

# Investment Education for the 21<sup>st</sup> Century

## Dispelling the Myths and Undoing the Tactical Errors of the Nineties

---

### **Authors**

Richard D. Glass  
Stan Marshall

### **Published in**

*Employee Benefits Journal*  
June 2003  
International Foundation of  
Employee Benefits

For more articles by Investment Horizons personnel, please visit our website at:

**[www.investmenthorizons.com/papers.htm](http://www.investmenthorizons.com/papers.htm)**

# Investment Education for the 21<sup>st</sup> Century

## Dispelling the Myths and Undoing the Tactical Errors of the Nineties

---

Richard D. Glass and Stan Marshall

The 401(k) industry is in a state of turmoil. During the 1990s providers were fat and happy. Revenues greatly exceeded costs. With the market's collapse over the last three years, however, the reverse has occurred—profit margins have tumbled.

During the 1990s, most American workers invested blindly. Few took the time to calculate the size of the retirement nest egg they would need for the retirement lifestyle they wanted.<sup>1</sup> To make matters worse, neither providers nor employers passed out gap analyses showing employees just how far they had or had not progressed along the road to retirement security. In addition, surveys such as those conducted by John Hancock<sup>2</sup> continually confirmed that large numbers of participants did not understand even the most fundamental investment issues. In spite of these facts, 401(k) plans were still touted as the “end all, be all” retirement vehicle for the average American worker.

Today, 401(k) plans are facetiously called 201(k) plans. Bill Wolman, the former editor and chief economist of *Business Week*, has coauthored a book titled *The Great 401(k) Hoax*.<sup>3</sup> In a recent issue of *Plan Sponsor*,<sup>4</sup> there was an op-ed piece titled, “What’s really wrong with 401(k)s?” The author, who did not want to be identified, argued that:

- The typical investment structure of 401(k) plans virtually assures failure to achieve investment success.
- It is outrageous to expect participants to receive adequate investment education paid for by the employer.
- Few participants are willing to help themselves achieve retirement security.
- The mutual fund industry is motivated to maximize profits and not to help participants.

The above comments are the good news. The bad news is even more dire:

- The financial press routinely reports that dishonesty runs rampant on Wall Street, easily leading to the conclusion that the market is rigged or at least not susceptible to honest evaluation. In fact, the dot-com collapse showed the country that growth fund managers can be just as gullible as the average investor.
- A recent *Smart Money* article on 401(k) plans states, “Your company thinks you are a complete moron.”<sup>5</sup>
- New York’s Attorney General Eliot Spitzer has turned the benchmark for fiduciary conduct upside down. He has categorically stated that “industry standard” is irrelevant. If an action or inaction is wrong, it is wrong. The misconduct of others does not justify yours.
- Internet-based advice has turned out to be an abysmal failure.

---

<sup>1</sup> *Retirement Confidence Survey 2001*, Employee Benefit Research Institute, American Savings Education Council, and Matthew Greenwald and Associates, Inc.

<sup>2</sup> *Defined Contribution Plan Survey and Insight Into Participant Investment Knowledge and Behavior* conducted periodically by John Hancock.

<sup>3</sup> William Wolman and Anne Colamosca, *The Great 401(k) Hoax*, Perseus Publishing, 2002.

<sup>4</sup> “What’s Really Wrong With 401(k)s?”, *Plan Sponsor*, August 2002.

<sup>5</sup> Eleanor Laise, “Get Your 401(k) Back on Track”, *Smart Money*, November, 2002, p. 97.

# Investment Education for the 21<sup>st</sup> Century

## Dispelling the Myths and Undoing the Tactical Errors of the Nineties

---

The purpose of this paper is to help plan fiduciaries and providers get a handle on the issues surrounding investment education and advice. First, the reasons 401(k) plans became popular will be reviewed. The failure of so-called “investment education” will be discussed next.

Then, the current state of participant knowledge will be explored. Finally, solutions for helping participants achieve financial security—thus reducing the likelihood of lawsuits arising from their inability to retire comfortably—will be presented.

### **Why 401(k) plans became so popular**

The original purpose of 401(k) plans was to provide participants with a tax deductible opportunity to supplement their defined benefit pensions. An additional benefit of these plans is that the employer can also make tax deductible contributions for each participant. Employer contributions are not fixed or even legally required. They can be changed, even eliminated, depending on business conditions.

In contrast to 401(k) plans, defined benefit plans have rigorous funding requirements, favor long-term employees and, in the eyes of many participants, have esoteric benefit formulas. In addition, poor investment performance can have a negative impact on a company’s credit ratings.<sup>6</sup>

From a recruiting perspective, 401(k) plans have a lot of sizzle.

- They are easy to explain.
- Participants can always find out the values of their vested account balances.
- Their portability has a great appeal since the average employee today changes jobs every 4 years or so.<sup>7</sup>

Given these realities and the high cost of maintaining a traditional pension plan, it is easy to understand why companies concluded that 401(k) plans should replace defined benefit plans as their primary, and often only, retirement vehicle.

### **Why so-called “investment education” has failed**

With the shift towards 401(k) plans as a company’s only retirement program, providers and employers anticipated new educational challenges:

- describing a 401(k) plan and the participants’ role in successfully using it;
- providing participants with enough basic investment information so they can make intelligent asset allocation decisions;
- making sure that participants receive accurate, complete and unbiased information.

The sad fact is that neither providers nor employers realized these obligations put them between a rock and a hard place. For example, should participants be told that they alone are responsible for providing their own retirement security and that doing so requires work and ongoing involvement?

---

<sup>6</sup> “General Motors Corp. Long-term Ratings Lowered as Pension Liabilities Increase”, *RatingsDirect*, Standard and Poor’s, October, 16, 2002.

<sup>7</sup> According to *The Job Openings and Turnover Study* (Bureau of Labor Statistics, August, 2002), 24% of American workers voluntarily left their jobs in the one-year period ending August, 2002.

## Investment Education for the 21<sup>st</sup> Century

### Dispelling the Myths and Undoing the Tactical Errors of the Nineties

---

This approach, while truthful, runs the risk of making participants not appreciate or even resent the plan, resulting in lower participant rates and demoralized employees. As we all know, neither employers nor their providers, which are really sales organizations, want to say this.

On the other hand, should participants be told that their 401(k) plan is a wonderful benefit, perhaps the best thing after apple pie and motherhood? This sales pitch tells participants to invest as much as they can and presents stocks as great long-term investments (by focusing only on their upside potential and ignoring their risks).

This almost universally adopted “apple pie and motherhood” approach was based on the conventional investment wisdom of the 1990s (which held that the bull market would last until at least 2010, the year in which baby boomers would start to retire). The theory was that participants did not really need to understand investing because, even if they invested blindly, the stock market would take care of them (as long as they put enough of their money in equity funds).

Presentations given at enrollment meetings implied that, by joining the 401(k) plan (with its employer match and professionally managed funds) retirement security would be essentially assured. In fact, the videos used in these meetings and the images found in enrollment kits consistently portrayed (and still do) retirement as a happy and secure time.

In short, sponsors and providers focused on making participants view 401(k) plans favorably instead of realistically. By not providing each participant with a personalized gap analysis, the need for the intelligent use of the plans was deemphasized. The runaway bull market of the nineties only reinforced the misperception that employees could take a carefree attitude towards retirement planning.

Perhaps it will never be known why sponsors and providers did what they did. However, some likely contributing factors include:

- Providers did surveys and concluded that their programs (which they labeled “best-practices”) met the needs of participants.
- Providers and sponsors maintained that participants read very little and understand even less.
- Providers maintained that sponsors didn’t want to pay for educational programs. Sponsors argued that participants were already receiving leading-edge education. Both providers and sponsors ignored the findings of surveys (such as those previously mentioned) and the fact that participants were not using websites for education.
- To support plan sponsors’s desires to not spend money, benefits attorneys rationalized that providing good educational materials and workshops could be construed as giving investment advice.
- ERISA did not mandate investment education. Thus, there was no need on the part of either provider or sponsor to afford participants the opportunity of becoming informed investors.
- No one asked (perhaps they were waiting for the courts to decide) what ERISA really means in stating that:
  - Fiduciaries have to act in the best interest of participants.
  - To qualify for §404(c) protection, information distributed to participants must be accurate, complete and unbiased.

- Both sponsors and providers hoped that participants would flock to Internet-based advisory services, and that these firms would provide the needed educational materials. No one anticipated that Internet-based advice would turn out to be a “bust.”

### **The state of participant knowledge today**

Participants have not been told that they should manage their 401(k) accounts the way trustees run defined benefit plans. Each participant must function as her own actuary and investment committee in order to maximize the likelihood that she will achieve her desired retirement income.

Surveys have shown, however, that most participants:

- don't understand basic investment issues;
- cannot or do not intelligently create their own asset allocations (as measured by the number of funds they use);
- have little interest in obtaining a working knowledge of investing or, at least, investment issues.<sup>8</sup>

According to Vanguard, participants are contributing only two-thirds of what they should.<sup>9</sup>

In spite of this knowledge, providers and sponsors have not changed their messages to participants. The hard issues are still being avoided. This is surprising because the stock market's collapse over the last three years, coupled with participants' having to postpone and/or settle for a much lower standard of living during retirement, will undoubtedly lead to countless lawsuits. Plaintiffs' attorneys are beginning to ask: “If providers and sponsors have been aware of this dismal state of affairs for years now, why haven't they done anything to remedy the situation?”

Unfortunately, there is no defensible answer to this question. Sponsors and providers have found it much easier to continue wearing rose-colored glasses than to:

- face the employee relations nightmare of selling participants on the need to help themselves;
- incur the expense of developing good educational materials;
- “face the music” once participants learn how much they need to invest to achieve their retirement goals.

### **Solutions for the future**

While history cannot be changed, it is possible to create an environment in which the ramifications of past mistakes are minimized. Moreover, it is imperative that these mistakes not be repeated in the future. The following four steps may be “just what the doctor ordered.”

- Each participant must be made aware of her problem and the size of it.
- Tools must be provided that help participants understand what asset allocation is all about. Tools must be available that help both uninformed and experienced investors.

---

<sup>8</sup> Surveys done by periodically by John Hancock have shown little improvement in the state of participant investment knowledge. Participants' lack of understanding manifests itself in how they invest. For example, Vanguard's *How America Saves* (2000 edition, p. 28) shows reports that nearly half (48.9%) of participants studied use only 1 or 2 investment options.

<sup>9</sup> *How America Saves*, Vanguard, 2000, p. 20.

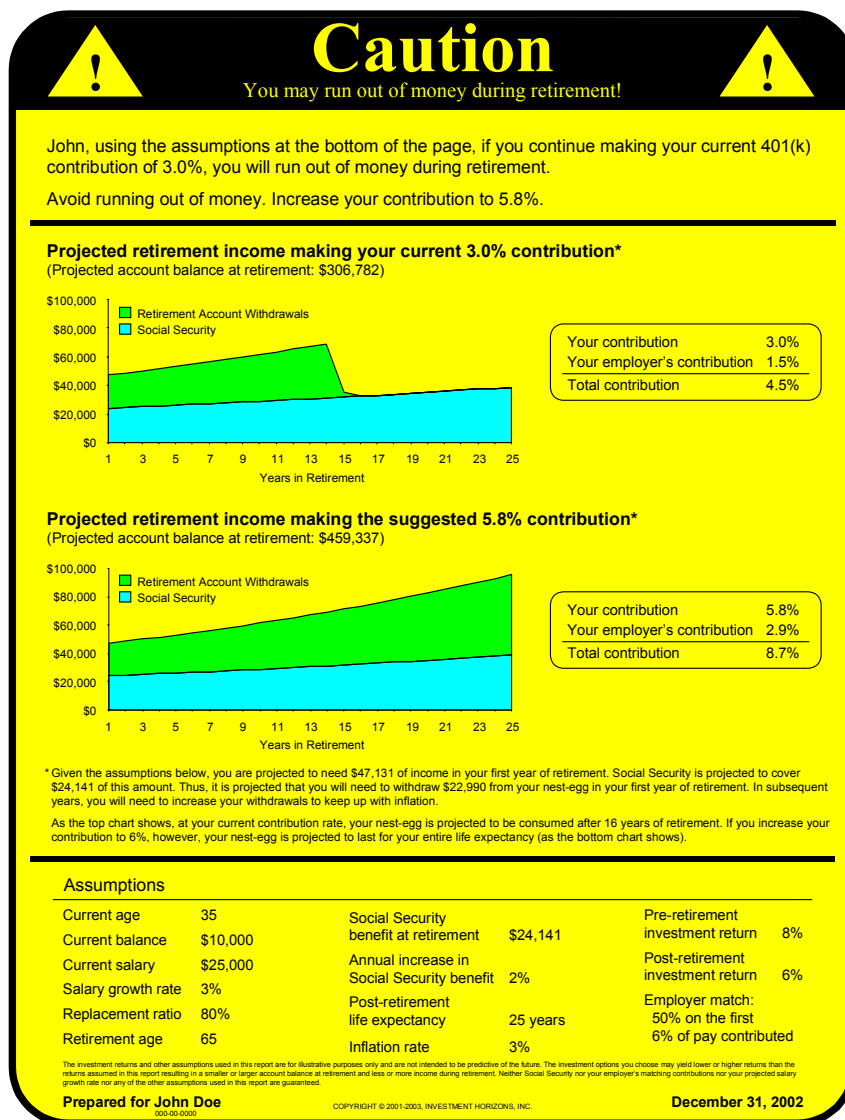
# Investment Education for the 21<sup>st</sup> Century

## Dispelling the Myths and Undoing the Tactical Errors of the Nineties

- Participants must be made aware that investing is all about dealing with uncertainty and events with little chance of occurring do, in fact, occur (such as the collapse of portfolio insurance in 1987 and the demise of Long Term Capital).
- Participants must be told, in no uncertain language, that investing is a process that can never be put on autopilot. After all, regardless of what so-called gurus may claim, no one has a good crystal ball.

Let's now address the first question: How to get participants to focus on their problems?

The answer is simple—hit them over the head. Give each participant a personalized gap analysis showing where they are along the road to retirement and a recommended contribution level. This analysis can be mailed to their home, passed out at meetings, or delivered via e-mail. According to Boston Consulting Group, the “arrival of paper statements is an important trigger to think about the account. This interaction must be maintained.”<sup>10</sup> The following is an example of a gap analysis.



<sup>10</sup> *Dynamic Trends in the 401(k) Industry*, presented at the 2002 SPARK Forum (November, 2002).

## Investment Education for the 21<sup>st</sup> Century

### Dispelling the Myths and Undoing the Tactical Errors of the Nineties

---

If participants get a gap analysis every year or every other year, they can never say you didn't make them aware of their responsibility for providing their own retirement security.

New enrollees must also get gap analyses, and their purpose and how to use them must be explained in the enrollment meeting. After all, the gap analysis will help the participants determine how much they should be contributing to the plan.

Paper-based gap analyses are still not personal enough, however. They should be supplemented by a web-based interactive gap analysis calculator with screens that duplicate the paper-based version. Such a tool will allow participants to perform "what if" scenarios, such as retiring sooner or later, living longer, changing investment growth rates, and factoring in income from other investments or part-time work..

If providing gap analyses is such a good idea, why aren't they routinely passed out? The answer is multifaceted:






- It costs money to produce the reports and neither providers nor sponsors want to pay for them. The irony is that the cost is a bona fide plan expense, and, as such, could be paid from plan assets.
- There is a fear, perhaps well founded in many cases, that the report will upset many employees, resulting in drops in morale and perhaps even lower participation rates. However, if employees aren't disturbed, they won't have an incentive to take corrective action—or even join the plan in the first place..
- Recordkeepers often do not have the salary information needed to create the report and don't want to ask the employer for it.
- Other times, recordkeepers do have the salary information but have no faith in its accuracy. (Keep in mind that recordkeepers are often not the organization that does compliance testing, especially in the small and midsize case marketplace.)

On the surface these seem like legitimate reasons not to pass out gap analyses. However, there are two other issues that must be addressed:

- Isn't providing a wake-up call (gap analysis) one of the most basic obligations of a 401(k) plan fiduciary? Does it make sense to spend participants' money (via asset-based and other fees) on bells and whistles only a few of them actually use instead of spending the money on making all participants aware of what they need to do?
- Corporations provide gap analyses to their most financially sophisticated, highly paid executives to encourage them to participate in the company's non-qualified mirror 401(k) plans. The reason for producing gap analysis is that these executives, like most rank and file employees, aren't aware of the magnitude of their retirement security problem.

The next step in the process is helping participants understand the importance of an appropriate asset allocation. Doing this is not difficult. The gap analysis shown previously addresses the need to make adequate contributions. The series of charts below show how asset allocations and rates of return have historically been related.

### Portfolio performance at a glance

	Portfolio A	Portfolio B	Portfolio C	Portfolio D	Portfolio E
					
<b>Long-term growth rate</b>					
Average 30 years	12.4%	10.4%	8.9%	7.3%	5.3%
Best 30 years	16.5%	13.7%	12.5%	11.2%	9.1%
Worst 30 years	9.0%	8.1%	6.6%	5.0%	2.7%
<b>Medium-term growth rate</b>					
Average 15 years	12.5%	10.7%	9.3%	7.8%	5.3%
Best 15 years	20.3%	17.1%	15.8%	14.6%	10.1%
Worst 15 years	1.1%	3.7%	4.5%	3.9%	2.1%
<b>Short-term growth rate</b>					
Average 5 years	12.1%	10.5%	9.3%	7.9%	5.3%
Best 5 years	43.4%	33.6%	26.6%	22.3%	13.7%
Worst 5 years	-21.5%	-13.6%	-8.5%	-3.6%	0.5%

### Portfolio C performance in depth

Time period	Annualized compound return	Average one-year return	Standard deviation	Years of positive returns	Years of negative returns	Highest one-year Return	Lowest one-year return
1926-2001	9.5%	10.3%	13.4%	60	16	50.7%	-25.4%
1940-2001	10.2%	10.7%	10.9%	50	12	31.5%	-11.3%
1950-2001	10.3%	10.8%	10.7%	43	9	31.5%	-11.3%
1960-2001	10.5%	11.1%	11.0%	35	7	31.5%	-11.3%
1970-2001	11.6%	12.1%	11.2%	28	4	31.5%	-11.3%

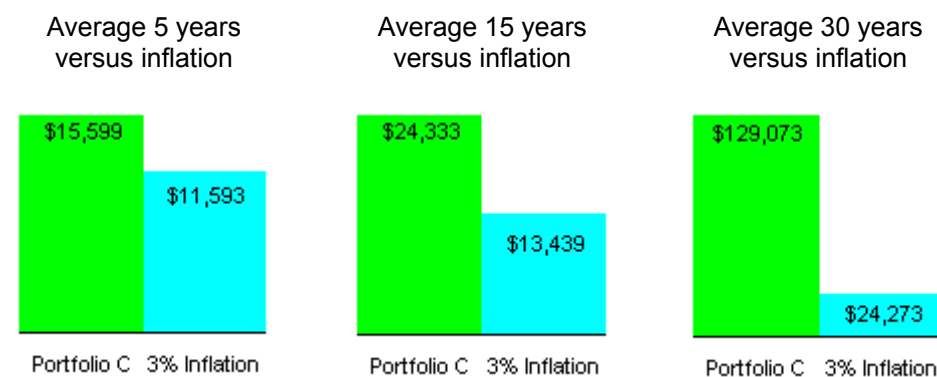
### Portfolio C performance by decade

Time period	Annualized compound return	Average one-year return	Standard deviation	Years of positive returns	Years of negative returns	Highest one-year Return	Lowest one-year return
1930s	6.4%	9.0%	24.4%	7	3	50.7%	-25.4%
1940s	9.3%	9.9%	12.3%	7	3	27.8%	-3.8%
1950s	9.4%	9.9%	10.3%	8	2	28.7%	-2.4%
1960s	7.2%	7.6%	9.9%	7	3	21.0%	-11.0%
1970s	8.1%	8.9%	13.4%	8	2	28.5%	-11.3%
1980s	15.2%	15.6%	9.7%	10	0	31.5%	-0.8%
1990s	12.7%	13.2%	11.0%	8	2	30.5%	-2.8%

**Likelihood of achieving a minimum return over different historical time periods (Portfolio C)**

Return of at least	Over 1 year	Over 3 years	Over 5 years	Over 10 years	Over 15 years	Over 20 years	Over 30 years
0%	79%	93%	94%	100%	100%	100%	100%
3%	75%	86%	90%	100%	100%	100%	100%
5%	67%	81%	85%	94%	98%	100%	100%
8%	58%	65%	65%	73%	75%	77%	83%
10%	53%	50%	49%	43%	39%	32%	30%
12%	47%	38%	31%	27%	26%	14%	0%
15%	34%	18%	17%	6%	2%	0%	0%

**Growth of \$10,000 invested in Portfolio C versus inflation**



Charts like these can be used by the three categories of investors—do-it-yourselfers, delegators, and validators (those who want to run their ideas past someone else). The charts will enable all three groups of participants to see (probably for the first time):

- how the returns of various asset allocations bounce around over time;
- how different allocations have kept up with inflation;
- the historical likelihood of various portfolios achieving targeted rates of return.

The delegators can use this information to either duplicate one of these allocations using their own investment options or to select a prepackaged (lifestyle or lifecycle) fund if these funds are among their investment options. The validators and do-it-yourselfers can use the charts in evaluating their own portfolios.

Charts like these can help all investors form more realistic expectations of future returns. (In fact, the educational process, to a large extent, about managing participant expectations.)

The validators and do-it-yourselfers may want to take portfolio construction one step further—model building. Thus, you should provide software so they can construct hypothetical portfolios and compare how they behaved in the past. This type of modeling software and the charts presented above allow participants to explore the behavior of the capital markets and see just how unpredictable they are.

# Investment Education for the 21<sup>st</sup> Century

## Dispelling the Myths and Undoing the Tactical Errors of the Nineties

---

The chart which practically every participant currently gets (the one that shows the cumulative growth of stocks, bonds and bills since 1926 to the present), however, is misleading because it captures only one time period and gives the false impression that, over the long term, stocks are a sure bet. Historically, stocks have outperformed bonds and T-bills, but by how much depends on the time period examined.

For example, during the 30 year period from 1950 through 1979, the S&P 500 had an annualized compound return of 10.9% while intermediate-term U.S. Government bonds grew at an annualized rate of only 3.9%. Over the last 30 years (1973 through 2002), however, the gap was not nearly as large. During this time period, the annualized compound returns for the S&P 500 and intermediate-term U.S. Government bonds were 10.7% and 8.8% respectively.

Moreover, as William Wolman and Anne Colamosca have reported, stock market bubbles (such as the one that burst in 2000) have typically been followed by long periods of poor stock returns. Wolman and Colamosca point out that there were three similar bubbles during the 20<sup>th</sup> century. The table below summarizes inflation-adjusted stock market performance in the 20 years following each of these bubbles.<sup>11</sup>

### **The aftermath of bursting stock market bubbles**

<b>Bubble peak year</b>	<b>Stock market inflation-adjusted annualized compound return during the following 20 years</b>
1901	-0.02%
1929	0.04%
1966	1.9%
2000	to be determined

Many will argue that participants aren't going to take the time to help themselves. That belief may be true but is not the real issue. The fact is that most participants in self-directed retirement plans don't know how to use their plans wisely and, more fundamentally, don't even understand why they should know how.

In addition, participants pay (directly or indirectly) most, if not all, of the plan's fees. Providers and sponsors have an obligation to give participants educational reports (such as ones showing where they are along the road to retirement) in addition to transaction-based statements. The fees they pay also entitle participants to user-friendly tools, interactive and static, such as the ones discussed above.

From a fiduciary perspective, it is dangerous for a vendor or a sponsor to assume that they know what participants will or will not do. After all, these are post-Enron times. It is also important to keep in mind that, if participants don't act appropriately after being made aware of their problems and given user-friendly tools, they have no one to blame but themselves if they come up financially short during retirement.

"But we offer an advisory service. Our participants just don't use it. If they would, their problems would be solved." is a common mantra of providers and sponsors. However, the lack of interest in

---

<sup>11</sup> William Wolman and Anne Colamosca, *The Great 401(k) Hoax*, Perseus Publishing, 2002, p. 191.

## Investment Education for the 21<sup>st</sup> Century

### Dispelling the Myths and Undoing the Tactical Errors of the Nineties

---

internet-based advice may not arise out of laziness but, rather, out of participants' understanding that these services don't really provide what they want and need. After all, participants do read (*USA Today*, Jane Bryant Quinn, and *Money*) and watch TV (*Wall Street Week* and Susie Orman).

Perhaps participants:

- believe, and perhaps rightly so, that there is no evidence that any advisory service has a model that works;
- recognize that different well-respected advisory organizations come up with asset allocation schemes that are quite different and produce dramatically different performances;
- know that various investment gurus differ dramatically in their predictions for the future of the capital markets and have concluded that there "ain't no such thing" as a market expert (Participants understand why the materials they receive include the disclaimer: "Past performance in no indication of future performance.");
- have learned that true advice is a process involving a lot of handholding and dialogue between them and their advisor (which is essential in today's world, but can't be obtained over the internet).

Another factor contributing to low utilization of internet-based advisory services is that communication occurs via writing (e-mails). Is it realistic to expect the average participant with both limited writing skills and a lack of investment knowledge to be able to clearly articulate questions and express concerns? The answer is obviously "no". (Some advisory services can provide call centers, printed materials, etc. However, the cost of these additional services results in much greater fees.)

Participants aren't stupid. In fact, many of them have a lot of common sense. In the 1990s, however, the stock market allowed them (as well as sponsors and providers) the luxury of being able to stick their heads in the sand. Today no one can afford to play ostrich.

The price participants will pay if they keep ignoring their responsibilities is a retirement filled with financial hardships. The price sponsors and providers will incur if they don't encourage participants to become active in their own retirement planning will be determined by the courts (when participants sue because they can't afford to retire). In addition, employers will likely find themselves stuck with a disgruntled workforce that, due to age discrimination laws, can't be fired.