A Survey of the Investment Issues Confronting Defined Contribution Plan Trustees

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This article will address some of the investment issues that confront trustees of defined contribution plans from the perspective of the fiduciary liabilities they create. Although much of the material is directed to the union trustees of Taft-Hartley plans, the issues are equally applicable to trustees of corporate and government plans.[1]

I will begin by predicting how defined contribution plans will evolve over the next several years. Then the concept of a trustee's fiduciary responsibility to a plan's participants will be explored. Next I'll compare how participants view defined benefit and defined contribution plans. Finally I'll approach the investment issues by reviewing my reasons for the predictions.

Plan evolution

The defined contribution environment of the twenty-first century will have the following characteristics:

1. Defined contribution plans will be as commonplace in the Taft-Hartley arena as they already are in the corporate arena.
2. Employees will know how financially secure they will be during retirement. Inflation's effects will be factored into this determination.
3. There will be no trustee-directed defined contribution plans. All plans will be participant directed.
4. The investment options will be of two types: traditional mutual funds and lifecycle funds.
5. Lifestyle funds and the risk tolerance tests that are used to help participants determine which one is for them will have gone the way of the dinosaur.
6. Investment education will be commonplace.

Trustee's fiduciary responsibility

Let's put my predictions aside for the moment and move on to the topic of a trustee's fiduciary responsibility to a plan's participants. All of a trustee's varied duties and responsibilities can be simply summarized: to do whatever is in the best interest of the plan's participants. When an individual is acting as a trustee, that individual must put the participants' interests before and above those of the employer or the union he or she represents. When this is not done, the trustee has probably breached his or her fiduciary responsibility. .

Participants' view of plans

Think about how your participants view defined benefit and defined contribution plans. Aren't defined benefit plans considered safety blankets? Isn't the defined benefit plan's guaranteed income, coupled with Social Security, viewed by your members as their source of financial independence during retirement? If severe income shortfalls occur, won't the participants think they have been deceived? In today's litigious society, isn't it likely they would want to bring legal action against all (trustees and plan sponsor) who presumably bamboozled them?

Let's discuss shortfalls for a minute. Do your members know that they are going to need, on an annual basis, 70-80% of their preretirement income adjusted for inflation? Even if a person retires on

[1] Government plans are not subject to ERISA, but similar fiduciary standards usually apply to them under state law.

100% of his or her preretirement income, inflation is going to erode buying power over time. If one of your members retired in 1975 with a $30,000 annual income (pension and Social Security), in 1994 that same individual needed over $86,000 to have the same standard of living as in 1975.[2] What can be concluded? It is imprudent at best to tout the adequacy of the defined benefit pension and to deny or minimize the importance of having a defined contribution plan.

Participants think of defined contribution plans, on the other hand, in terms of account balances and/or investment performance. Participants learn on a quarterly or daily basis what their accounts are worth. Defined benefit plans conjure up hopes and dreams while defined contribution plans force employees to think about the size of their nest egg and whether it has gone up or down since they looked last.

Investment issues

Because they don't understand the investment process, too many plan participants want their defined contribution accounts to grow in the same steady manner as their bank savings accounts. Unfortunately, when trustees try to please participants by creating portfolios with minimal volatility, the participants end up being shortchanged. This is because portfolios that are constructed to minimize volatility (by employing large amounts of bonds and short-term fixed income instruments) usually also minimize growth. Inflation, retiree medical care and the possibility of needing long-term nursing or home care make it apparent that a defined contribution account can never be too large.

Furthermore, participants who retire at 65 have a life expectancy of about 20 years. It is a safe bet that during retirement not much, if any, new wealth will be created. To make matters worse, most participants aren't wealthy and don't have another nest egg to supplement their retirement benefits. The threat that someone can outlive financial resources is very real. This is why it is imperative that the participants in defined contribution plans get the biggest bang for their bucks. Achieving this requires having a large portion of their defined contribution account invested in growth oriented investments such as U.S. and foreign stocks.

Trustees of defined contribution plans are caught between a "rock and a hard place." If the trustees (remember that most Taft-Hartley defined contribution plans are trustee directed) invest the way they should, i.e., aim for growth at a reasonable level of risk, they will periodically have a lot of unhappy campers (participants). This is because most participants don't understand:

1. the risks they face;
2. how to prioritize the various risks;
3. the relationship between volatility and time;
4. how the capital markets work;
5. the difference between real and paper losses.

On the other hand, if the trustees invest today with the attitude of not trying to upset the apple cart, i.e., create portfolios that have limited volatility, they increase the likelihood that the participants will not have financial security during retirement. As was explained earlier, this approach can have severe consequences. So what can the trustees do to protect themselves and help the participants simultaneously?

[2] . *Stocks, Bonds, Bills, and Inflation 1994 Yearbook*. Chicago: lbbotson Associates. Annually updates work by Roger G. Ibbotson and Rex A. Sinquefield.

Need for educational program

To begin with, an ongoing educational program should be instituted. The purpose of such a program would be to provide participants with a basic understanding of the capital markets and the investment process. They will learn and hopefully remember that volatility is inherent to the investment process and that even the best managers have bad years. When the market heads south, they won't jump ship. Rather, the participants will learn to view such times as buying, opportunities.

Such knowledge will help participants to understand the investment decisions of the trustees and also to evaluate the performance of their trustees. That's right. The participants' new knowledge will help them evaluate how good a job you're doing. This means that another one of your fiduciary responsibilities-your choice of funds will be in the spotlight. It is quite likely that the investment performance of the defined benefit plan will also come under scrutiny.

Another question with fiduciary implications arises: Should there be trustee-directed defined contribution plans? Let's assume that the average age of a plan's participants is 45. Half the participants are older, and the other half are younger. Perhaps a few or none are between the ages of 40 and 50.

If the trustees utilize an investment strategy that is appropriate for a 45 year-old, wouldn't it be too volatile for the older participants (maybe 55 and over based upon an age 65 retirement date)? And at the same time wouldn't it have too few assets invested in stocks for the younger participants? In other words, is it prudent for the trustees to direct the investments?

Lifecycle and lifestyle funds

You might argue that while trustee directed plans aren't perfect, they are better than turning the investment decisions over to the average plan participants who may be investment illiterate and/or who don 't want to make their own investment decisions. Five years ago you would have had a valid argument. Today this argument has lost much of its power because of lifecycle and lifestyle funds. These are professionally managed funds whose asset allocations are determined by an individual's age or retirement date (life cycle) or risk tolerance level (lifestyle). .

Future role of trustees

If the trustees offer both the traditional asset class mutual funds and lifecycle funds, and explain that the lifecycle funds are designed solely for investing for retirement and not to buy a new home or educate children, how much fiduciary liability can the trustees incur? I suspect none, especially if an ongoing investment education program is also provided.

This picture of the retirement plan arena is not the one of the past. Trustees will come under much more scrutiny because plan participants will be better educated. In defined contribution plans the participants will be making many of the investment decisions that were once the sole domain of the trustees. In the long run, the defined contribution plan participant will benefit because both trustees and product vendors will know whom they serve.