



Richard Deaves

DC risks 101

The CAP guidelines do not address education. But education crafted around the pre-packaged portfolios offered to members can be especially useful.

It is well documented that future retirees make potentially costly mistakes in managing their self-directed retirement accounts. Many procrastinate in saving and fail to understand risk. They put too much money into company stock. They tend to chase winners. And while people are aware of their lack of knowledge, they are often overconfident. Perhaps worst of all, despite the fact the asset allocation decision is central to a portfolio's long-term success, many allocate their money among fund options in an ill-informed fashion.

A 2004 survey of Canadian defined contribution (DC) plan members commissioned by SEI Investments, found the menu of funds offered significantly influenced risk-taking behavior. Give people a lot of bond funds to choose from and they are liable to take on too little risk; give them a lot of equity funds and they will load up on risk, the survey found. When members allow the menu to influence their risk-taking, they are signaling a lack of understanding of asset allocation.

In this climate of uncertainty and potential litigation, what are sponsors to do when confronted with this evidence? In my view, the courts are likely to look favorably on those who are doing their best to follow best practices. It is not only good business, but it is the right thing to do. The 2004 Capital Accumulation Plan (CAP) Guidelines are a commendable starting point on what these best practices entail. They mandate communication to CAP members, and they allow for advice. Education, which implies information retention and understanding, is not dealt with.

Still, I believe it is incumbent on sponsors to get members to do the right thing, and this may require the provision of education and even advice. DC plan members, however, are not always receptive to education. Unlike

advice and thus has insufficient savings? Or the member who takes advice and as a result does reasonably well over the long term? Remember—the whole point of advice is to increase the probability of having sufficient savings on

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university students preparing for an exam, their day of reckoning, retirement, is usually some distance off. But there are ways to improve education.

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For one thing, it helps to recognize the membership. We are dealing with people who are quite diverse in age, investment knowledge and educational background—plus there is evidence that plan members fall into fairly distinct attitudinal segments: “planners” and “avoiders.” Planners, unlike avoiders, are comfortable with retirement and pension concepts. Unfortunately, many educational programs and Web sites have been designed for planners. Such decision aids need to be refocused away from planners towards avoiders.

What about advice? The CAP Guidelines say that if advice is provided, care must be exercised to select and monitor providers. The initial reaction of some plan sponsors when advice comes up is: why even take on the risk? But who is more likely to be unhappy and sue? The member who makes poor decisions without the intervention of

retirement.

It can be argued that a strong form of advice is to offer members a set of pre-packaged portfolios. Education could be refocused around these portfolios. About five to 10, differing by equity exposure, should be enough. A questionnaire, and perhaps an interview, can map an individual on to the portfolio appropriate for them. Such an approach is especially useful for avoiders. Moreover, the word “advice” need never be used, and sponsors do not have to monitor the performance of third-party advice suppliers. While it is true that DC plans are exposed to litigation risk, the reward is that this risk can be effectively managed: by following best practices, by providing innovative education, by providing third-party advice, by offering pre-packaged portfolios—maybe even all of the above. Sponsors, members and overburdened courts will all be the better for it. **BC**

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