Will "Default" turn into "Your Fault?"

BY AL OTTO

Many would say that the issues with qualified retirement plans over the last few years could easily be viewed like the hurricane season of 2005—there have been issues like the late trading and market timing scandals, the recent pension consultant issues and the massive increase in class action lawsuits around plans with employer stock that, when another issue comes along, it makes you feel like "oh no, not another one!"

Well, here's one more potential sleeper—the default fund in your 401(k) plan. You're kidding! No way! How can the default fund in your 401(k) plan be an issue? Let's just say that it has to do with logic, ERISA and fiduciary liability … and ERISA is not exactly logical.

These situations occur when participants fail to select an investment option. A default fund is also used with plans that have automatic enrollment provisions. Fixed dollar investments (money market and stable value funds) are the most common choice as the default. For example 80 percent of Vanguard's 401(k) plans use a fixed dollar account as the default fund.[1]

Successful plan sponsors are reviewing their default fund decision for two main reasons: to limit their fiduciary liability, and/or to maximize the account value for those that do not make a decision for themselves. They've learned about the danger inside the key myths surrounding default funds.

Two typical plan sponsor myths about default funds:

1. "Our plan is protected by the safe harbor exemption of 404(c). If a participant doesn't want to make a selection, then they are choosing the default. It is their choice."
2. "We're not at risk because the participant will never lose money in the default fund. The principal of this investment is guaranteed."

Unfortunately they are both wrong. When a participant doesn't make a choice the default fund is the choice made for them by the plan's fiduciaries. So, there is no safe harbor protection, and the fiduciary is responsible for the fund selection being prudent for the participant.

According to Fred Reish[2], an ERISA attorney and a leading expert on ERISA fiduciary liability, there is no 404(c) protection for the fiduciary when a participant ends up in a default fund. ERISA dictates that, where participants do not give directions, the plan fiduciaries must prudently invest money on their behalf. This means you are at risk if you are a fiduciary.

Default funds are not protected by the safe harbor exemption of 404(c) on which most employers rely to minimize their liability. The 404(c) provision of ERISA transfers liability to plan participants for their investment allocation choices. Because the participant is not making the decision when a default fund is used, the plan fiduciaries remain responsible for the full investment oversight and control duties under ERISA.

Fiduciaries must invest for the exclusive purpose of providing retirement benefits to the participants of the plan and their beneficiaries.[3] It is not for the purpose of minimizing criticism or risk of principal in a participant's account. Imagine that you are 100 percent invested in the default fund. Is it more prudent to invest in a balanced account for the next 20 to 30 years or to invest in cash? Are you at risk for the difference in returns between a fixed dollar fund and a balanced fund?

To answer the question, look at the risk/reward characteristics for both options. There are two main risks to consider: the risk of losing capital and risk of losing purchasing power due to inflation. A perfect investment would have no risk of losing capital and would have returns over time that beat inflation.

According to Ilene Ferenczy, an ERISA attorney and expert on fiduciary issues, ERISA does not hold plan fiduciaries to performance certainty. Instead, ERISA requires that fiduciaries have a reasoned and thoughtful process for evaluating risks and returns and for providing an investment program that is both diversified and prudent.

Is a fixed default fund prudent? For example, a $10,000 investment in cash would grow to the following amounts based on the investment chosen.

In light of the significant difference in returns between the fixed dollar fund and the balanced fund, would a prudent investor put his or her retirement money in a fixed dollar fund? If not, is it prudent for you to do this for your noninvesting participants?

Hypothetical Range of Returns		Balance after 10 yrs	Balance after 20 yrs	Balance after 30 yrs
High (95th Percentile)	*Fixed Dollar Fund*	$15,200	$52,040	$132,800
	Balanced Fund	$22,520	$106,840	$392,720
Median	*Fixed Dollar Fund*	$14,080	$47,200	$114,800
	Balanced Fund	$16,080	$62,640	$187,960
Low (5th Percentile)	*Fixed Dollar Fund*	$12,800	$41,400	$99,680
	Balanced Fund	$11,440	$37,400	$96,040

Based on annual returns from 1960 – 2004. T-Bill returns used for fixed-dollar investment and the balanced fund assumes 60 percent invested in the S&P 500 Index and 40 percent in the Lehman Brothers Aggregate Bond Index.

What should you do?

1. At the very least, your plan committee should discuss this situation and document your decision.
2. Another proactive approach is for human resources to contact each default fund investor and have them acknowledge their choice in writing. Once that is done, they have made an election, and 404(c) coverage likely applies.
3. Consider using balanced fund(s) for those participants that aren't making an investment choice. B&CS

[1] Vanguard Report – *Selecting a Default Fund for a Defined Contribution Plan* (June 2005)

[2] ERISA Report for Plan Sponsors - *Rethinking Default Accounts* (July 2005), Reish, Luftman, Reicher & Cohen

[3] Exclusive Benefit Rule – ERISA § 1.401-1