

401(k) Fiduciary Risk Management:
Making Decisions Based upon Knowledge Rather Than
Fact-Resistant Beliefs and Wishful Thinking

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The illusions of hope are apt to close one's eyes to the painful truth.

—Harry F. Banks

ERISA, and the regulations under it, are often lamentably obscure—to describe them as a tangled web does not do them justice.

—Mark R. Kravitz

That...is what makes ERISA cases fun for litigators like me - nothing is ever simple, even the issues that one would think should be. This [results] ... from a complicated statute that leaves much to further development by the courts...to the frequent disagreement among circuits (and even among district court judges within the same circuit in some instances) on a variety of issues under the statute.

—Stephen D. Rosenberg

Certitude is not the test of certainty. We have been cocksure of many things that were not so.

—Oliver Wendell Holmes, Jr.

The foundation of effective 401(k) risk management is the recognition that 401(k) fiduciary responsibility is a “black box”. Neither ERISA nor the regulations define the duties of loyalty, prudence, and disclosure. To make matters worse, a reading of the legal literature leads one to conclude that the appropriate fiduciary conduct is a matter of the unique facts and circumstances of each case.

The good news, however, is that fiduciaries do not have to guarantee an outcome. Rather, ERISA §404(a)(1)(B) requires that they must act “with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

The icing on the cake is that implementing such a process will:

1. clearly demonstrate that the fiduciaries are trying to help their employees achieve a financially secure and comfortable retirement;
2. enhance employee appreciation of the plan;
3. increase the plan’s value to participants, fiduciaries, and sponsor while, at the same time, probably reducing fees;

401(k) Fiduciary Risk Management: Making Decisions Based upon Knowledge Rather Than Fact-Resistant Beliefs and Wishful Thinking

4. maximize the likelihood that 401(k) breach of fiduciary responsibility lawsuits will not be initiated or, if they are, will be dismissed before the discovery stage.

The components of effective 401(k) risk management include:

1. making decisions based upon facts rather than on how we want things to be;
2. owning-up to the reality that 401(k) plans are now routinely portrayed as the “goose that has been cooked” rather than the “goose that routinely lays golden eggs”, and thus any large plan can find itself in the “crosshairs” of aggressive, hungry plaintiffs’ attorneys;
3. consistently running the 401(k) plan in a manner that increases the likelihood that the participants will use it in a manner that is most effective in helping them achieve a comfortable and financially secure retirement;
4. recognizing the need to help participants develop realistic expectations regarding their role in retirement planning, the value and use of the 401(k) plan, the volatility of the stock and bond markets, and the limitations of professional investment advice/management;
5. differentiating between what workers claim they want and are willing to do versus what they can and will do and are willing to pay for;
6. framing issues in the way we want them to be understood so as to avoid the (likely negative) consequences of participants (mis)interpreting issues based on their background, current mindset (such as anger at Wall Street, fear of unemployment, level of optimism), and media environment (including YouTube, Fox News, MSNBC, favorite blogs, and friends);
7. making sure that the participant communications are delivered in such a way as to maximize the likelihood that the desired message will get through to the targeted audience;
8. accepting the facts that Congress reacts to public outcry with “righteous” (perhaps dysfunctional) indignation (such as Congressional committees holding hearings as to whether select Wall Street firms were saved at the expense of “Main Street”) and the DOL can retroactively change the rules simply by issuing new interpretive guidance;
9. obtaining from your providers detailed documentation as to why they offer the products and services they do, the utilization and effectiveness of each product and service, and their approach to updating their technologies to meet the evolving needs of 401(k) fiduciaries.

A good start to evaluating your 401(k) risk management program is to review your answers to the following questions. If you, like so many other large plan fiduciaries, find

401(k) Fiduciary Risk Management: Making Decisions Based upon Knowledge Rather Than Fact-Resistant Beliefs and Wishful Thinking

yourself without satisfactory answers, this realization should be a wake-up call to “get into gear” and reexamine your approach to running your plan.

1. What do we know (and how do we evaluate the soundness of our knowledge) versus what should we know.
 - A. Is it a fiduciary responsibility to know whether the average 401(k) participant is using the plan in a manner that will help her achieve a comfortable and financially secure retirement?
 - i. If it is, how are we measuring success?
 - ii. If it isn't a fiduciary responsibility to know this or if the goal of the 401(k) plan is something different, how did we arrive at those conclusions?
 - B. How do we evaluate the adequacy and effectiveness of our participant communications?
 - i. What will be considered “material information”? Will the same definition be applied in every case? Will the courts consider how the material is presented in addition to the content?
 - ii. Should both the content and presentation format be based upon facts and circumstances, such as the likely literacy level of the average participant?
 - C. Is it part of the fiduciary duties of loyalty and prudence to integrate plan design, employee literacy (financial, reading and math), participant behavior, participant communications, and investment options in such a manner that they reinforce each other and enhance the plan's overall value to the participants?
 - i. To maximize the plan's value, should recent findings of cognitive science, consumer behavior, behavioral economics, etc. be incorporated into the process of running the 401(k) plan?
 - D. How do we define and then measure the value the participants, sponsor, and fiduciaries receive for the fees paid?
 - i. Has your investment consultant provided you with sufficient documentation that his process can realistically project the future performances of his investment option selections?
 - ii. If he can't provide such documentation, does actively managed fund selection become a “roll of the dice” and their fees excessive?
2. Why don't we know what (we think) we should know?

401(k) Fiduciary Risk Management: Making Decisions Based upon Knowledge
Rather Than Fact-Resistant Beliefs and Wishful Thinking

- A. We lack the time to become informed or keep up with ongoing developments.
 - B. Obtaining the necessary information is expensive.
 - C. Our provider's technical limitations prevent it from turning data into meaningful information, such as:
 - i. differentiating and monitoring the behavior of self-enrolled vs. auto-enrolled participants, including their contribution rates and long-term participation in the plan;
 - ii. identifying participants who are using both a target date fund and at least one other investment option (indicating they may be misusing the target date fund);
 - iii. calculating how long a participant's retirement nest egg is expected to last given different assumptions.
3. In the future, will blindly "following the herd" (accepting industry standards as prudent) be a wise course of action?
- A. The "turning of a blind eye" can easily result in errors of omission and/or commission.
 - i. According to recent surveys (Deloitte's Top Five Total Rewards Priorities), sponsors place a much greater emphasis on employee appreciation of their programs than on the benefits that are actually being delivered. Perhaps this is why 401(k) plans are described as retirement plans rather than tools to achieve a comfortable retirement. After all, retirement plans imply company provided benefits while a tool is something one can use (often successfully only with skill) to accomplish a goal.
 - B. ERISA or the regulations are ambiguous and there are many possible interpretations of the issues?
 - i. The best course of action is likely one that supports the goal of helping participants achieve a comfortable and financially secure retirement and is founded on widely known facts (current research findings) and circumstances (actual participant behavior).
 - C. In the past, doing what we should have done would have:
 - i. gone against conventional wisdom;
 - ii. resulted in increased costs to the company;

401(k) Fiduciary Risk Management: Making Decisions Based upon Knowledge
Rather Than Fact-Resistant Beliefs and Wishful Thinking

- iii. utilized time and expended limited resources to explore replacing our advisors or recordkeeper;
 - iv. conflicted with corporate culture.
- D. We relied on experts—recordkeepers, attorneys, investment consultants—to make the right decisions for us and simply assumed that their agendas (biases), business models, and profit strategies would not result in any material conflicts of interests.
- i. In areas of ambiguity (such as ERISA’s vagueness or recognizing that an investment “bubble” is underway), is there any reason to believe that so-called expert judgment is better than the typical fiduciary’s?
 - a. *[T]here is so much disdain among high-ranking academics for forecasting exercises (the opposite of the attitude I would expect if they thought they held some advantage). One social science colleague told me with ill-concealed contempt: “We leave that for the media mavens.”*
—Philip E. Tetlock, Expert Political Judgment: How Good Is It? How Can We Know?, Princeton University Press, 2005, p. 233.
 - ii. What standards were used (what should we have known) to identify and evaluate (selection and monitoring of) experts?
 - iii. Are the experts telling us what we want to hear (the answers we want) or are they telling us what we should know (various options that we have and the likely consequences of each as well as how they arrived at those consequences)?
 - iv. The widespread (and still increasing) use of target-date funds provides an excellent example of the need for sponsors to constantly play devil’s advocate with their experts.
 - a. What evidence is there that the allocation scheme that is being used to create the glide path can accurately predict future returns, volatility, and correlations of the various asset classes over long (or for that matter, short) periods of time, especially in today’s world of constant and often dramatic change?
 - (1). Perhaps the reason why so many 2010 target date funds imploded in 2008 is that the models used to construct them are viable only in relatively static conditions?
 - (2). How many investment managers and consultants on December 31, 1999 thought that the U.S. stock market (as measured by Vanguard’s Total Stock Market fund) would have an average annual return of -

401(k) Fiduciary Risk Management: Making Decisions Based upon Knowledge
Rather Than Fact-Resistant Beliefs and Wishful Thinking

0.27% over the next ten years and international stocks would earn only 2.29% (Vanguard's Total International Stock fund)?

- (3). Given that the two bubbles (dot.com and sub-prime mortgages) that occurred during that same decade went unrecognized by practically all investment experts (or were ignored, according to Henry Blodget in *Why Wall Street Always Blows It*, The Atlantic, December 2008, because of all the money that Wall Street was making), isn't it crucial for fiduciaries and sponsors to understand the widespread criticism of the Efficient Market Theory and the inability of practitioners to effectively factor into their models so-called Black Swan events?
 - (4). Perhaps the above three issues provide the reason why the investment managers of target date funds are hesitant (usually refuse) to suggest a pre-retirement growth rate for participants to use in calculating their 401(k) contributions.
- b. Fiduciaries should not take comfort in the knowledge that the company that is providing participants with advice or designing their target-date funds was founded by a Noble laureate. Long Term Capital, for example, demonstrates that having Nobel Prize winners on board is no guarantee of success. Long Term Capital had no trouble rounding-up investors thanks to its highly respected team, including a pair of future Nobel Prize winners. In spite of this brain trust, however, Long Term Capital failed, and the Federal Reserve, fearing that the world's financial system was in peril, had to get Wall Street's leading banks to bail them out.

ERISA mandates that 401(k) fiduciaries run their plan in a prudent manner. An important component of being prudent means acquiring knowledge and then learning how to apply it in a manner that is appropriate for a given set of circumstances. Prudence also requires ongoing learning and reevaluating what was done before. Perhaps the above discussion can best be summarized by the words of John Kenneth Galbraith:

The enemy of the conventional wisdom is not ideas but the march of events.