

# White Paper

## April 2006

### Risk Management in a Typical 401(k) Plan

#### **Background**

In 1980, a tiny new element of the retirement investment world was born under the not-new Internal Revenue Code Section 401(k). The IRS unexpectedly issued a favorable ruling in response to a request from a consulting firm regarding a pre-tax deferred pay plan. Presto. A whole new era for employee retirement programs began that was destined to re-make the entire retirement plan world (yes, the entire globe).

A hallmark design feature which is almost universal in 401(k) plans (but was not required, or even specified in the Internal Revenue Code) is typically the pass-through to employees of the right (and the responsibility) to select their own mixture of investment vehicles from a pre-approved list determined by the employer.

The 21<sup>st</sup> Century dawned in the US with the near-certainty that two important factors would drive the future of retirement income for retirees: (1) beginning about 2010-2015, some portion of promised benefits from the US Social Security System will be severely threatened and (2) 401(k)-style private retirement plans will carry most of the nation's retirement income burden, while (3) the traditional defined benefit pension programs that were popular until the late 20<sup>th</sup> Century will pass quietly into extinction in private industry, because of global competitive business forces.

#### **Employee investment involvement is serious business**

Unlike traditional defined benefit pension plans that promise monthly retirement pension payments for life, a 401(k) plan's benefit payout to a plan participant depends largely on the investment return within that employee's account. Cash contributions to the plan are important, but, over time, it's the investments that determine the outcome at retirement.

#### **Premise**

Many or most 401(k) plan participants are less than comfortable assessing their personal investment risk, particularly when a long-term, highly significant situation, such as planning their retirement income resources, is at stake. Consequently, participants are equally uncomfortable with allocating their plan accounts among what is often a large number of investment choices, despite literally massive information tools offered by employers to aid their employees through the maze of goal-setting, decision-making and investment selection.

#### **Rule of thumb**

The younger the plan participant is, the more complex the decisions will be. This, in turn produces a natural reluctance to deal with the issues.

#### **Predictable result** (of failure to assess risk tolerance and determine their investing goals):

When employees become overwhelmed and/or intimidated by the task of arranging for investment risk and return in their accounts, they typically "default" to an asset allocation that is predominantly, or completely short term, without regard to their current age. Younger employees who stand to gain the most by investing fairly aggressively in growth categories often wind up acting like the proverbial deer in the headlights, blinded by their discomfort with converting available information into a set of decisions that they fear might involve multiple, compound mistakes.

#### **Heart of the problem**

A significant characteristic of the information made available to plan participants is that, although well-intended, the investment materials are usually massive and at least somewhat complex. Much of employer-provided "investment education materials" often fail to

interact with employees sufficiently enough to lead them through a designed path that actually fits their circumstances and attitudes. [Some progress has been made. Until the late 1990s, most benefits lawyers routinely advised their clients to avoid anything that might be considered “investment advice.”]

### Unwinding the problem

While participants in most 401(k) plans do understand that their investment choices will likely have significant economic impact on a major phase of their future life, it has been our observation that the following obstacles plague a large portion of them:

- **Irrational fears:** Many plan participants just cannot shake off their fear of (short term) market value declines. And when that fear is linked with what they find to be an intimidating array of choices among investment vehicles, the result is often a very “conservative” selection....in fact, there is a pronounced tendency to allocate a large proportion to the “stable value fund” which promises to pay a reasonable rate of interest and, more significantly, to have no fluctuation in its market value.
- **Chasing recently hot investment returns:** Among all of the apparently built-in human investing tendencies, the most difficult to manage is the yen to join one’s friends and others who earned stellar returns last year in the XYZ growth fund. Indeed, we have seen cases where an employer offered such an exhaustive array of funds that, among them were stock market sector funds; predictably then, some employees moved money into one of them...following a calendar year return of, say, 40-50%.
- **Making decisions using annual, calendar year historical returns:** Despite a pronounced human tendency to view investments in annual terms, there is no logical or demonstrated reasoning to support measurement of market performance in 12-month packages that begin on January 1<sup>st</sup>. Investment market cycles are not similar in any way to the annual cycles of typical retail businesses. In brief, a stock or bond market cycle will almost certainly begin and end at arbitrary points on a calendar that spans several years.

### Some Do’s and Don’t’s

Our observations over many years lead us to the following advice (for employers):

- **Select each fund to provide a distinct role in the lineup.** The mission of a set of investment funds offered to participants under a retirement plan is to deliver the opportunity for them to create a high quality, diversified, long term investment program. Some, or many of them will predictably choose not to utilize the full diversification benefits being offered; others (often very young employees) will select short term investment vehicles. Such results represent the inherent shortcoming of participant-directed investments.
- **Carefully evaluate the risks before offering a company stock fund.** Long before the Enron 401(k) stock fund debacle in 2002, we advised clients to be especially careful in deciding to make a retirement investment vehicle out of their company’s stock. A significant retirement plan commitment to one’s own company stock carries acute, two-fold risks: (1) By definition, a company stock fund has no internal diversification (called concentration-risk) and (2) there is a double-jeopardy when the source of one’s job is also the primary source of his retirement income, i.e., potential job loss and dwindling retirement assets are hanging by the same thread. [At a minimum, sharply limit each employee’s freedom to load-up his allocation to company stock under the retirement plan.]
- **Limit the number of investment choices.** It is difficult enough to provide effective communications materials covering a limited set of investment funds. Gradually adding a few new ones from time to time is simple; reducing the number is not. Be prepared to resist pressure. In almost any size company, there will be a handful of invariably outspoken employees who demand more choices. Indeed, they may insist upon the addition of *specific* investment fund choices, without which, they will claim, the workforce is being short-changed. The way to deal with the “squeaky wheels” among plan participants is to offer a brokerage option, via which, this small number of employees can access a large universe of funds...but the plan’s sponsoring company need not incur the cost and clutter of preparing materials

which describe and track the funds in that universe.

- ***Deliver coherent, big-picture investment materials for employees' use.*** To repeat the mission: the funds being offered are each selected to play a particular role in a well diversified, long term retirement investment program. The materials which describe those funds for employees should therefore avoid spotlighting each fund as if it were a stand-alone vehicle. Instead, the materials should encourage employees to design a suitably broad allocation. [Exception: so-called "life-cycle," balanced funds.] In order to reach individually suitable decisions, we encourage the use of an on-line questionnaire tool that, depending on an employee's responses, will guide him/her to an appropriate allocation range.
  
- ***Monitor ongoing results; evaluate continued suitability of each fund to fulfill its intended role and act upon the findings, as appropriate.*** While this item is self-explanatory, it is also a key aspect that was targeted by the US Dept. of Labor, in a brief filed in the Enron lawsuit, naming the 401(k) plan committee and its individual members as defendants. The brief alleged repeated failings by the committee to act upon the emerging decline of the plan's asset value (Enron stock, in this case).