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The Gathering Storm II – Of 401(k) Participant Performance, Safe Harbors, and Emperor’s Clothes

(This month’s newsletter is a continuation of an adaptation from a speech given by Bill Berg, Sigma’s president, at the April 16 Spring Seminar of the Western Pension & Benefits Conference in Portland, Oregon)

Imagine that you have an aging uncle and, at a family meeting, a decision is made that one of your cousins will take charge of the uncle’s financial affairs. You subsequently discover that your uncle signed an irrevocable contract for a decade’s worth of very expensive daily dance lessons. When you ask your cousin how this happened, he shows you a letter he drafted, signed by the uncle, absolving your cousin of responsibility for the uncle’s financial decisions. How would you feel about your cousin’s behavior?

There are the rules we know without being told, and the rules we don’t really know no matter how many times we’re told.

With respect to both care of family members and fiduciary duties in retirement plans under the Employment Retirement Income Security Act of 1974 (“ERISA”), it is important to focus on what is truly important, not legal formalism. There are two types of law: the common law, the set of rules passed down through history by religion and philosophy that everyone “knows” without being told; and statutory/regulatory law, rules invented by bureaucrats as expedient solutions to pressing problems that, like the tax code, are fuzzy to most people despite being written down and explained *ad nauseam*. ERISA contains both the common sense “prudent person” rule for fiduciaries and a set of regulations that may limit or even contradict the more general common law standard. Our hunch is that if these two types of law come into conflict, the common sense notions that are intuitive to most of us are likely to win out over the murky, hard to understand statutory/regulatory standards.

The conflict between the two types of law is clear with respect to fiduciary liability for the investment choices made by retirement plan participants (the employees). ERISA regulations set up a “safe harbor” under Section 404(c) to protect fiduciaries from this liability if certain standards are met. In theory, fiduciaries will be insulated from liability resulting from the investment choices of participants if: (1) participants are offered at least three different investment choices with different risk/reward characteristics; (2) they are given sufficient information to assess the investment options; and (3) certain disclosure and other requirements are met. Virtually every 401(k) plan we have seen that allows participants to select their own investments claims to be relying on (and complying with) these safe harbor provisions.

In practice, we do not believe the safe harbor is working in the way everyone thinks for three reasons. In the first place, ERISA attorneys will tell you that many plans are not in compliance with the technical provisions of the regulations. Second, the safe harbor only works within the purview of the law it is a part of, ERISA. Despite ERISA supposedly pre-empting other laws for retirement plan litigation, recent cases show that this will slow down smart plaintiff's lawyers for all of about five minutes. Fiduciaries will likely face liability under common law and various state laws where the "safe harbor" does not help.

Third, and perhaps most importantly, what is "sufficient" information for participants? "Sufficient" is a nice, vague term of the type that lawyers love. For example, say two of the mutual funds offered as investment options have different levels of revenue sharing (discussed in our April 2003 newsletter). The participants who invest in the fund with a higher kickback going to pay plan expenses are subsidizing participants who invest in the fund with a lower level of revenue sharing. If participants do not understand this, have they been given sufficient information? Few plans make such disclosure clear, but ERISA plaintiff attorneys will tell you that they believe this clearly violates the "safe harbor" provisions.

***The staggering pretense:
After an hour education session,
Joe on the loading dock is
qualified to determine his level of
emerging markets exposure.***

Even more significant, however, if participants have fallen far short of what they need in their retirement plans, was the information they received "sufficient?" A tremendous amount of lip service is paid in most 401(k) plans about the information and education participants receive. In practice, the education typically consists of handing out a few prospectuses and brochures and giving participants an Internet address to an education site that very few will ever access, much less use. Once or twice a year, a junior representative from one of the service providers will give participants an hour-long presentation. As a result of this "education," Joe on the loading dock and Brenda in the executive suite are suddenly supposedly capable of determining the appropriate exposure to emerging markets in their portfolios. The pretense involved in these "education" programs is staggering. It is a rare retirement plan fiduciary who does not brag about their plan's education, but the people who actually conduct the "education" sessions will likely tell you that it is a hopeless task.

Many plan fiduciaries focus almost exclusively on the performance of the investment options made available to participants. There is an obsessive concentration on mutual fund performance relative to peers, trailing return numbers and the like. The one number that really matters, however, how participants are actually doing, is invariably ignored. The operating assumption appears to be that if the investment choices are doing well, the participants are doing well.

We believe this is a terrible mistake. Based upon: (1) my own experience in the investment advisory business; (2) the retirement plans that Sigma has seen

as prospects; and (3) published numbers in various studies regarding investor performance, there is a large gap between investment performance and investor performance. In other words, the actual performance of investor portfolios falls substantially short of the performance of the instruments in which they invest.

How can this be so? The reason is that our brains are wired to make us naturally poor investors. Tell a stranger at a cocktail party that you know of a stock that just doubled, and you will find someone eager to know the name of the stock “with momentum.” Think how ridiculous this is – business fundamentals remaining the same, a stock that has just doubled is only half the value it was before the double. Ask somebody who works for a publicly traded company if they would buy their employer’s stock after it rapidly doubled, and the answer is no – they know too much about the company they work for. An ignorance of the business is required for the allure of a stock that doubled. If you told someone that the price of tuna fish just doubled, they would not race to the store because tuna has “momentum.” Our brains work correctly with tuna fish, but incorrectly with stocks.

There appears to be a nine percent annual headwind for investors, stemming from their behavior.

As a result, our emotions are seemingly always tugged the wrong way in investing. The longer the stock market goes up (and consequently values disappear), the more sure we are that it will continue to rise. The longer the market goes down (and consequently values increase), the more depressed we get, positive that investing in stocks is a bad idea. In the 17 years from 1984 through 2000, coinciding with the bulk of the biggest bull market in U.S. history, the average growth and income mutual fund had an average annual return of 14.4 percent. An ongoing study by Dalbar, Inc., a mutual fund research firm, estimates the return actually achieved by investors in equity mutual funds during that period to be 5.3 percent per year, less than the return from a money fund. In other words, there is an approximate nine percent annual headwind created by investor behavior.

How did investors give up almost two-thirds of the returns of the stock funds they invested in? By getting too excited and investing after the market had gone up, and getting too fearful and selling after the market had gone down. Other studies come up with different numbers, but the point isn’t to precisely calculate the behavioral headwind, but to see that it easily dwarfs in the long run the numbers the fiduciaries are focusing on – the performance differences between funds. We estimate that of the mutual funds in existence for the entire period of the Dalbar study, one that was in the bottom 15 percent of trailing performance would have an average return about two percent per year less than the average manager. An investor who stuck with this admittedly terrible fund would have done about seven percent *per year* better than the average stock fund investor.

Will the safe harbor work to protect fiduciaries from liability if the fiduciaries know, or are reckless not to have known, that the vast majority of participants are experiencing terrible investment returns for reasons separate from the quality of their investment options? If a majority of participant portfolios

have abysmal performance, is it likely the fiduciaries will be deemed to have provided “sufficient” information to participants? If fiduciaries are averting their eyes from the one number that would tell them whether they are doing their jobs, how the participants are actually doing, will they likely be seen as fulfilling their duties? Isn’t this like your attitude towards your cousin’s care of your uncle – if legal formalism is going to exempt a fiduciary from performing their most important task, what’s the point of having a fiduciary at all? To borrow a phrase from Abraham Lincoln in his debates with Stephen Douglas, the supposed fiduciary liability protection of the safe harbor is thinner than a “soup made from the shadow of a pigeon that has starved to death.”

The protection afforded by the safe harbor is thinner than a soup made from the shadow of a pigeon that starved to death.

If you have ever seen the movie *Eric the Viking*, and there is little reason you should, Eric mistakenly believes he has a charm that turns him invisible. He insanely directs his men to row up alongside a vastly superior enemy ship, activates the “charm” and dances around the enemy fighters, tweaking their noses and singing “I’m invisible, I’m invisible.” Fiduciaries ignoring participant performance are behaving with the same recklessness. As in the fable of the emperor’s clothes, they are living within an illusion. They are likely not complying with the technical provisions of the safe harbor. Even if they do, the safety only exists under one law among many under which they may be sued. The provisions contain vague terms that will be interpreted against the fiduciaries in a crisis. Given the likely performance of participants under 401(k) plans, a crisis is foreseeable.

When you analyze the broad, secular trends of the U.S. stock market over the past century, you can see long bull and bear markets that can be measured in decades. The Roaring ‘20s saw the culmination of a long bull market that ended in the Crash of 1929. The 1929 high was not surpassed until the 1950s in the middle of a long bull market from the depths of the Great Depression until the highs of the 1960s. The highs of early 1966 were not surpassed until late 1982. The troughs of the secular bear markets were in 1932 and 1974. The most significant legislation affecting the securities markets in the past century were the Securities Act of 1933 and ERISA, passed in 1974. Transforming legislation follows pain – it is no accident that landmark legislation coincided with bear market bottoms.

In the Securities Act of 1933, the standards set forth with respect to the duties of parties involved in a securities offering were not further defined by litigation until 1968, 35 years later. All the securities lawyers and accountants in the country spent 1968-69 attending continuing education seminars, finding out what they were supposed to have been doing for the previous three and a half decades. ERISA was passed 29 years ago, but the first 26 years of its life coincided with the biggest bull market in U.S. history. I do not believe ERISA fiduciaries should take much comfort in the paucity of litigation defining their duties – litigation follows pain, and pain has only recently begun to be inflicted on participants.

If we are now in the beginning of one of those bear markets measured in decades, my guess is that we will all know a lot more about fiduciary duties in 10 years than we do now. If the Dalbar numbers suggest the reality of how 401(k) participants are actually faring, what does this mean? The largest demographic group in the nation's history, the baby boomers, is about to start discovering that it cannot retire, or at least retire in the manner or timing expected. This suggests three possible outcomes: **(1) Meek Acceptance** – the baby boomers accept responsibility, decide it is their fault for not investing more wisely, and either work much longer than they thought or substantially reduce their lifestyle; **(2) Political Action** – the largest demographic group also represents the largest voting bloc, and the boomers decide to force less numerous younger voters to pay for their retirements; or **(3) Litigation** – the boomers decide it is not their fault, but rather the fault of flawed retirement plans, and sue the fiduciaries of their 401(k) plans.

*Will boomers accept responsibility
for their poverty in retirement?
That doesn't sound like us.*

In terms of avoiding conflict, the first is the most palatable – but probably the least likely. I am a member of the baby boom generation, the most self-indulgent generation in history, and I am sad to say that that kind of acceptance of responsibility just doesn't sound like us. The reality is probably most likely to be a combination of all three – diminished expectations and lifestyle, intergenerational political warfare and vastly increased ERISA litigation.

If I listen to my inner plaintiff's lawyer, I would love to point out the contrasts at a company that offers both a 401(k) plan and a traditional pension that provides a monthly benefit to retirees. In the traditional pension, if the plan investments do not work out, the company has to write a check to supplement the retirement fund. In the 401(k), bad investment performance by participants leads to poverty in retirement. To prevent having to write a check, the traditional pension sponsor hires actuaries to match plan liabilities with investment performance, to closely monitor how the plan is doing. In the 401(k) plan, nobody assesses participant performance and nobody ties participant accounts to likely retirement income needs, other than in the pretense called "education" engaged in by most plans.

I realize this flies in the face of what most people think of 401(k) plans, and I have to admit the best argument against what I say here is the equivalent of the old saying that nobody ever got fired for buying an IBM computer. Most plans are just doing what everyone else is doing, so how can they all be wrong? My reply is that the IBM computer referred to in the old saying was a mainframe, and plenty of people got fired for not adapting quickly enough to the new worlds of mini- and microcomputers. Even if you believe that participants will not blame, or not be able to blame, plan fiduciaries for their retirement portfolio performance, do you really want to bet the farm that way? I like to think of this bet in terms of the work of Blaise Pascal, the 17th century French mathematician. Pascal said that each of us is wittingly or unwittingly making a wager on the existence of a supreme being in the way we live our lives. Pascal suggested considering the risks of being wrong. A bet on the existence of a supreme being

risks the opportunity cost of the time spent in church, mosque or synagogue. If you bet on there not being a supreme being and are wrong, you suffer eternal damnation. The damnation resulting from a litigious baby boom generation may not be eternal, but it might seem that way.

***Why do we never hear
fiduciaries brag about how
the participants are doing?***

At Sigma, we are firm believers in the possibility of increased fiduciary liability. We have never heard a fiduciary brag about how his participants were actually doing. Usually, this is because they have no idea how the participants are doing. From what we've seen in these plans, we believe the Dalbar numbers, indicating an 8 or 9 percent annual shortfall, may have it about right.

We will only get involved in a 401(k) plan where participants select their own investments if the primary investment choice for participants is some kind of "life cycle" option. The asset allocations are pre-selected, and participants just choose how aggressive or conservative they want to be. This approach focuses on asset allocation, which investment theory tells us is vastly more important than the security selection or market timing most people cannot resist. It eliminates the pretense of education programs, where the participant has to be made into an investment genius for their retirements to work. We only ask the participants questions they are qualified to answer (i.e. how old are you, and what allows you to sleep at night?). We are not so arrogant as to think this is the only answer to the issues I've raised, but to date it is the only one we're comfortable with, thinking about our own potential liability and personal ethics. Most participants love not having to be investment geniuses to make their retirement plans succeed. Sometimes we are asked if our approach isn't a little paternalistic, to which we answer "Yes!". We are fiduciaries. Being paternalistic is what fiduciaries are supposed to do. You can look it up.

The ultimate objective of a 401(k) plan is to allow participants to provide themselves with a retirement income, not to minimize liability for fiduciaries. The paradox is that by focusing on the illusory safe harbor provisions in the law and ignoring participant performance, fiduciaries are harming the ultimate objective of the plan while increasing their potential liability. If they would go back to basics, think like a fiduciary, run the plan for the benefit of participants and pretend the supposed safe harbor did not exist, they would help both plan participants and themselves. The better participants do, the less liability will exist for fiduciaries and the better the 401(k) system will work.