

Selecting Your 401(k) Investments

Chapter Eight

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I was recently asked during a media interview if participants should continue to be allowed to decide how to invest their 401(k) contributions. This question surfaces every time the stock market takes a serious dip. I told this writer that participants won't tolerate giving investment control back to employers.

There are several reasons why it doesn't make sense for employers to decide how employees should invest their 401(k) money:

- Some presume that the employer will do a better job of selecting investments than employees. Over 90% of existing 401(k) plans cover less than 100 employees. The "plan sponsors" at these companies are generally the owners who have their minds on growing a business. And with few exceptions, they don't have any more investment expertise than the average participant. I've seen some of the worst investment results at plans where the employer controlled the investments.
- The typical 401(k) plan includes new entrants into the work place who are just starting to invest and those who are over age 60 with substantial account balances. A common set of investment options for all employees ignores the fact that participants have widely diverse investment needs.
- If employers take control, they would have to assume full responsibility and liability for the results. The fact is that employers don't want this responsibility. As I've said before,

why should employers be liable for how employees invest their own retirement savings?

I'm convinced that employees will continue to be responsible for investing their 401(k) contributions. This is not to say, however, that there isn't room for 401(k) participants to do a better job. Employee responsibility for investing has several major flaws:

- We have attempted to convert millions of amateurs into professional investment managers through limited education.
- Participants haven't been given access to professional investment advisors.
- The investment alternatives in most plans are inadequate.

On the education front, employers and service providers have indeed made extensive efforts in recent years. They all have good intentions, but the education has been woefully inadequate. First of all, it's unrealistic to assume that any amount of education will turn the majority of participants into successful investors. One of the problems is that participants don't have the time or inclination to really become students of investing.

The other problem is that those who need the most education are the least likely to take an active approach to learning. It's a common dilemma. At The Johnson Companies, we used to encourage our clients to provide voluntary on-site wellness training for their employees to help reduce health care costs. We soon discovered employees who were already health conscious attended, but those who smoked three packs a day and had Twinkies and coffee for breakfast usually didn't attend.

How did we get into this mess?

In 1992, in response to pressure from employers, service providers and industry trade groups, the Department of Labor issued final regulations that would provide fiduciary relief to employers when investment authority is given to participants. These voluntary regulations under Section 404(c) of ERISA explain how employers

should structure the investment options for their plans in order to reduce their liability. Employers that want the protection these regulations offer must provide adequate information to participants so that they can make informed investment decisions.

The Ongoing Education vs. Advice Debate

The 404(c) educational requirement created a new problem for both employers and service providers. An individual or organization that gives specific investment advice is considered a fiduciary under ERISA, and a fiduciary is fully responsible and liable for its actions. As a result, both service providers and employers pushed the DOL for further guidance because they didn't want to become fiduciaries. They were concerned that by providing the information required for 404(c) compliance, they could unknowingly cross the line from education to advice. The result would be to increase rather than decrease their responsibility and liability.

In 1996 the DOL responded to employer and service provider concerns by issuing an interpretive bulletin (I.B. 96-1) that explained how far employers and service providers could go before they crossed the line from education to advice. The bulletin provided the additional guidance employers and service providers wanted, but it also created the perception that it is illegal to give investment advice to 401(k) participants.

This guidance from the DOL provided the framework for employers and service providers to give participants sufficient information to become competent investors. The problem is that many participants really want someone to tell them how to invest—rather than information on how to do it themselves.

Drake Mosier founded a company that is now called mPower to provide investment advice to 401(k) participants. He approached me shortly

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after he founded the company and asked me to serve on his board. I'm often approached by individuals who think they have a great, new 401(k)-related idea. It's not always the case, and I'm not always interested. But I thought Drake's idea had merit. His goal was to provide the type of help to 401(k) participants that has historically been provided only to high net worth individuals and institutional investors.

Drake's dream was to make advice available to all participants at a cost of \$10 to \$30 per year. Drake and I agreed that attempting to solve the 401(k) investment problem by educating participants could not succeed. We were thinking along the same lines, so I joined mPower's Board and served until May, 2001.

During the early stages of helping mPower launch its business, I was instrumental in getting Olena Berg, the former Assistant Secretary of the DOL, to clearly state in an interview that investment advice is indeed legal. She also pointed out that the DOL actually wants participants to receive advice if it is done properly. Olena's interview clarified the situation, but another barrier to investment advice still remains. Many employers are reluctant to offer investment advice to their participants because they think they could be sued by unhappy participants down the road. This attitude is unfortunate because, in my opin-

ion, letting employees invest their money without this support is a lot riskier.

My investment knowledge is probably higher than most 401(k) participants, but I wouldn't pick my own funds without professional help. Frankly, the more I know about investing, the more I realize how ill prepared I am to pick funds totally on my own.

Like the majority of participants, I also don't have the time to evaluate various funds and investment alternatives. My involvement with mPower and other investment advisors has helped me appreciate the value of an investment advisor.

My first exposure to this type of service was when I was a board member of a seminary. We used an investment consultant to help us evaluate, pick and monitor fund managers. Unfortunately, most individuals base their investment decisions solely on past performance and/or input from relatives, friends, co-workers, etc. There are many things to consider other than a fund's investment track record, and you can't always rely on the advice of non-professionals. Participants from the mailroom to the boardroom need advice—and it needs to be delivered by a professional investment advisor.

The addition of investment advice to the 401(k) market has been a slow process, just like

Sample Time Horizon and Risk Tolerance Choices for Option 1

2010	2015	2020	2025
<input type="checkbox"/> Aggressive Portfolio	<input type="checkbox"/> Aggressive Portfolio	<input type="checkbox"/> Aggressive Portfolio	<input type="checkbox"/> Aggressive Portfolio
<input type="checkbox"/> Moderate Portfolio	<input type="checkbox"/> Moderate Portfolio	<input type="checkbox"/> Moderate Portfolio	<input type="checkbox"/> Moderate Portfolio
<input type="checkbox"/> Conservative Portfolio	<input type="checkbox"/> Conservative Portfolio	<input type="checkbox"/> Conservative Portfolio	<input type="checkbox"/> Conservative Portfolio
2030	2035	2040	
<input type="checkbox"/> Aggressive Portfolio	<input type="checkbox"/> Aggressive Portfolio	<input type="checkbox"/> Aggressive Portfolio	
<input type="checkbox"/> Moderate Portfolio	<input type="checkbox"/> Moderate Portfolio	<input type="checkbox"/> Moderate Portfolio	
<input type="checkbox"/> Conservative Portfolio	<input type="checkbox"/> Conservative Portfolio	<input type="checkbox"/> Conservative Portfolio	

most new ideas. But it will become a mainstream benefit available to all participants within a few years. I strongly encourage you to take advantage of this service when it becomes available.

The Move to More Investment Freedom

Although investment advice will help you manage your 401(k) more effectively, it can't do much for you when you're in a plan with limited investment options. An investment advisor can add greater value when you have the opportunity to select your investments from not just one fund family, but a large universe of investment alternatives. That's why I've been pushing to give participants more flexibility and options—so they can invest their 401(k) money as freely as they invest an IRA or any other vehicle.

One of the biggest problems in changing the 401(k) investment structure is the fact that most participants already have difficulty choosing among a limited number of funds. Most participants would be in big trouble if they had to choose from thousands of alternatives. If an advisor helps you choose the funds, there's less of a problem.

In the past year my discussions with many people have led me to the conclusion that a major change in the 401(k) investment structure is needed. At one end of the spectrum are those who want unlimited choice, and at the other end are those who have difficulty deciding how to invest in a limited number of options. The increasing number of investment options is due to the demands of those who want more choice—not those who can hardly handle the opposite.

Not all employers, however, have given their 401(k) participants greater investment flexibility. Some are very concerned that participants who incur major losses in an open investment structure will sue their companies. Employers are also concerned that most participants do not fully understand the complexities of more choice. If employ-

ees are overwhelmed, employers think their companies will be exposed to additional liabilities.

In response to these employer concerns, I'm recommending two investment safe harbors that would free both employers and service providers from fiduciary liability. I've recently met with retirement industry and government leaders to discuss this concept. Most have been very interested in my ideas.

Here's what I am thinking:

Option 1: Participants would be given the choice of a) structured portfolios that consider their time horizon and risk tolerance or b) the opportunity to select their own funds from a fund “window”. Employers and providers would be freed from liability if:

- Participants may select only one structured investment portfolio.
- Participant-paid expenses for each structured portfolio do not exceed 75 basis points.
- Participants who stay in a structured portfolio for at least 20 years receive a 7% guaranteed minimum average annual return.
- The additional participant-paid fee to access the fund window does not exceed \$150.
- 100% of the participant's account can be transferred into the fund window.
- An IRA option allows participants to retain their portfolios when they change jobs, companies are sold, etc.

The structured portfolios would have to comply with yet-to-be-determined industry standards. For example, the process used to build the portfolios would have to be reviewed and approved by an independent entity at least annually. Among other things, this independent entity would monitor fund selections to make sure fund managers do not drift from their investment styles. For example, they would be on the lookout for a small company stock manager who suddenly starts to invest in large company stocks.

Option 2: Participants would be permitted to invest in IRAs under the same rules that apply to SIMPLE-IRAs. The employer would pick a single financial organization to receive all new deposits, but participants could transfer all accumulated money to any other financial organization without penalty.

Although my ideas have generated great interest, there is no guarantee that either option will be adopted. In the meantime, you need to focus on understanding your investment choices.

The most common mistake I have seen 401(k) participants make is to randomly pick their investments without any idea of what they are investing in and why. One young man once told me that his return was above 20% the prior year, and he wanted to know what he should expect during the current year. My immediate answer was that his account value would go up and down. When I questioned him about the specific funds he chose, he didn't have any idea. All he knew was that he had received a good return and he wanted it to continue. A complete lack of knowledge may be okay during the early years of your retirement investing, but this is not acceptable when you have accumulated a larger amount of money.

Becoming more informed does not necessarily require a major time commitment. There are tons of books that cover the basics of investing that you can buy or borrow from the local library. Two notable ones are *Investing for Dummies* by Eric Tyson and *401(k): Take Charge of Your Future* by Eric Schurenberg. You can also get information about your funds from *Morningstar.com* and from *Schwab.com*.

Talk to others about the resources they find particularly helpful. I introduced Danny Brantley in Chapter 6. Danny rarely makes changes to the 401(k) investments he has chosen, but he actively manages his own investments outside the 401(k). He works the afternoon shift, which gives

him a couple of hours in the morning to work on his investments. His favorite resources are *The Wall Street Journal*, Wall Street Online, CNBC, *Morningstar.com* and *Business Week*. He says, "I learned a lot about the fundamentals of investing from reading material like Ben Graham's *The Intelligent Investor*, Robert Hagstrom's *Warren Buffet Way* and information from Vanguard's John Bogle."

If you aren't willing to put in any effort to become a more informed investor, access investment advice through your plan or buy some advice outside your plan.

Common Participant Mistakes

Once you become more informed, you have to be sure to focus on the right information. A common participant mistake is to base all investment selections on past performance. Even the mutual fund companies are required to tell you that past performance is no indication of future results. Despite this constant warning, most investors don't break the habit. The major reason that you can't overemphasize past performance is because good results are often fleeting. Many of the funds that appear on "Top 10" lists aren't repeat stars. A fund manager might go through a particularly lucky period, the companies owned by the fund may have a great short run—not all funds have what it takes to stay on top.

Although fund managers work hard to make informed investment decisions, sometimes the results exceed their skill or efforts. The manager may expect a 10 to 20% gain for a certain stock, but actually receive a 50% or larger gain. Picking that stock took skill, but the unexpected additional gain also involved a lot of good fortune.

The other important point is that the performance of any fund is largely determined by the market view of the type of companies that are represented. Those of you who are heavily

invested in funds that own a lot of technology stocks learned this lesson. Many of these funds were top performers prior to 2000 and then dropped into the worst performing category in 2000 and early 2001. The Warburg Pincus Japan Small Company Fund, for example, gained 100% during the first six months of 1999 followed by a 114% gain in the second half of 1999. But then when technology companies took a dive in 2000, the fund dropped by 71.8%.

If you were focused only on past performance, you would most likely have chosen to invest in that Warburg Pincus fund at the end of 2000. But if you had more carefully looked at the companies represented in the fund and listened to analyst predictions on the tech sector, you might have considered other funds.

Participants also make the mistake of comparing different types of funds. You must compare a fund's performance to others in its peer group. If you compare a bond fund to a stock fund, a large-cap fund to a small-cap fund, or a value fund to sector fund, you're comparing apples and oranges.

Sometimes it's not easy to identify fund types. You should be able to identify the fund type from the 401(k) provider's materials, but these materials are not always easy reading. An independent source like *morningstar.com* or *schwab.com* can be your best bet.

Once you know the fund type, you can look at the most recent and longer-term (three to five-year) performance and then compare it to others within its category. It's important to get both a short and long-term perspective. This kind of analysis points out if a single year is the major reason for exceptional results. Newer funds often have this history. The manager may pick a couple of stocks that are real winners in the first year or two. The fund appears on the best performer list and begins to attract a lot of money. It's more common to get a 100% return with a \$50 million fund than a \$1 billion fund, because larger funds

have less investment flexibility and they require much greater research capabilities.

That same Warburg Pincus Japan Small Company Fund rapidly grew due to its stellar 1999 results. The 214% return in 1999 will probably give the fund an attractive three-year average return at the end of 2001. But the manager is not likely to repeat this three-year result in the future. Most importantly, the only investors who did well are those who owned this fund at the beginning of 1999—long before its results attracted attention. The poor investors who purchased this fund after seeing its 1999 results have been hampered. There are many similar examples with other funds.

Another lesson I learned a long time ago is that the fund with the highest average return won't necessarily give me the most money. I learned this when I was helping a client pick an investment manager to run an employer-funded defined contribution pension and profit-sharing plan. All the investment managers he was considering claimed to have only top-performing funds. I decided to look beyond just the historical performance results. Instead, I tried to determine how much money my client would have after investing \$10,000 each year with each prospective manager. I discovered that the potential accumulation varied widely, depending upon when I did the comparative scorekeeping.

Here's how I discovered this fact. The following is a year-by-year comparison of two funds:

Net Annual Return

Year	1	2	3	4	5	3 Yr. Avg.	5 Yr. Avg.
Fund A	35.3	22.4	(8.7)	18.5	(7.6)	16.33	11.98
Fund B	21.1	17.3	(0.5)	13.2	2.7	12.63	10.76

The natural conclusion is that Fund A is a better choice because its five-year average return is

11.98% compared to 10.76% for Fund B. If you look at the amount that you would accumulate in both these funds, you would come to a different conclusion.

In the following example \$10,000 is invested in each fund at the beginning of each year.

Amount Accumulated

End of Year	1	2	3	4	5
Fund A	\$13,530	\$28,801	\$35,425	\$53,829	\$58,978
Fund B	\$12,110	\$25,935	\$35,755	\$51,795	\$63,463

I was very surprised the first time I worked through this exercise. The results were hard to believe even though I was a math major. The key is when the ups and downs occur and the amount that you have invested at each of these points. I learned several things from this process that have helped me invest my retirement money:

- A fund that has less dramatic ups and downs can outperform a more volatile fund.
- Average performance results are of limited value.
- Don't consider "top 10" listings the end of the story. Look beyond the obvious to find the funds that can sustain top performance.

Fund A would have been listed among the top funds at the end of the third year with a 16.33% average annual return—compared to only 12.63% for Fund B. Fund A would have appeared in the winner's circle after the first three years—and Fund B's 12.63% average three-year return probably would have attracted little or no attention. But when we look at the actual amount accumulated with each fund, we would have a slightly larger amount with Fund B. The difference is even more dramatic after five years. Fund A has achieved an 11.98% average com-

pared to 10.76% for Fund B, but the actual amount accumulated in Fund B is 7.6% more than Fund A.

The robust stock market performance during the 1990s was great, but it created unrealistic expectations. Most 401(k) participants have never experienced a prolonged stock market slump when the market doesn't really do much for five or more years. Some mistakenly expect annual returns in the 15 to 20% range. Returns in this range should never be built into your retirement planning. I personally would not recommend a return assumption of more than 9%. (And you should use a 9% return assumption only if at least 75% of your money is invested stocks. Otherwise you should reduce your expected return to 7 or 8%.)

One of the other things I learned when I did the Fund A and Fund B comparison for the first time is that it can take a long time to get back to where you were after a bad year. Assume you have \$100,000 invested in a fund that drops 20% to a value of \$80,000. A 20% gain the next year brings your value up to \$96,000. But you are still 4% behind. You really have a lot of ground to make up if your retirement plan assumed a 12% annual return. The \$100,000 you had invested at the beginning of this two-year period would have had to be worth \$125,440 to be on track, but it is worth only \$96,000 after the recovery. You need a 46% gain the third year to get on track, which is highly unlikely.

The combination of setting unrealistic return expectations and picking funds that do not do well during down markets may eventually result in a serious savings gap. You can't just be at a break-even point after a couple of bad years. Somewhere along the way you need to make up for the investment gains that didn't occur. This is another reason why it makes sense to pick funds with less dramatic ups and downs.

In the final analysis, the funds you choose must meet your personal objectives. My long-

term investment goal is to earn a 9% average return on my retirement savings. I know I have to be heavily invested in stocks to achieve this result. But due to my age, I'm not willing to accept more than a 10% drop in the value of my retirement account. As a result, I have most of my retirement savings invested in only two stock funds that have the potential to produce a 9% long-term return and had positive returns in periods of market turbulence.

The average annual returns for these funds are good—but most importantly, the 2000 returns were 7.9% for one fund and 16.3% for the other. So far in 2001 returns are 5.99% and 12.55% respectively. Since most funds have had negative returns from 2000 into 2001, my investments are doing particularly well.

The funds that I have selected with the help of an advisor have less risk exposure than the S&P 500 Index. I'm not yet ready to shift to bonds to reduce my risk even more. I expect to make that shift once I start withdrawing money from my retirement account. I'm also not looking for big winners. I was willing to give up the big gains from the technology sec-

tor during recent years in exchange for the reduced risk; however, I have to confess that these big gains were tempting at times. I've made some technology investments outside my retirement account where I am comfortable taking a higher risk.

Investing most of your retirement savings in two funds in the same category probably is not a good strategy for most investors, but it matches my goals at age 59.

You're not always going to follow conventional wisdom—you need to make informed investment decisions that are right for you.

Read the May 14, 2001 issue of Fortune to get some solid information about why the technology sector collapsed. Jason Zweig's article, "Wall Street's Wisest Man" in the June 2001 issue of Money is also particularly insightful.

Tips on Selecting Your 401(k) Investments

- *Know what you are doing and why: don't invest blindly.*
- *Use an investment advisor or other professional help to choose your investments.*
- *Remember that higher risk doesn't guarantee a higher return. Look for lower risk funds that have the potential to give you the long-term return you need.*
- *Don't focus on average returns when you compare funds. A fund with a lower average return can actually give you a larger nest egg.*
- *Avoid the temptation to pursue the high flyers unless you get a kick out of watching the value of your retirement account go up and down.*
- *Watch out for funds that have dramatic up and down swings, particularly if you are within a few years of retirement.*
- *Establish realistic expectations and then pick funds that have the potential to meet your goals.*
- *Use your best instincts: learn from how others invest, but build the portfolio that's right for you.*
- *For more information about my proposed 401(k) investment structure, visit 401kassociation.com*



