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401k Plan Sponsors: Is Your Investment Policy Statement Still Using Outdated Language?

by Christopher Carosa, CTFA May 17http://www.fiduciarynews.com/2011/05/401k-plan-sponsors-is-your-investment-policy-statement-still-using-outdated-language/?utm_source=FiduciaryNews&utm_medium=The4KeyElementsofaSuccssful401kPlanEducationProgram&utm_campaign=022712z

ERISA attorneys seem to have two minds when it comes to the Retirement Plan Investment Policy Statement (IPS). Some tell the plan sponsor it's safer not to put anything in writing because it would then produce a documented record which can

then be used against the plan sponsor. Others warn it's safer to have one as it limits the definition of the plan sponsor's fiduciary liability. Of course, in a 2008 Interpretive Bulletin, the Department of Labor said "The maintenance by an employee benefit plan of a statement of investment policy designed to further the purposes of the plan and its funding policy is consistent with the fiduciary obligations set forth in ERISA section 404(a)(1)(A) and (B)."

Congratulations, you've done your fiduciary duty and created an IPS for your ERISA plan. The trouble is, as the first group of attorneys say, you've just created a written record that can and will be used against you. In fact, the older your IPS is, the more likely it will contain outdated language that might just land you in a pile of you-know-what.

It's beyond the scope of one weekly column to provide a comprehensive review of updating an IPS, so we'll concentrate on perhaps the sexiest part of the plan: The Three Fundamental Investment Goals.

If you're a plan sponsor of a 401k plan, you're no doubt familiar with the 404(c) provision while requires you to offer at least three separate and distinct investment options to employees in order to safe harbor the plan. A better way to read this is "at least three separate and distinct investment goals," since investment options can (and do) have similar goals.

Many bankers, brokers and even some investment advisers continue to discuss investment matters in terms of these three traditional investment goals:

1. Safety of Capital.
2. Generation of Income.
3. Capital Appreciation.

The traditional goals have several advantages. They make intuitive sense. They accurately reflect the historic investment environment. They've been accepted and used for a very long time. Most important, they're really easy to understand. Indeed, if you're veteran broker, you might remember being taught to describe the relationship of these goals with a pitcher of orange juice and three (very large glasses). Each glass represents one of the traditional investment goals. The broker would ask the client to pour as much juice into each glass that would reflect the relative importance of each goal. A client could pour everything into one glass, split it between two glasses, or pour at list a little bit into all three glasses. In the end, the broker would use this exercise to explain the nature of investing as a zero sum game. You cannot add to one glass without taking away from another.

That, in a nutshell, represents one of the disadvantages of the traditional investment goals. They do not reflect today's investment environment. They're outdated and, if they're still reflected in the language of your IPS, that can prove problematic. Think of it in terms of this metaphor: If you want to get somewhere, would you use an outdated road map or an up-to-date road map? The biggest issue with the traditional goals is that all of them, by definition, conflict with each other. Again harkening to our metaphor, if you had to get somewhere, say, Tahiti, by land, air and sea, would you accept a proposal which lets you take either a car, a plane or a boat, but not all three?

For decades, investors have been taught – rightfully so – that these goals each conflict with one another. In other words, the more emphasis the investor places on one goal, the less likely he will achieve the other two goals. All these goals, in practice and in theory, fail to account for inflation. In addition, any goal that emphasizes income generation suffers against a mountain of evidence suggesting total investment return provides consistently higher returns for long term investors. Fortunately, we have defined a set of practical investment goals that will better serve plan sponsors and their employee-investors.

Enter the Modern Investment Goals. Every well-read student of investment theory – whether a practitioner or casual investor – uses these goals in one form or another:

1. Wealth Accumulation – Building and growing a portfolio for some future use.
2. Wealth Preservation – A portfolio that maintains one's current lifestyle (or other objective).
3. Wealth Distribution – Depleting an existing portfolio in a controlled manner for some set term.

These Modern Goals come with several advantages. They make intuitive sense – everybody can think in terms of accumulating wealth, preserving wealth and distributing wealth. They accurately reflect the modern investment environment – if everything goes according to plan, one will use each of these goals at least once in one's life. These investment goals help the 401k plan sponsor concentrate on the pragmatic matters of investment management. By using such practical terminology, plan sponsors can directly relate the strategy of the goal to an associated investment strategy (i.e., the investment option). More importantly, these goals work together rather than conflict with one another. Ultimately, this is the proof of the pudding: The Modern Goals work in the modern world.

For example, let's compare Safety of Capital with Wealth Preservation. Both seem to be saying the same thing, but they are different. Safety of Capital implies the preservation of the investment principal or an actual set dollar figure. Wealth Preservation implies preserving the lifestyle allowable at the current level of wealth. At the very least, Safety of Capital, in its traditional sense, has ignored the impact of inflation on principal. Wealth Preservation takes into account the impact of inflation. In practice, a portfolio of pure US government bonds would be adequate to meet the investment objective of Safety of Capital. In practice, a portfolio of pure US government bonds would virtually guarantee the failure of meeting the investment objective of Wealth Preservation. A Wealth Preservation portfolio, in order to meet the objective to maintain the current lifestyle, would naturally be a more conservative portfolio but it wouldn't be a static portfolio. It would require investments that would likely keep up with inflation. (N.B. For those sticklers, we're assuming the jury is still out on the effectiveness of inflation-indexed Treasuries.)

This is not to say the Modern Investment Goals don't possess some disadvantages. First and foremost, not everyone readily accepts them. Recalling our travel metaphor, if you go to a travel agent with plans to travel to Tahiti and your travel agent calmly says, "Can't get there from here," do you think that particular travel agent will be able to get you to Tahiti? Does it matter to you if the travel agent tries to convince you that St. Thomas is really where you should be going? Said another way, you might not want to go to Tahiti, but one of your employee could want to. Plan sponsors can't ignore the Modern Investment Goals.

Even when folks accept these goals, they might not use them, preparing the traditional world they grew up in. How does this stack up to our "Tahiti Test"? Well, the travel agent now accepts you can get from here to Tahiti. Alas, the travel agent does not have any packages to Tahiti? Again, does it matter to you if the travel agent can provide with a really terrific package to St. Thomas?

Finally, even if users accept and adopt the Modern Investment Goals, we still have the problem that everyone might not understand them. One last time (promise), we'll invoke our by now tired metaphor. OK, the travel agent both accepts the idea of going from here to Tahiti and actually offers a package to Tahiti. Unfortunately, the travel agent isn't sure what it costs, who you need to pay or how you're going to make the various connections you need to make to get to Tahiti. Does it sound like you should be going to a different travel agent?

Truth be told, the Modern Investment Goals really aren't so new. They first appeared in the 1999 book *Due Diligence: The Individual Trustee's Guide to Selecting and Monitoring a Professional Investment Adviser* (by Christopher Carosa, CTFA; Ardman Regional, publisher). They've appeared elsewhere in articles since and, under several variations of their names, seem to be growing in acceptance.

If you're a 401k Plan Sponsor, take another look at your IPS. Are your investment goals updated to reflect the language of the modern investment environment, or is your IPS just a travel agent with no clue about Tahiti?