Fiduciary News

Bad News Bonds Could Increase 401k Fiduciary Liability

By Christopher Carosa, CTFA | January 28, 2014

By the early 1990's, it became increasingly clear 401k investors had become too conservative in their investments. The ensuing decade of rigorous education programs designed to emphasize the long-term nature of retirement savings failed to move the needle sufficiently. Finally, in 2006, Congress passed the Pension Protection Act.

The Act contained incentives for 401k plan sponsors to address two major problems. The first dealt with insufficient savings rates as evidenced by lack of employee participation in plans. The second addressed the over-weighting of conservative investments in the retirement portfolios of those who chose to participate. This was the legislation that ushered in the popular automatic enrollment feature we see in most plans today (this addressed the lack of savings). The legislation also saw the governmental blessing of the fast growing Target Date Fund product (this was supposed to address the too little equity exposure).

We'll leave to other articles to discuss the historic problems with Target Date Funds (TDFs), but the biggest problem was simply bad luck. As soon as TDFs had become vastly promoted and accepted by 401k investors, the economic turmoil of 2008/2009 hit the markets. Like all other investments, the maelstrom of the credit crisis consumed TDFs. Unfortunately, especially for near-term TDFs, investors bought them with the idea they were safe.

They weren't.

We may be about to relive that experience. Only this time, 401k investors might have grounds to blame their plans' fiduciaries for not properly designing the plan to avoid this incredible feeling of déjà vu.

Last week State Street Global Advisors released the results of their Biannual DC Investor Survey. In part, the results confirm the results of earlier surveys that showed 401k investors are over-weighted in bonds. The SSGA survey states 49% of the "participants are investing more conservatively than they did five years ago – presumably by holding larger percentages in fixed income." The survey brought up two issues with this. First, this "investing more conservatively" sentiment conflicts with the usual pattern of "investing more aggressively" when optimism increases. SSGA feels its survey respondents did express future optimism, yet, it notes "conservative" investors outnumbered "aggressive" investors by a 7:1 ratio.

Worse, finds SSGA, investors seemed to have a fundamental misunderstanding regarding the nature, risk and safety of bonds. More than a third (36%) "say, incorrectly, that bonds help minimize the impact of inflation." The study warns "Participants may not understand the impact that greater conservatism can have on their portfolios' vulnerability to inflation and ability to generate the growth they need for retirement." The problems of holding bonds in long-term growth portfolios are well documented.

"When the market crashed in 2008, there was a stampede to safety and lower risk investments," says Sean Ciemiewicz, Principal of Retirement Benefits Group in San Diego, California. "Five years later, there is still a large number of investors in 401k plans who believe bonds are still the safest investment option for their assets. As I visit with individuals who are close to retirement, they all indicate that they can't bear to take the same hit on their investment value like 2008. We try to explain that there are risks with being heavily invested in bonds. In 401k plans there are very few alternatives from stocks or bonds so their only choice is to go with what is described in the materials as the lowest risk category."

Steven Elwell, Vice President at Schroeder, Braxton & Vogt in Amherst, New York, is concerned for the 401k investors who "moved all or a significant portion of their 401k assets to bonds after 2008. They panicked, sold their stocks while they were low and bought bonds, which they considered safer. Now with interest rates starting to creep up they may be in for a bumpier ride than they expected."

"Investors, as a group, have shunned risk assets since the financial crisis," says says Daniel H. McElwee, Executive Vice President at Ventura Wealth Management in Princeton, New Jersey. "When asked, many will incorrectly state 'I can't lose money in a bond.' The problem here is clearly a severe case of risk aversion (fear of equity markets) and poor education about a major asset class."

These financial advisers reflect the general consensus of the industry for some time now. Given this time element, astute 401k plan sponsors should also be fully aware of the problem. This presents a potential fiduciary liability issue for plan sponsors and their advisers. Not only do we have the issue of long-bond volatility, but we also have the thorny issue of the difference between bond funds and individual bonds. Elwell says of investors are comforted to know "if they bought individual bonds that as long as they hold to maturity they will get their money back." Bond funds are really equities – they have no maturity.

"When you buy an individual bond, you receive interest, based on the face-value of the bond, regardless of whether the value of the bond fluctuates in value," says Adam D. Koos, President/Portfolio Manager at Libertas Wealth Management Group, Inc. in Columbus, Ohio. "Assuming the bond doesn't default at some point (insured bonds have guarantees against such an event), you would expect to receive this interest until the bond matures, at which point, you would get back the face value, which could be more, less, or the same as what you paid for it. Between now and maturity, however, if you sold the bond early, you could get less, more, or the same as what you paid for the bond, all depending on the prevailing price of the bond at that moment. When buying mutual funds, on the other hand, you're buying a basket of bonds and you're paying one price-per-share for that basket. If the value of the bonds goes up or down, your investment goes up or down with it. When interest rates go up, bond values fall. Rates are at 30-year lows, so they can't go down from here – at best, they can stall before rising, but eventually, they're going to rise. There is no 'maturity date' per se, when it comes to bond mutual funds, so when interest rates go up and investors' bond prices fall, their principal will fall in the mutual fund right along with the falling values of the underlying bonds. Interest rates might help to cushion this blow, but the longer the maturity of the underlying portfolio, the more it'll hurt when (not if) interest rates rise."

Can 401k plan sponsors do anything to mitigate their potential fiduciary liability? Education is often treated as a panacea of things like this, but it seems to regularly fall on deaf ears. One way to address the problem is through the investment menu. Joe Gordon, Managing Partner, Gordon Asset Management, LLC, Durham, NC says to "Offer stable value or money market funds as part of your plan." Holmes Osborne of Osborne Global Investors, Inc in Santa Monica, California, says solving the problem is "very difficult. The plans have bond funds. You try and warn people of the coming rise and try to put them in bond funds with shorter durations."

Koos suggests to "avoid 'conservative' allocation funds where the mutual fund company invests your money for you and is limited to a minimum in fixed income investments and avoid 'target date' funds where the mutual fund company shifts your allocation to a heavier bond weighting as you age."

The issue is real but the potential solutions are complex. Still, 401k plan sponsors must recognize the problem and try their best to address it – before it's too late. In reminding us it's a matter of utmost due diligence, McElwee says, "The damage that can come from rising interest rates is real and threatens some of today's most vulnerable investors. The more investors are aware of the problem, the higher the likelihood that they will take appropriate actions in their portfolios."

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The principal value of a target date fund is not guaranteed at any time, including at the target date. The target date represents the approximate date when investors plan to start withdrawing their money. Investing in mutual funds and target date funds involves risk, including possible loss of principal.