EXCERPT

SETTING THE TABLE: Investment Decisions for Sponsors of Employee-Directed Retirement Plans

by Keith Hocter, CFA

... defined contribution plans are distinguished by the nature of the investment decision-making process. Investment decisions are inherently a shared responsibility between the employee and employer. This has profound implications and consequences.

First and foremost, remember that employees make decisions concerning their own money. They are allowed to be as rash and foolish and reckless as they want to be. Most aren't -- far from it, people are usually much more thoughtful about investment decisions than we give them credit for. But they have no duty to be responsible, other than a diffuse and barely enforceable duty to their families. The plan sponsor, on the other hand, must make decisions that affect other people's money. The law, and basic ethics, dictates that plan sponsors have a duty to employees. For most plans the basic duties of the plan sponsor are set forth in a law known as ERISA. For others, trust laws or other state statutes apply.

Regardless, they all follow a common theme -- plan sponsors must make their investment decisions in a prudent and responsible manner, and solely in the interest of the employees that participate in the plan and their beneficiaries. In other words, plan sponsors are fiduciaries to plan participants. It makes tremendous sense. However, if investment decision-making is a shared responsibility, where does the plan sponsor's responsibility end and the participant's begin? If an employee wants to do something dumb, does the plan sponsor have a duty to stop them? Fiduciary responsibility is often illustrated by the relationship between a parent and child. Parents have a responsibility, both moral and legal, to act in the best interest of their children. The analogy, while not entirely wrong, is perhaps a little overstated. I prefer to view the plan sponsor’s role like that of a good host at a banquet or Thanksgiving dinner. The host strives to create a feast that makes everyone happy – or at least satisfied, with most people happy. You don’t have the resources or time to serve up everything, and besides your guests don’t really want to choose from everything. You certainly don’t want to serve poison, but you can’t expect to serve exactly what everyone wants either. Rather, you put out a thoughtful mix of foods and expect that each guest will put together a satisfying plate for themselves. Likewise, plan sponsors set the table for participants, by providing a thoughtful menu of investment choices designed to meet the needs of the widest possible cross-section of employees. Participating employees are responsible for putting together a plate that satisfies their retirement spending objectives.

Second, employee-directed retirement plans are unique in the degree of scrutiny applied. They are completely transparent; every participant knows about every investment decision the plan sponsor makes. In a larger organization, that means every decision is instantly subject to 10,000 critics. No one complains to their HR director (or their CEO) because the Investment Committee makes a bad call on a pension investment, but when performance slips in the 401(k) plan you'll know about it quickly. A poorly run defined contribution plan can actually hurt morale and become a focal point for employee dissatisfaction.

Finally, these retirement plans are more subject to fundamental changes in the workforce. Many employees have become much more knowledgeable of investment and financial matters. Information once reserved for the moneyed few now flows freely through the press, TV, and the Internet. Advances in trading and recordkeeping technology have allowed investors with the smallest of accounts to participate directly in the stock market, while mutual funds provide access to professionally managed, diversified portfolios for nearly everyone. Some folks have embraced the market. Their expectations are high, and they demand access to investment vehicles and data to really put their retirement dollars to work. Others lack the patience, aptitude, or free time to learn the ropes. The knowledge gap between the most and least savvy participants has never been wider. Trouble is, most plan sponsors have the entire spectrum in their workforce. How do you meet the needs of the investment expert and the novice with

the same set of investment options? Overarching all of this, running a retirement plan is rarely anyone's full-time job or exclusive responsibility! Harried benefits managers pilot a suite of health & welfare programs, retirement plans, and supplemental programs through a myriad of laws and operational challenges. Finance professionals have pressing matters that directly impact the organization's bottom line. Operations managers, lawyers, and executives all have a thousand other things to worry about. In other words, plan sponsors are not in the business of running a retirement plan!

But viewed at the national level, this system works pretty well despite the complexities -- it has certainly worked well for me as a participant. Assets in defined contribution plans are growing, we have not seen the avalanche of employee-driven litigation many have feared, and participants seem pretty happy. Credit a host of factors, including long stretches of favorable market conditions and a competitive environment for service providers. But I'll credit first and foremost plan sponsors who make these plans work every day, despite demands on their time. Excellent plan sponsors get results from their plan without sinking large amounts of time into running the plan. They have the best of all worlds: they run cost-effective plans that require minimal attention from management and generate happy employees. In my experience, these plans share two common traits: (1) careful selection of the service provider or recordkeeper, and (2) solid governance processes over investment matters.

In this book, we will deal with the latter issue. Our goal is to set up a governance process over investments that will keep employees happy, allow plan sponsors to meet their fiduciary duties, and not require a great deal of time or expense to maintain. It can be done, with a reasonably small up-front investment of time to put the process in place.

That is not to say that investment matters are more important than recordkeeping or operational matters. Far from it, they are equal pillars supporting a successful retirement plan. Our focus on investments in this book makes sense because, for the most part, operational and investment matters can be addressed separately (although as we will see in chapter 7, the concept of service bundling requires us to consider operational issues in selecting investments, in order to manage plan service costs).

If you're already running a plan with a strong investment program, perhaps you'll pick up a few tips from this book to make improvements on the edges, or save yourself some time. If you are running a plan with a less than adequate investment program, or with outright investment problems, I hope you'll find the answers you need here. More often than not, it's worth the time to take a step back and install a sound investment governance process, then use it to attack the specific problems of the day. In my experience, that's better no matter how loudly participants are yelling...

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