TheStreet.com

Stephen Schurr

Meet the Biggest Threat to Your 401(k) Plan: You

By Stephen Schurr
Senior Editor

09/16/2003 07:15 AM EDT
URL: http://www.thestreet.com/funds/stephenschurr/10113019.html

"Education costs money, but then so does ignorance." -- Sir Moser Claus

The 401(k) industry is littered with flaws, including hidden fees, conflicts of interest among plan providers and fraudulent behavior among money managers. But these issues pale in comparison to the biggest problem of all: a profound lack of investor knowledge.

Despite a decade of educational initiatives from 401(k) sponsors, providers and nonprofit organizations, Americans still are perilously uninformed about retirement planning, and many aren't saving enough. And as the safety nets provided by companies and the federal government shrink, the economic fate of millions hangs in the balance.

"Financial illiteracy is a monstrous problem in this country," said William Wechsler, vice president of research at consulting firm Greenwich Associates. "The person best suited to manage 401(k) investments is the individual. By any stretch, however, the average person is in no way capable of doing so." (Click here to see if you're a self-destructive 401(k) participant.)

Now, as the movement to address 401(k) investor illiteracy gains momentum, two possible fixes are emerging. First, a growing number of experts are urging that investors get greater access to person-to-person advice and education, without holding companies who sponsor the plans liable for their advice. Legislation that would allow fund firms and employers to offer advice is currently making its way through Congress.

Second, many academics, sponsors and industry professionals are suggesting something more radical -- a form of benign paternalism that takes much of the responsibility for managing the plans away from the individual. This approach includes automatically enrolling employees in plans; setting up a system to take more out of employees' payroll as their salary grows; and opting for a "less is more" approach to 401(k) offerings that runs counter to the "open platform" plans that include hundreds of funds. With the first solution slow in coming, the latter idea has been gaining a surprising following.

The Seven Deadly Sins of 401(k) Plans
Hidden 401(k) Fees Are Stealing Your Nest Egg

Why the need for such drastic measures? Over the past 30 years, the world of retirement planning has seen a tectonic shift away from defined-benefit plans -- in which the employer takes stewardship of the plan -- in favor of defined-contribution plans such as the 401(k), in which the ultimate responsibility for managing the plan falls to the employees. This shift suited the needs of both employers concerned about costs and liabilities, as well as employees who were changing jobs. However, as this unplanned revolution in retirement plans unfolded, few people realized the implications of letting tens of millions of workers with little investing education take charge of their nest eggs.

The problem has been exacerbated by a host of factors: Many employers who sponsor the plans are ill-informed, or simply avoid educating and advising individuals for fear of litigation. Several fund firms and consultants who run 401(k) plans have offered outstanding educational Web sites for participants in their 401(k) plans, but studies show that these sites go largely unused.

"One of the worst things we see is people who think they're smart enough to invest wisely but make horrible decisions, like shifting all their assets into tech funds in 2000," said Rick Meigs, president of 401(k) Help Center, an educational Web site for 401(k) participants and sponsors.

"The biggest problem involved with 401(k) plans is thinking that most participants are going to manage the investment side of this wisely, being left on their own," said Ted Benna, who created the initial 401(k) plan and now runs the 401(k) Association, an advocacy group dedicated to improving 401(k) plans.

The 401(k) Help Center's Meigs, a former retirement-industry professional who champions investor education and awareness on his site, agrees. "Deep down inside, I have this idea that if we really want to make sure people have a good retirement, take it out of their hands and let the professionals do it -- even though, in reality, the whole premise of 401(k) plans is for you to take charge of your future," Meigs said.

The Failure of Education

The push to educate investors on how to manage their 401(k) plans has fallen short for several reasons, with the responsibility falling in part to sponsors, fund firms and the individuals themselves.

While many Fortune 500 companies are big enough to have a group of well-trained human resources staffers to oversee the 401(k) plan, there are more than 432,000 401(k) plans -- and about 90% of them are at companies with fewer than 100 participants. Many of these companies lack the resources to have aggressive oversight of 401(k) plans, let alone the staffers trained in fiduciary responsibilities of 401(k)s.

"Most companies are in the business of making widgets; most of these plan sponsors don't have people equipped to handle the responsibilities of a 401(k) plan," said Ward Harris of McHenry Consulting Group in Berkeley, Calif.

Many sponsors don't even realize that they have a fiduciary responsibility to oversee these plans and may be vulnerable to legal actions by participants. "We don't spend a dime educating and training the five million men and women who have the responsibility for managing these plans for companies," said Don Trone, who founded the Pittsburgh-based Center for Fiduciary Studies, a nonprofit organization that trains retirement-plans sponsors and providers. Trone, who also serves on the Department of Labor's ERISA Advisory Council and **General Electric's** (GE:NYSE) Advisory Council for the Center for Financial Learning, is helping lead the push to educate the human resources and personnel workers who have a great deal to do with how millions of Americans retirement plans take shape.

Meanwhile, the sponsors don't shoulder the blame for the lack of education alone. Most times, sponsors farm out the education of their plans to the providers of the 401(k) plans -- be they financial-service firms such as **Charles Schwab** (SCH:NYSE) , insurance companies such as **Nationwide** (NFS:NYSE) or asset management firms such as **Fidelity** or **Vanguard**.

The education levels are often inadequate. Many sponsors provide educational materials that serve more to peddle their own products and offerings rather than offer unvarnished education. However, many providers offer outstanding educational information, either over the Web or in distributed literature.

"A lot of 401(k) providers have set up Internet sites that offer fairly powerful and interesting material," said Greenwich Associates' Wechsler. "The problem is, study after study shows this information is very much underused."

While some 401(k) participants may not be informed of the education tools their plans provide, many simply lack the initiative to educate themselves. "There's always that 20% to 30% of individuals who take the time and have the aptitude to do it themselves," said the 401(k) Help Center's Meigs, "but the large majority of individuals don't have the time or the aptitude to set goals, the discipline to save enough money and stick with the plan."

Therein lies the crux of the problem, which many participants may be loath to admit: The majority of participants don't have the time or inclination to be educated. "Most individuals don't know the difference between a stock and a bond, and aren't especially interested in learning," said Wechsler. "They just want to be told what to do."

The Lack of Advice

This need for advice hasn't been met, however. Only 16% of defined-contribution plans offer one-on-one advice, either in person through advisors or over the phone, according to research by Greenwich Associates.

Most 401(k) providers, as well as sponsors, don't dispense the kind of advice investors seek. The primary reason for this is the issue of liability -- offering advice exposes employers and fund firms to lawsuits if the portfolio goes bust. On the flip side, of course, employers are open to lawsuits if they don't provide access to advice as well as part of their fiduciary responsibility.

"The whole issue of advice has been a very challenging area," said Steven Winks, co-founder of the Society for Senior Consultants, a trade group of consultants to retirement plans. "Everyone acknowledges they need help, but everyone's afraid about liability."

Winks and other consultants, financial-services firms and the mutual fund industry hold high hopes for legislation under consideration that would allow 401(k) service providers to give advice on their own fund offerings. The Pension Security Act, sponsored by Ohio Republican Rep. John Boehner, would remove the liabilities associated with advice.

Advice problem solved, right? Not entirely. If the floodgates are opened on litigation-proof advice, the dreaded issue of conflicts of interest rears its ugly, hydralike head. Some consultants and service providers offer outstanding advice, but conflicts of interest run deep in the 401 (k) industry. "To get truly objective counsel is a rare thing," Winks said.

Meanwhile, millions of investors don't realize how woefully far away they are from building next eggs on which they can retire. "Individuals aren't saving enough -- no reform of the industry will magically fix that central problem," said Trone of the Center for Fiduciary Studies. "Some people will say participants aren't educated enough to make a prudent diversification. You cannot allocate yourself out of this problem. If you have $9,000 in your retirement plan, no allocation is going to get you to a million dollars."

Is 'Libertarian Paternalism' the Solution?

Surprisingly, one of the strongest currents in the financial illiteracy movement is to give up the ghost on the central component of the 401 (k) revolution -- letting investors do it themselves.

By and large, the fountainhead for this movement has been behavioral finance research that has demonstrated how often ill-equipped individuals are when left to their own investing devices. Studies from investor-psychology expert Terrance Odean at the University of California at Berkeley and financial-services consultant Dalbar have shown that individuals trade entirely too much, with devastating effects on their nest egg. Meanwhile, University of Chicago's Richard Thaler and UCLA's Shlomo Benartzi have conducted several studies showing the often-devastating costs of investor autonomy -- ranging from putting too much money in company stock to choosing mutual funds based on past performance. Of course, many individuals, left to their own devices, don't even take the time to enroll, and in doing so lose out on $5 billion a year in matching 401(k) contributions. "The approach that I'm pushing is libertarian paternalism -- nobody's forcing participants to do anything, but you make it easy for the needy to get help and default to sensible options," said the University of Chicago's Thaler, who has worked with Vanguard and other 401(k) plan providers to improve their plans based on behavioral-finance research.

Among the solutions this libertarian paternalism provides: automatic enrollment for eligible participants; having the default fund be either a balanced stock-bond fund or a "lifestyle fund" that is allocated over the course of an investor's lifetime; and what Thaler calls the "Save More Tomorrow" plan, in which individuals sign off on the sponsor's taking out more money as their salary grows. This plan stems in part from a pilot program by University of Chicago's Brigitte C. Madrian and **UnitedHealth's** (UNH:NYSE) Dennis F. Shea, which found that when the company changed its default option to enroll individuals unless they explicitly opt out, enrollments jumped from 37% to 86%.

Vanguard has introduced some of these options -- including the Save More Tomorrow plan, rechristened the One-Step Program -- and the early results have been phenomenal, said Gerard Mullane, director of institutional sales at Vanguard. "When you look at those who sign up, almost no one drops out. Intuitively, it makes sense -- getting investor inertia to work for you."

With major education initiatives failing to bear fruit and with advice remaining a thorny legal issue, these "libertarian paternalism" plans have been gaining fans, even a partial endorsement from the father of the 401(k), Benna.

"We thought the problems with 401(k) were going to be resolved via education," the 401(k) Association's Benna said. "Millions of dollars have been spent in the effort, but it remains. I've come to the conclusion that most 401(k) plans need to have their investment structure reworked." While Benna firmly believes that individuals who are educated enough about retirement planning should chart their own 401(k) investment course, "the majority of investors might be better on auto pilot."

Click here to read a letter about this story.