Communicate, Don't Litigate

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In the past when I would walk around preaching that plan sponsors and providers must get their investment education act together or face lawsuits, corporate benefit attorneys told me I was nuts. Now others seem to share my view.

At a recent conference one well-respected Employee Benefits of America attorney told me that not only are many class action attorneys sharp, but after the First Union settlement, one group of lawyers new has $50 million to educate themselves on ERISA issues. It's also been rumored that class action law firms are a good place for former DOL attorneys to hang their hats. In the future, disgruntled employees will not have to look too hard to find their share of competent plaintiff attorneys.

Alfred Stieglitz, the father of American photography, once observed "In my opinion, the most difficult problem in photography is learning to see." Learning to see what is in front of is of us is a universal problem. Look at your communications/education products and services head on, sideways, and in minute detail. Good communications can solve problems before they occur. An honest presentation can work wonders and keep the fiduciary liability bogeyman away.

Consider the following questions:

- Do you feel that most plan sponsors and providers have really tried to make participants understand what it costs to achieve financial security during retirement?
- Why don't providers routinely pass out personalized statements showing participants where they are along the road to retirement? Could it be that providers are lacking complete data, are concerned about the increased costs for collecting and storing this data, or do not view participant statements as the effective asset gathering tools they really are? Are plan sponsors afraid that such reports will create disgruntled employees or are they simply not interested?
- When it comes to communicating with participants, do you feel that plan sponsors have been guided by what their attorneys tell them rather than what makes good business sense?
- Why would a participant sue his or her plan sponsor? Quite candidly, there haven't been all that many lawsuits as of yet. A common underlying thread in the lawsuits that have already occurred is that participants feel that they have been taken to the cleaners. Participants feel that they have lost money due to plan sponsor behavior – real or perceived.

I don't think that better communications can solve those types of lawsuits. If plan sponsors do something stupid – illegal, or legal but morally unacceptable, they have a problem. It's that simple. Fortunately, I think that lawsuits stemming from these causes are going to be relatively small in number.

In the future most lawsuits are probably going to arise due to the following six issues:

1. Employees find that they do not have enough money on which to retire comfortably.
2. Participants feel that the recommendations of their employer sanctioned advisory service were way off the mark.
3. Participants find that their investment results looked poor to mediocre when compared to the performances of their friends' fund options.
4. After reading the financial press, participants feel that their sponsor did not manage their plan properly, especially when it came to the value participants received for the fees they paid.

5. Participants feel that the sponsor and provider should have given them more information so that they could have made much better decisions.
6. Participants argue that the education/communication materials they received were so incomplete that they were inaccurate and thus misleading.

These issues are going to the be the cause of the majority of lawsuits because most plan sponsors have abdicated responsibility for participant communications/education to their providers. Mary Barneby, president of Delaware Investments, has noted that her company found that less than one-third of all plan sponsors, regardless of size, paid attention to what their vendors distributed. To assume that a mutual fund company, a bank insurer, or an advisory service wants to tell your participants what they need to know is wishful thinking at best. After all, these are sales organizations whose goal is to sell more products. Increased sales and educated consumers often don't go hand-in-hand.

To make matters worse, seldom do attorneys – even the ones at major law firms – include investment options and participant education/communication materials in their fiduciary audits.

How can good communication address these issues? Let's use the following hypothetical case study as an example:

A group of employees sue because they find that they will not be able to retire when they want to. Their lawyers make the following case:

1. The plan sponsor never told the participants how much money they would need to live comfortably during retirement.
2. During the enrollment meeting the 401(k) plan was portrayed as the best thing after apple pie and motherhood. Join and your retirement problems will be solved. Never once was it discussed that the plan must be used intelligently, adequate contributions and appropriate allocations be made, and that the gods of the capital markets must look favorably upon you, i.e., you must have luck. Invest according to your risk tolerance was the mantra.
3. The advisory service the participants were permitted to use bombed out. A 60/40 asset allocation of stocks and bonds would have done better. To make matters worse, other well-respected advisory services performed much better.
4. Stocks were touted as great long-term investments. Their risk decreases with time. Since the probabilistic nature of investing was never explained to participants in language they could understand, too many participants over invested in stock funds.
5. Many of the actively managed funds underperformed their passive benchmarks. What value did the participants get for the fees they paid? Why weren't index funds offered as an alternative?

Let's begin by lumping arguments 1 and 2 together. How would you respond to the argument that you, as a plan sponsor, never told the participants how much money they would need to live comfortable during retirement?

Since ERISA does not require plan sponsors to give advice or provide education, you could argue that it is the participants' responsibility to do the necessary calculations. This might be a reasonable argument if:

- You are using low cost index funds.
- You are using a no frills recordkeeper that uses an enrollment kit with what are considered the minimal required handouts.

- During the enrollment process participants are told that the 401(k) plan is a great opportunity only if it is used wisely. The first step in using the plan wisely is for participants to determine their retirement income needs, how much they have to invest, and what type of portfolio in the past would have achieved their income goals.
- The participants are given a list of Web sites and/or reading materials where they can find calculators and information about investing.

If you are using the typical bundled provider who professes to offer a great deal of value, you should insist on either personalized reports showing participants where they are along the road to retirement or the money to have a third party create such a report.

Giving participants such a report is important because most participants haven't taken the time to do the calculations, and everyone knows this. As fiduciaries, plan sponsors have a responsibility to judiciously use the asset management fees paid by participants. Could anything be more beneficial to participants than hitting them over the head with personalized statements?

If you passed statements like this out to all your participants every year or two, no one can say that you didn't tell them that they may have had a serious problem. If you want to really do this right, you should have on your Web site a calculator with the same interface as the statement so that participants could run what-if scenarios, including early and late retirement, changes in life expectancy, different growth rates, etc.

From a provider's perspective, this idea should have a lot of appeal because the chances are great that most participants will find that they should be contributing more money to the plan. Unfortunately few providers realize that investment education can be a powerful asset-gathering tool.

Let's explore argument 2 from our hypothetical case study a little further. Everyone agrees that an important purpose of the enrollment meeting is to tell participants how great their 401(k) plan can be. However, for the 401(k) plan to be a great investment opportunity, it has to be used wisely. Have you ever been in an enrollment meeting in which participants were told that investing wisely involves study on their part? Have you ever heard a communicator from a bank, insurer, or mutual fund company tell participants that they should routinely read the financial press so that they can develop a better understanding of the capital markets and mutual fund investing? Of course not and the reason is simple. Providers don't want participants to read articles criticizing:

- The mutual fund industry
- Their own investment options
- Fund management fees
- Stock analysts and portfolio strategists

Have you been in an enrollment meeting in which participants were bluntly told that achieving financial security is their responsibility, and not their employers? If they were told this, was it done in a fashion that resembles the fine print in a legal contract or a disclaimer?

All of us know that no plan sponsor walks around telling their employees that successful investing requires knowledge, sufficient contributions, and luck. Plan sponsors want happy employees not disgruntled ones. Unhappy campers only cause trouble. It is for this reason that the challenges of investing are downplayed. This is also why plan sponsors are actively considering making advisory services available.

Advisory services are touted as bringing institutional quality research to the average client. The following question seems to have gotten lost in the shuffle, however. Does the average client's perception of what he is going to get from an advisory service coincide with what the advisory service actually does?

The average client wants an advisor with a perfect crystal ball so he will have financial security during retirement. He is not interested in gurus who are trying to cover their fannies with Monte Carlo simulations. The value of these simulations is that they show the probabilistic nature of investing. Monte Carlo simulations are not crystal balls.

Studies have shown that there are three groups of investors:

1. *Do-it-yourselfers* The do-it-yourselfers are just that. They make all their own decisions and don't seek advice.
2. *Affirmation seekers* The affirmation seekers develop their own plan, but like to run it past others, hoping to have their wisdom confirmed.
3. *Delegators* It is this group who are going to sue because they believe they are getting solutions to their problems rather than processes that may or may not work.

The financial press has been filled with articles about large financial service firms that were sued successfully because products, such as real estate limited partnerships and vanishing premium life insurance, were misrepresented when it came to realistically assessing their likely performance.

Don't forget Portfolio Insurance and Long Term Capital Management Fund (LTCMF) and the havoc both wreaked on the capital markets. LTCMF had two Noble Laureates at its helm, while Portfolio Insurance was developed by brilliant mathematicians. Both Portfolio Insurance and LTCMF were based, like the advisory services, on mathematical models. Their followers included the crème de le crème of the investment world. Both the purveyors and purchasers of these models forgot the words of Axel Nieson "In theory there is no difference between 'theory' and 'practice.' In practice there is."

Plan sponsors and providers should also recall that the famous economist, John Maynard Keynes, did not consider economic models to be scientific ones:

"It seems to me that economics is a branch of logic . . . Progress in economics consists almost entirely in a progressive improvement in the choice of models . . . But it is of the essence of a model that one does not fill in real values for the variable functions. To do so would make it useless as a model . . . because, unlike the typical natural science, the material to which it is applied is, in too many respects, not homogenous through time . . . economics is essentially a moral science and not a natural science. That is to say, it employs introspection and judgments of value."

The average client needs to be told the truth: The advice he or she receives may or may not work and if he or she went to another advisor, the advice given could be quite different. Table 1 shows this quite clearly.

Before participants are allowed to sign up for an advisory service, a full disclosure must be made. Otherwise, plan sponsors and providers are playing Russian roulette.

The participants' next complaint in our hypothetical case study is that the stock market's long-term degree of risk was misrepresented, thus causing them to overload their portfolios with stock mutual

funds. To make matters worse, the participants argue that as the markets were heading south and account values were falling, they were told not to panic, hold the course, and that market timing doesn’t work.

Table 1: Asset Allocation Recommendations

Brokerage House	Stocks	Bonds	Cash
Lehman Brothers	80%	20%	0%
Morgan Stanley D.W.	70%	20%	10%
Edward D. Jones	71%	24%	5%
Goldman Sachs	70%	27%	0%
Paine Webber	52%	34%	14%
A.G. Edwards	60%	40%	0%
Prudential Securities	75%	10%	10%
J.P. Morgan	50%	25%	25%
Credit Suisse F.B.	55%	30%	15%
Bear Stearns	55%	35%	10%
Raymond James	55%	15%	20%
Salomon Smith Barney	60%	35%	5%
Merrill Lynch	40%	55%	5%

Data from Aaron Lucchetti and Terzah Ewing, "Flight to Cash by Strategists Has Paid Off", *Wall Street Journal*, November 10, 1999. Figures shown are for periods ending 9/30/99 and do not include transaction costs.

During presentations, charts of historic market returns and charts demonstrating the relative riskiness of stocks, bonds, and bills were often shown. These charts provided peace of mind before their account values plummeted. Now they feel they know why the Nobel Laureate Paul Samuelson has argued that the stock market's riskiness does not decrease over time. They also feel they understand why another Nobel Laureate, Harry Markowitz, allocated his retirement account equally between stocks and bonds. Markowitz felt he couldn't predict the future, and apparently he didn't know anyone else who could either.

The hypothetical participants also argue that there is little or no real value in charts that show the growth of stocks, bonds, bills, and inflation over long periods of time. After all, how many money managers worry about what the stock and bond markets did 15 (let alone 76) years ago? In fact, many money managers go back only a few years, if that, in determining their guesstimates of future market behavior. After all, the structure of the markets change over time. Ben Graham, the father of value investing, said that investors must always seek value, but value is a moving target since its definition keeps changing.

In the final regulations to section 404(c) of the DOL took the position that fiduciaries have an affirmative obligation to provide participants sufficient information to make informed investment decisions. Presumably, the "sufficient information" must be written in language that the typical employee in a given plan can understand.

Do the aforementioned charts adequately explain the risk of investing in stock mutual funds? I doubt it. First of all, the average participant may have never had standard deviation and confidence levels explained to him or her. Even if the participant did, those concepts don't adequately get across the concept of downside risk as effective as showing what occurred in the capital markets during the

1970s. You understand downside risk when you lose 40 percent of your money in just two years. Your understanding of risk also increases when you see the monthly volatility of stocks.

There is absolutely no reason why charts with appropriate text that tell an accurate, complete, interesting, and understandable story can't be given to participants. Included in that story would be the risks we haven't even mentioned, such as inflation, currency, size, and style.

Compare your current participant handouts to what I'm recommending. When you get to court, which approach would you like to rely on if your materials are accused of being misleading?

The hypothetical participants' last complaint was that active management cost them money. The funds' performances were inferior to those of index funds and the expense ratios of the actively managed funds were considerably higher than those low cost index funds. I'm not here to discuss either the merits of active versus passive management or to defend or criticize and fund's expense ratio.

Plan providers have to justify their fees and plan fiduciaries have to justify how they spend their participants' money. There is no better way of justifying fees than to show that the participants are being helped along the road to retirement through meaningful educational tools and materials. That is real value.