The Silent Scandal: 401(k)s and the Failure of Responsibility

by Robert Markman

Corporate sponsors, pension consultants, investment companies and the media labor mightily to respond aggressively to the needs and concerns of five percent of the investing public. Meanwhile, the other 95 percent suffer from benign neglect. An enormous legal and fiscal crisis looms ahead. Can we disenthrall ourselves from the myth of self-reliance long enough to change course before we run aground?

Where We Are and How We Got There

One of the more significant developments in the past 10 to 15 years has been the steady shifting of corporate retirement investing away from defined benefit plans and toward defined contribution models. By 1998, 401(k)s have grown to represent the average American's largest single pool of investment dollars. By the year 2000, it is estimated that employees will be managing $1 trillion of their own retirement money. The size of this pool of constantly growing dollars-and the uses to which it is put-have enormous implications for the financial markets and the larger economy. Accordingly, an enormous amount of energy and resources are being expended to make 401(k)s "work" for participants. Nowhere is this more evident than in the explosion of choices within 401(k) plans.

As recently as a decade ago, the typical plan had but three or four choices-one of which was often company stock! Hardly the stuff from which a long-term investment program could be constructed. But how things have changed. Today, we regularly read of plans that have expanded their menu of choices to literally hundreds of mutual funds. Indeed, so intense is the "rush to choice" that now many plans allow participants to open brokerage accounts where they can speculate on stocks and funds daily!

These changes have been met with universal approval. But like many other universally accepted pieces of conventional wisdom, the "more is better" approach to 401(k) options is folly, not wisdom. It is misguided, ill-thought-out and, like other manias, will end badly. The support for this view is grounded in three simple realities, realities of which most observers are in complete denial.

Reality #1

Most investors cannot or will not manage their own portfolios. Adding more choices does nothing to change this and probably only makes things worse. Adding more choices to a 401(k) seems absurd when nearly every quantitative study confirms the fact that many plan participants are woefully ignorant of even basic investment fundamentals.

For example, a 1997 John Hancock study reported that 50 percent of respondents thought money market funds invested in stocks and bonds; 40 percent didn't know that a balanced fund contained stocks and bonds; only 25 percent knew what happens to bond funds when there is a move in interest rates. Even more amazing, 74 percent of investors recently polled in an American Century Investments survey failed to answer six or more basic IRA questions correctly. In fact, the number of investors answering six or more questions correctly was down 12 percent from the year before.

The reality is, the combined circulation of *Barron's*, *The Wall Street Journal, Smart Money, Worth, Kiplinger's, Investor's Business Daily*, and *Morningstar* is well under five million. While estimates vary, we can assume the number of adult investors with steadily growing stakes is somewhere north of 60 million. You do the math; the percentage of investors actually engaged in the process is very low. Those engaged are intelligent, vocal and demanding. Perhaps that's why we believe their numbers to be greater. In other words, the media is delivering rousing and inspiring sermons...to the choir! The rest of the world, meanwhile, remains heathen.

"Aha!" the industry exclaims, "that's where education comes in! We will teach these poor souls how to fish so they can eat from the bounty of their 401(k) for their whole lives!" And so we arrive at reality #2.

Reality #2

Calls for "more" and "better" education are the mutual fund industry's version of President Johnson's "War on Poverty." Enormous resources have been and will be expended. The goal is so noble, so self-evidently positive, that we are willing to ignore the fact that there is little evidence that force-fed information translates into substantially better results for most investors.

For several years now, there has been an ongoing, aggressive push for investor education. The result? Workers feel less equipped to make investment decisions now than they did three years ago! A 1997 Merrill Lynch survey revealed that only 50 percent feel knowledgeable versus 67 percent in 1994. Recall also the previously mentioned American Century survey in which the results were lower than the year before.

This is not mere bashing of the unlettered consumer. One does not have to look far to find other remarkable examples of the disconnect between education and real life results. If there were ever a company in America that could pose as the poster child for an enlightened 401(k) plan with engaged and well-educated participants, it would be Morningstar. Morningstar enjoys a well-deserved reputation for cutting-edge, in-depth research and analysis of mutual funds. It would be well nigh impossible to find another 401(k) plan whose participants are able to be better informed about funds, asset classes and asset allocations. That's what makes the February 17, 1998 article "Telescoping in on Morningstar's 401(k)," published on *Morningstar Net*, so surprising and revealing. The article took a candid look at some strategic decisions, results and dilemmas experienced by Morningstar plan participants after a wild 1997. A fair and careful reading clearly shows that even Morningstar employees are subject to some of the same errors we see in other plans: among them, a little bit of performance chasing and letting allocations grow disproportionately out of alignment. The two most popular funds in the plan were Brandywine (up 12 percent for the year) and PBHG Growth (down 3.3 percent for the year). Additionally, some 20 percent of Morningstar employee dollars were allocated to three international funds, which also collectively managed to lose substantial amounts in 1997. One could be excused for concluding that from both an absolute or risk-adjusted basis, even in the belly of the information beast, many participants might have been better off in alternative strategies, some of which we will soon address.

This is not meant as an ad hominem attack on Morningstar employees. The point is, if Morningstar, with arguably the best investment-educated work force

in America, can stumble, what is the hope for education programs to transform the results of less informed and motivated workers?

Efforts to educate can and do create some positive results. We also must not deny that it is the moral responsibility of employers and fund companies to work harder in this arena. But let's not kid ourselves: real skills improvement occurs only at the margins. Simply making education available-or even mandatory-will no more create legions of Peter Lynches than our state education systems will produce thousands of Einsteins.

Reality #3

Survey after survey confirms that the shortage Americans feel most is not information, not education, but time! *Barron's* recently reported research that says "an astounding 44 percent confessed that, given the choice, they'd rather have more free time than money." (We doubt that they meant more free time to read *Barron's*.) The "lack of time/unwillingness to take the time" syndrome is the ultimate trump card in the whole equation. All efforts to empower, educate and expand choice ultimately fail when confronted with this reality.

The bottom line is that current moves to expand participant choice and educate investors is the financial equivalent of rearranging the deck chairs on the Titanic.

Myth of Bull Market Returns

One might ask, if the situation is as flawed as we've laid out, why isn't there more concern raised about this issue? The answer lies in a common misperception about mutual fund returns. Even sophisticated fund investors frequently miss the fact that the return achieved by a fund is often far different from the return achieved by the investors in that fund.

The Boston market research firm Dalbar found that between 1984 and 1995 the average stock fund posted a yearly return of 12.3 percent, while the average investor in those funds made just 6.3 percent. Similarly, another study showed that during the period January 1, 1991, through October 31, 1995, the 20th Century Ultra fund posted an official return of 26.5 percent. The average shareholder over that period, however, earned only 16.0 percent!

Numerous other examples abound that illustrate the same phenomenon: due to errors in the timing of purchases and sales, most investors do not reap the reward one would expect from their allocations. We call this phenomenon "wastage." Thus, industry analysts, looking at snapshots of 401(k) allocations at various points in time, assume (incorrectly) that participants have held those funds for the entire period being studied.

Of course, a bull market is a wonderful balm. Most 401(k) participants, seeing a 15 percent return, are unlikely to cry foul. But if they've taken risk and the market has made 30 percent, we can be assured that all is not well. What can we expect when market returns become more normalized, as they must over the long term? The effects of wastage will then be devastating.

Consequences of Flawed Current Model

The long-term consequences of requiring an unqualified and unwilling person to act as their "chief investment officer" should be obvious. The net real-life effect will be lower dollar accumulations, over time, in the individual's plan. This will be the result of three events that inevitably flow from ignorance and disinterest:

1. Fewer dollars will be contributed. Studies consistently show that the less one knows, the less confident one is, the less one contributes. This is not rocket science: fewer dollars in, fewer dollars out.
2. Allocations will be too conservative. When long-term retirement savings get channeled to money market and fixed return options in lieu of equities, the ultimate consequence is less accumulation over time.
3. Even skilled and veteran investors know how easy it is to clutch defeat from the jaws of victory. We all know how unforgiving the market can be to those who succumb to market timing, performance chasing and other common frailties that seem hardwired into our brains.

The New York Times, reporting on this phenomenon, sounded a warning back in 1994: "The result, some say, is a crisis in the making. As corporate paternalism is replaced by employee self-reliance, millions of Americans could be left with insufficient retirement savings." In that same report, former SEC commissioner Carter Beese, Jr. concurred: "For many retirees, the money won't be there and this will affect most Americans' standard of living."

Beese further predicted that if employees can't afford to retire, businesses will bear the burden, either through lawsuits or through pressure to retain older employees past retirement age. "I believe this is a ticking time bomb for corporations across the country," he stated.

We might add that the scope of this potential shortfall is great enough across the middle class that it ultimately will be an issue the federal government will be called in to resolve. The monetary consequences of such an event would be disastrous to the economy.

Solutions

Is there any way out of this box we seem hell-bent on constructing? Can we change course and avoid the iceberg? Yes, there are solutions-solutions that are cost effective, easy to implement and proven to work. But they must be implemented soon.

Solution: The Managed Option

Rather than attempt to graft skills, resources and time onto unwilling or unable participants, why not simply deliver skills, resources and time to participants in a prepackaged form? A proper 401(k) model will include a range of managed options. These are choices that enable participants to make one simple decision and then receive the benefit of intelligent diversification and professional management.

There is a class of packaged mutual fund investments that hold great potential in this arena. They are commonly known as lifecycle funds or multifunds. These mutual funds invest in other mutual funds to construct broadly diversified portfolios managed on an ongoing basis by skilled professionals. What

these vehicles do is enable participants to meld the more traditional "paternalistic" defined-benefit investment dynamic onto the new "individualistic" defined-contribution model.

Lifecycle Solution

Lifecycle funds take an approach in which the composition of the managed portfolio is keyed to the length of an investor's time frame. The best-known example is the Fidelity Freedom Fund Series. This group invests in other Fidelity funds and consists of portfolios targeted for the years 2000, 2010, 2020 and 2030. The shorter the time frame, the more cautiously allocated is the portfolio. The longer-term portfolios contain larger, more aggressive equity positions. The portfolios are managed to slowly but steadily change over time to reflect the period remaining until retirement. The theory here is that you match your time until retirement with the appropriate fund and let the managers safely bring you into port.

Multifund Solution

The more traditional and widely accepted multifund approach creates portfolios that relate to risk/reward dynamics rather than time frames. Groups that take this approach usually offer a conservative, moderate and aggressive (or growth) allocation. The managers create complete, diversified portfolios of stock, bond and money market funds that adhere to carefully spelled out risk/reward disciplines.

Participants are relieved of the responsibility and burden of acting as their own investment manager. They are no longer forced to make decisions they are not qualified to make. They are, however, put in a position to make a single, simple decision that they are undoubtedly qualified to make: how much risk do they want to take?

'In-House' Multifund Option

The large multifund group offers a much wider range of sponsor options than the lifecycle group. These sponsors can be broken down into two major subcategories: in-house and independent. The in-house category consists of multifunds that construct portfolios using funds from a single fund complex. Well-known examples are the Vanguard Life Strategy Funds, T. Rowe Price Spectrum Funds and the Scudder Pathway Series. The greatest attraction of in-house multifunds is cost. Many in-house multifunds charge no additional fees to "package" their funds together. The opportunity to receive professionally designed diversification monitored regularly at no cost is likely to be a vast improvement for most 401(k) participants.

'Independent' Multifund Option

These funds do not limit their selection of investments to any one fund group. They attempt to select what they consider to be the "best" choices from the larger universe of thousands of mutual funds. Some better-known examples of multifunds in this category are the Schwab One Source Portfolios, Kobren Insight Funds and the Markman MultiFunds.

Independent multifunds tend to be more actively managed than in-house funds and are more likely to engage in proactive tactical asset allocation strategies. Unlike in-house multifunds, independent multifunds do not receive fee income from the underlying funds used to construct the portfolio. Accordingly, they do charge a fee to construct and manage the portfolio. The more competitive independent multifunds have expense ratios of 0.5 percent to 1.0 percent.

The data clearly indicates that multifund options offer the very real potential to boost investor returns in the context of a prudent long-term investment approach. And why should anyone be surprised at this outcome? Who is likely to produce the best portfolio: an unlettered and unmotivated office worker or the investment team at Vanguard? Will an inexperienced investor choosing from a limited fund menu likely beat the returns over time of fund veterans whose teams have the luxury of seeking values across the entire fund universe?

Consultants Share the Blame

Investment consultants must shoulder much of the blame for the minimal penetration of multifunds in 401(k)s. Sloppy, uninformed analysis often leads them to compare multifunds to other individual funds. For example, they will look at the returns of Vanguard Life Strategy Growth Fund for the past three years, compare it with one of the growth funds they have selected for the 401(k) menu, and conclude that Vanguard offers nothing special. The essential point often missed in this exercise is that Vanguard Life Strategy Growth is a complete portfolio, while the individual growth fund is but one element in a complete portfolio. Any apples-to-oranges comparison like this will inevitably lead to faulty conclusions.

Plan sponsors should demand that consultants perform a dollar-weighted analysis of participants' allocations and returns to determine what actual results are being created from the existing structure. Those actual results should then be compared with returns that various multifunds would have produced in comparable periods. We suspect that this approach would go much further toward justifying many consultants' fees than their current activities, which often consist of little more than acting as supervisor for the aforementioned Titanic deck chair exercise.

We also challenge the current practice of providing "models" based on risk/reward characteristics. Often a plan sponsor will bring in a consultant or financial planner who will advise participants on which funds to select from the current menu to achieve various potential outcomes. The prudent plan trustee often fails to appropriately assess such consultants' or financial planners' investment qualifications.

What kind of advice have they produced in the past? Is there any history or record to look at to determine the competence of the advice? The greatest flaw in this model comes from the fact that even assuming fantastic allocation advice at the outset, the burden remains on the participant to stay engaged and make adjustments over time. The reality, though, is that, after the initial excitement fades, the program too often gets put on auto pilot; that once great allocation, left alone, could spell trouble in years ahead.

Social Security Connection

We have recently entered a new phase of the seemingly permanent Social Security debate. For the first time, some degree of privatization seems to be a

realistic political possibility. This has sparked discussion and analysis that are particularly illuminating in light of what we've previously noted here about 401(k)s.

Fear of privatization generally centers on concern over what the long-term consequences would be for the inexperienced and uninformed investor. And, as we've seen, that concern is more than justified. No one expects the guy on the loading dock to make investment decisions on a level with the folks in the executive suite. Yet this is exactly what the current 401(k) model demands.

We must never lose sight of the reality that financial markets make no distinction between a pot of dollars earmarked "my privatized Social Security account" and the pot of dollars labeled "my 401(k) account." So if we are rightfully concerned about the safety of one, shouldn't we be equally concerned about the other?

And if those concerns lead us to pursue Social Security privatization models that offer some investment structure and protection for workers, should we not shine a similar light on 401(k)s?

Burdensome New Mandate?-Wrong!

We recognize that any call for new government intervention in the affairs of private business is likely to be met with significant resistance in many quarters. As small business people ourselves, we are sympathetic to that view: we've personally experienced how a simple stroke of the pen in D.C. can result in an inefficient and costly burden in the heartland.

In that light, it is vitally important to recognize that our proposal to require inclusion of a managed choice in all 401(k)s will, most often, add absolutely no additional cost or administrative burden.

Managed multifunds like those we've discussed are simply no-load mutual funds. Thus, the fulfillment of a requirement to offer a range of managed options could be completed by merely adding three funds to an existing menu. Once we get beyond the initial anti-mandate reaction, the reality becomes clear:

This is a rare opportunity to make a real and lasting quantitative improvement in workers' lives at little or no cost. The question is not why, but why not?

It should be crystal clear to any informed observer that there are large holes in current fiduciary reasoning through which one could drive a truck full of lawsuits. Priority number one for both consultants and corporate fiduciaries should shift from the mad scramble to add "more of the same" to ensuring that there are available options that have proper diversification and risk control built in.

The first investment element of every plan-yes, every plan-should be a series of multifund options. Protect those least able to protect themselves. Then, and only then, should well-thought-out menus and self-directed brokerage accounts be added.

Do not be misled by participant silence on this issue. Those most in need are mute. They do not possess the vocabulary to give voice to these issues. As always, the "squeaky wheel" (informed, aggressive plan participants) gets the grease. Let us not neglect the silent problems (the "o-rings," if you will) that, if ignored, would cause disaster down the road.

The problem is clear. The solution is obvious. Denial and delay will only serve to exacerbate the negative repercussions of a currently flawed system.

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Editor's Note: This opinion piece was adapted from a longer article by Robert Markman.