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Theme

Dumb and Dumber: Giving Members Investment Choice in DC Plans

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Canada

Tons of independent research provides more than sufficient evidence to prove that giving investment choice to plan members in defined contribution (DC) pension plans is a dumb idea from a legal perspective and even dumber from a financial performance perspective. Yet most sponsors do it.[1] Why?

In Canada, some have said it's necessary to give members investment choice to comply with the so-called CAP Guidelines issued in 2004 by CAPSA[2] and the Joint Forum of Financial Market Regulators.[3] But the very first section of those guidelines makes it crystal clear; they don't apply if no choice is given.[4] Accordingly, if an employer doesn't provide any options, the employer relieves itself of having to comply with many of the responsibilities identified in the guideline, especially many of the suggestions relating to communication, education, process and documentation.

Maybe Canadian DC plan sponsors give choice because they are influenced by US laws that specifically relieve fiduciaries of some responsibility in circumstances in which a plan participant is able to exercise independent investment control.[5] In Canada, there are no equivalent safe harbours. And even in the US, the safe-harbour rules don't provide blanket protection. US plan fiduciaries are still exposed to liability if they fail to select prudent investment options, fail to consider costs or fail to appropriately monitor the options.[6] After a lull following the

1 Of the 2,748 defined contribution plans that had filed statements of investment policies and procedures in Ontario, Canada by 31 July 2016, only 3.4%, or 95, were administrator-directed defined contribution plans; the rest were all member-directed defined contribution plans. Government of Ontario, '2017 Report: Ontario Pension Plan Filings of Statement of Investment Policies and Procedures Information Summaries' *Financial Services Commission of Ontario* (2017) 9–10. <https://www.fsco.gov.on.ca/en/pensions/investment/Documents/2017-sipp-report.pdf>.

2 Canadian Association of Pension Supervisory Authorities.

3 CAPSA, 'Guideline No. 3: Guidelines for Capital Accumulations Plans' *Canadian Association of Pension Supervisory Authorities* (May 2004) <https://www.capsa-acor.org/Documents/View/18>.

4 Ibid [1.1.1]. The Guideline only applies to 'a tax assisted investment or savings plan that permits members of the CAP to make investment decisions among two or more options offered within the plan.'

5 *Employee Retirement Income Security Act of 1974* ('ERISA'). ERISA creates certain safe harbours, for example for 404(c) plans or 401(k) plans that comply with specific provisions under s 401(k) or s 403(b).

6 Commentators have pointed out the difficulties in complying fully with all requirements, and that compliance is not a defence if the fiduciary fails to select prudent investment options or fails to provide appropriate ongoing monitoring of the

2008 recession, US 401(k) complaints and law suits are again surging,[7] particularly in connection with excessive investment or administrative fees,[8] followed by inappropriate investment choices[9] and self-dealing issues, like holding employer securities.[10]

DC plan litigation in countries like Canada and the UK does not seem to be anywhere near the levels in the U.S. This may have something to do with the litigious culture of the U.S.; or perhaps it relates to smaller plan size or simply limits courts tend to impose before approving contingency fees in Canada.[11] Nonetheless, Canadian employers with DC plans still face many complaints relating to fees, choice, transparency, education, restrictions or delays in executing investment directions, foreign currency conversion fees, rear-view fund performance results, as well as imprudent decision-making and monitoring processes.[12] These are all sources of complaint that could be virtually eliminated by not giving individuals investment choice in DC plans.

If an employer does not provide investment choice, legal risk is limited to managing one pool of assets prudently.[13] Obviously, not

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options. See for example: 'How "Safe" Are ERISA 401(k)/404(c) Safe-Harbors?' *The Prudent Investment Fiduciary Rules* <https://iainsight.wordpress.com/2013/04/17/how-safe-are-erisa-401k404c-safe-harbors/>.

7 Alicia H Munnell, '401(k) lawsuits are surging. Here's what it means for you', *Market Watch* (12 May 2018) <https://www.marketwatch.com/story/401k-lawsuits-are-surging-heres-what-it-means-for-you-2018-05-09>.

8 Ibid.

9 Ibid. And this is true even though US pension standards laws provide a so-called 'safe-harbor' for investment choices.

10 Ibid. But see also, George S Mellman and Geoffrey T Sanzenbacher, '401(k) Lawsuits: What are the causes and Consequences?' *Center for Retirement Research at Boston College* (May 2018, Number 18-8) <https://crr.bc.edu/wp-content/uploads/2018/04/IB_18-8.pdf>. This seems to be in contrast to an earlier Forbes article suggesting that US litigation may be tailing off because past litigation has resulted in lower fees, better fiduciary practices, more experienced defence counsel and judges, not to mention the limited number of plans with enough assets for a lawsuit to be economically viable: see Rick Unser, 'Will 401(k) Fee Lawsuits Soon Be In The Rearview Mirror?' *Forbes* (27 March 2018) <https://www.forbes.com/sites/rickunser/2018/03/27/will-401k-fee-lawsuits-soon-be-in-the-rearview-mirror/#7f64443e4398>.

11 Although the legal systems share much in common, they are also profoundly different. For many years Canada was reluctant to allow class actions or contingency fees for fear it would encourage frivolous lawsuits or overcompensation of lawyers, fears which are slowly receding in favour of allowing greater access to justice, particularly for those who cannot afford a lawyer, or whose single case would be too expensive to prosecute.

12 Elizabeth Brown and Natasha Monkman, 'Pension and Benefits Litigation Coming to a Canadian Courtroom Near You…?' *Hicks Morley Hamilton Stewart Storie LLP* (2008) <https://hicksmorley.com/wp-content/uploads/2016/03/P_B_Litigation.pdf>; Frances Denmark, 'ERISA Class-Action Suits Shape U. S. Retirement Future' *Institutional Investor* (16 February 2011) <https://www.institutionalinvestor.com/article/b150xyst4btflv/erisa-classaction-suits-shape-us-retirement-future>; See also the articles referenced at Collected Wisdom on Court and Legal Actions Related to Retirement Plans: <http://www.401khelpcenter.com/401k_court_legal.html#.Wd_1IWeWw3F>; Anna Sharratt, 'DC Sponsors Face Bigger Legal Risks Than They Believe' *Benefits Canada* (April 2016).

13 Legal prudence in the management of pension fund assets requires exercising the care that 'a person of ordinary prudence would exercise in dealing with the property of another person'; a fairly low standard to meet. See s 22 *Pension Benefits Act*, RSO 1990, c P.8.

providing investment choice still requires periodic review of the investment program, but employers who don't give choice won't have the same volume of review, since they won't have multiple funds, multiple managers, multiple risk offerings, multiple costs and multiple risk tolerances to review. Nor will they have the same degree of investment communications and educational issues to contend with. This does not mean putting everyone in a passive balanced fund or an indexed fund — although that could be one effective way to do it. It could also mean more active management, just as one would manage a DB fund. So this could mean performing an actuarial review to identify relevant demographics and to develop a factor-optimised investment policy that addresses the risk profile of the group as whole — whether passive, active or otherwise. And even though a single fund may not be the optimal mix for each individual in the group, in most cases there will be plenty of room for individuals to balance things out in their own personal DC plans and their other savings.[14]

By not giving investment choice employers can eliminate multiple sources of cost that could be litigated and multiple sources of class actions relating to communications, investment disclosure, monitoring, counselling and education. By not giving individual investment choice, the governance structure and oversight can be focused exclusively on net performance and financial risk management. No choice means eliminating the cost and much wider array of legal risks that arise when choice is offered.

If giving choice is a bad idea from a legal perspective, it's even worse from a financial perspective.

It is well-documented that both DC participants and their investment advisors are not very good at investing by comparison with DB plans. Most investment advisors can't even achieve for themselves the rates of return realised in an average DB plan, let alone doing it for their clients.[15] An interesting Canadian study indicates that participant-directed investment arrangements result in the portion of the final benefit coming from investment returns dropping from 75% in a typical DB arrangement to 45% in a DC plan.[16] By eliminating investment choice, DC plans should be able to reduce that differential and get closer to DB performance proportions. They should also be able to dial back the many added costs associated with managing many individual investment accounts and the information and education costs that go along with providing choice, all of which put a significant drag on net investment performance.

Behavioural finance recommends simplifying DC plans and limiting investment choices.[17]

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[14] Combined employer and employee contributions to employer DC plans and RRSPs are about half of the tax-assisted contribution room available to plan participants: see 'DC Plans Need Better Design and Raised Contribution Rates: Report', *Benefits Canada* (19 February 2016) <http://www.benefitscanada.com/pensions/cap/dc-plans-need-better-design-and-raised-contribution-rates-report-77131>.

[15] Juhani T Linnainmaa, Brian T Melzer and Alessandro Previtero, 'Costly Financial Advice: Conflicts of Interest, or Misguided Investment Beliefs?' (Working Paper, December 2015); Keith Ambachtsheer cites this and other research indicating that the portfolio performance of the average financial advisor in the implementation chain is worse than their clients: see Keith Ambachtsheer, 'Workers and Efficient Retirement Saving: Why "Fiduciary Rules" Are Not Enough' *The Ambachtsheer Letter* (May 2016).

[16] Brown, Robert and Craig McInnes, *Shifting Public Sector DB Plans to DC*, Canadian Public Pension Plans Leadership Council (October 2014) 2.

[17] 'Ten Ways Behavioral Finance Can Boost Retirement Security', *International Foundation of*

What could be simpler than providing no investment choice at all?

No doubt a high degree of participant investment choice makes DC plans very attractive in accommodating individual desires, decisions and feelings of control. Nonetheless the vast majority of participants are in the default fund.[18] Those who aren't, don't always follow expert advice, don't monitor fund performance on a periodic basis, and most participants certainly don't have properly balanced portfolios.[19] For example, one US study found that more than 50% of DC plan members had either no funds invested in stocks — exposing them to very low investment returns — or had almost all assets allocated to stocks, making for a much more volatile portfolio.[20] Anecdotally, I am aware of many members invested in fixed income who think they are being conservative. They have no clue that the value of their holdings could tank if interest rates go up![21]

One solution may be improvements in participant education. But ultimately being good at retirement savings requires discipline, goal setting, and an ability to appreciate or estimate, uncertainties such as lifetime earnings, asset returns, health status and longevity. In other words, it requires expertise. As one researcher put it: 'No one would imagine that you or I could perform surgery to remove our own appendix after reading an explanation in a brochure published by a surgical equipment company. Yet, we seem to expect people to choose an appropriate mix of stocks, bonds and cash after reading a brochure published by an

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Employee Benefit Plans (2019) <https://www.ifebp.org/news/featuredtopics/retirementsecurity/Pages/behavioral-economics-retirement-security.aspx>; S Lyengar, W Jiang, and G Huberman, 'How Much Choice is Too Much? Contributions to 401(k) Retirement Plans' in O S Mitchell and S P Utkus (eds) *Pension Design and Structure: New Lessons from Behavioural Finance* (Oxford University Press, 2004) 83–95.

18 'DC Trust: Presentation of Scheme Return Data 2016–2017', *The Pensions Regulator* (UK Government) key findings <http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-presentation-of-scheme-return-data-2017.aspx#s23722> This study of 34,500 DC plans over the period from 2009 to 2016, found that 92% of members are invested in the default strategy.

19 Insights from behavioural research suggest that when provided with a high level of choice and faced with complexity or uncertainty, plan members tend to make suboptimal decisions. They under-diversify, over-invest in familiar stocks, tend to sell or purchase at the wrong time, base decisions too much on past performance, get overconfident, trade too much or too little, and don't really understand the impact of fees and expenses. O S Mitchell and S P Utkus, 'Lessons from Behavioral Finance for Retirement Plan Design' (PRC Working Paper No. 2003-6, November 2003).

20 William B Fornia and Nari Rhee, 'Still a Better Bang for the Buck, An Update on the Economic Efficiencies of Defined Benefit Pension Plans', *National Institute on Retirement Security* (December 2014) 3 <https://www.nirsonline.org/wp-content/uploads/2017/07/bangforbuck_2014.pdf>; which refers to S Holden and J VanDerhei, '401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2000', *Employee Benefit Research Institute* (EBRI Issue Brief 239, Washington DC, 2001).

21 The foregoing is all consistent with 'evidence that investors with DC pension plans display attitudes to risk and portfolio construction that are at odds with accepted investment principles.' Alistair Byrne, 'Employee Saving and Investment Decisions in Defined Contribution Pension Plans: Survey Evidence from the UK' (2007) 16(1) *Financial Services Review*, <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1012855>.

investment company. Some people are likely to make serious mistakes.'[22]

A better solution for employers offering individual account based DC plans is to get rid of individual investment choice and adopt the pooled investment approach inherent in DB plans. There is evidence in many jurisdictions that larger funds and pooling results in lower charges, improved governance, and better access to alternative asset classes, such as infrastructure. One UK study suggests that pooling could boost individual retirement savings by 62%.[23]

It is no secret that DB plans are too risky for most private sector employers due to cost volatility and financial reporting requirements; but it is a well-established fact that DB plans provide retirement income on a much more cost efficient basis than DC Plans. Independent research indicates $1 of pension income under the average DB plan can be provided at 48% less cost than under the average DC plan.[24] Put another way, contributions to a DC plan need to be 92% higher than contributions to a DB plan in order to provide the same $1 of pension income! So the issue is how can an employer take the best features of DB plans — namely, lower legal risk, lower cost, and better investment returns — while simultaneously avoiding the financial risk associated with DB funding and financial reporting?

More than 75% of the added cost in DC plans can be directly related to lack of scale, individual account management and moving from equities to fixed income as members near retirement.[25] Those in DC arrangements also experience lower returns than collective and expert managed funds because of high fees and structural biases in participant-directed investment under DC plans that do not and cannot provide exposure to alternatives, such as hedge funds, private equity, infrastructure and real estate.

Take away participant investment choice and employers can deal with one large fund, not many small pots. Take away all the drags associated with fees and costs inherent in managing individual pots, including lack of scale, education and communication, and the savings have a material impact on total accumulations.[26]

The bottom-line: there is substantially reduced legal risk and substantially increased financial opportunity if employers do not provide individual investment choice in DC plans. To provide more satisfactory investment performance results, and reduce legal risk, DC administrators ought to adopt one of the best features of DB plans, namely collective investment of the assets. One smart way to start getting there with individual account based DC plans is to eliminate individual plan member-directed investment

22 Z Bodie, 'Thoughts on the Future Lifecycle Investing in Theory and Practice' (Jan/Feb 2003) 59(1) *Financial Analysis Journal* 24.

23 James Phillips, 'DC Pooling Could "Boost Retirement Pots by 62%"', *Professional Pensions* (8 November, 2017) <https://www.professionalpensions.com/professional-pensions/news/3020623/dc-pooling-could-boost-retirement-pots-by-62; see also, John Greenwood, 'PPI: Why pooling, alternatives, fiduciary management and higher charges could boost DC returns', *Corporate Advisor* (10 November 2017 <https://www.corporate-adviser.com/ppi-pooling-alternatives-fiduciary-management-higher-charges-boost-dc-returns/>.

24 Ibid, above, n 20.

25 Ibid, above, n 20.

26 Paying 1% extra in fees over a 40 year savings period can eat up almost 25% of total savings: see, Chris Daykin, 'Transparent or Opaque – Charges in DC Pension Plans', *International Pension and Benefit Lawyers Association* (2012) 3 <http://www.ipebla.org/Resources/Documents/P5%20Hidden%20Fees%20and%20Charges%20-%20Chris%20Daykin.pdf>.

choice and move to an administrator-directed investment platform.