Fiduciary protection and other benefits of risk-based strategies in a defined contribution plan investment menu

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This paper discusses an approach for plan committees to improve their plan's investment menu opportunities and practices:

1

By adding a suite of risk-based strategies, plan committees can enable participants to invest in a way that matches their tolerance for risk and volatility without needing to know how to construct a diversified portfolio out of the individual funds in the plan's core investment menu.

2

In doing so, committee members will be better protected from claims of imprudent participant investing because risk-based funds (RBFs) — also known as target-risk funds — are based on the Employee Retirement Income Security Act's (ERISA) investment principles.

3

The addition of risk-based strategies could also allow committees the opportunity to streamline their plan's investment lineup if needed, by eliminating under-utilized or redundant investment options.

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Fiduciary protection and other benefits of risk-based strategies in the DC menu

Fiduciaries of defined contribution (DC) plans face a daunting task when designing their plan's investment lineup. There are legal challenges for prudently selecting and monitoring the quality and expenses of the investments. There are also risks that participants may improperly use the investments offered by the plan.

And there are "best practice" considerations for helping employees get to a financially secure retirement. There may also be considerations of helping employees retire when they want to, rather than continuing to work because they can't afford to retire.

Unfortunately, many participants don't know how to use a plan's investment lineup to properly allocate their DC plan portfolio. For example, many are unclear as to how best to match their investments to their needs and tolerance for market risk, return and volatility. As explained in a recent University of Pennsylvania Law School study:[1]

> "The challenge with this system is that U.S. employees are poorly equipped to make decisions about how to invest for retirement. **Retirement investing is complicated, the typical 401(k) plan offers participants products that many of them do not understand,** and retirement saving is most effective when people begin saving early. In addition to the initial decisions, effective retirement investing requires plan participants to evaluate whether to make changes to their portfolios over the course of their career and, when they retire, to determine how to manage the balance in their accounts to provide income for the rest of their lives."

Plan committees primarily focus on the quality and costs of the plans' investments, yet how participants invest is even more important for producing outcomes. As a result, plan committees should also focus on tools to help participants make better investment decisions.

Many participants do not have the investment experience or the education needed to put together a risk-appropriate portfolio using the plan's investment options.

There's a significant number of participants who want to be involved in making decisions about investing but are not comfortable taking on all of the responsibility. They are engaged but want some help in selecting investments that are appropriate for their goals and objectives. The professional management of risk-based investment options, when combined with tools to select the option that best reflects their risk preferences, will meet the needs of many of these participants.

Participants in a recent Cerulli study were asked about the factors they consider in choosing their DC plan investments. One of the most commonly cited factors, by 49.7% of the respondents, was "risk and return characteristics."[2] Needless to say, that is consistent with the use of risk-based options.

Both the Cerulli study and the University of Pennsylvania study point out that participants are ill-equipped to initially select from a plan's investment lineup to invest their accounts and, after that, to monitor and make adjustments. While a possible solution is investment education, it is unlikely that a few hours a year of education will empower participants to take charge of their accounts in an informed manner. But there are other solutions.

For example, many plans offer target date funds (TDFs) as the default investment for participants, as well as an investment option they can select on their own. However, these funds are based only on an expected retirement age (or vintage), and gradually become more conservative over time. This can be a conflict as many participants may be concerned about other issues, such as market risk and volatility. For example, some participants may want to invest more conservatively than the assigned target date fund vintage because they are risk adverse. Other participants may be willing to take more risk than the assigned TDF vintage (because, e.g., their home is paid off, they have other assets, or they are generally comfortable with investment risk). In other words, many participants may want to invest based on their personal views, experience and other considerations, rather than just on their age.

However, some — perhaps many —of these participants do not have investment experience or the education needed and don't know how to put together a risk-appropriate portfolio using the plan's investment options. There is a solution, though.

Offering a suite of risk-based strategies has several advantages:

- The needs of the participants to invest in a way that matches their risk preferences will be met.
- Professionally designed and managed investments with risk tolerance objectives are consistent with ERISA's principles and will provide fiduciary protection for plan committees.
- Plan committees have the opportunity to streamline the core menu by removing some of the less-used options that were included in the lineup to allow participants to build risk-based portfolios in their accounts.

In effect, a plan's investment lineup can be simplified, reducing the fiduciary complexity and easing decision-making for participants.

Discussion of legal protection afforded by risk-based strategies

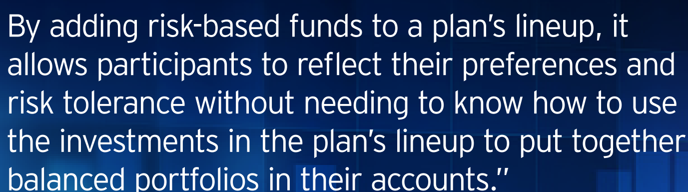
The investment principles in ERISA are based on generally accepted investment theories and prevailing investment industry standards.[3] The most commonly accepted of those theories and standards is Modern Portfolio Theory (MPT).

Those concepts, and MPT in particular, have been built into the Department of Labor's (DOL) guidance for plan fiduciaries and have been accepted by the courts. For example, a DOL regulation[4] explains that fiduciaries must give "appropriate consideration" to **"the role the investment or investment course of action plays in that portion of the plan's investment portfolio."** In a field assistance bulletin, the DOL said that, with regard to participant investment advice, fiduciaries should ask about "…the extent to which advice to be furnished to participants and beneficiaries will be based upon generally accepted investment theories."[5]

In other words, ERISA's investment provisions contemplate that plans will have investment "portfolios" (and that participants will build portfolios in their accounts) that are consistent with Modern Portfolio Theory.

That regulation goes on to describe "appropriate consideration" in a manner that reflects MPT's foundational role in ERISA:

> For purposes of this section, **"appropriate consideration"** shall include, but is not necessarily limited to,
>
> A determination by the fiduciary that the particular investment or investment course of action is reasonably designed …taking into consideration **the risk of loss and the opportunity for gain** (or other return) associated with the investment or investment course of action, and…**the composition of the portfolio with regard to diversification.**



That concept is reinforced by the DOL's regulation on Qualified Default Investment Alternatives (QDIAs), which incorporates the basic concepts of MPT. Regarding target-date funds, the regulation[6] describes the design of a qualifying TDF as follows:

> An investment fund product or model portfolio that applies **generally accepted investment theories, is diversified so as to minimize the risk of large losses, and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age,** target retirement date (such as normal retirement age under the plan) or life expectancy.

The fiduciary safe harbor in the QDIA regulation also includes balanced funds, or risk-based funds, and describes them as follows:

> An investment fund product or model portfolio that applies **generally accepted investment theories, is diversified so as to minimize the risk of large losses, and that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk…** An example of such a fund or portfolio may be a **"balanced" fund.**

These quotes from the QDIA regulation make it clear that target-date funds and risk-based funds satisfy the fundamental requirement that investments and portfolios must be consistent with generally accepted investment theories, such as MPT.

The Department of Labor would not have made them "safe harbor" investments absent the fact that those funds are designed and managed in a manner consistent with ERISA's basic investment principles.

But, of course, DC plans contemplate that participants will have the opportunity to direct the investments in their accounts from the plan's lineup. Even there, though, plan fiduciaries should offer a broad range of investments that enable participants to construct reasonably well-designed portfolios in their accounts. That is true for two reasons. First, a reasonable reading of the general fiduciary rules would lead to that conclusions (that is, the prudent man rule would likely be interpreted to say that fiduciaries must provide a broad range of investments to allow participants to properly invest their accounts). Second, fiduciaries should comply with DOL ERISA section 404(c) in order to be protected from imprudent investment decisions by participants.

The protections in the 404(c) regulation[7] require that participants be offered a broad range of investments and goes on to say:

> A plan offers a **broad range of investment alternatives** only if the available investment alternatives are sufficient to provide the participant or beneficiary with a reasonable opportunity to:
>
> A) Materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and **the degree of risk to which such amounts are subject;**
>
> B) Choose from at least three investment alternatives:
>
> 1) Each of which is diversified;
>
> 2) Each of which has materially different risk and return characteristics;
>
> 3) Which in the aggregate enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and
>
> 4) Each of which when combined with investments in the other alternatives tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio.

The last two points above make it clear that participants should have the opportunity to invest in a manner consistent with MPT and that they need to be able to build portfolios (or invest in professionally managed portfolios, such as risk-based strategies) in their accounts in a manner consistent with the degree of risk that they are willing to take.

The meaning of these rules to fiduciaries

The purpose of discussing these regulations is to stress the significance of participants investing in portfolios that are professionally designed and that are invested using commonly accepted investment principles, such as Modern Portfolio Theory. The last quote, from the 404(c) regulation, points out that the contemplation is that participants should be able to invest in risk-based portfolios. By adding risk-based funds to a plan's lineup, it allows participants to reflect their preferences and risk tolerance without needing to know how to use the investments in the plan's lineup to put together balanced portfolios in their accounts. In effect, a portfolio consistent with MPT is provided to them, and they can select the risk and reward levels that they want.

Similarly, the QDIA regulation points out that fiduciaries are protected if participants are defaulted into target-date funds or risk-based funds. Think about that. If fiduciaries are protected for defaulted participants, it is inconceivable that fiduciaries would not be similarly protected for participants who affirmatively elect to be in those investments.

Finally, the 404(a) regulation is discussed to emphasize that the general expectation is that plans will have well-designed and balanced portfolios.

As a practical matter — to the extent that fiduciaries can structure their plan's investment lineups so that more participants have access to diversified risk-based (or balanced) portfolios — it may help participants invest well and protect fiduciaries from potential claims.

Additional considerations

Committee members should also consider whether participants are properly using the investments offered by the plan. That is particularly true now that many committees are receiving detailed reports about the investment patterns in their plans (e.g., based on age groups and other factors).

Committees are expected to review plan materials and understand what they mean. For example:

- **Are participants combining target-date funds and other investments, even though TDFs are designed as "one-stop" investments?**
- **Are older participants heavily invested in equities in a way that might be considered high risk?**
- **Are younger participants invested in a manner that might be considered overly conservative relative to the investment growth needed to accumulate adequate retirement benefits?**

Committees should look for patterns that might indicate a deficiency with their plan's services or investments. Is the information that is given to participants inadequate to explain how the investments should be used? Are the educational programs and materials missing the point in terms of helping participants invest? The investment patterns identified by examining the information given to committees will help the committee members spot any deficiencies and consider the causes. One potential "solution" to sub-optimal investing patterns may be to add risk-based options to the lineups. By adding those investments, committees protect themselves by providing choices that comply with ERISA's fiduciary standards and give participants another way to invest properly based on their risk preferences. In all likelihood, that would improve the overall investing patterns in the plan.

Examining the behavior and needs of participants is not a new concept. As two courts have explained:

> "At the very least, [fiduciaries] **have an obligation** to...determine the needs of a fund's participants..."[8]
>
> "Indeed, it has been held that [a fiduciary] **has a duty to inquire of the particular needs of the plan** vis-à-vis its participants."[9]

However, many plan committees are now receiving more data about the operations of their plans and the behavior of their participants. Committee members need to review that data and, where indicated, to correct problems in the operations of their plans.

Committees need a periscope to help reduce future risk

As a final thought on risk management for plan committees, it is important to know that the next wave of fiduciary litigation is unpredictable. Undoubtedly, the committees of large employers such as Enron, Anthem, BB&T, Vanderbilt, MIT and Johns Hopkins were composed of knowledgeable and thoughtful people. Yet, each of those committees lost or settled fiduciary lawsuits for millions of dollars. They were sued by their own plan participants for issues such as risky investments, excessively expensive investments, and high fees for recordkeepers.

But, if the committee members had anticipated the claims and, as a result, made different decisions, they could have avoided being sued, spending years in depositions and possibly trials, and highly publicized and expensive settlements or judgments.

Unfortunately, it would have been difficult, if not impossible, for the committee members to predict the claims that were ultimately filed against them. So, what should committees do? Since the precise claims can't be predicted, it would be good risk management for the committee members to ask their consultants and lawyers for a range of possible future claims.

That list should include, at the least, the following: expenses of investments compared to comparable plans, participant investment practices and patterns, and cost of service providers such as recordkeepers. In addition, committees should consider participant outcomes and how to improve financial security for retirees. That would include plan design and services to increase plan coverage and levels of deferrals, and investments and services to improve the quality of participant investing. While it's impossible to predict the next wave of lawsuits, it is possible to improve the quality of plan operations and outcomes, thereby reducing future risk.

Adding risk-based strategies to the investment menu

Plan fiduciaries who want to protect themselves, while offering flexibility and investment opportunity to their participants, may design the plan's investment structure as follows:

TIER 1

Target-date funds as the Qualified Default Investment Alternative (QDIA) and as a diversified age-based option that can be selected by participants who do not want to be engaged with their investments.

TIER 2

Risk-based funds as an investment to be selected by participants who want to use professionally designed and managed "portfolios," but who want to decide how much risk they will take with risk tolerance questionnaires and tools to help.

Unfortunately, some plans lack Tier 2 options (or, even if a plan offers one or two balanced funds, it may not offer a range broad enough to provide participants with a full opportunity to invest in risk-based funds that match their needs).

TIER 3

Single asset class investment options (i.e., not balanced). These investments allow engaged participants to make decisions about how to invest based on a full range of considerations. Presumably, these participants will do the work necessary to understand the investments and properly manage their accounts.

Where plan committees want to provide even more options and greater investment opportunities, a mutual fund or brokerage window can be added to the plan as a Tier 4 option.

Conclusion

There are several key benefits of adding risk-based strategies to the investment menu:

1. It will enable participants to match their investment choices to their risk preferences.

2. It will afford additional protections to plan committees to the extent that participants are in professionally managed portfolio investments.

3. It may allow committees to streamline the plan's investment lineups by eliminating under-utilized or redundant investment options.

Committees should consider improving their plan's investment structures by including risk-based funds as a separate tier for those participants who want to be more engaged in selecting their investments, but lack the experience, education or interest in using the plan's investment lineups to construct (and monitor) portfolios in their individual accounts.

The inclusion of a reasonable range of risk-based funds in a plan appears to be a "win-win" scenario: plan simplification, meeting participants' investment needs, and protections for plan committees.

About the author

Fred Reish represents clients in fiduciary issues and tax-qualification, as well as Department of Labor, Securities and Exchange Commission and FINRA examinations of retirement plans and IRAs.

Fred works with both private and public sector entities and their plans and fiduciaries. He works with banks, trust companies, insurance companies, and mutual fund management companies on issues related to plan investments and retirement income. He also represents broker-dealers and registered investment advisers on issues related to fiduciary status and compliance.

Fred regularly blogs at FredReish.com, where he provides updates and insights on the retirement industry for service providers, plan sponsors and registered investment advisers.

[1] Fisch, Lusardi & Hasler, Defined Contribution Plans and the Challenge of Financial Literacy, Research Paper no. 19-22, Institute for Law and Economics, University of Pennsylvania Law.
[2] The Cerulli Edge, U.S. Retirement Edition, 3Q 2019, Issue #52, at page 15. School (2019).
[3] DOL Field Assistance Bulletin 2007-01; *Laborers Nat. Pension Fund v. Northern Trust Quantitative Advisors, Inc.,* 173 F.3d 313 (5th Cir. 1999); *Lanka v. O'Higgins,* 810 F.Supp. 379 (N.D.N.Y. 1992).
[4] 29 CFR § 2550.404a-1 – Investment duties.
[5] DOL FAB 2007-01.
[6] 29 CFR § 2550.404c-5 – Fiduciary relief for investments in qualified default investment alternatives.
[7] 29 CFR § 2550.404c-1 – ERISA section 404(c) plans.
[8] *Liss v. Smith,* 991 F.Supp. 278, 300 (S.D.N.Y. 1998); see also, *Whitfield v. Tomasso,* 682 F.Supp. 1287, 1304 (E.D.N.Y. 1988).
[9] *Lanka v. O'Higgins,* 810 F.Supp. 379, 388 (N.D.N.Y. 1992).

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A target-risk fund is a type of asset allocation fund that holds a diversified mix of stocks, bonds and other investments to create a desired risk profile. The fund manager of a target-risk fund is responsible for overseeing all the securities owned within the fund to ensure that the level of risk is not greater or less than the fund's target-risk exposure.

A target-date fund identifies a specific time at which investors are expected to begin making withdrawals, e.g., Now, 2020, 2030. The principal value of the fund is not guaranteed at any time, including at the target date.

Modern portfolio theory (MPT) is a theory on how risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward.

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