

Workforce

MANAGEMENT

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A Cool Head Under Pressure

Employers with 401(k) plans need to heed the advice they are giving participants and not take rash actions during these volatile times.

By Lori Lucas

For 401(k) plan sponsors, these times may seem like the ultimate test. Just as many employers have put in place automatic enrollment programs for their 401(k) plans and added target-date funds as defaults, markets across the board have cratered, leaving benefits-center phones blaring. So now what?

Right now, the best action for plan sponsors is to keep a cool head. That, for the most part, means business as usual. Are the plan's funds behaving as expected on a relative basis? Are the service providers sound? Are participants getting the right messages?

Still, the current market turmoil does create a few wrinkles.

For example, many plan sponsors will find that this is the first major market decline ever experienced by their target-date funds. Even target-date funds that have been around for a full market cycle have, in many instances, experienced dramatic changes to their investment approach over the past several years, effectively making this their first bear-market test. What expectations were laid out in terms of how the target-date fund would navigate such an environment? Is this claim playing out in terms of actual performance? Is the target-date fund's exposure to certain markets and certain sectors in line with expectations

relative to their stated glide path? And if not, what rationale does the fund manager have for the change in strategy?

Stable-value funds are another unique animal, and particularly challenging in the current environment. Like other short-duration bond funds, the underlying investments in many stable-value funds have not performed well. Now more than ever, it is important for plan sponsors to require extreme transparency and to closely monitor the performance of the underlying investments within the stable-value fund. Other crucial steps include evaluating the type of insurance wraps (which provide the stability of the stable-value fund) used by the investment manager and understanding the scenarios under which the wrap providers supply protection to the fund.

If the plan has a money market fund, the plan sponsor will want to understand whether the fund is participating in the U.S. Treasury temporary guarantee program for money markets, and just how important that participation is. For example, are the underlying securities of the money market fund impaired? Or is the guarantee important to participants just from a psychological perspective?

Essentially, what plan sponsors are looking for here are red flags that indicate a fund change may be required. Either way, it will be prudent to formalize this due diligence

so that a written record is maintained showing that a thorough review was undertaken. In a similar vein, now more than ever, it will be important to make sure that an up-to-date investment policy statement is in place. Among other things, it can help guide the investment committee, and keep decision-making rational.

Reacting without overreacting

In some instances, reacting quickly and decisively to the current environment really is necessary. For example, is the plan's record keeper exposed to or affiliated with a financial services company that has collapsed, been purchased, or is teetering on the brink? If so, it will be essential to promptly examine the potential impact on plan delivery. Plan assets, of course, won't be at risk, given that they are held in trust for participants. However, serious service disruptions could be possible. At a minimum, a due diligence meeting should be conducted. It may even be necessary to undertake an actual record-keeper search.

In a measured way, plan sponsors will also want to take the current market environment into account in the execution of any plan changes. This is not to say that plan sponsors should be reluctant to proceed with strategic plans to replace a fund, change the composition of the fund lineup, or even implement a new record keeper. It

is impossible to predict when the market will be calmer—and for how long. However, it is still important to recognize that market volatility is likely to cause plan participants to be hypersensitive to changes, and this should be taken into account.

For example, plan sponsors who are seeking to eliminate a company stock fund will wish to be especially cautious about allowing ample time between the announcement of the change and the actual event itself so that participants can understand that the move is strategic, and so that they can choose how and when to transfer the money on their own. This might also be a time to consider cutting-edge approaches such as the Shlomo Bernartzi's "Sell More Tomorrow" program, which is effectively a mechanism to dollar-cost-average over time out of employer stock.

Even when it comes to diversified funds, participants may be susceptible to concerns about "locking in their losses" within funds that are being replaced due to performance (or other) issues. This may tempt the plan sponsor to freeze the fund instead of replacing it. However, it is difficult to rationalize why a fund that is not suitable for ongoing contributions is a reasonable place for existing participant monies. Further, the 2006 Pension Protection Act did provide considerable guidance (and protection)

around fund mapping, which should provide plan sponsors with some comfort. Again, communication will be key. Given the current circumstances, plan sponsors may wish to allow more time than usual to communicate fund changes, and to allow participants to move monies out of the fund prior to the mapping exercise, if they choose.

Note that none of these recommendations involve changing plan features or investments in reaction to short-term market volatility. For example, it may be tempting to replace or augment the plan's stable-value fund with a money market vehicle. But is the addition of such a vehicle really consistent with the long-term focus of the retirement plan? Is it even feasible, given 12-month put options and other limitations that tend to be in force? Likewise, it may seem appealing to add a low-correlation gold fund in hopes of improving diversification. However, plan sponsors will recall that it might also have seemed like a good idea to add a technology fund in 1999 and an REIT fund in 2005. Adding "hot" funds often simply leads to market timing by participants, not improved diversification. Also, plan sponsors could inadvertently send a message about the market to participants through such changes. In the example above, the addition of a money market fund could suggest to participants that the plan

sponsor believes this is a good time to get out of equities.

Preventing participant panic

Of greatest importance, perhaps, is the need for plan sponsors to allay the fears of participants by providing them with a context for what they are seeing in the markets. Record keepers have not been reporting an all-out panic by participants, but they do indicate that benefit-center call volume has risen significantly, Web site hits have soared, and transfer activity from equity to fixed-income funds is higher. Many record keepers have already posted content to their Web sites on topics ranging from historical market volatility (e.g., the 1973–1974 bear market and subsequent recovery) to how stable the record-keeping organization is. Participants also need to be reassured regarding the fact that they ultimately own their 401(k) account—not the company or the record keeper. Concepts such as how the plan's funds work, the dangers of market timing and the concept of rebalancing will also need to be reinforced.

Above all, it will be important for plan sponsors to lead by example, and keep a cool head in what is clearly a very challenging environment.