Passive Options in 401(k) Lineups

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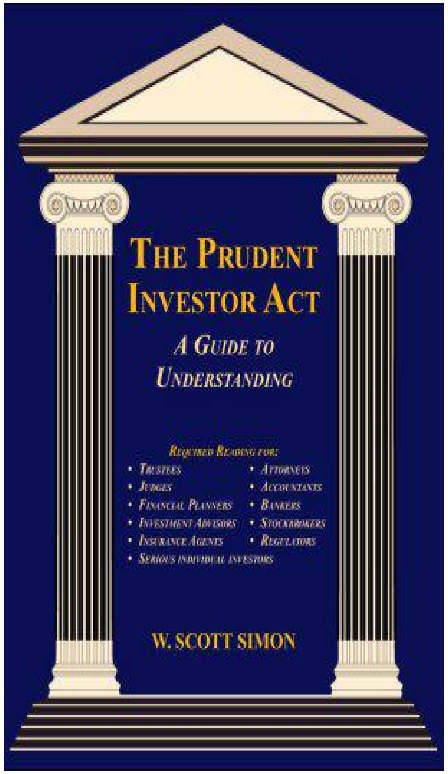
The Prudent Investor Act:

A Guide to Understanding

by W. Scott Simon



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The Ultimate Goal of Every 401(k) Plan

Provide Plan Participants with

Retirement Income Security that

Maximizes the Odds of a Comfortable Retirement

Plan Sponsors Achieve Two Important Goals by Including Passive Investment Options in 401(k) Plan Lineups

- Minimize Sponsors' Personal Fiduciary Risk
- Maximize Participants' Chances for a Comfortable Retirement

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Employee Retirement Income Security Act (ERISA)

- The Federal Law that Governs Qualified Retirement Plans such as 401(k) Plans
- The Duty of Loyalty Incorporates the Duty to Keep Costs Reasonable (ERISA section 404(a)(1)(A))
- The Duty to Diversify the Risk of Large Losses (ERISA section 404(a)(1)(C))

The Duty to Keep Costs Reasonable (ERISA section 404(a)(1)(A))

- Plan Investment Options Have:
- “Visible” Explicit Costs (e.g., Annual Expense Ratios)
- “Invisible” Implicit Costs (e.g., Bid/Ask Spread Costs and Market Impact Costs)
- Invisible Costs are Often Higher Than Visible Costs

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First Take-Away

- Plan Sponsors Should Insist that Their Retirement Plans Offer Passive Investment Options with Low Explicit and Implicit Costs

Second Take-Away

- Plan Sponsors Should Insist that Their Retirement Plans Offer Passive Investment Options That Diversify Risk Broadly

The Goal of Active Investing: "Beat the Market" Return

Three forms of active investing:

1. Stock Picking - focus on the future to predict the future

2. Market Timing - focus on the future to predict the future

3. Track Record Investing - focus on the past to predict the future

The Past is Not Prologue

- U.S. Securities and Exchange Commission Warning on Mutual Fund Advertisements: “Past Performance is No Guarantee of Future Results”

- A More Accurate Warning: “Past Performance is Not Only No Guarantee of Future Results, it’s Not Even an Indicator of Future Results”

Passive Investment Options in 401(k) Plan Lineups Are Far Superior

- Active Options Are Focused on Increasing Return - a Factor Over Which They Have Absolutely No Control
- Result: Lower Returns Due to Higher Costs and Poor Diversification of Risk
- Passive Options Are Focused on Decreasing Costs and Risks – Factors Over Which They Do Have Control
- Result: Higher Returns Due to Lower Costs and Broad Diversification of Risk

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Resources

- All Morningstar "Fiduciary Focus" columns (now 82) dating back to 2003 by W. Scott Simon:
- **http://morningstaradvisor.com/articles/articlelist.asp?colId=536**

- Other articles by W. Scott Simon:
- **http://www.prudentllc.com/resources_articles.html**

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The Dangers of Active Investing

- Active strategies…entail investigation and analysis expenses and tend to increase general transaction costs, including capital gains taxation. Additional risks also may result from the difficult judgments that may be involved and from the possible acceptance of a relatively high degree of diversifiable risk. These considerations are relevant to the trustee initially in deciding whether, to what extent, and in what manner to undertake an active investment strategy and then in the process of implementing any such decisions. If the extra costs and risks of an investment program are substantial, these added costs and risks must be justified by realistically evaluated return expectations.

- **Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule), comment h, page 30**

The Restatement 3rd of Trusts on Attempts to "Beat The Market" Return

- Economic evidence shows that, from a typical investment perspective, the major capital markets of this country are highly efficient, in the sense that available information is rapidly digested and reflected in the market prices of securities. As a result, fiduciaries and other investors are confronted with potent evidence that the application of expertise, investigation, and diligence in efforts to "beat the market" in these publicly traded securities ordinarily promises little or no payoff, or even a negative payoff after taking account of research and transaction costs. Empirical research supporting the theory of efficient markets reveals that in such markets skilled professionals have rarely been able to identify underpriced securities (that is, to outguess the market with respect to future return) with any regularity.

- **Reporter's General Note on Section 227 of the Restatement 3rd of Trusts (Prudent Investor Rule), page 75**

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America's First Nobel Laureate on Passive Investing

- Every departure from indexing that you hope will put you ahead - as when you give eight money managers with different styles one-eighth each of your portfolio to manage - when the resultant ends far from diversification agreement with the overall index, your risk-corrected long-run performance is in jeopardy to a degree that you are not able even to estimate.

- **Paul Samuelson, the second (and first American) recipient of the Nobel Prize in economic sciences (1970)**

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Another American Nobel Laureate on Passive Investing

- [A]ny pension fund manager who doesn't have the vast majority - and I mean 70% or 80% of his or her portfolio - in passive investments is guilty of malfeasance, non-feasance or some other kind of bad feasance! There's just no sense for most of them to have anything but a passive investment strategy … Most pension fund managers cannot even reasonably hope to do any better than a passive fund. And on a risk adjusted basis they don't!

- **Merton Miller, co-recipient of the 1990 Nobel Prize in economic sciences**

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The Sage of Omaha on Passive Investing

- Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees.

- **Warren Buffet, in the Chairman’s Letter, 1996 Berkshire Hathaway Corp. Annual Report**

Peter Lynch on Passive Investing

- [Most investors would] be better off in an index mutual fund.

- **Peter Lynch, legendary (former) manager of Fidelity Magellan, in "Is There Life After Babe Ruth?,"** ***Barron's*****, April 2, 1990, page 15**

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The Reporter for the Restatement 3rd of Trusts on Passive Investing

- When we think of the relative efficiency of our major central markets, we see compelling evidence that it's hard with any consistency or predictability to beat the market through stock picking. Therefore, one ought to be concerned about heavy expenditures for an undertaking unless it offers some realistic prospect of a corresponding payoff.

- **Edward C. Halbach, Jr., Reporter for the Restatement 3rd of Trusts and Walter Perry Johnson professor of law emeritus at the University of California law school**

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Jack Meyer on Passive Investing

- **Q**: How can individuals find managers who can beat the street?
- **A**: Most people think they can find managers who can outperform, but most people are wrong. I will say that 85% to 90% of managers fail to match their benchmarks, if you properly specify their benchmarks.
- **Q**: That's pretty pessimistic.
- **A**: Yes. But because managers have fees and incur transaction costs, you know that in the aggregate they are deleting value. The [active] investment business is a giant scam. It deletes billions of dollars every year in transaction costs and fees.
- **Q**: So what should individuals do?
- **A**: Most people should simply have index funds to keep their fees low and their tax down. No doubt about it.

- **Jack R. Meyer, Former CEO of Harvard Management Co., in *Business Week*, Dec. 27, 2004**

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