Dumb and Dumber: Individual Investment Choice in DC Plans

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Tons of independent research provides more than sufficient evidence to prove that giving investment choice to plan members in tax-assisted DC pension plans is risky from a legal perspective and even riskier from a financial performance perspective. Yet most sponsors do it. Why?

In Canada, some have said it's necessary to give members investment choice to comply with guidelines issued by the Joint Forum of Financial Market Regulators in 2004. But the very first section of those guidelines makes it crystal clear; they don't apply if no choice is given. Accordingly, if an employer doesn't provide any options, the employer relieves itself of having to comply with many of the responsibilities identified in the guideline, especially many of the suggestions relating to communication, education, process and documentation.

From a legal perspective, offering investment choice means an exponential expansion of legal risk. Recent U.S. headlines warn "Employers Beware of a Tsunami of 401(k) lawsuits" or "401(k) Litigation; the 'Next Asbestos'?" And while there has not been the volume of DC plan litigation in Canada that has occurred in the U.S., and while much of the litigation in Canada has centered around conversion of DB to DC, I know our firm has been involved in settling or resolving several cases relating to fees and expenses, faulty communications, breach of fiduciary duty and less than predicted investment performance.

If an employer does not provide investment choice, legal risk is limited to managing one pool of assets prudently. Obviously, not providing investment choice still requires periodic review of the investment program, but employers who don't give choice won't have the same volume of review, since they won't have multiple funds, multiple managers, multiple risk offerings and tolerances, expanded communications and educational issues to contend with. This does not mean putting everyone in a passive balanced fund – although that could be one effective way to do it. It could also mean more active management, just as one would manage a DB fund. So this could mean performing an actuarial review to identify relevant demographics and develop a factor-optimized investment policy to address the risk profile of the group as whole – whether passive, active or otherwise.

As for concerns that a single fund may not be the optimal mix for each individual in the group, in most cases there will be plenty of room for individuals to balance things out in their own personal plans and their other savings. This is because on average, combined employer and employee contributions to tax assisted DC plans are about 1/4 of the available tax-assisted contribution room.

Fees are a very significant legal risk. For instance, last year, Lockheed Martin Corp. agreed to the largest-ever retirement plan settlement, $62 million, over claims the company invested more than 180,000 employees' 401(k) savings in overly costly funds. By not giving investment choice employers can eliminate multiple sources of cost as well as the risk of class actions relating to costs, as well as communications, investment disclosure, counselling and education. By not giving individual investment choice, the governance structure and oversight can be focused exclusively on net performance and financial risk management. No choice means eliminating the much wider array of legal risks that arise when choice is offered.

If choice is dumb from a legal perspective, it's even dumber from a financial perspective.

It is well-documented that both DC participants and their investment advisors are not very good at investing by comparison with DB plans. Most investment advisors can't even achieve for themselves the rates of return realized in an average DB plan, let alone doing it for their clients. An interesting Canadian study indicates that participant-directed investment arrangements result in the portion of the final benefit coming from investment returns dropping from 75% in a typical DB arrangement to 45% in a DC plan. By eliminating investment choice, DC plans should be able to reduce that differential and get closer to DB proportions. They should also be able to dial back the many added costs associated with managing many individual accounts and the information and education costs that go along with providing choice and put a significant drag on net investment performance.

Behavioural finance recommends simplifying DC plans and limiting investment choices. What could be simpler than providing no investment choice at all?

No doubt a high degree of participant investment choice makes DC plans very attractive in accommodating individual desires, decisions and control. Nonetheless the vast majority of participants are in the default fund; 92% according to a recent survey conducted by the UK pension regulator.

Those who aren't in default funds, don't always follow expert advice, don't monitor fund performance on a periodic basis, and most participants certainly don't have properly balanced portfolios. For example one U.S. study found that more than 50% of DC plan members had either no funds invested in stocks – exposing them to very low investment returns – or had almost all assets allocated to stocks, making for a much more volatile portfolio. Anecdotally, I am aware of many members invested in fixed income who think they are being conservative. They have no clue that the value of their holdings could tank if interest rates go up![1]

One solution may be improvements in participant education. But ultimately being good at retirement savings requires discipline, goal setting, and an ability to appreciate or estimate, uncertainties such as lifetime earnings, asset returns, health status and longevity. In other words, it requires expertise. As one researcher put it, "No one would imagine that you or I could perform surgery to remove our own appendix after reading an explanation in a brochure published by a surgical equipment company. Yet, we seem to expect people to choose an appropriate mix of stocks, bonds and cash after reading a brochure published by an investment company. Some people are likely to make serious mistakes.

A better solution for employers offering DC plans is to get rid of individual investment choice and adopt the pooled investment approach inherent in DB plans. There is evidence in many jurisdictions that larger funds and pooling results in lower charges, improved governance, and better access to alternative asset classes, such as infrastructure. One UK study suggests that pooling could boost individual retirement savings by 62%.

It is no secret that DB plans are too risky for most private sector employers due to cost volatility and financial reporting requirements; but it is a well-established fact that DB plans provide

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retirement income on a much more cost efficient basis than DC Plans. Independent research indicates it costs about 48% more to provide the same $1 of pension income under the average DC plan than under a DB plan. So the issue is how can an employer take the best features of DB plans – namely, lower legal risk and better investment returns – while simultaneously avoiding the financial risk associated with DB funding and financial reporting?

The added cost in DC plans can be directly related to lack of scale, individual account management and moving from equities to fixed income as members near retirement. Take away investment choice and employers can deal with one large fund, not many small pots. Take away all the drags associated with fees and costs inherent in managing individual pots, including lack of scale, education and communication, and the savings have a material impact on total accumulations. Paying 1% extra in fees over a 40 year savings period can eat up almost 25% of total savings. And stop moving to fixed income as individuals approach retirement. Don't do this and employers might add 10% more to a participant's total savings.

The bottom-line: there is substantially reduced legal risk and substantially increased financial opportunity if employers do not provide individual investment choice in DC plans. To provide more satisfactory results, DC plans need to take the best features of DB plans – lower legal risk and better investment returns – while simultaneously avoiding the financial risk associated with DB funding and financial reporting requirements. One smart way to start getting there with DC plans is to eliminate individual plan member investment choice and move to an administrator-directed investment platform.

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