DiMeo Schneider & Associates, L.L.C.

Plan Sponsor News

DiMeo Schneider & Associates, L.L.C.
▶ OCTOBER 2009

Education after the Crisis: A Refocus on Risk and Time Horizon

Jim Modelski, Senior Consultant

During the recent global stock market and economic downturn, investors lost over a trillion dollars in retirement savings. Countless newspaper articles and television shows carried stories of those near retirement who lost 30% or more of their nest egg because of failure to manage risk and/or changes in time horizon. Other stories captured the behavior of twenty- and thirty-year olds who: 1) elected to not participate in their 401(k) plan at all; 2) stopped contributing to their Plan; or 3) conservatively re-allocated accounts despite their long-term time horizon. Stories like these have led many to question the effectiveness of 401(k) participant education and its role in preparing participants, particularly in communicating the two concepts of risk and time horizon.

A Refocus

Given the recent stock market and economic environment, what is needed? The answer is a refocus on risk and time horizon. Plan Sponsors should ask their education providers to refocus efforts on helping participants understand their willingness and ability to take risk. When a participant talks of risk they most likely mean that they are loss averse. Behavioral finance experts Richard Thaler, Daniel Kahneman & Amos Treversky demonstrated that investors hate losses 2.5 times more than they like gains.1 Investors feel the pain of monetary loss more than they enjoy the pleasure of gains.

A risk tolerance questionnaire/profile is still one of the most important steps for a participant to help them tailor a portfolio. In fact, participants should take a risk tolerance questionnaire/profile annually. However, it is not the only step in risk assessment.

Plan Sponsors should ask for active training that includes examining actual dollar impact on a participant's account. Because participants cannot control market performance, active education which helps investors focus on areas such as savings and spending rates, asset allocation, costs and the impact of any employer contributions can help a participant along a "life-cycle" even when in retirement.

The long-term is made up of a series short-term periods. Plan Sponsors should also ask their education providers to help participants examine various scenarios along their time horizon or "life-cycle" such as what happens if the market turns downward just as a participant decides to retire or live off the 401(k) portfolio? A situation like this may call for a reevaluation of a participant's spending rate to reduce the speed of the drawdown in retirement.

Similarly, participants in the accumulation phase of the life-cycle - 20 to 40 year olds - who do not participate in the Plan, reduced/stopped contributions or re-allocated to a risk-averse portfolio (i.e. cash, stable value or bonds) may experience no losses or less volatility. However, these actions could result in a significant reduction in retirement security especially when the equity market begins to rebound. Participants may run out of money earlier than those who maintained a balanced asset allocation or require a significantly higher savings rate to close the gap between retirement savings and retirement security.

Next Steps

The recent global stock market and economic downturn provides Plans Sponsors and education providers with an opportunity to help employees improve planning and preparedness.

- Willingness and ability to take risk - Active engagement with participants to examine actual dollar impact of their accounts.
- Time horizon - Participants invest over a finite time horizon. What factors impact a participant *today* at his/her given time point in real dollar terms? What adjustments, if any, should be made to savings/spending rates, asset allocation and re-balancing according to position within the time horizon?
- Retirement income - Plan Sponsors and participants now perceive the need to convert 401(k) balances into an income stream. Work with your Plan's record keeper to see what solutions may be available to participants.

What to Do…We can help!

Eighty-two percent of Plan Sponsors think their participants will not be adequately prepared for retirement.[2] The fact is, 401(k) plans are *individual* retirement plans and participant education should be personal. Education campaigns should help participants discover and acquire a working knowledge about risk and time horizon in order to motivate individuals to make sound decisions. Creating a written education strategy and policy is an effective way to move away from a "general" approach to one that is personalized and for the individual especially as it relates to risk and time horizon.

Contact Jim Modelski at jmodelski@dimeoschneider.com or 312-853-1000 for a more detailed look at your options.

[1] Richard H. Thaler, Amos Tversky, Daniel Kahneman, and Alan Schwarts. "The Effective Myopia and Loss Aversion on Risk Taking: An Experimental Test," *Quarterly Journal of Economics* (May 1997). pp. 647-661.
[2] Deloitte and the International Foundation of Employee Benefit Plans. *The 401(k) Benchmarking Survey. 2008 Edition.* p. 33