

Implementing Default Contribution Rates, QDIAs, and Investment Advice in 401(k) Plans:

Where Congress's Goals and Fiduciary Conduct Conflict

The enactment of the Pension Protection Act of 2006 (PPA) was Congress's recognition that corporate America's retirement programs—both defined benefit and 401(k) plans—were not working as anticipated, and unless these programs are managed much more effectively, America would face a severe retirement crisis.

To enhance the efficiency of 401(k) plans and to give 401(k) sponsors and fiduciaries peace of mind, Congress sanctioned the use of auto-enrollment combined with a default investment alternative (QDIA)—a target-date fund, a balanced fund with “a target level of risk appropriate for participants of the plan as a whole”¹, or managed accounts. The PPA also provided a prohibited transaction exemption that enables certain fiduciaries to be compensated for providing investment advice to 401(k) participants.

The good news is that fiduciaries, with the full support of plan sponsors, proceeded to enthusiastically incorporate auto-pilot programs and investment advice into their 401(k) plans. After all, an employee can't participate in a 401(k) plan unless he is enrolled. Further, participants who use professional investment management gain the advantage of the managers' presumably much better understanding of the capital markets. In addition, the investment pros supposedly provide participants with a much “steadier hand at the wheel” during turbulent times.

The bad news is that, in adopting auto-pilot and QDIA programs, all too many fiduciaries have inadvertently made themselves easy targets for 401(k) fiduciary lawsuits. However, it is easy for fiduciaries to correct their mistakes which include:

- ignoring the simple reality that the use of professional investment management, while psychologically very soothing, has not been a good predictor, let alone a guarantor, of investment success:
 - In 2008, 2010 target-date funds imploded.
 - In that same year, Financial Engines found that professionally managed products—be they target-date funds, managed accounts, or advice—did as poorly as 401(k) participants who were managing their own accounts.²
 - Morningstar has warned that the glide paths of most target-date funds lack a “solid theoretical basis”.³
 - There is no evidence that the use of fancy optimizers can produce, on average, better glide paths than the simple algorithm: percent of portfolio invested in stocks equals 100 minus the investor's age:

“[A]n algorithm that is constructed on the back of an envelope is often good enough to compete with an optimally weighted formula, and certainly good enough to outdo

expert judgment. This logic can be applied in many domains, ranging from the selection of stocks by portfolio managers to the choices of medical treatments by doctors or patients.”

—Noble laureate, Daniel Kahneman⁴

- Financial engineering and models often generate more problems and crises than they resolve or avoid, as Adrian Wooldridge, an editor at the Economist, has pointed out:

“The economics profession did an abysmal job of predicting the worst economic crisis since the Second World War—a failure of foresight that is made all the worse by the fact that several economists designed the fancy financial techniques that helped to produce the disaster.”⁵

- encouraging unrealistic expectations, and thus rude awakenings, by not bluntly telling auto-enrolled participants that the default contribution rate is way too low to enable the vast majority of them to achieve a financially secure retirement even if their investment options perform well;^{6,7}
 - **The GAO has documented that 401(k) participants are not receiving the benefits of target-date fund investing in large part because their contribution rates vary too much from those assumed by the funds’ investment managers.**⁸
- assuming that the duties of loyalty, prudence, and disclosure do not require fiduciaries to periodically provide each participant with a personalized gap analysis that compares his projected retirement income given his current contribution rate versus a suggested one;
 - A clever plaintiffs’ attorney can easily argue that fiduciaries are helping—even encouraging—participants to “remain in the dark” when they don’t use a small fraction of the fees participants pay for gap analyses given that the average 401(k) participant is clueless about retirement planning and lacks many of the skills required for successfully performing this task;⁹

Remedy: Provide both participants and non-participants with an annual personalized gap analysis that is designed to catch their attention and clearly demonstrates the need for them to start their retirement planning as early as possible and to contribute as much as they can.

Another major mistake fiduciaries often make lies in their approach—or lack thereof—to implementing a thorough process for monitoring whether or not a QDIA and/or investment advice is actually providing value to the participants for the fees they pay. After all, providing a tool that is supposed to help participants is no guarantee that that tool will perform as advertised.

There are two undeniable reasons for assessing, at least annually, whether or not a QDIA or an advisory service is providing significant value to participants. The first is that ERISA mandates it:

“Nothing in this section shall relieve a fiduciary from his or her duties under part 4 of title I of ERISA to prudently select and monitor any qualified default investment alternatives under the plan or from any liability that results from a failure to satisfy these duties, including liability for resulting losses.”¹⁰

“... the Department believes that fiduciaries selecting advisory programs are subject to the same fiduciary duty to prudently select and monitor investment advisers regardless of whether the advice arrangement was established under the section 408(b)(14) exemption.”¹¹

Secondly, many, if not most, QDIAs have not weathered the recent turbulent markets well. This reality, along with the implosion of professionally managed accounts in 2008, provide examples of why many leading authorities on expertise believe that professional investment management provides only an “*illusion of skill*”.^{12,13} The active vs. passive management debate and the many studies that have shown that indexes consistently outperform most active managers also point to professional investment management’s illusion of skill.

Additionally, annually monitoring where participants are on the road to retirement (by modeling where they will be at retirement given various assumptions) enables fiduciaries and sponsors take an intelligent, from the standpoint of 401(k) litigation risk management, approach to framing participant communications and managing participant expectations.

Remedy: Monitor the retirement readiness of all participants (for the plan as a whole as well as by specified employee groups) using several sets of assumptions regarding future investment growth. Doing this will enable fiduciaries to compare the retirement readiness of participants who use various forms of professional investment management to each other as well as to participants who self-manage their 401(k) accounts. The analyses should compare projections of retirement income needs with projections of the retirement income participants will have given their current contribution rate. It should also compare their current contribution rate to a suggested rate. The analysis should factor in Social Security and other company retirement programs and permit various assumptions to be changed.

¹ DOL’s final rule on default investment alternatives, 29 CFR Part 2550, RIN 1210-AB10.

² *Help in Defined Contribution Plans 2006-2010*, September 2011, p. 22.

³ *Lifetime Asset Allocations: Methodologies for Target Maturity Funds*, February 2008, p. 28.

⁴ Daniel Kahneman, *Thinking, Fast and Slow*, Farrar, Straus and Giroux, New York, 2011, p. 226.

⁵ Quoted in Alan Murray, *Reworking the Workplace*, Wall Street Journal, December 5, 2011, A15.

⁶ Roger Ibboson, James Xiong, Robert P. Kreidler, Charles F. Kreidler, and Peng Chen, *National Savings Guidelines*, Journal of Financial Planning, April 2007.

⁷ Alicia H. Munnell, Francesca Golub-Sass, and Anthony Webb, *How Much to Save For a Secure Retirement*, Center for Retirement Research at Boston College, Brief 11-13, November 2011.

⁸ For a detailed discussion of the issues/problems of target-date funds, see GAO-11-118, *Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants*, January 2011.

⁹ Annamaria Lusardi, *Americans’ Financial Capability*, Pension Research Council Working Paper, January 2011.

¹⁰ § 2550.404c-5(b)(2).

¹¹ DOL Field Assistance Bulletin 2007-01, Issue 2.

¹² Kahneman, *ibid*, p. 212.

¹³ Daniel Kahneman and Gary Klein, *Conditions for Intuitive Expertise: A Failure to Disagree*, *American Psychologist*, September 2009, 515.