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Helping DC Participants Through Troubled Times

There are a number of things 401(k) plan sponsors can do to help plan participants get back on track for retirement.

By Lori Lucas

Twenty-eight percent. That is the amount that the average defined-contribution participant's portfolio declined in value in 2008, according to the Callan DC Index. It's a devastating number, and one that will set the average participant back significantly in his or her retirement goals.

Short of turning back the hands of time, there's little that can be done about last year's market carnage. But what DC participants can control are the dozens of much smaller setbacks dealt to their portfolios on a regular basis. These are the "little" mistakes that over time take a very big toll on savings and retirement income adequacy.

I'm reminded, for example, of a plan where participants would stop their deferrals at bonus time to avoid front-loading their plan contributions—only to forget to restart deferrals after the bonus was paid. There is the participant who took a withdrawal to make a down payment on her home because she didn't understand that she was eligible for a plan loan. Or the one-third of investors in the typical self-directed brokerage account who leave their money in the low-yielding sweep fund, even though they have access to a much higher-yielding stable-value fund within the plan.

One of the biggest "little" mistakes that DC participants make is failing to rebalance their portfolio. According to the Callan DC Index, DC participants' allocation to stock funds declined 13 percentage points, from 71 percent to 58 percent, over the course of 2008. This is a significant change in risk profile, and one that stems from several deeper issues.

At the top of the list is the fact that few DC participants have well-defined risk preferences. In other words, participants have no idea whether they should have 71 percent or 58 percent (or something entirely different) in stock funds. A study by Shlomo Bernarti of UCLA demonstrates this dilemma. In the study, DC investors were shown two different unlabeled portfolios: their own and a portfolio created by an investment advisory service. When asked to rate the attractiveness of the portfolios, 61 percent said they preferred the advisor portfolio over their own, 19 percent were indifferent, and 20 percent preferred their own portfolios.

The study also found that many of the participants had no opinion about the future performance of the investment funds in their plans. Without well-defined risk preferences, it is not surprising that participants in DC plans never bother to rebalance their portfolios, and instead allow market movements to dictate their asset allocation.

Also at issue is the fact that participants in DC plans tend to profoundly misunderstand concepts such as diversification and long-term investing. A few years ago, I attended a series of focus groups where participants in DC plans were asked about investment principles. Most were familiar with the term diversification, but demonstrated very little true understanding of the concept. One focus group participant thought that her portfolio was well-diversified because she had her money spread across the three best-performing funds in the plan—not understanding that the funds needed to complement one another. Likewise, when it came to long-term investing, people in the focus groups frequently used terms such as "pick and stick," but associated it with never changing their asset allocation. For such individuals, the notions of rebalancing or portfolio reallocation—both sound investment principles—run counter to their understanding of being a long-term investor.

Participants in DC plans tend to demonstrate a high level of inertia. On the positive side, participant inertia is why automatic enrollment is so successful, with few participants opting out of plans

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once enrolled. Also, inertia means performance-chasing in DC plans is not widespread. However, when it comes to rebalancing and reallocation, inertia works against DC participants.

Finally, making changes to an investment portfolio is time-consuming and even emotionally taxing, especially in the current environment. In focus groups, participants experienced angst both at being forced to pay attention to their portfolios on an ongoing basis, and uncertainty about their capacity to make the right decision. As one said: "I'm a scientist, not an investment professional. I don't expect people to be able to analyze the chemical content of water."

Many plans already offer the means to improve participant diversification, including target-date funds, investment advice and managed accounts. It is a matter of getting participants to use such tools.

When it comes to target-date funds, it may be necessary to address the bad press they have experienced recently, pointing out their professional management, diversification and ease of use. Since many target-date funds are designed to be used not only up to retirement, but beyond, target-date fund communication may also need to explain the risk/return implications of significant equity allocations going into the drawdown phase. Plan sponsors also may wish to address why a certain target-date fund series was selected for the plan in order to give a better understanding of how the target-date funds are intended to operate. In light of recent market volatility, it is more important than ever that plan sponsors communicate with their participants and proactively reiterate the reasons to use target-date funds.

For online advice, the trick is often to overcome participants' hesitancy in three areas.

- Online advice is impersonal: People find it difficult to entrust their portfolio to an adviser with whom they have no personal relationship.
- It also takes effort: People often don't want to carve out the necessary time to use the online tool.
- Online advice is difficult: People aren't confident they can use the online advice tool effectively.

In recent years, some online advice providers have done a good job of addressing these issues, supporting online advice with phone reps, simplifying it and making it less time-consuming. Because of this, plan sponsors that have hesitated to offer online advice may want to take another look. And plan sponsors that do offer new and improved online advice may want to take the opportunity to advertise these enhancements.

In turn, managed accounts also may seem impersonal to DC participants. Further, participants may have hesitated in the past to give up discretionary control of their plan accounts. In the face of market turmoil, however, the option to allow a professional service to take control of the 401(k) may look much more appealing. Some managed account providers are eager to support efforts to communicate the value of managed accounts, making it affordable for plan sponsors to do so in harsh economic times.

Many plan sponsors already offer automatic rebalancing, and according to a Hewitt Associates survey, among those that don't, nearly 20 percent say they are very likely to add it in 2009. While an excellent feature, automatic rebalancing is only as strong as the asset allocation that is being rebalanced. If the asset allocation is appropriate, automatic rebalancing can be very useful in taking the emotion out of selling investments that have done well and buying investments that have gone down in value. If the asset allocation is poor, however, then automatic rebalancing is only reinforcing a bad investment position. That is why it is important to couple auto rebalancing with the tools mentioned above.

For a number of participants, rebalancing is too painful right now, even if it is automated. As one record keeper recently put it, in today's environment it is important that any communication to DC participants shows a lot of empathy. People's retirement dreams have been dented, or worse, and getting back on track won't be easy. Ongoing market volatility may feel overwhelming, and the possibility of more losses may seem unbearable. A softer-touch solution may be to encourage participants to direct future contributions to equities if they cannot bring themselves to redirect current balances. A dollar-cost-averaging approach to getting back into stock funds may also be more palatable.

Adding or showcasing DC investment tools is not only a way to help anxious participants, it can also bolster the employer/employee relationship. No one knows when the market and the economy will turn around; however, employees are likely to be more loyal to an employer that sought to help them through troubled times.

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Lori Lucas is an executive vice president and defined-contributions practice leader for Callan Associates, a San Francisco-based institutional investment consultant. To comment, e-mail editors@workforce.com.

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