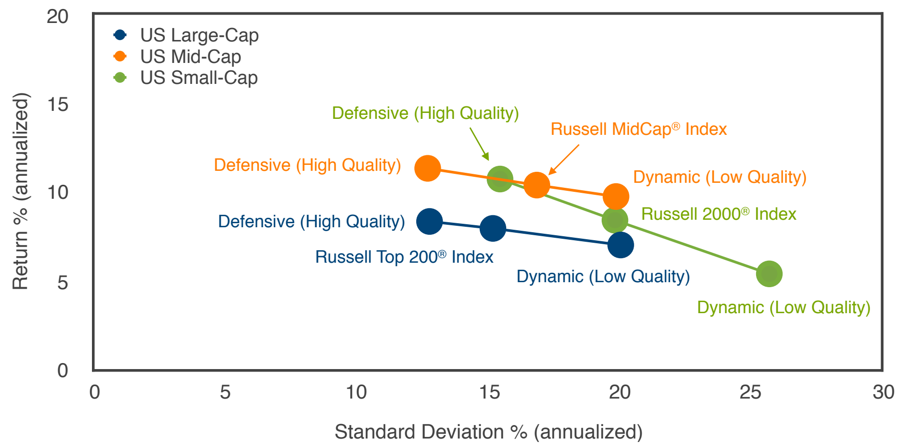


EXHIBIT 2.1
7/1/1996 - 6/30/2017

Capitalization	Russell Quality	Annlzd Return (%)	Annlzd Std Deviation (%)	High Quality Return Benefit (%)	High Quality Risk Benefit (%)
US Large-cap	Russell Defensive (High)	8.3	12.7		
	Russell Top 200® Index	7.9	15.2	5%	-16%
	Russell Dynamic (Low)	7.0	20.0	19%	-36%
US Mid-cap	Russell Defensive (High)	11.3	12.7		
	Russell MidCap® Index	10.3	16.8	9%	-25%
	Russell Dynamic (Low)	9.7	19.8	16%	-36%
US Small-cap	Russell Defensive (High)	10.7	15.4		
	Russell 2000® Index	8.4	19.8	28%	-22%
	Russell Dynamic (Low)	5.4	25.7	99%	-40%

Russell Core and Stability® Indexes
Data Source: Morningstar Direct

SUMMARY

DC participants and plan sponsors face unique risks when it comes to performance, especially in times of market stress; Participants face the threat of not achieving their financial retirement goals; Plan sponsors face the threat of increased fiduciary liability exposure.

In summary, this study illustrates how investing in higher quality equity managers can not only mitigate downside performance risk (vs. benchmark) in times of market stress but can also deliver stronger returns at reduced risk levels over the long-term.

At Gosselin Consulting Group, we are strong proponents of using high-quality holdings-biased equity managers who consistently exhibit at-market or greater-than-market financial strength. As an acknowledged fiduciary to our clients, it serves to better our collective fiduciary position and, most importantly, can improve outcomes for participants.

If you have questions or would like to learn more about how we select and monitor high quality investment managers, please feel free to contact us at info@gosselinconsultinggroup.com. We would be happy to hear from you and provide more information.

IMPORTANT DISCLOSURE

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