

Investment Education or Advice? That's the Wrong Question to Ask!

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In "The Quadrennial Fear Of Ideas," Daniel Casse, former special assistant to President Bush and currently a senior director of the White House Writers Group, argues that presidential "campaigns rarely make or propose policy these days. It is considered too risky an undertaking. Ideas still have consequences, but ... presidential campaigns keep a safe distance from them." He also agrees with former Clinton confidant Dick Morris that "ideas are nothing more than the proper distillation and interpretation of public sentiment."

Casse also maintains that pollsters, the fellows who actually control the campaign, advise candidates:

"to present easily digestible themes that change each day, week, or month. To these advisors, the 'issues' are non-divisive topics such as 'jobs', 'child care', 'the economy,' or 'our children.' Ambiguity is what people want, and ambiguity is what people get."²

So what does the rhetoric of presidential candidates have to do with the investment education versus advice debate that is such a hot topic in the 401(k) arena today? The answer is ambiguity and absence of substance.

It is virtually impossible today to find, among all the materials that mutual fund companies, banks, and insurers routinely distribute to plan participants, a clear explanation of the current classifications of mutual funds and how each category can be used in the portfolio construction process. No money manager worth his salt would walk into a large institutional investor and discuss his brilliant "growth and income" style or his "aggressive growth" style. No informed investor would know what these styles mean, let alone if they could complement her existing manager lineup. 401(k) participants, however, are expected to successfully use an outdated classification system designed solely for its psychological effect on the retail investor.

The ambiguity does not stop there. It has been widely touted that investment education has failed, and advice is what the average participant needs and wants. But what do the terms "education" and "advice" mean to plan providers, plan sponsors, and participants? When it comes to these terms, do these three groups even speak the same language? Unless all the players in the self-directed retirement plan arena clearly understand and accept the meanings of education and advice, fiduciary liability lawsuits will be just around the corner.

The purpose of this paper is not to debate whether advice is better than education. Rather it is to argue that this debate shouldn't take place until the parties involved:

1. define the goals of the programs they wish to initiate;
2. assess the feasibility of desired programs in today's work environment;
3. recognize that participants must get fair value for the fees they (often unknowingly) pay;
4. clearly outline to the participants what their responsibilities are;
5. develop realistic expectations of what can be accomplished.

Underlying issues. Unless corporate retirement programs change dramatically, in the next millennium 401(k) plans will be the primary source of retirement income for most workers. Social Security will be

¹ The author would like to thank John G. Ferreira, Esq. of Morgan, Lewis & Bockius, Pittsburgh, for his assistance with this Article.

² Daniel Casse, "The Quadrennial Fear Of Ideas", Policy Review, August & September, 1999.

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the icing on the cake, but the retirement nest-egg will be whatever the worker accumulates in her 401(k) and IRA accounts. Workers must clearly understand that they are responsible for their own retirement security.

The process workers should utilize in determining their retirement income needs and funding requirements is essentially the same as that used by large defined benefit plans in determining their liabilities and contribution requirements. Unfortunately, the average worker is ill-prepared to take on this task. To make matters worse, he is unfamiliar with the magnitude of his problem.

John Hancock's Sixth Defined Contribution Survey, *Insight into Participant Knowledge & Behavior*, clearly demonstrates this. Less than 25% of the respondents consider themselves to be knowledgeable investors. The respondents' overall knowledge level has not increased significantly, if at all, since the first survey was taken in 1991.

The survey's authors concluded that most participants have no strategy or goal for allocating their retirement investments. Many participants who have access to investment advice through their employer don't utilize it, even if it's free. The increased allocation to stocks over the past several years has probably not resulted from education, but rather from the stock market's exceptional performance (over 20% per year for four successive years) and the eight-year U.S. economic expansion. They concluded:

“Even though many would like to credit the concerted efforts to educate individual investors about the long-term benefits of stocks, individuals may be no more knowledgeable about stock investments and no more accepting of the downside risk and volatility of stocks than they had been previously. Whether they have ‘strong stomachs’ has not yet been tested.”^{3,4}

At the 1999 annual meeting of the Profit Sharing 401(k) Council of America, Dennis Ackley of J.P. Morgan/American Century said that investment education is in a shambles. He believes that most messages presented in so-called education sessions and materials have little impact, and there is a “blizzard of content-free terms.” He maintains that there is a real need to question conventional wisdom and what plan providers call “best practices.” Furthermore, he argues it is imperative to learn from the failure of current retirement and investment education techniques. After all, (referring to a 1998 Plan Sponsor article) just 37% of plan sponsors feel their communication efforts are working and only 12% believe their communications reduce employees' stress about future finances.

At the same conference Mary Rudie Barneby of Delaware Investments' Retirement Financial Services presented findings of a survey her firm conducted. Perhaps the two most relevant conclusions are:

1. Only 16% of plan sponsors are very confident that their participants with annual incomes of \$25,000 to \$80,000 clearly understand their investment choices.
2. 72% of plan sponsors do not have a process in place to evaluate educational materials.

³ *John Hancock's Sixth Defined Contribution Survey Insight into Participant Knowledge & Behavior*, 1999, p.19.

⁴ This author argued that the move into equities by participants was not due to education. On the contrary, communicators used peripheral route persuasion to get participants to change their allocations. See Richard D. Glass, “Investment Education: A Review of the State of the Union,” *Employee Benefits Journal*, 1998, March. P.2.

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How could attempts at investment education have failed so miserably?⁵ There are many reasons, but perhaps the most significant are:

1. Neither plan sponsors nor plan providers take the time to determine what the educational goals should be and ask if they are realistic. For example, no one asks what it means to empower participants. Does it mean that participants should be able to perform their own asset allocations? Or does empowerment mean that participants should:
 - a. have an adequate understanding of investment concepts;
 - b. have realistic expectations for the behavior of the capital markets;
 - c. be able to determine if they should seek out investment advice;
 - d. understand the limitations of the recommendations of advisory services?
2. Investment education involves time commitments. If education programs are to be done on company time, how often can employees be pulled off the job before costly work slowdowns occur? In the unlikely event that the company could manage work slowdowns, there would probably be a shortage of qualified educators.
3. Enrollment sessions are called education even though they have little educational content, usually last less than an hour, and skim over too many topics. The essence of the entire program is razzle-dazzle, glossy expensive handouts, and snazzy videos. Often, no effort is made by either vendor or plan sponsor to differentiate among education, communication, and peripheral route persuasion (especially when it comes to getting participants to allocate more of their accounts to equities).
4. Written materials are essentially the same as those used in the retail marketplace. They have little, if any, educational substance because they are basically marketing pieces with the philosophy of “leave the driving to us” and “your in good hands with...”
5. Materials are designed with the premise that one-size-fits-all and that one size is aimed at the lowest common denominator of formal education, investment sophistication, and motivation. For example, no one asks if volatility, risk as defined by modern portfolio theory, is the appropriate definition of risk for the average plan participant. For many participants, the likelihood of not having an adequate inflation-adjusted income is probably the greatest risk they face.
6. Plan sponsors and plan providers ignore free agent learners— those independent and highly motivated adults who are taking responsibility for their own ongoing learning, as opposed to relying on employers to provide it for them.⁶ No one asks what tools bundled providers should provide free agent learners.⁷ Plan sponsors ignore the fact that it is a fiduciary obligation to spend the participants' money wisely.
7. Plan sponsors and plan providers assume that participants understand the magnitude of their responsibilities pertaining to retirement planning. Surveys, such as those done by EBRI,⁸ have shown that this is a fallacy. No one asks if all employees should be given a statement showing how far along the road to retirement security they are. After all, no more than half of all

⁵ Richard D. Glass and Robert A. Johnson, “Educating Participants on Investment: Is the Myopic Legal Tail Wagging the Dog?” *Plan Sponsor*, February 1997.

⁶ Shari Caudron, “Free Agent Learner,” *Training & Development*, August 1999.

⁷ Richard D. Glass, “Investment Education: Whose Fooling Whom?” *Employee Benefits Journal*, March 1999.

⁸ *1999 Retirement Confidence Survey* (Employee Benefit Research Institute).

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employees have tried to do the calculations themselves. Vendors and plan sponsors forget that people like and need personalized reports.

8. Plan sponsors and their communicators often make the 401(k) plan out to be the best thing after motherhood and apple pie even though participants pay 80-100% of the cost of running the program. To make matters worst, it is often implied that the 401(k) plan is self-completing. Just join and your retirement problems will be solved. This implication reflects the concern of many sponsors that their workforces would be demoralized and in a state of revolt if they truly understood that they assume the full risk of their retirement security.
9. Plan sponsors, due to downsizing and a trend towards concentrating on their core competencies, assume that bundled providers can provide adequate educational services (as they profess). No one stops to ask why an asset gatherer would want an informed clientele. Informed participants would demand lower fees, better performances, and a much more rigorous standard of value.
10. There has been a wide spread myth that education can easily be construed as advice.

The result of these pitfalls is that so-called education programs are often not educational at all. Plan sponsors engaging in this type of pseudo-education, or who are doing little or nothing to educate, often rationalize their behavior as liability management. Their oft-stated concern is that significant education efforts could expose them to liability for doing a negligent job or, worse, providing poor advice. In legal terms, employers are counting heavily on Section 404(c) of ERISA as a shield against liability. However, this protection can be maintained only if, among other things, the plan sponsor gives employees sufficient choices and the minimal amount of required information and otherwise leaves all asset allocation decisions in the hands of the employees.

Forgetting for the moment the many reasons why this “hands off” approach is poor human resources management, it may be that employers who think that providing pseudo-education, or no education, is a shield against liability are living in a fools’ paradise. When (not if) the long-delayed market correction finally arrives or inflation again heats up, and employees who have made poor asset allocation decisions find themselves without adequate retirement income, 404(c) may prove to be more fig leaf than bulwark. Courts are notoriously fickle about respecting statutory boundaries on fiduciary responsibility if a case has “bad facts”; just ask the numerous companies who have complied with all of the technical ERISA disclosure requirements and have nevertheless been successfully sued for failing to comply with “implied” fiduciary duties of full and fair disclosure.⁹

Companies concerned with this potential burden, and aware that their employees are both poorly informed about investments and are making poor decisions, might decide to offer investment advice to employees. The safest approach would seem to be to engage a professional investment advisor to provide the actual advice (either at employer expense or with a substantial subsidy) in a one-to-one fashion, making sure that advisor is able to give advice that is objective, unbiased and consistent with ERISA’s prohibited transaction provisions. ERISA’s fiduciary provisions are generally kind to

⁹ See, for example, *Bins v. Exxon Co. U.S.A.*, 22 EBC 1617 (9th Cir. 1999) (employer had affirmative fiduciary duty to inform employees considering retirement that employer was seriously considering implementing an early retirement incentive, even though no change had been finally adopted); *Krohn v. Huron Memorial Hosp.*, 173 F.3d 542 (6th Cir. 1999) (employer had affirmative duty to inform injured employee about deadline to apply for long-term disability benefits, even though it had previously provided a written summary of the plan describing the application requirements); *Bixler v. Central Pa. Teamsters Health & Welfare Fund*, 12 F.3d 1292 (3d Cir. 1993) (employer may have had an affirmative duty to remind a surviving spouse who called about life insurance of the deadline for electing COBRA benefits, even though it had properly complied with written COBRA notice requirements).

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employers that are “procedurally prudent,” and engaging a professional adviser to work directly with employees would seem likely to meet any reasonable prudence burden.

However, many employers who provide advice are doing so in a manner that is no better, and perhaps even worse, than offering no advice at all. This is because the mistakes that have contributed to the pervasiveness of pseudo-education— the inability or unwillingness of plan sponsors and plan providers to define their goals, assess how realistic they are, and then carefully develop an implementation strategy— are being repeated when the desirability of offering Internet based advisory services is assessed.

First, advice must be defined. Is advice just telling a participant how to allocate his money? Or is advice the dynamic interactive process that occurs when an advisor and her client sit down together and discuss the pros and cons of different approaches to solving a problem or formulating a strategy or prioritizing a group of issues?

If advice involves a dynamic interactive process, is it a one-time affair or is it ongoing in nature? In either case, can such a process occur over the Internet by simply filling out questionnaires? If questionnaires are not sufficient, is it reasonable to expect participants to ask questions and articulate their concerns about a topic of which most of them are uninformed? After all, a basic requirement for an Internet based advisory service is the ability of participants to write about complex subjects in clear, concise statements. If press reports as to the low level of literacy in America are accurate, this requirement will never be met by a significant number of participants.

The heart of any of these Internet based advisory services is its optimizer. A plan sponsor must have good reasons to believe that the optimizer will work. Optimizers come in different flavors and their output, given the same input, can be quite different. But what does “work” mean? This is not a trivial question. Harry Markowitz, a mentor of the founder of Financial Engines, William Sharpe, and a pioneer of mean-variance optimization, did not use an optimizer for his own retirement planning.¹⁰

He said:

“I should have computed the historical covariances of the asset classes and drawn an efficient frontier. Instead, I visualized my grief if the stock market went way up and I wasn't in it— or if it went way down and I was completely in it. My intention was to minimize my future regret. So I split my contributions fifty-fifty between bonds and equities.”¹¹

Tables 1 and 2 summarize the data in a recent Wall Street Journal article which clearly demonstrates that selecting an advisory service is anything but trivial.¹² In fact, it is a monumental task. The article showed the performance of asset allocation blends recommended by 13 major brokerage houses for the 12 and 60 month periods ending September 30, 1999.

¹⁰ Both Markowitz and Sharpe have won Nobel prizes in Economics.

¹¹ As quoted in “Five Investing Lessons from America's Top Pension Fund” by Jason Zweig, *Money*, Jan. 1998.

¹² Aaron Lucchetti and Terzah Ewing, “Flight to Cash by Strategists Has Paid Off,” *Wall Street Journal*, November 10, 1999.

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Table 1: One-year Performance of Recommended Asset Allocations¹³

Rank	Brokerage House	1 Year
1	Lehman Brothers	19.95%
2	Morgan Stanley D.W.	18.88%
3	Edward D. Jones	18.21%
4	Goldman Sachs	17.73%
5	Paine Webber	16.69%
6	A.G. Edwards	16.06%
7	Prudential Securities	15.80%
8	J.P. Morgan	14.84%
9	Credit Suisse F.B.	14.37%
10	Bear Stearns	13.84%
11	Raymond James	13.62%
12	Salomon Smith Barney	11.78%
13	Merrill Lynch	7.64%

Table 2: Five-year Performance of Recommended Asset Allocations¹⁴

Rank	Brokerage House	5 Year
1	Lehman Brothers	19.46%
2	Morgan Stanley D.W.	18.85%
3	Goldman Sachs	18.64%
4	Paine Webber	18.08%
5	Prudential Securities	18.01%
6	Credit Suisse F.B.	17.63%
7	Edward D. Jones	17.59%
8	A.G. Edwards	17.54%
9	Salomon Smith Barney	16.35%
10	Raymond James	14.43%
11	Merrill Lynch	14.14%
N.A.	J.P. Morgan	N.A
N.A.	Bear Stearns	N.A

For both time periods, Lehman Brothers and Merrill Lynch had the best and worst performance respectively. Lehman Brothers greatly exceeded the average of the 13 firms in the study during both time periods. Merrill Lynch underperformed significantly during both periods. In fact, a robot blend of 55% stocks, 35% bonds, and 10% cash also significantly outperformed the well-respected,

¹³ 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.

¹⁴ Ibid.

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international powerhouse Merrill Lynch. The lesson is: Being an investment powerhouse is not the same as being a market guru with an accurate crystal ball.

The *Wall Street Journal* study also shows how varied the results of different asset allocation services can be. The percentage of stocks in the current recommendations of these brokerage firms ranges from 40% to 80% while the recommended cash position ranges from 0% to 25%. (See Table 3.) Some include international stocks, and some don't. Which one is right? Only the future will tell.

Table 3: Current Asset Allocation Recommendations¹⁵

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

Internet-based advisory services usually use risk tolerance questionnaires. However, at least one well-publicized firm (Bill Sharpe's Financial Engines) does not. The latter argues that participants' risk tolerance levels are totally unrelated to the type of portfolio that will most likely fulfill their needs. Those advisory firms that use risk tolerance questionnaires believe that risk tolerance is essential in creating appropriate portfolios. Unfortunately different risk tolerance questionnaires can generate dramatically different risk tolerance levels for the same individual. In fact, an individual will often times give different answers to the same question if the question is worded differently.

It can be argued that the output of a risk tolerance questionnaire is irrelevant. What is important is that the answers serve as a basis for discussions between the advisor and the client. While this opinion may have considerable merit when counseling takes place in one-on-one sessions, its worth diminishes greatly when an Internet based service is used for the reasons mentioned above.

Perhaps the most important issue in regard to advisory services are the expectations of participants who are told that an expert is going to help them (especially if that expert is a Noble laureate) and that the advice they receive is based upon the same technology that large institutional investors employ? What happens if the recommendations are way off target and significant shortfalls occur or, even worse, a participant reads in the financial press that his advisor had the worst performance

¹⁵ Ibid. A) 11% in international stocks; B) 12% in international stocks; C) 3% in commodities; D) 5% in real estate; E) 10% in real estate, 6% in international stocks; F) 14% in international stocks; G) Always 55% stocks, 35% bonds, 10% cash.

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record (e.g., Merrill Lynch in the Wall Street Journal article cited above)? Will the advisor's quantitative shortfall analysis provide the plan sponsor any comfort from a fiduciary liability standpoint if it is determined that the input data had little correlation to what actually happened in the capital markets and/or that participants (and perhaps even the plan sponsor) did not grasp (or was not informed of) the limitations of optimizers?

Many issues must be analyzed before a plan sponsor engages or recommends to participants an advisory service. If these analyses are not done, the plan sponsor will have little to fall back upon if the recommendations "bomb." Giving participants what they think they want and what will make them happy now, an easy way out of the asset allocation challenge, might be exactly what they don't need. Plan sponsors must proceed with caution down the advisory path and not fall victim to the all too human frailty that Novalis succinctly stated: "My opinion, my conviction, gains infinitely in strength and success, the moment a second mind has adopted it."