WILLIS INVESTMENT COUNSEL
Principled Investing

February 2019

Common 401(K) Plan Mistakes

The 401(k) plan was created in 1978 when Congress passed the Revenue Act of 1978. It was simply added to the Internal Revenue Code – Section 401(k) – which allowed employees to avoid being taxed on deferred compensation. The 401(k) Plan began experiencing wide adoption in 1981 when the IRS developed new rules that allowed payroll deductions. Within two years of this new rule, nearly half of all large companies were offering 401(k) plans or were considering it.[1]

What originally started as a way for employers to offer something besides a pension fund[2] has now grown exponentially as a tool for employees to save for retirement on their own, in a tax-efficient manner. Today, more than 97 million Americans are covered by DC plan accounts, with assets now in excess of $7.5 trillion.[3]

But has this shift to 401(k) plans benefitted employees? Some may argue that when compared to the once popular pension fund, 401(k) plans have actually harmed employees. While 401(k) plans allow employees to decide how much they contribute and how those contributions are invested, it can be argued that this shift of responsibility is detrimental to those that do not have experience with making investment decisions. As a result, participants may opt not to make a decision (leave it in cash) due to decision-making paralysis; or they move in and out of funds too frequently; or they may choose to not save or not save enough.

Willis Investment Counsel partners with businesses in the management of their 401(k) plans. Throughout our 40-year history, we have found that many plans tend to be more complex and expensive than they need to be. As we work with committees in designing 401(k) plans, we emphasize understandability (for employers *and* employees), fewer investment menu "choices" including the use of a default fund[4] to further minimize the "need" to make decisions about the way funds are invested, and lower costs for both plan administration and mutual fund options. 401(k) plan investment committees have a responsibility to emphasize the above in an effort to provide the tools necessary to help their employees (participants) successfully prepare for retirement.

[1] Employee Benefits Research Institute
[2] Around the time that 401(k) plans became more heavily used, new pension fund laws dictated that any underfunded pension fund would be characterized as "debt" on the corporate balance sheet – something that employers did not want to risk negatively impacting their overall financials.
[3] Vanguard, How America Saves 2018
[4] A default fund is used when 401(k) participants choose to or fail to intentionally select a model portfolio or individual investment option(s) for their contributions. This is typically a balanced fund or a target date fund that has asset class diversification built in (i.e., 60% stocks, 40% bonds). It is also used as the investment option for automatic enrollment, *unless participants intentionally select a model portfolio or individual investment option(s).*

Based on our 40 years of managing client portfolios (including pension fund portfolios), working with many endowment fund, pension/401(k) plan, and similar investment committees, and studying 401(k) plan trends, Willis Investment Counsel offers these observations of common mistakes made by 401(k) plan decision-makers. Many of these mistakes are rooted in psychology, emotion, and in the dynamics of group behavior. [5]

The following summarizes common 401(k) plan mistakes that Willis Investment Counsel has noted throughout our time working with investment committees:

1. **The committee's discussion is too congenial; there is inadequate debate and excessive group think among the committee which can harm effective decision making.**

   The behavior of 401(k) plan investment committees sets the stage for important decision-making. Many of the behavioral problems, such as group-think, are common with investment committees. Some of the more common problems that diminish effective debate and rational decision-making follow:

   - Too many committee members; six to nine members is about the right number[6]
   - Tenure of members is too short and promotes "not on my watch" short-termism
   - Because conflict and discord are uncomfortable, they are discouraged
   - The more congenial and homogenous the group, the more unlikely robust, spirited debate occurs in a meaningful manner
   - Opinions are confused with facts; opinions, especially espoused by a strong personality, are taken as fact
   - Over-confidence is very common; accomplished professionals and business executives extend their expertise in their field to other fields, including investments; they believe they know more than they really do
   - Extrapolation of recent events is almost impossible not to do; recent trends are over-weighted and assumed to continue
   - A study by Vanguard[6] of investment committees indicates:
     - Committees give <u>too much</u> weight to:
       - Performance (rate of return) ranking
       - Manager changes
       - Markets
     - Committee gives <u>too little</u> weight to:
       - Costs
       - Portfolio construction
       - Risk
       - Transparency
       - Conflicts of interest

[5] Vanguard, *What Matters Most? An Analysis of investment committee decisions*, Karin P. LaBarge; September 2010; Vanguard, *Group Decision-Making; Implications for Investment Committees*, Gary Mottola, Stephen Utkus; CFA Institute, *Behavioral Finance and Investment Committee Decision-Making*, Arnold Wood, December 2006.
[6] Vanguard, *Duty, opportunity, mastery: Investment committee best practices*, April 2017

2. **Mutual fund options are excessive; causing plan participants to become overwhelmed with the decision-making process as they select their investments.**

   The norm is for a 401(k) plan to offer its participants at least 15-20 mutual fund options, and many 401(k) plans offer 30-40 mutual funds. More is considered better. A broad array of investment styles and strategies is considered preferable. Quite differently from this norm, WIC believes less is more, less is better, and participants are often harmed when offered more than 10 investment options. When 401(k) plan participants have numerous investment options it often leads to two very different harmful behaviors: indecision (no investment decision is made and the allocation remains all in cash), or excessive market-timing/frequent changing of funds (buying high and selling low).

   Most 401(k) plan participants do not have the education, training or experience to make rational investment decisions. Therefore, the investment committee should structure the enrollment process[7] and the investment selection process[8], to help the participant save and rationally invest. WIC believes constant education is critical to encourage ongoing saving by the participants and to dissuade them from entering the investment decision-making process (i.e., participants should leave the investment options alone).

3. **Plan administration and mutual fund costs are too high and have poor transparency.**

   As with most business decisions, cost should not be the driver. But in the 401(k) world, costs are often excessive (partly because all costs are not easily identifiable). Mutual fund costs are especially difficult to identify (some costs are buried in the fine print) and vary widely.

   Higher investment-related fees can arise when the plan unnecessarily pays retail vs. institutional level fees. And, visible dollars-and-cents costs are not the only costs. Equally significant excess costs can arise from the substantial (and rarely understood) costs associated with firing/hiring/switching mutual funds and managers. This cost can be unnecessary if the new fund or manager performs no better than the terminated manager (academic research suggests this is often the case).[9] Another "invisible" cost arises from indecision caused by over-analysis or inertia, which also can present opportunity cost.

   In addition to mutual fund fees, the administrative fees also tend to be opaque, layered, and excessive. In WIC's experience, we have noted that the structural complexity of the management process (i.e., too many outside advisors/managers/administrators) can significantly increase costs.

   WIC believes costs are minimized and well-managed when all costs are identified, when relatively lower institutional fee structures are accessed, when hidden costs of indecision and mutual fund changes are well-understood, and when no-load mutual funds with competitive expense ratios are used (along with some low cost index funds).

---

[7] Automatic enrollment where participant has to opt out if he/she does not want to participate

[8] An automatic election of funds for the participant by the committee where the participant can subsequently change that automatically election if later so chooses

[9] The Journal of Finance, *The Selection and Termination of Investment Management Firms by Plan Sponsors*, Amit Goyal and Sunil Wahal, August 2008.

4. **Morningstar ratings are given too much weight.**

   Almost universally, committees and their advisors over-weight Morningstar ratings. These ratings are taken at face-value and are considered to be scientific, objective, predictive, and almost the only benchmark needed for effective mutual fund selection. Yet, ample academic research questions the efficacy and reliability of the rankings' predictive power. Nonetheless, committees and advisors frequently draw unwarranted conclusions from these ratings and they are prominent in most quarterly reports.[10]

5. **Mutual fund (or manager) track records are given too much weight, while the importance of risk and risk-adjusted returns is minimized.**

   A very similar problem is the precision associated with manager and mutual fund historical track records and comparisons to benchmarks and indices. Far too much precision and predictive power is assigned to historical records. Academic research almost proves historical track records have little predictive value. Yet, they are universally used and relied on.

   The benchmarks themselves are misunderstood. Over time, benchmarks change and can be misleading. The fact that so few funds and managers "beat the market" brings into question the efficacy of benchmarking to the market (e.g., S&P 500). Too little attention is given to risk and risk-adjusted returns.

   Manager philosophy and strategy are rarely given as much attention as track records. Rather than effectively spending time discussing a mutual fund or manager's philosophy and how they make investment decisions, most wrongly believe a few numbers (the 1, 3 and 5 year performance numbers) tell the whole story. All players in the investment world draw unwarranted conclusions from historical track records.

6. **Table of returns in quarterly reports trigger too much action and tends to pressure the committee to "do something" when the short-term performance is lackluster.**

   Closely related to the foregoing is the natural tendency to spend a lot of time on the report's mutual fund performance data. It is only natural for business people to look at data, the scorecard, and look for "deficiencies and problems" that need attention. Investment committee members are trustees and fiduciaries and naturally want objective data to discharge their duties. Too often, good stewardship is seen as "doing something", taking action, making changes, and that taking action often is about replacing "under-performing" funds with better-performing funds. It is far from certain if the net-of-all-costs end result of "doing something" is beneficial.

---

[10] Morningstar Advisor, *The Percentile Trap*, Jeffery Ptak, June/July 2013; Fiduciary News, Morningstar Star Ratings: Do They or Don't They Predict? Christopher Carosa, January 29, 2013.

7. **Media drives the discussion – there is too much interest in the headlines, which can lead the committee to rely on forecasts (which can be highly inaccurate and unreliable) when making investment option decisions.**

   Again, human nature is "the problem". Business people especially have a need to discuss the business, economic, and market news and trends of the day. That discussion tends to be led by the media; the media essentially decides what is important, puts it in the headlines, and their topic becomes the focal point. Often, that discussion leads to forecasts that are acted on and acting on forecasts often increases risk (forecasts are highly inaccurate and unreliable).

Recommendations to improve decision-making. The following checklist reflects the above discussion, our experience, and academic research and provides a roadmap to better 401(k) investment committee behavior and decision-making:

- A committee of no more than nine people; a diverse group with substantive investment experience
- A chair that speaks last and forces robust debate and disagreement
- A healthy skepticism of Wall Street and complexity
- More conversation about risk, costs, and education than about historical performance
- A culture of truly long-term thinking and philosophy
- An understanding of the limitations of statistics and track records, and of their limited predictive value
- No more than ten mutual funds
- A combination of actively-managed and passively-managed funds with competitive, below-average fee rates
- Automatic enrollment to encourage savings
- Automatic selection of investment options to protect participants from themselves, and to recognize they are not sufficiently trained in investment theory and practice

Lastly, to help employees save and realistically prepare for their retirement, constant, effective communication is critical. Selecting "the right" mutual funds is not the silver bullet.

For more commentary, we invite you to visit our website at www.wicinvest.com.

Contact Information

WILLIS INVESTMENT COUNSEL
Principled Investing

710 Green Street
Gainesville, GA 30501
P: 770.718.0706 | F: 770.718.0805