

Educating Participants on Investment: Is the Myopic Legal Tail Wagging the Dog?

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The laws and regulations governing participant investment choices and employer-sponsored investment education stress the key moral precept underlying ERISA's fiduciary rules: Participants must be told the truth. But at the same time, they raise Pontius Pilate's metaphysical question: "What is truth?"

When plan sponsors discuss their legal concerns, they focus on regulatory safe harbors: How many investment options must the plan offer? How diversified must they be? What information must the plan provide in order to transfer to participants responsibility for their own investment choices?

But this focus on a presumed "responsibility-free zone" diverts attention from more critical long-term issues. It may permit or encourage certain trends in participant investment choices, such as risk tolerance questionnaires and lifestyle investment funds, that could damage uninformed participants' long-term prospects.

As employees come to rely extensively on 401(k) and other participant-directed plans, employers must face the key question that the law does not answer: Will the employee be able to afford to retire when she wants or needs to? Do the plan's investment options afford the employee reasonable opportunity to capture the breadth of activity in the capital markets? And does the employee know enough about investing to make reasonable choices from these options?

Asset allocation is commonly believed to produce over 90% of a portfolio's total return. Since large varieties of fund options are readily available, no practical impediment exists to offering numerous investment options.

Do the ERISA section 404(c) regulations mean that the sponsor has no clear legal obligation to provide more than three options? Perhaps. But what plan fiduciary would want to face the following question from a participant: "For the past six years small-cap and foreign stocks have taken off while US large-cap stocks have stumbled along. Why did our plan not allow us to invest in the winners?" No answer would satisfy an informed participant.

Selecting investment options for the plan is a fiduciary responsibility independent of 404(c). By unduly limiting the number of investment options, the fiduciaries may prevent participants from achieving retirement security. Even if providing retirement security is not a legal obligation, the plan sponsor's interests are surely best served when participants can afford to retire comfortably.

However, most employees have only a minimal understanding of investing, not to mention how to use the options available to them. Even fulfilling 404(c) to the letter does not by itself empower plan participants to make informed decisions. How much practical information, for instance, can even a knowledgeable investor obtain from a defensively written prospectus?

Recent intensive analysis of the huge Fidelity Magellan fund illustrates this critical issue, often obscured by fund prospectuses. Famous since the Peter Lynch days and with an exemplary track record, Magellan was marketed as a broadly diversified growth stock fund, and as such was viewed as an appropriate 401(k) option. But this supposedly diversified stock fund turned out to be an asset allocation fund—over 35% cash and fixed-income—that made, and lost, several large sector bets.

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This example clearly demonstrates the need for a thorough, periodic performance monitoring process by plan fiduciaries and participants. If a participant selects a fund because it is a large-cap fund, and another because it is a small-cap fund, the participant has made a definite asset allocation decision. If the large-cap manager then decides to invest in bonds and mid-cap stocks, the participant's allocation has gone awry.

Unfortunately, the average participant cannot readily find out about changes in the manager's style and the type of securities in which the fund is investing in a timely manner and in a format that does not need extensive analysis. Could the courts one day rule that the plan fiduciaries did not act in their participants' best interests if they:

1. did not make an effort to provide such information or at least notify the participants of a dramatic change in the types of securities a fund holds?
2. did not tell the participants that they should try to get this information on their own?
3. imprudently picked "closet" asset and/or style allocation funds?

Some plan participants simply will not "get it" even with a good investment education program or may understand the process but still wish for "experts" to make asset allocation decisions for them. For these participants, additional options may be appropriate, such as life-cycle funds, whose allocations are based on retirement age or life expectancy.

If plan fiduciaries know that many of their participants cannot create appropriate asset allocations for themselves, would it be imprudent not to offer life-cycle funds? This is another issue the courts may ultimately have to decide.

Communications

Risk and time are two essential interrelated areas of employee ignorance that any successful investment education program must hit very hard. All too many of the communication pieces that we have seen treat inflation and risk as separate issues. A few short paragraphs describe how inflation erodes buying power. Elsewhere risk is defined as annual volatility. An accompanying chart usually shows Treasury bills as the least risky or safest investment—and the poorest performing—and US small-cap and international stocks as both the riskiest and yielding the best returns.

But these brief handouts usually do not discuss such matters as: how the volatility of funds, asset classes, and portfolios declines over time; the inflation-adjusted returns of different asset classes and subclasses; how to prioritize the risks a participant faces; and the difference between paper and real losses.

How can participants make informed decisions if they do not know enough to ask, and get answers to, such basic questions as:

- Is not having an adequate inflation-adjusted income during retirement a greater risk than one of my options periodically losing five percent?
- If my time horizon is 25 years, does an 8% paper loss threaten to my financial security or is it an event to be anticipated periodically?
- Should I be concerned over the volatility of the individual funds? Or is it more important to concentrate on the volatility and return potential of the portfolio I have constructed with them?

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Section 404(c) does not require investment education. And most benefits attorneys posit no clear generic legal basis for a participant to sue the plan sponsor over such complaints as, “You never told me about risk and time. You never told me that if I invested solely in the stable asset fund, my account might look as if it was always growing—even though it was losing purchasing power.”

But how can participants make informed decisions—the goal of 404(c)—if the information distributed is incomplete, and thus potentially inaccurate and misleading? For example, lifestyle funds, which reflect different risk levels, strike us as potentially hazardous to both participants and fiduciaries. If the average participant knows little about investing, and receives no means to overcome this educational deficit, the answers to a “risk tolerance” questionnaire could reflect nothing other than ignorance, fear, and misperception.

Unfortunately the lines dividing what the sponsors or fiduciaries of self-directed retirement plans are legally obliged to do and what they should do as good employers are poorly defined. The issues involved in the selection of investment options and the participant investment education clearly demonstrate this.

In today’s climate of downsizing and reengineering, plan sponsors are holding the line on benefit costs, including how they embellish their 401(k) plans. The reasons for doing so are clear. But until the issues discussed above are resolved, plan trustees and their advisors would do well to recall the words of Thomas Paine: “A long habit of not thinking something wrong gives it the superficial appearance of being right.”