

Investment Education: A Review of the State of the Union

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Participant investment education is a hot topic in the self-directed defined contribution (401(k), 403(b), and 457) marketplace. Since recordkeeping and investment options have been commoditized, participant education has become a salient, if not the primary, differentiator of bundled providers.

Bundled providers tout their communication/education departments as being leading-edge. After all, their programs and materials (written, audiocassettes, videos, software, Web-sites, etc.) are appropriate and state-of-the-art. Supposedly they are based upon adult learning techniques, focus groups, and surveys of participants' needs, wants, and levels of knowledge. Surveys are also trotted out that purport to show their effectiveness as well as how satisfied participants and plan sponsors are with existing programs, materials, and communicators. Thus, it is no surprise that plan sponsors are delighted to delegate responsibility for participant investment education to their bundled provider.

Unfortunately three recent surveys suggest that the effectiveness of existing education programs has been grossly exaggerated. John Hancock Financial Services' fifth defined contribution plan survey, *Insights Into Participant Investment Knowledge & Behavior*, conducted by the Gallup Organization, has found, among other things, that:

1. Over the past 4 years, participants' familiarity with stock and stable value funds has not changed significantly. Using a scale of 1 (not familiar) to 5 (very familiar), participants' understanding of stock funds and stable value funds has gone from 2.8 to 3.1 and from 3.0 to 2.7 respectively.
2. Only 9% of participants know that money market funds contain only short-term securities. About half of the participants (47% today versus 50% 4 years ago) believe that money funds hold stocks.
3. 64% of the participants feel they cannot lose money in government bond funds.

The *1997 Retirement Confidence Survey*, co-organized by the Employee Benefit Research Institute, the American Savings Education Council (ASEC), and Mathew Greenwald & Associates, Inc., found that only 27% of American workers have any notion of the amount of money they must accumulate by the time they retire. Don Blandin, president of ASEC, has said:

"We know from our survey that many Americans are intimidated by retirement planning—29% of workers who have not tried to calculate how much they will need gave as a reason that they are afraid of the answer, 20% said the process is too complicated, and 39% said they can't find the time."

A recent Access Research study (presented at the SPARK conference in November 1997) found that although the average plan has 6.3 investment options, the average participant uses only 2.2 options. This fact demonstrates that the concepts of asset allocation and diversification have either fallen on deaf ears or have not been communicated effectively.

These surveys clearly demonstrate that plan fiduciaries must get involved with and assume responsibility for investment education. Leaving the education process to bundled providers has, on the whole, been less than satisfactory. Plan sponsors must decide on goals, determine how they are to be implemented, and how the program's effectiveness will be monitored. After all, it is they and their

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company's stockholders who will ultimately pay the price of having a workforce that cannot afford to retire.

No one, however, really knows what a plan fiduciary's obligations are when it comes to providing investment education. On one hand, ERISA does not require that employees be educated. On the other hand, ERISA mandates that plan fiduciaries must act in the best interest of participants.

What does that requirement mean? If the plan fiduciaries know that their participants know little about investing, will the courts decide that there are certain minimal educational responsibilities that must be carried out? Will it be successfully argued one day that some of the asset management, 12(b)(1), and other fees that the participants are paying should have been used to conduct meaningful educational sessions?

If plan sponsors want to qualify for section 404(c) protection, the risk and reward profiles of each investment option must be adequately explained. They also have to provide complete, accurate, and unbiased information. Does a prospectus or a one-page fact sheet do this? How many of them discuss risk-adjusted returns or compare nominal versus real (inflation-adjusted) returns? Unfortunately there is no consensus as to what the Department of Labor means when it uses these three adjectives—complete, accurate, and unbiased—to describe information.

Perhaps, as a minimum, every plan sponsor should convey, in no uncertain terms, these messages and concepts:

1. Participants bear the full responsibility for their own retirement security.
2. There is no such thing as instant or one-shot investment education.
3. Participants must implement self-study programs. A survey in USA Today revealed that adults spend an average of only 9.1 hours a year planning for their retirement compared with 145.6 hours annually selecting their wardrobe.
4. In contrast to popular belief, 401(k) plans are not the best thing after motherhood and apple pie. They are good wealth accumulation tools only if participants make adequate contributions, allocate wisely, and the gods of the capital markets look favorably upon them. 401(k) plans are not self-completing, get rich quick schemes as so much of the hype surrounding them has implied.
5. Participants must develop realistic expectations of market performance. There will be periods in which the stock market appears to be a perennial money tree. During other periods, the stock market will behave like a roller coaster, with sudden and violent movements. At other times, it will be boring, going either nowhere or just “schlepping” along. Regardless of what occurs, participants must learn that they can't afford to panic or become overconfident. In good times, they can't forget to rebalance. In scary times, they must not let their emotions rule their behavior and turn paper losses into real losses.

So what does it mean to educate? Is it a realistic goal for a plan sponsor to feel that it can educate participants? When should a plan sponsor ignore the education process and just “hit participants over the head” with an idea or concept?

When you educate, you are engaging people's minds. You are encouraging them to think, learn, and question, perhaps even challenge. Only by doing this will plan participants appreciate the importance of paying attention to their 401(k) plan. What is often forgotten, however, is that participants must recognize the need for education. If they don't acknowledge this, they will not be willing to invest the time to help themselves.

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Perhaps the best way of starting an education program for the typical participant is to “hit him over the head” with a report that shows each participant where he or she is along the road to retirement security. This report should include:

1. reasonable estimates of their retirement income needs,
2. the effect of inflation on them,
3. the periodic contribution that must be made to generate the necessary nest egg,
4. the assumptions used in arriving at the values,
5. the effects of changes in the assumptions,
6. the portfolios, based upon asset classes, that have historically achieved the necessary growth rates at the contribution level being utilized,
7. a comparison of the total account's and each fund's annual rate of return.

Why fight human nature? Accept the fact that participants are not using worksheets and don't waste money printing them. It is probably wiser to periodically distribute the report outlined above for it will enable participants to see if they are on course in meeting their retirement goals.

This approach transforms retirement planning from a generic need to a personalized one. The participant can no longer fantasize that retirement security can be had without planning and making adequate contributions to the 401(k) plan. Each participant learns where she is along the road to financial security. This tool can be even more valuable and powerful if the participants' non-401(k) assets, such as IRAs and personal investments, can be incorporated into it along with Social Security and the company's pension benefits.

The next step would be two mandatory educational sessions. Spouses and significant others would be encouraged to attend. The first session would review the assumptions used in developing the personalized statements. The presenter could drive home the importance of making realistic assumptions, monitoring them on an ongoing basis, and making adjustments when necessary.

The next session would introduce concepts that few, if any, participants would have seen before. These would include:

1. the importance of differentiating between an asset class's historical nominal and inflation-adjusted returns;
2. prioritizing the risks each participant faces, such as achieving over time adequate inflation-adjusted returns versus minimizing annual volatility;
3. coordinating the risks and rewards of each asset class with the financial goals the participant wants to achieve, such as pairing the amount of money a participant has to invest with the likelihood that her portfolio will grow to the desired nest-egg;
4. realizing what “how bad is bad” means for the different asset classes, such as understanding the historical frequency and magnitude of losses and the length of time it took to recoup losses;
5. understanding why, for a long-term investor, a portfolio's likely inability to generate adequate inflation-adjusted returns is a better definition of its riskiness than its annual volatility;
6. explaining the role of diversification (“don't put all your eggs in one basket”) in portfolio construction, and, in particular, how diversification can minimize losses and stabilize the portfolio's growth rate;
7. demonstrating why participants should think in terms of a portfolio's volatility rather than the volatility of the funds comprising it;
8. showing how portfolios with different asset allocations can generate dramatically different income streams.

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In both workshops interactive software would be used. Such software catches and maintains the audience's attention by enabling the presenter to immediately answer participants' questions. This is because changes in assumptions, time periods, and other parameters can easily be made. Portfolio risk can also be demonstrated from the perspectives of time horizon, volatility, and the ability to generate inflation-adjusted returns. It is a sure bet that few, if any, participants will have seen such a presentation before.

Perhaps the most important thing that can come out of these sessions is the recognition by the participants that they must be actively involved in their retirement planning. The covered material will clearly demonstrate that, at best, assumptions are only intelligent guesses. They are not the ironclad guarantees that so many participants would like them to be.

Participants will also learn the need to carefully define and prioritize their goals. For example, what is more important—having a portfolio with minimal volatility or one with much more volatility but a good likelihood of providing an adequate inflation-adjusted income during retirement?

The presenters must stress that the above two sessions barely scratch the surface of the knowledge participants will need to be actively and productively involved in achieving their retirement security. The presenters must make it perfectly clear that while managing a self-directed retirement account is not rocket science, it does require an understanding of basic investment concepts. Obtaining such an understanding does not come quickly. A “one minute” program to investment genius simply doesn't exist.

Unfortunately, “one minute” educational programs are what plan fiduciaries and their vendors have wanted and have delivered. The “one minute” approach explains why participants in general have not increased their knowledge of investing over the last four years and why so few American workers know how much they should be saving for retirement (see previously mentioned surveys).

Plan fiduciaries and their communication vendors must recognize that if workers cannot afford to retire and must stay on the job, their low morale will create major productivity problems. Major productivity problems will threaten corporate survival, etc. It is imperative that plan sponsors define what their role, if any, will be in educating plan participants and clearly communicate that to all their workers. (A plan sponsor need not educate participants to be in compliance with ERISA and section 404(c) in particular.)

It is also important that plan sponsors make it perfectly clear to participants what their responsibilities and roles are in providing for their retirement security. In fact, one of the requirements for compliance with section 404(c) is that a plan sponsor must tell participants that they are responsible for their retirement security. Many plan sponsors, however, convey this message in “fine print” (figuratively, not literally) for fear of upsetting participants. Plan sponsors don't want participants to feel that a 401(k) plan is a legal way for them to throw its workers to the wolves when it comes to retirement security.

All too often communication vendors enthusiastically endorse the virtues of participating in self-directed retirement plans but either downplay or totally ignore the amount that each participant must contribute if a comfortable retirement is to be achieved. Both these communication vendors and the plan fiduciaries who hire them are very concerned that if participants know how much they should contribute to assure themselves a high likelihood of retirement security, the appeal of the 401(k) plan would be diminished greatly.

Furthermore, that participants must develop an understanding of asset allocation is also downplayed, or perhaps more correctly put, circumvented through the use of risk tolerance questionnaires and

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presentations extolling the historical performance of equities. The use of risk tolerance questionnaires raises at least three serious questions. They are:

1. Does a person's risk-tolerance level have any correlation to the portfolio that will likely meet his needs?
2. Can a typical participant intelligently answer the questions commonly found in risk tolerance questionnaires, such as, "I am comfortable with low returns over the long term if I can feel confident that my savings will be fully secure. I understand that this may mean my investment return does not keep pace with the rate of inflation." After all, to answer intelligently, a participant must understand the issues that underlie that question, including:
 - The greatest retirement risk she faces is not having an adequate inflation-adjusted income during retirement;
 - Paper losses are common and to be expected;
 - The interrelationships among an account's time horizon, volatility, and the likely ability to recoup losses;
 - How badly even a low rate of inflation can erode buying power.
3. If plan fiduciaries know that sizeable numbers of participants cannot answer intelligently the questions on a risk tolerance questionnaire, why are they and their vendors endorsing a technique whose output is questionable at best?

Unfortunately, risk tolerance questionnaires are used because of the widespread beliefs that participants want to be told how to invest and that the use of these questionnaires does not equate to giving advice. While plan sponsors might avoid issues pertaining to giving advice, they are likely to open up many other "cans of worms."

Another problem that plan sponsors will likely encounter stems from presentations that extol the historical performance of equities. These speeches come with the best of intentions, namely, helping participants choose or approach the appropriate asset allocation. Conventional wisdom maintains that equities, or sizable amounts of them, are the way to go for long-term investors. Large quantities of fixed-income investments will surely lead to inadequate retirement nest-eggs.

Why are stocks so great? Conventional wisdom argues:

1. Stocks have historically outperformed other asset classes on both a nominal and inflation-adjusted basis.
2. The risks of owning diversified stock portfolios decrease dramatically over time.
3. In capitalistic societies all over the world, the most money is made by owning companies, i.e., buying stocks, and not by lending firms money, i.e., buying bonds.

Unfortunately, not everyone, including Nobel laureates Paul Samuelson and Robert Merton, and the well-respected consultant and commentator on the capital markets, Peter Bernstein, agrees that the past will be a good guide to the future and that the riskiness of stocks decreases over time. (See Paul Samuelson, "The Long-Term Case for Equities", *The Journal of Portfolio Management*, Fall, 1994 and Peter Bernstein, "Long Run or Also-Ran", *Worth*, July/August, 1997.)

Can you imagine what would happen if the stock market's bubble bursts? Picture the lawsuits in which the participants' attorneys are arguing:

"You (the plan fiduciary) knew that many market pundits thought that the market was greatly overvalued. You also knew, or should have known, that some Nobel laureates did not view large

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positions in the stock market as the end-all, be-all for the typical participant. But not only did you ignore all of that, you sent communicators to persuade them, to advise them, to greatly increase the amount they allocate to stocks. And now that the market has tanked, financial security during retirement may never be within their grasp. We need you (the plan sponsor) to significantly subsidize their accounts.”

Investment education, as it is practiced today, sets the plan sponsor up for a myriad of problems, including fiduciary liability ones and having a workforce that won't be able to retire. Plan sponsors and their vendors are trying to give participants what they think the participants want; a no-brainer, but adequate introduction to investing. Recent surveys have shown that this approach has failed.

Plan sponsors, their education vendors, and their participants must recognize and accept that learning in general and developing an understanding of investing in particular is a life long process. Educators throughout the world have accepted this fact and are incorporating it into their new paradigms. (See *Learning: The Treasure Within*, Jacques Delors, editor, UNESCO Publishing, 1996.) And so must we if retirement security for American workers is to be had.