

February 1997

“Mr. Trustee, could you please turn to page 158 of your consultant’s report and tell the court how this ‘alpha’ number is derived?”

Baby boomers are aging, Social Security is becoming less secure, we are increasingly switching jobs and working for smaller companies without traditional “pension plans.” Employers want neither the burden nor the potential financial risk of promising specific annual pension benefits for their employees. The result is the rise of so called “defined contribution” plans (like 401(k) plans) in which the employer contributes money but no promise is made about investment results or ultimate benefits. Investments are overseen by trustees or made directly by the employees from a menu of choices. This is a huge shift of the burden for our retirement from our employers (and our government) to ourselves. More of us than ever are now investors, and the stakes involved are critical.

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To reduce future litigation risk, plan trustees often hire consultants to evaluate the plan. Some consultants advise the plan trustees generally based primarily on their experience, but without a detailed plan study. Others produce mountains of data filled with Greek letters and investment jargon (the source of our title) that is not understood by the trustees. We believe trustees of these plans should consider the following:

1. The litigation risks of your plan may be greater than you think. Defined contribution plans are created under the Employee Retirement Income Security Act of 1974 (“ERISA”). At the end of 1974, the Dow Jones Industrial Average was at about 600. In other words, the only experience of most retirement plans is one of the biggest bull markets in history. A huge percentage of money invested in these plans has been contributed since the last 10 percent market correction in 1990. Since then, the total return on the S&P 500 has averaged more than 18 percent annually, or about 80 percent better than the 70 year average. Plan procedures and the adequacy of the information provided to employees may be tested in court with elderly plaintiffs who lost the bulk of their retirement nest eggs after some future bear market. In that context, will having handed out fund prospectuses be deemed sufficient?

2. How far back does the data go showing the experience of different investment choices? Many plans have “models” that show sample returns for asset mixes going back maybe 15 years. In other words, those models only show what happens when the market is going up by a factor of six. In 1996 heavy rains in the Pacific Northwest caused flooding in many areas. There was much

discussion about whether this was a “30 year flood” (previously encountered in 1964) or a “100 year flood” (last encountered about the turn of the century). Having plan models dating back only 15 or 20 years is akin to building your house on a flood plain because there has been no recent flood. Your risk of being sued as a trustee primarily arises when the market goes down, a situation not captured by models that simply extrapolate the recent past.

Sometimes consultants tend to tell their clients what the client wants to hear, rather than what they need to hear

3. What are the incentives of your consultant? Many consultants receive trailing commissions or other payments from some of the funds recommended for retirement plans. Guess which funds get emphasized? Bad incentives don’t necessarily relate to hidden commissions -- sometimes they just involve telling the client what they want to hear rather than what they need to hear. A representative of an investment institution asked us how best to characterize the risk of a relatively new fund he was selling. We suggested showing the volatility of past returns for the assets in which the fund invested. Statistical measures tell us that about 5 percent of the time, large company stocks have lost more than 28 percent in a year and small company stocks have lost more than 51 percent in a year. “I can’t tell them that,” he replied, “that will scare them to death!”

4. Are you monitoring the choices of individual participants? Even if the fund choices offered are reasonable, participants may make mistakes. Fund investors consistently underperform the funds they invest in due to ill-advised market timing. But isn’t a jury faced with sympathetic retirees who lost most of their retirement money understandably going to try and find a way to help them? We believe trustees should at least consider the possibility of monitoring the investment allocations of participants against reasonable standards, and document giving more information to employees that fall outside of those standards.

Fiduciaries for pension plans should not be lulled into a sense of complacency by one of the biggest bull markets in history. The lack of volatility in the stock market in the last six years is unprecedented. The question is not whether your plan eventually will be tested in a bear market environment, but when. When that day comes, courts will place a premium on trustees who have clearly defined, well-documented procedures for creating fund categories, selecting funds, and monitoring participant allocations. Trustees should hire consultants who not only perform quality work, but are able to explain it in a manner you can understand.

For a copy of “Questions Every ERISA Plan Trustee Should Be Able To Answer,” contact us (info@sigmainvestment.com.)