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SENIOR CONSULTANT
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Democratizing Professional Investment Counsel

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Concerns over the long-term viability and availability of Social Security benefits and defined benefit pension plans have magnified the relative importance of defined contribution (DC) retirement plans to today's workers — future retirees. This increased importance has placed greater responsibility to save and invest wisely squarely on the shoulders of individuals. Unfortunately, John Hancock's 2004 Survey of Defined Contribution Plan Participants conducted by Mathew Greenwald & Associates illustrates the continued lack of investment knowledge and skill in spite of years of participant education efforts. Consider that the shortcomings of those efforts have less to do with the efforts themselves, but rather the audience. Survey work by Forrester Research has indicated that as many as eighty-five percent of investors would like assistance with investing. The marketplace reality is that the vast majority of DC plan participants are *reluctant* investors who do not have the time, desire, or knowledge to invest for themselves.

Managed Accounts have been dubbed as the next wave to sweep the DC industry. The ERISA Advisory Council refers to them as Optional Professionally Managed Accounts (OPMA's). Managed Accounts are the next wave because they are the solution for reluctant investors. Specifically, Managed Accounts empower participants to make the manageable decision between "do I want to manage my own account?" or "would I rather have a professional manage it for me?"

> MANAGED ACCOUNTS EMPOWER PARTICIPANTS TO MAKE THE MANAGEABLE DECISION BETWEEN "DO I WANT TO MANAGE MY OWN ACCOUNT?" OR "WOULD I RATHER HAVE A PROFESSIONAL MANAGE IT FOR ME?"

Today, participant-directed plans have an average of fifteen investment options from which to choose.[1] Put simply, as the relative importance of DC plans has increased; dealing with them has become more and more complicated. While the number of choices has steadily increased over time, the number used by participants has changed very little comparatively. This behavior has been very telling and has led to numerous studies being conducted relating to choice and inertia:

- Dr. Sheena Iyengar, Columbia University, has observed that too much choice can have debilitating effects, de-motivating savings and diversification.[2]

- Dr. Brigitte Madrian, Wharton University, has chronicled the negative implications of inertia and the potential benefits derived from the proper design of defaults.[3]

The Managed Account solution simplifies the initial investment decision for those participants who are ill-equipped or not pre-disposed to dealing with those fifteen investment options. Furthermore, via intelligent plan design using Managed Accounts as a plan's automatic investment election (default), there are positive implications for both plan participants and plan sponsors:

Plan Participants

Managed Accounts satisfy participant needs and desires, as well as defeat inertia as an enemy to successful investing behavior. If participants are automatically enrolled into a Managed Account program, "good things would happen to participants who do nothing." This is the very challenge made to the industry by David Wray, President of the Profit Sharing/401(k) Council of America at their 2001 National Conference.

Roughly two-thirds of participants have all of their retirement savings in their employer's DC plans.[4]. Therefore, the minimum "inputs" necessary to appropriately manage accumulation portfolios are available directly from the recordkeeper or plan sponsor. The data is used to balance human and investment capital:

Human Capital

The participant's investment time horizon is derived from their date of birth input and determines their future ability to earn income and generate savings. As one grows older, the ability to earn income and generate savings begins to decline until one is no longer generating income. The lost income needs to be replaced from their accumulated savings and other sources of retirement income. Investment time horizon is used as the proxy for their human capital.

Investment Capital

The participant's accumulated savings and other sources of dedicated retirement income include the participant's DC account balance, prior year pay, Social Security benefit, and any other employer sponsored retirement benefits. For this purpose, Social Security is estimated based on pay and date of birth, and the retirement benefits are provided in present value form by the actuary. These assets constitute the participant's investment capital.

As human capital declines, i.e., one grows older, the decline needs to be offset by their investment capital. The DC account is allocated to balance the adjusted present value of existing debt holdings (i.e. social security and defined benefit pension benefits[5]) to best fit the individual's investment time horizon. Critical to this approach is the annual re-calculation of this relationship to maintain an appropriately diversified portfolio for the participant as inputs change.

Given the typical inactivity of reluctant investors, it is fortuitous that the inputs do not necessitate that participants complete forms. There is no need for participants to complete risk tolerance questionnaires which by their nature are inappropriate[6]. This approach leverages technology to calculate and communicate portfolio allocations among the plan's investment options to the recordkeeper as well as use their existing infrastructure (e.g. participant statements) for communications and administration.

As a result individualized managed accounts can be delivered to the reluctant investors regardless of account size at a fraction of the cost a professional would require – even if willing to accept the "small" account.

This design serves reluctant investors by overcoming the behavioral hurdles that have prevented investment success for the vast majority of plan participants. Participant usage statistics range from 68-90%. Perhaps more impressive is the durability of the initial usage statistic which remained stable during the bear market of 2000-2002.

Plan Sponsors

In addition to offering a highly utilized and appreciated benefit, plan sponsors significantly enhance their ability to manage fiduciary exposure:

1. ERISA §404(c) protection is enhanced for the plan sponsor who receives acknowledgement from participants who elect not to use the Managed Accounts. Participants opting out of a Managed Account program certify their understanding that they could have had a professional invest for them and that they are taking responsibility for their investment decisions. ERISA §404(c) allows plan sponsors to delegate both the privilege and responsibility for their plan participants' investment decisions to the participants themselves if sponsors fulfill a number of investment design, communication/disclosure and ongoing monitoring requirements. While the regulations under §404(c) theoretically offer relief to plan sponsors, §404(c) compliance has some vulnerability:

    - Several provisions in the regulations are vague.
    - The effectiveness of §404(c) protection has yet to be tested in the court system.
    - It can be argued that many participants do not want to do their own investing and reject both the privilege and responsibility of making investment choices.
    - If participants do not take effective control of their investments (e.g., unless and until participants designate their investment choice(s) – elect out of the default), then §404(c) protection does not apply per Revenue Ruling 2000-08. This position was reaffirmed in the proposed 401(k) regulations issued in 2003.

2. The Managed Account provider becomes a fiduciary in the plans as a 3(38) Registered Investment Advisor taking on liability for investments managed under ERISA §405 as a named fiduciary in the plan document. Automatic elections (a.k.a. default funds) designed to use managed accounts now can engender protections.

The DC industry must focus on what participant behavior is rather than what we would like it to be. Only then will we have the ability to deliver help in an effective, durable manner. Managed Accounts are the industry's next wave; a purposeful solution when positioned as the automatic investment election in a plan.

About the Author

Michael S. Falk, Vice President and Chief Investment Officer, ProManage LLC is responsible for developing and monitoring ProManage's investment policies and procedures. He directs the investment manager research effort, as well as the construction of investment portfolios. He is the Chair of the company's Investment Committee as well as the primary liaison among the Investment Committee, the company and its clients.

Aside from his duties at ProManage, Mr. Falk is part of the CFA Institute's Speaker Retainer Program, an active committee member for the Profit Sharing 401(k) Council of America, and teaches as an adjunct professor at DePaul University in their CFP Certificate Program as well as on behalf of the Investment Analyst Society of Chicago. Mr. Falk graduated from the University of Illinois with a B.S. in Finance. He is also a CFA Charterholder, a member of the CFA Institute, and holds the CRC designation.

Notes

[1] "46th Annual Survey of Profit Sharing and 401(k) Plans reflecting 2002 Plan Year Experience" Profit Sharing/401(k) Council of America

[2] "Choice and its Discontents: Challenges of the New Millennium" by Iyengar, 1999, "When choice is Demotivating: Can one desire too much of a good thing?" by Iyengar & Lepper, 2000, "How Much Choice is to Much?: Determinants of Individual Contributions in 401(k) Retirement Plans" by Iyengar, Jiang, Huberman, Columbia University 2003

[3] "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior" by Madrian & Shea, 2000, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance" by Choi, Laibson, Madrian, Metrick, 2001

[4] Vanguard, 1996

[5] Integrating Investments and the Tax Code, by Jennings & Reichenstein "Strategic Asset Allocation for Individual Investors: the impact of the present value of Social Security benefits" Financial Services Review, Fraser, Jennings, & King, 2001

[6] "Most employees can retire securely if they seek advice early", Investment News, Sortino, 10-4-2004

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