Investment Education:
A Very Sharp Double-Edged Sword

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Investment education is a hot topic, and for good reason. Retirement plan participants need it! Not only have several surveys over the past few years demonstrated that employees don't understand the basics of investing, a recent Employee Benefit Research Institute (EBRI) study found that only a third of them have tried to calculate how much they should be contributing to their 401(k) accounts—and only a third of those have confidence in their calculations.

Plans sponsors, too, recognize the need for retirement education programs. LIMRA's study *Marketing 401(k) Plans to Small and Midsized Employers* found employers, when choosing investment managers, rated good educational material 8.1 on a scale of 1 to 10 (with 10 meaning extremely important). Only 25 percent of these employers felt available educational material enabled employees to establish formal, written retirement plans.

ERISA section 404(c) regulations give a green light to plan sponsors to provide participant investment education. These regulations state that offering well-thought-out investment educational programs and materials will not be construed as giving investment advice. These regulations are another step taken by the Department of Labor to encourage plan sponsors to provide complete, accurate, and objective materials so that participants can make better-informed investment decisions.

It is in an employer's best interest to have its 401(k) participants understand the basics of investing. The more that participants know about investing, the more they will value and wisely use this important benefit, maximizing their likelihood of having financial security during their retirement years.

Bundled service providers are beginning to recognize that in the future, quality investment education and other participant services will be the keys to attracting and retaining clients. Recordkeeping and mutual fund offerings are rapidly becoming commodities. Access to the same fund family can be achieved through many distribution channels, ranging from the fund family itself to mutual fund supermarkets and alliances developed by insurers, banks, and consulting firms. Commoditization, therefore, will force providers to offer the required services efficiently and competitively or see their book of business dwindle.

Asset management, 12(b)(1), and other fees are coming under intense scrutiny. Plan sponsors are finally beginning to realize that they have a fiduciary responsibility to know all the costs, explicit and implicit, that their vendors are charging and to determine the reasonableness in light of the services rendered. Further, thanks to the popular financial press, participants are realizing that they too share in paying for their 401(k) plan's expenses via the fees that directly reduce each investment option's total return.

Participants are starting to ask what they get—besides actively managed options that frequently underperform index funds—for the asset-based fees they pay. Investment education and advice and more general financial counseling are what they need and want. Investment education thus appears to be an excellent way for a bundled provider to differentiate itself from its competition, since investment education has not yet been commoditized.

What is your reply when a prospective client asks for a synopsis of your investment education program? Before answering that question, ask yourself a few more:

- What is the likelihood that the client has the foggiest idea of what an investment education program is?
- Does the client want the investment program to take place during the enrollment meeting?
- How many different audiences (as defined by age, educational background, knowledge of investing, etc.) does the client feel he or she has? Does he or she want several different programs, each targeted toward a different group?
- At what reading level does the client want you to prepare the written handouts?
- How does the client want to structure the content of the program?
- Over what period of time and in how many segments does the client want it delivered?
- Or, is the client leaving everything up to you and your staff of home office experts?

It should be apparent that passing out a few glossy brochures and spending 30 minutes during an enrollment meeting discussing fund options are not an investment education program. Nor is sending all participants a quarterly newsletter written at the fourth grade level. But isn't that just what most bundled providers and plan sponsors consider an acceptable investment education program?

Facing up to the risks
The dilemma confronting bundled providers is twofold:

1. Do we try to educate plan sponsors as to what the real issues are, even if we seem to overcomplicate the situation and thus risk losing the case?
2. If we continue to give uninformed plan sponsors only what they want, do we risk being accused of supplying plan participants with inaccurate, incomplete, and misleading information?

Plan sponsors also face a dilemma. Providing a quality investment education program is costly and takes time to develop, update, and deliver. Alternatively, to risk being accused of passing out oversimplified (thus inaccurate and misleading) information that may result in inadequate account balances at retirement is also expensive (i. e., litigation).

The concept of risk illustrates the problems that oversimplification generates in retirement planning. For a 40-year-old, the biggest risk to face is having inadequate inflation-adjusted retirement income. How often is this last statement actually made? In the brochures I have reviewed, inflation is discussed in terms of losing buying power, while risk is discussed in terms of volatility of the individual investment options. For an individual who probably will not retire for 25 years and then has a life expectancy of another 16, how significant is the annual volatility of an investment option? In fact, the volatility of individual investment options is not a real issue at all. The significant issue is the likelihood of the participant's portfolio generating an adequate retirement nest-egg, assuming reasonable contributions are made to the 401(k) account.

But what do typical participant reports show? Unless a participant invests in a prepackaged portfolio, such as a lifecycle or lifestyle fund, the report he or she receives shows only the performances of individual funds and not the account as a whole. This almost universal reporting practice actually emphasizes exactly what a good education program would de-emphasize. A well-thought-out education program concentrates on portfolio construction based on rational asset allocation and diversification within each asset class. Through education, the participant learns that because of diversification, the risk of the portfolio is usually less than the risk of the riskiest (as measured by volatility) individual funds.

Tracking performance

Participants do, however, want to know how individual funds perform. They want to make sure that their plan sponsors have picked good performers and that they are not investing in losers. Research in behavioral finance has found that the pain of loss, i.e., losing money or poor performance, is much greater than the joys of success, i.e., making money or having a good return. Thus, it is most important that individual fund performance be adequately explained.

During the first half of this year, many small-cap growth funds, especially those emphasizing momentum, have been clobbered. Participants want to know why they have performed so poorly compared with the S&P 500 and small-cap funds in general.

From an educational perspective, such poor performance creates an excellent opportunity to explain how the individual options were selected and why the specific funds were chosen to implement each investment option. Issues such as style, manager tenure, the manager's investment strategy and its effect on the fund's volatility, and how one fund's poor performance affects the total portfolio's return can be addressed.

Do participants want this type of information? You bet. After all, it is their money and their retirement security that are at risk.

The real issues

"Hold on," you might say. "What the participants want and what they and their plan sponsors are willing to pay for are usually two different things. And even if a bundled provider were willing to hold meetings to discuss these issues, how many plan sponsors would be willing to give their employees time off to attend them? In fact, how many plan participants would show up?"

Although these are very important questions when it comes to designing and implementing investment education programs, they are not pertinent to the real issues:

- Did the bundled provider, during the sales process, tell plan fiduciaries that it would provide meaningful investment education products and services?
- Which of these products and services are included in the standard fees and which are provided for an additional charge?
- How should fees be adjusted if the plan sponsor, after reviewing the vendor's communication pieces and services, concludes that the informational content is wanting?
- What liability, fiduciary or otherwise, is the bundled provider generating for itself and for the plan sponsor when it distributes short pamphlets with titles like "The Basics of Investing" or "How to Achieve Retirement Security" and represents these as complete, accurate, objective, and well thought out?

Bundled providers sell not only asset management and recordkeeping services, but one-stop shopping for 401(k) plan sponsors. In these times of downsizing, plan sponsors are outsourcing many needed services and duties. The outsourcing phenomenon turns bundled providers into consultants to the plan fiduciaries. Bundled providers may take issue with this statement, but they would be hard pressed to challenge the view that perhaps the majority of their clients look to them for technical and compliance assistance, if not outright legal advice.

If bundled providers don't differentiate between investment education products and services and communication pieces and short meetings with little informational, let alone educational, content, a myriad of problems and potential lawsuits will likely arise. It is in the vendor's best interest to tell their current and prospective clients what they actually do and the charges for it.

On the other hand, if the client is not interested in educating employees or is not willing to pay for the education, this should be documented well before participants find that their nest eggs are insufficient to provide adequate financial security during retirement.

Investment education, if done properly, is an excellent tool for bundled providers to differentiate themselves from the competition and solidify client relationships. Done improperly or ignored, it leaves everyone–participant, plan sponsor, and vendor–at risk.