Not on the Internet, Please

Author
Richard D. Glass

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Asset allocation is undeniably the key to long-term investment success. Thus, it is no wonder many fiduciaries of 401(k) plans are asking if Internet-based asset allocation services should be offered to participants. Plan sponsors maintain participants want to be told how to manage their accounts. By providing asset allocation services, plan sponsors would be giving participants exactly what they want. The “icing on the cake” is that much sweeter when a plan sponsor can tell participants that the asset allocation service being used is run by a man who won a Nobel prize for pioneering work in modem portfolio theory.

Offering an asset allocation service sounds like a win-win situation for both participants and plan sponsor. The greater the praise the plan sponsor bestows upon the asset allocation vendor, the greater the likelihood participants with little investment knowledge will view the recommendations as guarantees. This perception sets the stage for lawsuits against the plan fiduciaries and vendor if the recommended allocations miss their marks.

Vendors will reply they are neither predicting the future nor guaranteeing anything. Rather, they are just helping participants to construct portfolios scientifically and then quantify the likelihood that these portfolios will achieve the desired growth rates. They also will argue their services are ongoing in nature. When changes need to be made, participants will be advised.

Several fiduciary issues immediately jump out. First, providing a collection of probabilities and other statistics cannot reasonably be expected to jibe with the participants’ desire to be told how to invest. Participants will assume the recommended asset allocations are appropriate. For this to be so, both model and inputs must be able to capture the future behavior of both the capital markets and a plan’s individual investment options.

John Maynard Keynes observed that to turn an economic or financial “model into a quantitative formula is to destroy its usefulness as an instrument of thought...by filling in figures, which one can be quite sure will not apply next time...” the value of the model is destroyed[1]. Even if Keynes’ criticism can be overcome, the Internet as the means of communication must be questioned. If the reading level, number of pages and presentation style of today’s typical 401(k) communications accurately reflect the capabilities of the average participant, it is naive to expect most participants to pick up sophisticated concept from materials distributed over the Internet. There isn’t any reason to expect most participants to read them - vendors and plan sponsors claim participants do not read what is being distributed now and that it is foolhardy to try to explain mean, standard deviation and correlation.

Advisory services purport to offer advice. Advice, however, is developed only after extensive fact-finding and discussion with a client. The plan sponsor, before endorsing any service, must believe that the Internet is an effective communications channel for the advisory process. As vast numbers of high school and college graduates lack basic writing skills, it seems far-fetched that these same individuals will be able to intelligently discuss unfamiliar concepts using a skill in which they are handicapped.

Participants are advised to develop long-term strategies. “Don’t panic” is the message participants receive when the market nose-dives. “The market will recoup losses and continue climbing” and

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[1] Daniel M. Hausman, ed., *The Philosophy of Economics,* Cambridge University Press, 1994, p. 287

“market-timing is foolhardy” are mantras with which participants are indoctrinated. Then along comes periodic advice with directions for getting their portfolios back on course, which participants could construe as closet market timing. Alternatively, if market moves are not correctly anticipated, the value of the advisory services will be questioned. There is no easy answer. Plan sponsors cannot assume that an important tool for sophisticated investors can be used with equal effectiveness by uninformed ones. To ignore this is an open invitation for litigation against plan fiduciaries.