What Will Participants Do When the Bull Market Goes Bye-Bye?

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"How are participants in self-directed retirement plans, such as 401(k), 457, and 403(b), going to behave when the current bull market comes to its end?" is a popular question among product vendors (mutual fund companies, banks, and insurers) and the more sophisticated plan sponsors. Are the participants going to jump ship, i.e., bail out of equity funds, and move to, perhaps even demand, stable-asset type products? Or, are they going to be able to hang in there and ride out the storm?

The behavior of plan participants will be determined in large part by how the bull market ends and how long the succeeding bear market is expected to and actually does last. Will the market suddenly head south taking with it the current year's gains as well as decimating account balances? Perhaps only the last six to twelve months of growth will be lost? Alternatively, the bull market could just fade away. Future growth would occur in a lethargic manner—annual increases in the low to mid-single digits—thus making the returns of the usually less volatile fixed-income investments look much more attractive. The nature of the transition from a bull to a bear market, then, will be a major factor in determining whether participants are left feeling afraid of stocks or just disappointed in them.

The financial press' reporting of the market's activities will also be a prime determinant in the reaction of participants to a bear market. If pessimism permeates reporters' comments, would significant movement from stock to fixed-income funds surprise anyone? After all, sponsors of defined benefit plans, with their keen sensitivity to short-term results, would probably be leading the charge.

Besides having a certain entertainment value, cogitating on how the typical plan participant will react to an uncertain or bear market environment is a fruitless endeavor. Perhaps three much more relevant questions are:

1. How would we like plan participants to behave when the bull market is over?
2. What can be done now to prepare participants for the time when the market heads south, or somewhere other than north?
3. How does the answer to the second question compare to what we are currently doing?

How would we like participants to behave when the bull market is over?

To begin with, we don't want them to panic. We all remember the acronyms, FIRG and GIRF, that appropriately describe the behavior of so many investors. (Fear inevitably reverts to greed and greed inevitably reverts to fear). It should be a goal of plan sponsors and retirement plan vendors alike to minimize the swing of the mental pendulum between fear and greed. Acting emotionally, especially when it comes to investing, is generally counterproductive.

In order to minimize, the fear/greed/panic syndrome, plan participants must develop realistic perceptions of market behavior. They must realize that both bull and bear markets are to be expected. Participants must understand that bear markets can inflict severe losses and recovery, at least judged by the size of their account balances, could take several years.

Many, perhaps most, participants should view bear markets as buying opportunities. For them, what is relevant is not the size of their account balance, rather it is the number of shares they are accumulating. Paper losses will not affect their retirement security. On the contrary, the ability to buy more shares because the share price is down will enhance their retirement security.

What can be done now to prepare participants for bear markets?
If participants don’t have realistic expectations of market behavior, it will be easy for them to believe that they were misled, even given a deliberate sales job, rather than educated, during employer and/or product vendor sponsored sessions in which speakers extolled equity investments over fixed income ones. To make matters worse, one commonly used criteria for measuring the success of many so-called educational sessions is the size of the increase in contributions flowing into equity funds. Add to this that equity funds carry much higher fees than fixed income funds and that the talk was given by the product vendor’s employees, and the plan sponsor and the product vendor could easily find themselves the target of law suits.

Well thought out investment education programs are perhaps the only way plan sponsors and product vendors can simultaneously protect themselves from participant law suits and help most of participants prepare for bear markets. Plan sponsors must remember that they are not required to educate their employees, but, if they do, the educational programs and their handouts must be complete, accurate, and not misleading.

What are we doing versus what should we be doing?
Plan sponsors have no legal obligation to help participants prepare for retirement, yet alone provide guidance on how to handle investments in a bear market. However, if they undertake educational programs (and the courts may one day define education rather broadly) that address these issues, and if the plan sponsor wants to comply with ERISA section 404(c), it is imperative that the programs be well thought out and directed to the appropriate participant audience.

Unfortunately, all too many programs and materials in use today are directed exclusively at employees with the least educational background even though they are distributed to all participants. Such programs, due to their simplicity and lack of completeness, provide little if any empowerment for the majority of plan participants. In fact, it can be argued that they are inaccurate, incomplete, and misleading. For example: If a bear market is just around the corner, should participants be encouraged to invest most of their contributions in equity funds? (Unfortunately this is not the place to discuss market timing.)

Plan sponsors can no longer simply assume that the standard programs and materials provided by vendors will approach, yet alone meet, their needs. Plan sponsors must analyze and define their goals and then develop an understanding of how to address them. There is no getting out of the necessity to thoroughly review and possibly dramatically revamp existing programs.

After all, having productive employees who appreciate company benefit programs rather than having a disgruntled workforce that cannot afford to retire is an issue that directly affects a company’s bottom line—both the plan sponsor’s and the vendor’s.