

Issues in Participant Investment Education

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ERISA mandates that qualified plan fiduciaries must act for the “exclusive benefit” and the “sole interest” of participants. In fact, trustees responsible for making investment decisions must act as “prudent experts.” Congress realized that most trustees are not investment professionals so ERISA allows them to delegate specific responsibilities to professional money managers and to hire consultants to guide them through the investment process.

Since the trustees are ultimately responsible for the plan’s investment policy and strategy, consultants often provide education as well as advice. Even if ERISA had never been passed, most defined benefit plan sponsors wouldn’t dream of making investment decisions without professional help. After all, the cost of funding the program is the company’s responsibility and burden.

In the past, however, trustees of most participant-directed defined contribution plans have expected participants to make investment decisions without the benefit of investment education. Plan sponsors have been reluctant to provide education (or even the tools to allow employees to educate themselves) because they feared that doing so could be considered giving investment advice. Fortunately, 404(c) has solved this dilemma; education will not be construed as advice. In fact, “it is the view of the Department [of Labor] that providing...general information...would not, in and of itself, constitute the rendering of “investment advice.”¹ The fact remains, however, that relatively little participant education takes place. There has been a surge in communications programs, but most of these are not educational.

The purpose of this paper is to describe the benefits of providing quality participant investment education, differentiate between education and communication about investment options, and outline the process of designing and implementing an effective program.

A tale of two companies

Once upon a time there were two companies, Megabucks, Inc. and Lackluster Corp., which offered 401(k) plans as part of their benefits packages. The two plans were quite similar. Each offered a GIC fund, a bond fund, and several stock funds. Both plans included an employer match of 50%, and both contained loan provisions. Each company had designed its 401(k) plan with the employees’ best interests at heart. Neither wanted its employees to encounter financial problems during retirement.

Although the plans were practically identical, Megabucks’ employees seemed to be making much better use of their 401(k) plan. Participation and contribution levels at Megabucks were much higher than at Lackluster. Moreover, participants at Megabucks were retiring with larger account balances.

Differences could also be found in the employee’s attitudes. A Megabucks employee recently remarked to a co-worker, “It’s good to work for a company that cares. Take the 401(k) for example. The company doesn’t have to offer it, but it sure will help us have a better retirement.” Another Megabucks employee responded, “Yeah, I’m only 25, so I’m putting most of my money into stocks. The market’s having a bad year, but it doesn’t matter since I have a long way to go until retirement.” Lackluster’s employees, on the other hand, seldom discussed their 401(k) plan.

The trustees at Lackluster were perplexed. “Why don’t our employees participate and contribute more? Why aren’t their account balances as large as those at Megabucks? And why do Megabucks’ employees know so much more than our’s about investing and how their 401(k) plan benefits them?”

¹ “Labor Department Final Rules Under ERISA Section 404(c) on Participant-directed Investments,” *BNA Pension Reporter*, Vol. 19, October 12, 1992, page 1767.

Issues in Participant Investment Education

What Lackluster's trustees didn't realize was that the third question answered the first two. Participation and contribution levels were higher at Megabucks because these employees had a much better understanding of the advantages of participating in the 401(k) plan. Further, Megabucks' employees had larger account balances because they understood investing better.

How can the differences be explained? Megabucks' 401(k) plan included a quality participant education program. Lackluster's plan also included an educational program, but, much to the chagrin of Lackluster's trustees, all educational programs are not created equal.

In the real world, plan sponsors are just beginning to realize that their communications programs often have not been educational. Several surveys have shown that employees do not understand the basics of investing, often in spite of much communication (see Table 1).

Table 1: What Participants Don't Know

Concept	Percentage of Participants Who are Not Familiar or Only Vaguely Familiar with the Concept
Benefits of Tax Deferral	64%
Compounding	75%
Inflation's Impact on Investing	74%
Age as it Relates to Investment Risk	72%
Asset Allocation	79%

Source: Survey conducted by New York Life and the Gallup Organization. 1991-1992.

The survey on which Table 1 is based also found that younger employees tend to be more conservative investors than their older counterparts. This is exactly the opposite of what should be. Younger employees should invest more aggressively because time is on their side.

Another survey (conducted by The Gallup Organization for John Hancock) raises an interesting question. The survey found that employees consider themselves to be more familiar with money market funds than any other type of fund except company stock. However, 48% of those employees thought that money market funds include stocks and 46% thought that money market funds hold bonds. Conventional wisdom says that employees are not investing in stocks because they are too afraid of the stock market. The survey, however, indicates that many employees who are investing in money market funds believe they are investing in stocks. The question, then, is: Are employees avoiding stocks intentionally or unintentionally? Regardless of the answer, it is obvious that many employees do not know enough about investing to make rational decisions regarding retirement planning.

Employers also benefit from a quality educational program

A quality educational program benefits employees by helping them achieve a more financially secure retirement. But what are the benefits to the employer? A good educational program can boost participation and contribution levels and increase morale. If employees don't understand the 401(k) plan, they aren't likely to appreciate it or even use it. Educated employees, however, will understand and appreciate their 401(k) plan. As a result, they will view the plan as an excellent investment

Issues in Participant Investment Education

opportunity and a key component of their compensation package. In other words, a well structured 401(k) plan which includes a quality educational program can help attract, retain, and motivate employees.

SEC Commissioner J. Carter Beese has pointed out what may be the most important benefit of an educational program to employers. He and many others warn that current 401(k) savings trends will lead to inadequate account balances for many retirees. Beese warns that “[in the future] if millions of retirees are having trouble making ends meet, you can bet that plaintiff’s lawyers across the country will be looking for someone to sue.” Most likely, that “someone” will be the plan sponsor. A meaningful educational program can be used as evidence that the plan sponsor has acted in the best interest of the employee.

Goals

Many educational programs are less successful than they could be simply because they lack direction. At the outset, realistic goals must be defined. The program can then be designed to fulfill these goals. Setting realistic goals is especially important in the face of budget constraints, which limit a plan sponsor’s capabilities. A good educational program does not have to cost a small fortune. In many cases, existing programs can be greatly improved relatively inexpensively by having a consultant or human resource staff coordinate the program and supplement the materials provided by investment product vendors and recordkeepers.

The plan sponsor must realize that, even without budget constraints, no plan can reach every employee. Some employees will reject the 401(k) plan no matter what the plan sponsor does. A small number of employees may be incapable of grasping investment basics. On the other hand, some employees will participate enthusiastically even if there is no educational program. Educational efforts should be directed at the rest of the employees. These are the ones who are most likely to be persuaded to participate or contribute more.

Communication vs. education

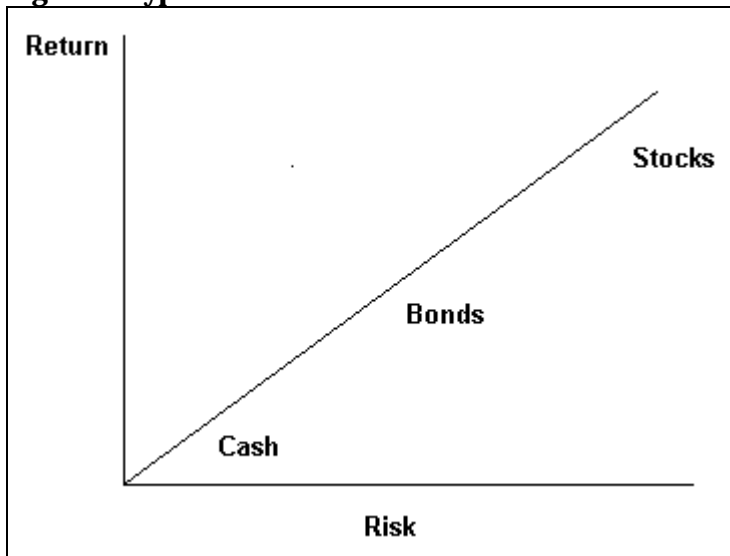
It is important to realize the difference between education and communication. Clear communication is a necessary ingredient of a good educational program. However, even the clearest communication does not guarantee quality education. Clear communication conveys ideas or facts. Good education provides empowerment. It imparts an understanding of the investment process. Armed with such an understanding, participants can overcome their irrational fears and make better investment decisions.

For example, Figure 2 is typical of charts used extensively to “educate” employees about the risks and rewards of various asset classes. Such charts are supposed to show that risk and reward go hand-in-hand. These charts, however, address only one type of risk (volatility). Moreover, they don’t explain the role of time in reducing volatility. For example, stocks can be very volatile from year to year. In the long-term, however, this volatility is reduced, and stocks tend to be the best performing asset class.

Since most people are risk-averse, employees tend to imagine the worst when they see Figure 2:² “Stocks are very risky so I’ll probably lose my savings by investing in them.” This reaction is unfortunate because many participants should be more concerned about keeping up with inflation than market value fluctuations.

² For a discussion of human risk tolerances, see *Rational Choice in an Uncertain World* by Robyn Dawes (San Diego:Harcourt Brace Jovanovich Inc., 1988).

Figure 2: Typical Risk/Reward Chart



The role of seminars

All too often, investment product vendors or recordkeepers hold an enrollment meeting (explaining in an hour or less how to participate, the plan options, and how to invest) and call it an educational program. Unfortunately, participants cannot be educated about investing in a single session. Furthermore, psychologists have concluded that most people retain very little of what they hear in seminars. People are more likely to remember the quality of the speaker and the visual aids than the substance of the seminar. At best, they will remember one or two concepts. No one will remember the details, and it's the details which count.

This is not to say that meetings and seminars cannot play an important role in an educational program. They can, especially for marketing the plan to the employees and for focusing their attention on a concept. Most importantly, seminars provide an opportunity for employees to ask questions.

Marketing the plan to employees

The first step in the educational process is to get employees to participate. Employees will be much more likely to participate if they realize that they are responsible for their own retirement security. Well designed payroll stuffers, for example, can be a cost effective means of communicating this responsibility.

Employees must also be made aware of the consequences of being investment illiterates. Many programs fail to impress upon employees that they are on the way to an uncomfortable retirement. Employees, however, can't be motivated to fix a problem unless they know the problem exists. Table 3 shows a chart which can be used to help impress upon employees how important it is for them to start participating or contributing more today.

Employees must also recognize that, by making wise decisions, they can impact their own retirement security. Many employees feel they lack control over how their investments perform.³ As a result, they believe time spent learning how to invest is wasted.

³ In technical terms, the employees have a perceived external locus of control (i.e. they feel that external forces, such as the market or the economy, determine how their investments perform.) For a discussion of this, see *Psychology* (3rd Ed.) by Henry Gleitman (New York:W.W. Norton & Co., 1991).

Issues in Participant Investment Education

Table 3: The Importance of Starting Early

Employee 1			Employee 2		
Age	Annual Contribution	Year-end Account Balance*	Age	Annual Contribution	Year-end Account Balance*
25	\$1,200	\$1,308	25	\$0	\$0
26	\$1,200	\$2,734	26	\$0	\$0
27	\$1,200	\$4,288	27	\$0	\$0
28	\$1,200	\$5,982	28	\$0	\$0
29	\$1,200	\$7,828	29	\$0	\$0
30	\$1,200	\$9,841	30	\$0	\$0
31	\$1,200	\$12,034	31	\$0	\$0
32	\$1,200	\$14,425	32	\$0	\$0
33	\$0	\$15,724	33	\$1,200	\$1,308
34	\$0	\$17,139	34	\$1,200	\$2,734
35	\$0	\$18,681	35	\$1,200	\$4,288
36	\$0	\$20,362	36	\$1,200	\$5,982
37	\$0	\$22,195	37	\$1,200	\$7,828
38	\$0	\$24,193	38	\$1,200	\$9,841
39	\$0	\$26,370	39	\$1,200	\$12,034
40	\$0	\$28,743	40	\$1,200	\$14,425
...	\$0	\$1,200	...
60	\$0	\$161,089	60	\$1,200	\$147,762
61	\$0	\$175,587	61	\$1,200	\$162,369
62	\$0	\$191,389	62	\$1,200	\$178,290
63	\$0	\$208,615	63	\$1,200	\$195,644
64	\$0	\$227,390	64	\$1,200	\$214,560
Total Contributions		\$9,600	Total Contributions		\$38,400
Total Earnings		\$217,790	Total Earnings		\$176,160
Final Account Balance		\$227,390	Final Account Balance		\$214,560

*Assumed growth rate: 9%

Plan sponsors are forever complaining that their employees won't read anything they pass out. Given that the employees' often feel powerless, it's little wonder they ignore company materials. The problem is compounded by the fact that, in many cases, employees are inundated with company literature on other subjects.

The first part of the educational program, then, is a sort of advertising campaign. No matter how high the quality of the education is, it will be ineffective if the employees don't participate. After all, you can't make a horse drink until you get it to water.

Issues in Participant Investment Education

Education is a process (ideally, a multimedia process)

Once employees have been sufficiently motivated to participate in the program, education can begin. Remember, up to this point the program has been an attempt to market the 401(k) plan. Now the program must become educational.

What is often forgotten is that education is an ongoing process, not a one shot deal. Unfortunately, there is no turn-key, quick-fix answer to the problem of employee education. Each program must be tailored to meet the knowledge level of the participants. For example, a program designed to educate employees of an accounting firm probably would not be effective for coal miners (and vice-versa). In fact, companies employing a diverse group of people might design several programs for different segments of their employee population. For example, a manufacturing firm might want to use one program for blue collar workers, a program for white collar hourly staff, and possibly a third for management.

The design of an educational program must also consider what media will be most effective for a particular group of employees. Clear communication requires that the participant be comfortable with the media being used. Computer software provides an excellent example. Software should only be considered in offices where employees use computers regularly. People who don't use computers tend to be overwhelmed by them. The anxiety many non-computer users feel when forced to use a computer often causes them to completely ignore what the program is telling them. Computers can be a great tool for educating plan participants, but only certain plan participants.

In most cases, more than one media should be used. For example, videos can be a highly effective means of focusing the employees' attention. However, employees aren't likely to remember many details of the video. Thus, written reference material must be used to reinforce the video. An advantage of written material is that employees can take it home and refer to it for years after they have forgotten what they've heard in seminars or saw on videos. Another advantage of written material is that it allows employees to study in a relaxed atmosphere and at their own pace.

Using several types of media provides reinforcement. Reinforcement is a psychological term for learning the same thing in several ways. Studies of human learning have concluded that reinforcement aids understanding tremendously and helps employees retain more of what they have learned.⁴

Another important point is that a quality educational program must not only teach basic investment concepts, but it must also show employees how to use the knowledge. Too many participants are inundated with facts and figures but are never taught how to apply the information to their own situations.

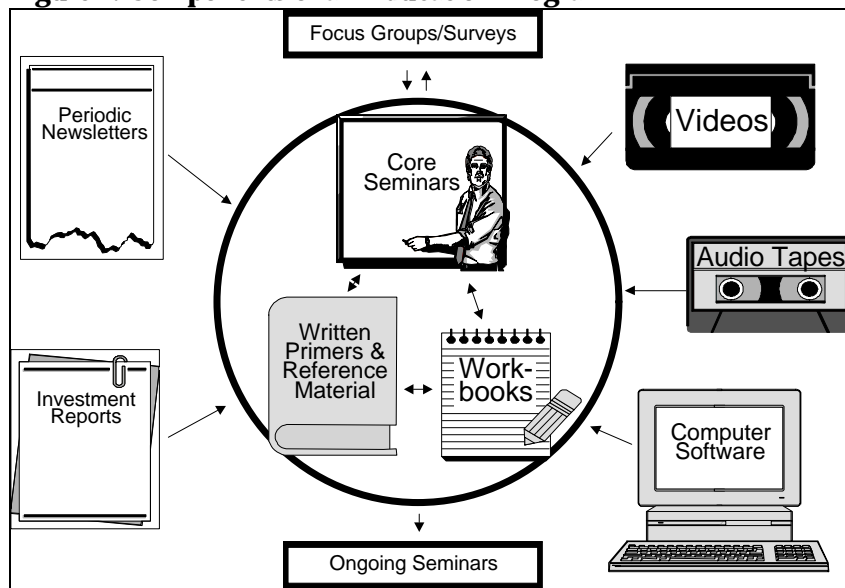
An example of such empowerment is helping employees determine their own risk tolerances. This should be done at the end of the program. Too many 401(k) providers pass out questionnaires at enrollment meetings and expect employees to determine their risk tolerance right away. The problem is that most employees define risk according to misconceptions and unwarranted fears. How can someone who doesn't understand the different types of risk determine his or her risk tolerance?

Some final thoughts

Every plan sponsor and every group of participants has its own unique needs and wants. Because of this, there is not an off-the-shelf educational program which will work in every case. What's appropriate for one group of employees may not be appropriate for another. (Figure 4 shows many of the possible components of an educational program.)

⁴ For a technical discussion of reinforcement, see *Introduction to Psychology* (10th Ed.) by Rita Atkinson, et. al. (Geneva:Harcourt Brace Jovanovich Inc., 1990).

Figure 4: Components of an Education Program



Nonetheless, there are some basic questions which must be answered in developing any educational program.

- What's the goal? To educate the employees or just to provide tools and let the employees educate themselves?
- Should the program be mandatory or voluntary? Or a combination?
- Should the program provide standalone investment education or should it be integrated with overall financial planning education?
- What should be done by in-house personnel? What can realistically be expected from product vendors and recordkeepers? What role should a third-party consultant play? How do these efforts get coordinated?
- Who should bear the costs; the employer, the employees, or both? Perhaps education would help employees increase their returns sufficiently to justify reducing the employer contribution to pay for the program.
- What portion of the program should be conducted on company time? What should employees be expected to do on their own time?

These are but a few of the many issues which must be addressed in developing an educational program. The answers to these questions are not set in stone. Each plan sponsor and each group of employees is unique. For this reason, it is often beneficial to involve a consultant with the expertise to customize and coordinate the program.

Lastly, always remember to start with the issues and then develop a solution which addresses them. All too often, product vendors and recordkeepers have prepackaged communication and education programs which are suppose to fit all situations. The ineffectiveness of this approach has already been discussed (Table 1).