

Value and Prudent Process (Part II)

The Diffusion of Responsibility and Its Effect on Value

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A remarkable feature shared by the three [legal] principles I have discussed is how few words it takes to enunciate them, and how many years it takes to understand and implement them

— Retired Supreme Court Justice Sandra Day O'Connor¹

The problem is not with what you don't know; the problem is that so much of what you think you know just ain't so!

— Mark Twain

If the recent wave of lawsuits over 401(k) fees launched by Schlichter, Bogard, and Denton did not catch the attention of 401(k) fiduciaries, Roger Ibbotson's recent paper, "National Savings Rate Guidelines for Individuals"², should. In this paper, the authors quantified why the average "boomer's" retirement will most likely be financially strapped.³

Since the Ibbotson paper makes it easy to conclude that large numbers of 401(k) participants are not on track to a comfortable retirement, fiduciaries must ask themselves (because others will) if participants are getting adequate value for the fees they pay. If they are not, should some, perhaps even a significant portion, of the blame for this be borne by the fiduciaries themselves?

Unfortunately, the answer is arguably "yes". The factors that contributed to so many fiduciaries ignoring their responsibilities arise primarily from the sponsor's corporate culture, the historical paucity of lawsuits alleging fiduciary imprudence⁴, and the diffusion among non-fiduciary advisors of responsibility for fiduciary decisions. In short, "too many cooks spoil the stew." This paper will discuss how this bouillabaisse of responsibility evolved and the concomitant loss of what the letters "I" and "S" in ERISA represents—income security.

A disconnection exists between a corporation's priorities and their employees' needs and wants.

A recent Deloitte/ISCEBS survey found that whether or not the average employee will achieve an adequate retirement income through his 401(k) plan is a "non-issue" for possibly the majority of corporate senior management teams. However,

"more than a half of the respondents, 59%, cited their ability to afford retirement as the issue most important to them personally... However, when asked to identify their company's Top Five challenges, the ability to afford to retire was far down on the list, with only 25

¹ Sandra Day O'Connor, *The Majesty of the Law*, Random House, New York, 2004, p.260.

² Roger Ibbotson, James Xiong, Robert Kreitler, Charles F. Kreitler and Peng Chen, "National Savings Rate Guidelines for Individuals Should", *Journal of Financial Planning*, April 2007.

³ The numbers, quite frankly, are shocking. For example, if a 35 year old has an annual salary of \$40,000 and enrolls in a 401(k) plan for the first time, she must contribute approximately 14% (including the employer match if there is one) of her salary if she hopes to have a comfortable retirement. This contribution rate still won't pass muster since it does not factor in the sizeable funds needed to compensate for the likely future reductions in Medicare and Social Security benefits.

⁴ For a discussion of how the lack of such lawsuits may have encouraged fiduciaries to ignore the relevance of research involving participant behavior, capabilities and knowledge, see "Tracking Down Lost Signals" in Sidney Finkelstein, *Why Smart Executives Fail and What You Can Learn From Their Mistakes*, Penguin Group, New York, 2004.

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percent listing it in the Top Five priorities and only 1 percent reporting it as their company's number one priority.”⁵

The fact that measuring whether or not 401(k) plans are meeting expectations has fallen off senior management's radar screen is not synonymous with 401(k) plans being considered superfluous. The same survey found that “the ability...to attract, motivate, and retain” talented employees was ranked as one of their firm's Top Five priorities by 75% of the respondents. To accomplish this priority, a company needs an attractive benefit package. A 401(k) plan, of course, is usually the retirement component of this package. Apparently senior management is much more concerned about how the 401(k) plan is perceived by their employees rather than what it actually delivers to them.

Is understanding how participants utilize their 401(k) plan a fiduciary “must do”?

ERISA's mandates and how the courts interpret them, as well as what ERISA does not require and/or (specifically) address, guide fiduciary conduct. The two “non-requirements” that have significantly impacted fiduciary conduct are that offering a retirement plan and providing retirement/investment education are voluntary decisions.

If a sponsor offers a 401(k) plan, however, ERISA dictates that the fiduciaries must act “solely in the interest of” and “for the exclusive purpose of providing benefits to the participants and their beneficiaries and defraying reasonable expenses of administering the plan”⁶. Furthermore, the fiduciaries must act “with the care, skill, prudence, and diligence under the circumstances then prevailing” that a prudent “expert” would employ⁷.

In the past, sponsors, fiduciaries, and their benefit attorneys have almost universally adopted what Fred Reish has called the “red state” approach—namely, “individuals should be responsible for their own planning, savings, and investing.”⁸ If the employees can't afford to retire or their lifestyle is drastically lowered, they have no one to blame but themselves.

Under the red state scenario, conventional wisdom purports that the fiduciaries' responsibilities are limited to:

- hiring a well-respected recordkeeper that uses the latest technology, has state-of-the-art websites for both sponsors and participants, charges competitive fees, and offers a broad selection of investment options;
- employing investment consultants to select, monitor, and terminate investment managers/options;
- signing-off on the communication/education campaigns that the provider recommends and develops;
- considering and possibly incorporating innovations, such as self-directed brokerage accounts, advisory services, and autopilot programs;
- reviewing periodically the performances and fees of their providers and consultants.

⁵ 2007 Top Five Total Rewards Priorities, Survey by Deloitte/ISCEBS.

⁶ ERISA §404(a)(1)(A)

⁷ ERISA §404(a)(1)(B)

⁸ Fred Reish, “Red States and Blue States: Part II”, *Plan Sponsor*, February, 2007.

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Fiduciaries apparently fulfill their obligations to the participants, then, if they create a high tech plan that conforms to industry standards and enables knowledgeable and self-disciplined participants (“do-it-yourselfers”) to achieve a comfortable retirement.

Whether or not the plan (by its design, participant communications, and sponsor involvement) gets (or even encourages) average employees to act responsibly regarding their retirement security has apparently not been considered a measure by which to judge fiduciary (as well as provider) performance. Managing employee expectations about their retirement prospects has also been considered a non-issue.

If sponsors would pay most or all of the costs of their 401(k) programs, then the red state approach could easily be justified. After all, the sponsor is providing and monitoring a tool with significant tax benefits for employees and a possible employer match. If employees elect not to take advantage of the plan or not use it wisely, it’s their problem and not their employer’s.

The reality, however, is that participants pay all or most of a 401(k) plan’s cost, and most participants are not knowledgeable do-it-yourselfers when it comes to investment/retirement planning.^{9,10} Thus, it is difficult to argue that ignoring how the plan is utilized by the average worker can fit into any plausible theory of 401(k) fiduciary responsibility. Perhaps the Supreme Court, given the “proper” philosophical persuasion,¹¹ will rule that the “deliberate indifference” to, while having “actual knowledge” of, the participants’ (and non-participants’) capabilities and attitudes, especially their mistrust of financial service providers¹², is a significant act of fiduciary irresponsibility, perhaps even compromising 404(c) protection.¹³ After all, without such knowledge, fiduciaries will not be able to intelligently use the participants’ money (fees) to implement a plan that provides maximum value for the average worker.

Characterizing in great detail the American worker (who is the typical American consumer) and his cultural environment is beyond the scope of this paper. However, all fiduciaries should take heed of the maxim—“know your customer”—and keep in mind the following observations when evaluating and monitoring their 401(k) plan, including how all aspects of the program are communicated to the employees:

- “One in three workers aren’t sure how much money they’ll need to have saved by the time they retire...Among those who have estimated how much money they’ll need to save, more than one in three just guessed at the number.”¹⁴
- “63% of American workers spend less than thirty minutes on benefit decisions. They will spend, however, 1.3 hours buying a pair of shoes and over 3 hours buying a television set.”¹⁵

⁹ Annamaria Lusardi and Olivia S. Mitchell, “Financial Literacy and Behavioral Finance: Implications for Retirement Wellbeing”, Michigan Retirement Research Center, Working Paper WP 2005-108.

¹⁰ “Plan Investment Options and Participant Behavior”, TIAA-CREF Institute Research Summary, June 2006.

¹¹ Justice O’Connor discusses this subject on p.45 of her book (see footnote 1). President Bush’s attempt to create a conservative leaning Supreme Court provides an example of how Courts of specific persuasions are created.

¹² Julie R. Agnew, Lisa Szykman, Stephen P. Utkus, and Jean A. Young, “Literacy, Trust, and 401(k) Savings Behavior”, Center for Retirement Research at Boston College, May 2007.

¹³ For a discussion of this possibility, see Brooks Hamilton, “A Fork in the Road”, *Journal of Pension Benefits*, Vol. 7 (1), 1999.

¹⁴ Eighth Annual Transamerica Retirement Survey, 2007.

¹⁵ MetLife’s Fifth Annual Study of Employee Benefit Trends, 2007.

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- “What is news? It's all a blur, run into the ground, with war, politics and pop culture given the same value. It's like pulling all-nighters to cram for exams. Sure, you'll pass, but did anything really ‘stick?’”¹⁶ The ongoing coverage on prime time new programs of pop culture’s heroines Rosie O’Donnell, Anna Nicole Smith, Paris Hilton, and Lindsay Lohan is proof of what “turns on” the average American.¹⁷
- “Our literacy, and with it our verbal communication skills, are in decline. The only category of novel that is gaining ground in our increasingly visual world is the graphic novel...the growth of graphic novels and narratives (is) explosively exponential.”¹⁸

Diffusion of responsibility contributes to the fiduciaries’ current conundrum.

Fiduciaries usually turn to one or more experts to help them design and run their 401(k) plans:

- benefit lawyers to explain ERISA’s requirements and oftentimes emerging trends;
- investment advisors to select and monitor investment options;
- third party administrators (TPAs) to implement plan design—participant recordkeeping, compliance testing, and data analysis;
- consulting firms (with recordkeeping capabilities) and bundled providers for one-stop shopping (plan documents, participant education/communication, advice on trends, etc.).

By hiring one or more of these experts, the fiduciaries believe they are acting prudently. They are, but the mistake fiduciaries make is to assume that the sum of the parts—input from the different experts—will, with minimal coordination and lack of aggressive questioning on the fiduciaries’ part, coalesce into a robust 401(k) program that provides adequate value to the average participant.

After all, each hired expert approaches the plan’s needs from the perspective of her discipline and her organization’s business model and profit objectives (just as the sponsor does when evaluating how its corporate dollars should be spent). Furthermore, with the possible exception of the investment advisor, none will assume fiduciary status let alone overall responsibility for the plan.

For example, the benefits lawyer gives his interpretation of ERISA. Since ERISA was written for a defined benefit world, it is a work in progress regarding many 401(k) fiduciary issues such as what it means to act “with the care, skill, prudence, and diligence under the circumstances then prevailing” that a prudent “expert” would.

Will the eventual interpretation by the courts of “under the circumstances then prevailing” require 401(k) participant communications to frame ideas and desired participant behavior in a manner that reflects current mainstream American values, such as, (to quote three times Pulitzer Prize winner Tom Friedman) “to extol consumption over hard work, investment, and long-term thinking”?¹⁹ Lest

¹⁶ “What War? We Have Sanjaya!”, Nancy Giles, CBS Sunday Morning News, May 6, 2007.

¹⁷ For a discussion of this cultural transformation, see Benjamin R. Barber, *Consumed: How Markets Corrupt Children, Infantilize Adults, and Swallow Citizens Whole*, W. W. Norton & Company, New York, 2007.

¹⁸ John Naisbitt, *Mind Set*, HarperCollins, New York, 2006, p. 115.

¹⁹ Thomas L. Friedman, *The World is Flat: A Brief History of the Twenty-first Century*, Farrar, Straus and Giroux, New York, 2005, p.252.

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one think that this example is an exaggeration, just recall President Bush's metaphor for normalcy after 9/11—shopping at the mall.

A fiduciary would be hard pressed to find a benefits attorney who will opine on this question. The typical attorney's reply will most likely be: find a communications expert.

Likewise, if the fiduciary asks her attorney what statistical reports she needs, the lawyer will probably answer: "Ask your recordkeeper. He knows what information fiduciaries need to fulfill their responsibilities."

Is this an acceptable answer since it requires a legal interpretation of "under the circumstances then prevailing"? This phrase could easily be interpreted to include in its meaning "how the plan is being used, misused, or not used at all by different demographic segments."

This information is found in a plan level "retirement readiness assessment". Such an assessment should contain the following statistics for the overall employee population as well as for the individual demographic groups of employees:

- What percent are projected to be on track for a financially secure retirement as measured by the income replacement ratio, "the most important statistic of success"?²⁰
- For those who are not on track, on average, how long will their retirement nest eggs provide the targeted inflation-adjusted income?
- For those who are not on track, on average, by how much (subject to both federal and plan constraints) should they be increasing their contributions?

A retirement readiness assessment makes plan utilization transparent, thus enabling fiduciaries to evaluate if their (fiduciaries' and providers') previous decisions have had the desired effect. A retirement readiness assessment also enables sponsors to determine if advisory and/or managed accounts programs are working and to proactively address issues as they emerge.

For example, autopilot programs with a SMarT feature are often portrayed as "wonder drugs" for getting eligible non-participants onto the road for a comfortable retirement. Unfortunately, a 3% default contribution rate along with an automatic 1% increase in contributions will not be of much help to employees whose contribution rates should be in the high teens (a not uncommon circumstance).²¹

The retirement readiness assessment allows fiduciaries to monitor the consequences (one of which can be the misrepresentation of a plan feature's value—as in the autopilot example) of their actions and inactions. Without such information, it can truly be said that "the blind are leading the blind."

If the fiduciary takes her lawyer's advice and asks the recordkeeper for his opinion, she will most likely be presented with a packet of standard reports. Depending on the plan's size and profitability for the provider, a limited number of customized reports may be made available.

Retirement readiness assessments are seldom included in these reports even though research over the years (with which fiduciaries, benefit attorneys, and providers should be quite familiar) has

²⁰ Fred Reish, "Statistics of Success", *Plan Sponsor*, March, 2007.

²¹ See the Ibbotson et al. paper footnoted on page 1.

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consistently shown that the average American has not seriously embraced retirement planning.^{22,23,24} To make matters worse, providers are often reluctant to release the data necessary to produce a retirement readiness assessment. This is ironic since:

- the sponsor owns the data;
- today's recordkeeping systems allow the creation of data extracts;
- it is not in a recordkeeper's best interests to prevent fiduciaries from fulfilling their responsibilities.

This conduct is creating an opportunity for class action lawyers to argue that providers:

- portrayed participation in the 401(k) plan as leading to a financially secure retirement (via the images in their communications);
- did not provide the "map" (retirement readiness assessments) needed to put the participants onto the road to a financially secure retirement;
- interfered with the fiduciaries obtaining retirement readiness assessments from other organizations.

Selecting investment options is another area that also requires considerable quarterbacking. For example, few investment advisors (and even fewer money management firms) tell fiduciaries that to be "75% sure he's skillful, you'd generally have to track a manager's performance for between 16 and 115 years."²⁵ Unfortunately, a fiduciary will be hard pressed to find an individual alive today who has managed money for that length of time.

An obvious question is: If a fiduciary doesn't know whether an actively managed fund's performance is due to luck or skill (because the manager's professional career is short), how does she justify using that actively managed fund, even if its performance has been stellar, over that of an index fund with much lower fees?

If the fiduciary can't convincingly justify her choice of the actively managed fund, it is easy to imagine an attorney arguing that participants should be reimbursed for the difference between the actively managed fund's fees they paid and those of an index fund of the same asset class(es).

In some of their lawsuits, the Schlichter firm has raised another question: Is an actively managed fund an index fund in disguise (a "closet" index" fund)?²⁶ These lawyers will presumably argue that an actively managed fund's fees can be competitive when compared to the fees of other actively managed funds but still be excessive when compared to the expense ratio of an "undisguised" index fund.

²² See The Employee Benefits Research Institute's Retirement Confidence Surveys.

²³ Luke Delorme, Alicia H. Munnell, and Anthony Webb, "Empirical Regularity Suggests Retirement Risks", Center for Retirement Research at Boston College, January 2006.

²⁴ *Retirements at Risk: A New National Retirement Risk Index*, Center for Retirement Research at Boston College, June 2006.

²⁵ Ted Aronson, Jason Zweig, "Confessions of a Fund Pro", *Money*, February 1, 1999.

²⁶ *Steve Martin et al. v Caterpillar Benefit Funds Committee of Caterpillar Inc., Caterpillar Investment Management Ltd.*, United States District Court Western District of Missouri, Case 2.06-cv-40208-SW, September 1, 2006.

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(Fiduciaries should keep in mind that, given the right analytical tools, it is not difficult to analyze the factors contributing to a fund's performance and how those factors compared to the ones that generated the benchmark's performance. Thus, an active manager's contribution to performance—*alpha* in modern portfolio theory parlance—is relatively easy to quantify.)

These comments should not be interpreted as an argument in favor of index funds over actively managed funds. Rather, they are intended to illustrate that fund fees can be competitive and still excessive, and worse yet, may possibly provide little, if any, value. It is naïve for fiduciaries to assume that there is no need for them to do their “homework”—to develop an understanding of the strengths and weakness of fund analysis—and to carefully understand their investment advisor's philosophy and sources of compensation (commissions, finder's fees, soft dollar arrangements).²⁷

Fiduciaries should keep in mind the words of Christopher Cox, the chairman of the Securities and Exchange Commission, for they clearly demonstrate just how hot a topic mutual fund fees are today:

“To far too great a degree, and in substantial part because of a regulatory cumbersomeness that obscures the real numbers, our financial services industries are able to skim off much more of the assets they handle than would be the case in a well-functioning market. The difference materially burdens an investor's annual expected returns. And compounded over the retirement time horizon of even someone in his or her 50s, this can result in truly astronomical shortfalls.”²⁸

Fiduciaries must manage participant expectations.

Gap analyses, advisory services, target date funds, managed accounts, etc. are tools that, if used wisely by the participants, can get them moving in the right direction (based upon the available information at a given point in time). Fiduciaries must make participants understand that the phrase “moving in the right direction” should be interpreted as a guideline and what the “right direction” is will change periodically and sometimes unexpectedly.

In their paper²⁹, Ibbotson and his colleagues succinctly summarize this reality:

“The world is ever changing. In the future, much will be different from our projections. The savings guidelines should be considered as a guide only; individuals should monitor their progress and adjust over time to ensure they reach their goals.”

Many vendors, however, are concerned that if fiduciaries and participants clearly understood just how imprecise their products can be, few would purchase them. The result of this concern is that vendors imply that their products are much more precise than they really are. Thus, it is incumbent on fiduciaries to understand the limitations of the products that they approve and to make sure that their vendor's communications adequately, clearly, and honestly describe a product's capabilities.

The importance of Monte Carlo simulations is an example of such hype. These simulations show how the volatility of stock and bond returns can affect the size of a participant's account when she retires. Participants should not be told (even though marketers often imply) that these simulations will give them an accurate projection of what their account will be at varying contribution rates. After

²⁷ An excellent discussion of the active versus passive management debate can be found in John C. Bogle, *The Little Book of Common Sense Investing*, John Wiley & Sons, Inc., Hoboken, 2007.

²⁸ Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference, Washington, D.C., April 13, 2007.

²⁹ See footnote 2.

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all, change the inputs and you also change (oftentimes significantly) the contribution rate needed to reach the same goal.

For example, the Ibbotson paper uses an expected return for the S&P 500 of 10.96%. In a recent article in the *Wall Street Journal*, Princeton professor Burton Malkiel (author of *A Random Walk Down Wall Street*) “suggests that stocks are priced to produce about 7.5% future returns, well below the 10.5% annual returns achieved from 1926 through 2006.”³⁰

A 346 basis point difference in the stock return is a “big deal”. To simplify matters, assume that a participant contributes \$2500 annually to her 401(k) account. If her account could earn an annualized compound rate of return of 10.96% over a 20 year period, she would accumulate approximately \$177,000.

If her account would grow at 7.5%, she would have only \$116,000. To accumulate \$177,000, her annual contribution would have to be increased to slightly more than \$3800.

Lawyers will argue that who is right is irrelevant. In fact, neither has to be right. All ERISA requires is that a prudent process, in this case, the intelligent use of Modern Portfolio theory, is used in addressing the needs of participants.

Perhaps the lawyers are right, but fiduciaries should not forget that a large portion of that 10.5% return of the last 80 years was due to the fact “we were the only economy standing after World War II, and we had no serious competition for forty years.”³¹ To make matters worse, America is now outsourcing overseas much of its industrial and research capabilities.

Fiduciaries have a responsibility to understand and feel comfortable with a provider’s methodology and value proposition before hiring him. If they are not comfortable with them, they should not hire him regardless of his reputation or client list. Once hired, the provider must be monitored on an ongoing basis. After all, the consequences to participants for a fiduciary’s lack of due diligence, as shown above, can be disastrous and, more likely than not, the plaintiffs’ attorneys will be able to make a strong case for attaching a price tag to them.

Conclusion

The goal of the first paper in this series was to define a value-driven, results-oriented prudent process for running a 401(k) plan.³² In this paper, the red state approach to fiduciary responsibility is shown to be hard, if not impossible, to justify since participants pay most, if not all, of their 401(k) plan’s costs. With this realization comes the recognition of the importance of frequent retirement readiness assessments and the need for fiduciaries to quarterback their advisors—and not the other way around.

Without frequent retirement readiness assessments, fiduciaries will be hard pressed to prove that they understand whether their participants are using the plan wisely and, thus, getting their money’s worth for the fees they pay. Without fiduciaries quarterbacking their advisors, diffusion of responsibility occurs. In the current environment of distrust of Wall Street and financial service providers, allowing the diffusion of responsibility to occur is tantamount to asking the fox to guard the hen house.

³⁰ Burton G. Malkiel, “Irrational Complacency”, *Wall Street Journal*, April 30, 2007, p. A15.

³¹ Thomas L. Friedman, p. 252.

³² Richard D. Glass, “Value and Prudent Process: Redefining Both Terms in Light of the Recent Spate of Class Action Lawsuits over 401(k) Fees”, *Benefits and Compensation Digest*, June 2006, p.

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Fiduciaries should not put themselves into a position where they may have to explain to a court why they allowed their advisors to set the standards (i.e., to cherry-pick what aspects of the latter's performance—or lack thereof—should be subjected to scrutiny and what aspects could be ignored). In their dealings with all their advisors, fiduciaries should heed the General Accountability Office's warning that "service providers may steer plan sponsors towards investment products or services that may not be in the best interest of participants and may cause them to pay higher fees."³³

³³ Highlights of GAO-07-21, Changes Needed to Provide 401(k) Participants and the Department of Labor Better Information on Fees", November 2006.