Meeting Participants’ Investment Needs: A Guide to Selecting Investment Options for DC Plans

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Published in
Profit Sharing
Sept.-Oct. 96

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Trustees of DB plans routinely hire consultants to develop their plans' investment philosophies and the strategies to implement them. The importance of asset allocation is stressed because it accounts for more than 90 percent of a portfolio's return. Consultants also emphasize the need to select money managers who not only profess to have a well-defined investment style, but also religiously stick to it. Money managers whose style cannot be well defined are shunned and others are fired quickly when they depart from their professed approach. After all, who can implement successfully a desired asset allocation if the large-cap value manager is investing heavily in mid-cap growth stocks or if the mid-cap manager has taken major positions in small-cap stocks to make their performances look better? In fact, a major task of many consultants is dissecting the factors that determined a manager's performance, good or bad.

The asset-allocation process has become quite complex. Gone are the days when all a trustee had to worry about was how much should be put into stocks, bonds and cash. Stocks were defined as the Standard and Poor's 500 while bonds were the Lehman Brothers Aggregate Index. Today, U.S. equity managers are classified by both style (value and growth) and market capitalization (large-, mid- and small-cap). Of course, each manager, as well as each consultant, has his own definition of what constitutes each category.

Similar issues apply to foreign stocks, but their currency risk complicates matters further. Different, but equally as challenging, concerns arise in selecting fixed-income managers. Alas, one might wonder, is all this complexity worth the trouble and expense? Perhaps it would be best just to use simple index funds. Remember, however, the employer is responsible for funding the DB plan. In today's world of global competitiveness and re-engineering, managing a corporation's cash flow is of utmost importance. It is the trustee 's job when all is said and done to get the plan sponsor the biggest bang for its buck.

So how does this discussion of DB plan investment issues relate to how trustees of profit-sharing and 401(k) and other self-directed retirement plan's should select investment categories and the funds to include in them? To begin with, trustees of participant-directed plans have many of the same responsibilities as DB plan trustees. Although self-directed plan trustees don't make asset-allocation decisions for each participant, they have the responsibility of selecting an adequate number of funds that represent a sufficient diversity of asset classes so that a knowledgeable participant can create an appropriate portfolio to meet his or her investment needs.

But meeting a participant's needs, especially in a DC plan that can have tens of thousands of participants, is not the same as keeping each participant happy with the choice of funds that is offered. Rather, to meet a participant's needs means that each participant will have a choice of funds from which he or she can create a portfolio that, from the perspective of return and risk, will provide an acceptable level of performance. Aggressive, conservative, and those in-between investors all should be reasonably satisfied with their asset allocations and the resulting portfolios if plan fiduciaries judiciously fulfill their tasks of selecting investment options.

Trustee challenges

So how many funds are needed to do this? To begin with, plan trustees must decide which asset classes they want represented. Although there is no one true answer, the following table offers a starting point. Then, they must decide if they want to use active or passive management.

The following three issues must be addressed to help trustees with this decision:

1. Do the trustees feel that they can pick active managers who consistently will outperform their benchmarks? This is an important question. The financial press routinely runs articles that tout the virtue of indexing. The argument in favor of indexing goes like this: Since over long periods of time active managers as a group underperform passive benchmarks such as the S+P 500, does it make sense for plan participants to pay the much higher management fees for active management, when they can invest in index funds at a lower cost and get higher returns?

   The real issue is not whether indexing is better than active management. Good active managers can outperform passive strategies. Rather, the crucial question is: Do the trustees feel that either they or their consultants can pick the funds that will be winners in the future? If they feel that their crystal balls work well, active management is the way to go. Otherwise, they better fully understand the pros and cons of both approaches and be able to justify their decisions.

   To complicate matters further, plan sponsors must recognize that, unlike so many DB pension plans that use separately managed accounts, they have no control over who will be a mutual fund's manager. This decision is a strategic one made by the mutual-fund organization. Thus, when you invest in a mutual fund, you are investing in a track record that may not have been established by the current manager or management team. In fact, your fund's manager may be the new kid on the block.

2. Do the trustees feel that the funds they have selected are appropriate for constructing portfolios? Most mutual-fund prospectuses provide managers with a wide latitude for making investment decisions. The manager's goal is to make money for the shareholders, and how the manager does that is left up to him. This is fine if an investor says he wishes to "leave the driving to us," as is common when selecting funds for a specific purpose, such as a child's education.

   But this isn't the case for participants in self-directed retirement plans who are told that it is their responsibility to create their own asset mix from a group of pre-chosen funds. Participants in these plans can't make meaningful asset-allocation decisions if the managers of the funds that have been selected have the latitude to invest wherever and whenever they wish.

   These are not theoretical issues. Fund managers often make heavy industry bets in their attempts to beat benchmarks. Others will go to large cash positions if they feel that stocks are overvalued or will purchase bonds hoping to profit from interest-rate moves. These managers might hit home runs with their decisions, but are their deviations from their professed strategies appropriate for 401(k) participants when they would not be acceptable for DB plan trustees? Furthermore, they're doing market timing (tactical asset allocation) and the success rate of this strategy is subject to much debate.

   Trustees of self-directed retirement plans have a responsibility to pick funds that will not deviate from the asset classes in which they are supposed to be investing. Index funds and many actively managed funds meet this criteria, however, many other actively managed funds do not. Trustees a11 too often ignore their selection responsibility and pick well-known funds that have a lot of sizzle and high ratings, presumably to create a high comfort, level for participants. This tack is fraught with potential fiduciary problems, however.

3. Should a particular investment style be selected over another? Equity managers usually are classified as value or growth, depending on how they select the stocks that go into their portfolios. During some periods, value stocks are in vogue while at other times growth stocks shine. When a style is hot, managers of that persuasion can outperform significantly a market benchmark, such as the S+P 500 or the Russell 2000. The converse, however, is also true. Over the long haul, there is no solid evidence to suggest that one approach dominates the other or that a pure style approach will outperform a market index.

   Fixed-income managers also emphasize different techniques in their attempts to outperform the bond market as a whole (Lehman Brothers Aggregate Index} or specific segments of it. Trustees must become familiar with these different approaches to determine their comfort levels with them and which, if any, offer greater rewards than pure-bond indexing.

Trustees also face another challenge—determining the roles of fixed-income investments in a portfolio. Should a fixed-income investments provide a stabilizing influence in participant's portfolio? Trustees know that participants like stable-asset funds because they are valued at book. However, in periods of falling interest rates, their performance will lag considerably behind intermediate- and long-term bond funds. Conversely, stable-asset funds do not lose value, as bond funds do, when interest rates are rising. If trustees decide that fixed-income securities should be opportunities for capital appreciation, then they must decide if other types of funds, such as convertible and high yield, should be offered as well.

Finally, once trustees have decided which asset classes they wish to include and if active or passive management, or a form of each, is the way to go, another question arises. Do participants have a sufficiently strong understanding of asset-allocation principles to create portfolios that are appropriate for them? If they do not, should prepackaged lifecycle, or life-style, portfolios be offered? In fact, an important fiduciary issue is whether trustees have a responsibility to offer such portfolios when they know or have good reason to believe that a substantial number of participants don't understand investment basics. Unfortunately, there is little guidance on this matter.

Conclusion
Trustees of self-directed retirement plans face investment issues that are extremely complex. Perhaps someday the courts will decide that these trustees should be held to a higher fiduciary standard than DB plan trustees because in the latter, it is the corporation that bears the burden of poor investment performance. In DC plans, it is the participants who pay the price. If the investment options are not chosen with adequate due diligence and participants are unable to create or participate in portfolios that are appropriate for them, their financial security during retirement will be jeopardized and plan trustees may be charged with not fulfilling their fiduciary responsibilities.