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## The Paradox of Performance III: the Truth is No Coward

As investors, we desire investment performance, but we tend to misperceive and misuse performance reporting. This misperception and misuse is not trivial – investors are diverted from a rational investment process and are much less likely to achieve their retirement or other goals. This tendency is particularly prevalent in a critical area – 401(k) retirement plans. We cannot change human nature, but retirement plan fiduciaries and participants can help control its destructive aspects by a proper focus on critical but usually ignored information – not investment performance, but participant performance. This is the true measure of a retirement plan – why are plan fiduciaries afraid of the truth?

With respect to performance, investors make two seemingly contradictory mistakes. The first mistake is that they chase performance reported by mutual funds and other investment managers, investing in whatever has done well recently, blindly assuming that past superior performance will be repeated in the future – and most often, it is not. The second mistake is that they do not calculate, or do not pay attention to, their own performance numbers – how their overall portfolio is actually doing. We can see this in the stock brokerage world, where very few customers know how their accounts are doing, and the brokers have no incentive to tell them. The second mistake enables the first mistake – if people knew how dismal their results were from the losing strategy of chasing performance, they would be forced to at least consider switching to a better strategy. By ignoring their own performance (and the attendant risk to their self-esteem), however, they continue in their folly.

Most large 401(k) plans allow participants to select from among a palette of manager choices – international, small company, growth stocks, etc. The first performance mistake – chasing performance – is committed by both plan fiduciaries and plan participants. Plan fiduciaries make the choices of which investments will be offered to

participants. If they decide to add a new fund to the plan, nine times out of ten, they will choose the available alternative with the best trailing performance (e.g., in 1999, the most tech-laden manager). The participants, in turn, tend to push their money towards the investment choice with the best trailing performance. In 1999, the performance numbers of that tech-laden growth fund looked awfully alluring compared to the more sedate trailing performance of bond funds, value managers, international investments and the like. So the mistake of chasing performance is doubled, occurring at both the fiduciary level and the participant level.

As bad as this is, however, it pales in comparison to both fiduciaries and participants committing the second mistake – not paying attention to the performance of participants. At Sigma, we are

***“There is never a duel with the truth. The truth always wins and we are not afraid of it. The truth is no coward.”  
– Dudley Field Malone***

consultants to 401(k) plans. It is exceedingly rare that plan fiduciaries are able to tell us how their participants are doing. They tend to know performance of the individual choices offered to investment participants. They tend to speak with pride of the “education” they offer to participants (glossy brochures and an annual presentation on the condition of the “market” by a representative of the investment consultant). But they

have little notion of the critical information that would allow them to assess the quality of plan education specifically and the retirement plan generally – how the participant portfolios are actually faring. The goal of 401(k) plans is to provide for the quality of retirement living for participants, not to have highly regarded mutual funds as investment options or to have admirable brochures to distribute at the enrollment meetings. We cannot know if the real goal is being achieved without knowing how participants are doing.

Based upon our experience of analyzing participant returns, we believe most plan fiduciaries and participants would be dismayed or even horrified at the performance of participant accounts. Fiduciaries are not being mendacious in not assessing participant performance – our impression is that the thought has just never occurred to them. The liability of plan fiduciaries for this failure may be in doubt, left for the courts to determine sometime in the future. If the participant performance shortfall exists, however, the diminished quality of life of participants in their retirements is not in doubt. The truth will be known eventually.

Most employers are paternalistic on matters far less important than the retirement of their employees. Isn't it time that we progressed towards a more modern appreciation of how to design a 401(k) plan? Isn't it time that we took the simple step of looking at the fact of how participant portfolios are performing, of the efficiency of the plan in meeting its goal – of the truth? If you are a plan participant, we suggest you demand from your plan a way of estimating your individual account performance. If you are a plan fiduciary, we suggest you find a way to calculate the performance of plan participants, at least in aggregate. There are effective ways to combat the misperception and misuse performance mistakes – if you know the truth. We can help. Call us at (503) 419-3938 or check us on the web at [www.sigmainvestment.com](http://www.sigmainvestment.com).