

# Conventional wisdom, fiduciary duty and 401(k)s

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For almost 30 years, conventional wisdom has maintained that 401(k) fiduciaries can easily fulfill their duties through a few crucial steps:

- hiring a competitively priced record keeper that routinely deals with plans of their size;
- using a well-respected investment consultant to advise on selecting and monitoring “competitively” priced investment options; and
- complying with the letter (as distinct from the spirit) of the law.

Conventional wisdom also assumed that employees are rational adults who are fully willing and capable (educationally and financially) of tackling the challenges of achieving a financially secure retirement.

Unfortunately, conventional wisdom, more often than not, reflects what we wish to believe rather than fact.

The simple reality is that Congress did not incorporate into the Employee Retirement Income Security Act of 1974 a definition of fiduciary duty, “instead appearing content to abdicate the development of the scope and effect of the duty to the judiciary,” as William A. Birdthistle, assistant professor of law, Chicago-Kent College of Law, has pointed out. That is what the courts are now doing by legislating the meaning of fiduciary responsibility, setting standards for evaluating when fees reflect free-market competition or are merely byproducts of industrywide incestuous relationships, and determining whether a fee, just because it is competitively priced, is reasonable and provides adequate value for investors.

Unfortunately, no one can predict either the judges' decisions or the extent to which they will be conflicting. After all, the legal literature is full of conflicting views as to the meaning of fiduciary responsibility, and this ambiguity is the primary reason the U.S. Supreme Court has taken up the Jones vs. Harris Associates case in its current term.

To complicate matters even further, Jones vs. Harris Associates is an excessive-fee case brought under section 36(b) of the Investment Company Amendments Act of 1970. 401(k) fiduciaries will now get an insight into the extent to which decisions involving securities law might affect their ERISA mandated responsibilities.

## **Uncharted territory**

Thus, 401(k) fiduciaries must recognize that they are in uncharted territory and pay heed to the advice of Robert Khuzami, director of the Securities and Exchange Commission's Division of Enforcement, that “it's better to be in the prevention business than the cleanup business.”

The steps fiduciaries should take to minimize the likelihood of successful lawsuits against them include:

1. Employees must be told that while the investment assumptions used in their educational material seem to be reasonable and are based upon history, the future will likely be dramatically different. Thus, employees have to be made to understand that monitoring their accounts is a “must” and that this responsibility is theirs alone.
2. Effectively spending the fees the employees pay for running the plan is a fiduciary responsibility. As such, the sponsor must carefully monitor the effectiveness of its provider's approach to achieving the desired employee behavior. This is a critical step given all the publicity that Wall Street has garnered about its “bad” behavior.
3. The judicial opinions in the Deere Inc. and Wal-Mart Stores Inc. cases clearly show why fiduciaries must insist that their record keepers provide them with analyses that document that the fiduciaries are using, and have used, an evidence-based process for running the 401(k) plan. In dismissing the counts that the fees were excessive and unnecessary, the judges in the cases did not pass judgment on the merits of the issues. Rather, dismissal occurred because the plaintiffs' attorneys did not persuade the judges the alleged fiduciary breaches probably occurred. Thus, fiduciaries should not interpret these dismissals as giving them a “green light” to rest easy and not worry about fee cases.
4. To protect themselves as well as to fulfill their responsibilities to their employees, fiduciaries should demand that their providers, at least annually, provide them with group retirement readiness assessments. Unfortunately, fiduciaries often receive lots of data but little meaningful information. These assessments should identify different employee segments and then show for each group where they are along the road to retirement security, including suggested contributions and the length of time it will likely take to deplete their retirement nest egg. Without such analyses, it will be difficult for the fiduciaries to demonstrate that they implemented a systematic process to provide participants with adequate value for the fees they pay and to critically monitor their providers' performances and recommendations.
5. Sponsors should acknowledge that picking actively managed funds that will do well in the future is often compared to shooting craps. The well-respected money manager Theodore Aronson has observed that “under normal circumstances, it takes between 20 and 800 years (of monitoring performance) to statistically prove a money manager is skillful, not lucky.”

Caltech's Leonard Mlodinow takes a different approach to asking whether a manager's performance is due to chance or skill. He compares the ability to identify top-performing managers to flipping coins and concludes that the probability of picking just a single good manager is almost nil, let alone a portfolio of them.

Given the difficulty in picking actively managed mutual funds, plaintiffs' attorneys will likely argue that fiduciaries should concentrate on controlling what they can (reducing fees by using index funds) rather than on what they can't (increasing investment returns by trying to identify good active managers). To make matters worse, good plaintiffs' attorneys will point out that research (such as that of Roger G. Ibbotson) has shown that "about 90% of the variability in the returns of a fund across time is explained by policy (asset allocation) ... and on average about 100% of the return level is explained by the policy return level."

6. Target-date funds are very appealing to both sponsors and participants. It must be remembered that even though Congress approved their use as a qualified default investment alternative, fiduciaries must still justify how they arrived at the termination date of the glidepath and why they believe that modern portfolio theory, the foundation for creating these funds, actually works in today's environment. Given what is now known of the limitations of financial modeling in general, and modern portfolio theory in particular, this is not a trivial task.

### **Final thought**

Whether 401(k) plans should be corporate America's primary retirement plan is a critical issue, but it is not one that affects the fiduciaries' responsibilities. Thus, fiduciaries should heed the advice of Gen. Stanley McChrystal, the commander of U.S. troops in Afghanistan: "You have to navigate from where you are and not from where you wish to be."