Investment Guidance versus Investment Advice

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Many plan sponsors, both public and private sector, wrestle with the issue of providing investment advice to employees as part of their defined contribution plan. Education and guidance are important parts of most plans, but is this really sufficient?

Although there is no right or wrong approach to helping employees plan for retirement, it is recognized that an employer's fiduciary duty includes making sure that participants are provided sufficient information and tools to make educated and appropriate investment decisions. Some participants need more handholding then others when it comes to making investment decisions. In fact, some believe that, in order to ensure appropriate decisions are being made, investment advice needs to be an available option.

This brochure:

- Explains the differences between investment guidance and advice
- Illustrates the types of advice available today
- Explores concerns that employers face when considering advice alternatives
- Describes the selection and monitoring process for investment advice providers

What is guidance?

In June 1996, the US Department of Labor (DOL) issued Interpretive Bulletin 96-1 that clarified what constitutes investment guidance, and is not considered advice. Although this Bulletin was specific to plans covered under the Employee Retirement Income Security Act (ERISA), government sector employers typically follow ERISA as guidelines unless state laws dictate otherwise.

guid·ance (noun) -
The act or process of guiding; a guide implies intimate knowledge of the right way and of all difficulties and dangers that might result

There are four broad categories of information that the DOL bulletin identifies as investment guidance.

Plan-specific information includes explanations of the advantages of participating in the employer plan, the benefits of increasing contributions and other information such as details on the available investment options (e.g., each option's risk and return characteristics, historical return information, prospectus).

General financial and investment education informs participants about investing concepts such as types of risk (market, inflation, etc.), diversification, dollar cost averaging, compounding, etc. This category also includes general information about asset classes as well as determining time horizons, risk tolerance levels and retirement income needs.

Asset allocation modeling provides employees with examples of diversified portfolios based on certain investor profiles. This information may include pie charts, graphs, or case studies that pertain to hypothetical individuals with differing time horizons and risk profiles.

Interactive investment material provides participants with tools to help them make investment decisions and generally will include questionnaires, worksheets, software, and similar materials. These tools can help participants estimate their own future retirement income needs as well as

assess the impact different asset allocation models might have on their future retirement income.

The most important take-away from the above listing is that guidance provides information, education and tools to help participants make investment decisions, but it requires them to make their own decision as to how it applies to their specific situation.

What is investment advice?

ad·vice *(noun)*- ***Recommendation regarding a decision or course of conduct***

Investment advice provides participants with specific recommendations on how to invest their deferred income for retirement. There are several different methods of investment advice that a plan might offer that include:

- do-it-yourself Internet or software programs
- telephone or in person one-on-one counseling
- managed personal accounts

Investment advisors are subject to the Investment Advisors Act of 1940. This Act requires that certain steps be taken by advisors, such as conducting a suitability analysis before advice can be given. This analysis considers individuals' total financial picture, investment objectives and risk tolerance to ensure recommendations are appropriate for their specific situation.

Investment advice may be provided in a discretionary or non-discretionary manner. In a discretionary advice approach, participants turn over the authority for decisions within their account to an advisor or manager, who then is responsible for the account activity and investment decisions. Discretionary advice is generally established through personal managed accounts.

A non-discretionary advice approach results in recommendations for investing but participants have discretion as to if these recommended actions will be followed. Examples of non-discretionary advice services are do-it-yourself Internet or software programs and personal counseling (one-on-one or by phone) that offers specific investment recommendations based on information provided by the plan and/or participants.

Investment advisors that provide discretionary or non-discretionary advice for a fee, or other direct or indirect compensation, are considered fiduciaries with respect to this service. Although this means that the advice provider shares the fiduciary role with the plan sponsor, they cannot absolve the state or local government employer for the ultimate fiduciary responsibility of offering this service to their employees.

Today's Advice Models

According to the Profit Sharing and 401(k) Council of America's *47th Annual Survey of Profit Sharing and 401(k) Plans* (based on 2003 data) 54.1% of private sector employers are providing advice today in their 401(k) plans. This survey shows that the most common forms of advice found in the private sector are:

- One-on-one counseling (56.2%)
- Internet providers (52.2%)
- Telephone hotlines (31.5%)

Fewer public sector plans are offering advice in their defined contribution plans, with only 30% of state and local governments reporting in the *NAGDCA 2003 Survey of Plans* that they were providing advice services at that time. The most common form of advice in the public sector is Internet based.

Some plans choose to offer lifestyle or lifecycle funds as an alternative to investment advice. These investment options provide employees with a pre-packaged diversified portfolio that correlates to a specific type of investor.

- ✓ Lifestyle funds are generally categorized by risk profiles, from conservative to aggressive investors. Participants can take into consideration all of their assets when selecting a risk-based fund that meets their needs. However, they must periodically review and revise their selections as they near retirement when their risk profile usually changes to a more conservative approach.

- ✓ Lifecycle funds correlate to an individual's time horizon or age, such as a 2010, 2020, 2030, 2040 fund and so on. With these funds, the portfolios automatically become more conservative as the end date nears (presumably to match participants' retirements). When selecting a time horizon-based fund, however, it is much more difficult to consider the entire assets an investor has, such as their employer-provided pension plan, and could result in a too conservative approach for some employees. It also assumes all investors with the same time-horizon have the same risk profile.

Another approach to advice that public sector plan sponsors are beginning to explore is managed accounts. These options provide participants with the ability to "hire" a manager to invest their deferred assets based on their individual risk profile and time horizon needs. Generally, the manager may charge an asset based fee for this service and may either use a combination of the investment options offered within the plan's core menu, or the manager may have more flexibility to use a broader list of investment choices to structure participants' portfolios.

There are different levels of personalization within today's managed account options. Some approaches base investment decisions for participants on the information contained within the employer's and/or administrator's record keeping system (such as current and retirement age, income, account balance, etc.). More personalized managed accounts will also take into consideration external data provided by the participant that includes investments and assets outside the retirement account.

In regard to these different types of asset allocation approaches, the 2005 Retirement Confidence Survey[1] found that lifecycle funds are the most desirable. This survey identified that:

- 21% of non-participating workers said they would be much more and 44% somewhat more likely to participate in a workplace savings plan if it offered lifecycle funds

[1] This annual survey, which is conducted by the Employee Benefit Research Institute (EBRI) and Mathew Greenwald & Associates, Inc. and was underwritten by Nationwide, has been tracking the attitudes and behaviors of American workers and retirees since 1991.

- 13% said they would be much more and 36% somewhat more likely to participate if the plan offered lifestyle funds

- 15% believed they would be much more and 20% somewhat more likely to participate in a managed account option were offered

Statistics from this study regarding workers currently participating in their employer sponsored savings plan showed that:

- 38% of current participants invest in a lifestyle fund and, for those who do not have this option available in their plan, 21% would be very likely and 46% somewhat more likely to use this if it was offered.

- 19% of current participants invest in a lifecycle fund and, for those who do not have this option available in their plan, 23% would be very likely and 45% somewhat more likely to use this if it was offered.

- 16% of current participants use a managed account as part of their plan and, for those who do not have this option available in their plan, 15% would be much more and 36% would be somewhat more likely to use this if it was offered.

Lifecycle versus Lifestyle Funds

Lifecycle funds are investments that automatically provide workers a more conservative investment allocation as their retirement date approaches

Lifestyle funds are a set of mutual funds with a pre-set mix of conservative, moderate and aggressive investments.

Concerns About Advice

Plan sponsors should focus on the needs of their employees when deciding if guidance is sufficient or if advice should be added to their defined contribution plan. Looking at current plan statistics (such as participation rates, diversification of account balances) and/or conducting an employee survey can help you decide if your current education/guidance efforts are effective and employees' needs are being met.

Expanding beyond guidance to investment advice causes some employers to worry about fiduciary liability for this activity. However, if plan fiduciaries recognize that the workforce is unsophisticated about investing and not making appropriate decisions within their defined contribution plan, it can be argued that under the general prudence rule (fiduciaries must act with care, skill, prudence and diligence as a prudent person would in similar circumstances) fiduciaries must make investment advice available to fulfill this duty.

The concerns most commonly raised when considering advice are:

- Potential liability for losses that could result from the advice provided
- Responsibility for selecting advice provider
- Role in on-going monitoring of this service

Although you cannot eliminate your fiduciary responsibility for this service, you can minimize its impact by following a prudent selection and monitoring process when adding investment advice to a defined contribution plan.

Selecting Advice Providers

Any decision to hire a service provider for the defined contribution plan is a fiduciary action as it is an exercise of discretionary authority. This includes the action to designate a person or firm to provide investment advice to plan participants and beneficiaries. As a result, this decision must be made prudently and solely in the interest of the plan participants and beneficiaries. This applies both in the initial selection of an advisor and subsequent decisions to retain or replace this provider.

The prudent selection of an investment advisor minimizes the employer's liability and should be executed in essentially the same manner that is used to select any other service or product provider. It should be based on an objective process (such as through a competitive request for proposal) that allows you to assess the provider's qualifications, quality of services, reasonableness of fees, etc.

Prudence = Process

Results cannot be guaranteed, so as a fiduciary, prudence must be handled through a well-defined process. It doesn't matter if the decision is ultimately found to be wrong if you followed an appropriate process to arrive at your decision.

Your process must include sufficient criteria for selecting appropriate investment advisors and on-going monitoring of their services.

Bundled Services

In general, there are two ways to accomplish this prudent selection process. The first is to make this part of a bundled package that includes advice along with other services such as third party administration (TPA), participant education, investment products, etc. These services may be provided by one company or many, but generally will be procured through one selection process and governed by a single contract.

The procedure followed when making the decision to offer advice through a bundled arrangement should include an examination of:

- The relationship between the investment advice provider and the contractor/TPA, including any compensation or commission arrangements
- Qualifications of the advice provider
- How the contractor/TPA selected the advice provider that is part of the bundled arrangement (e.g., was a competitive bidding process used) and the basis for their decision to select this provider
- What is the process in place to monitor the provider to ensure the advice is unbiased and follows fiduciary standards
- How the advice will be delivered to participants and does this meet your plan's needs
- The cost associated with this service and fees assessed the plan and/or participants

Unbundled Services

As an alternative to the bundled approach, an employer may decide to independently select an advice provider that is totally separate from the other products and services currently contracted

for the plan. This is accomplished through a separate procurement process and contract for service.

Because the employer is taking full responsibility for contracting, instead of using a bundled approach, a more comprehensive review is needed. The employer may choose to do this internally or seek the help of an outside expert/consultant to assist in the process to select advisory services. The procedure that is followed to decide to contract for services should include a thorough examination of:

- Qualifications of the company and staff who will be advising participants and beneficiaries
- Company's approach and philosophy to investment advice (e.g., basis for advice, software used, personal approach)
- Any compensation or commission arrangements between the plan's investment products and advisory services firm and the fees that will be assessed participants
- Approach to delivering the advice services to participants and will this meet your plan's needs.
- Relationship of the advisory firm with any other product or service providers currently under contract

Monitoring Advice Providers

Regardless of the approach (bundled or unbundled) used to select an advice provider, the employer is ultimately responsible for monitoring this service to ensure it continues to be appropriate to offer to participants. To address this, guidelines should be established and followed to evaluate this service on an on-going basis.

The best approach is to incorporate the evaluation criteria and monitoring process into the plan's investment policy statement. Reviewing the advisory services should become part of the process that is established to monitor the plan's investment products and reviews should be conducted at least annually.

Within a bundled plan approach, the employer will need to confirm that the contract administrator is conducting periodic reviews of the advice services provider. Documentation about this review should be made available to the employer to determine that the advice provider continues to meet the established monitoring criteria and is providing appropriate and suitable investment advice to participants. The employer should also consider feedback from participants (such as through evaluation forms for those using the service and/or surveys) in the periodic review of the investment advice provider to determine their satisfaction with this service.

The process to monitor investment advice secured through an unbundled arrangement should be more comprehensive than that conducted within bundled plans as there is no third-party automatically assisting in this effort. The employer can retain the responsibility for on-going monitoring in-house or use the services of an independent consultant. The evaluation criteria should include an assessment of fees, level of services, continuing philosophy of the advice provider, and feedback from participants (e.g., evaluation forms, surveys).

Employers may also use plan statistics to evaluate the advisory services to determine if it is providing adequate and appropriate advice to the plan and its participants. These statistics may include:

- ✓ participant usage of the investment advice services
- ✓ diversification/allocation of assets before and after advice
- ✓ level of deferrals (increase/decrease) to the plan before and after advice
- ✓ participant satisfaction/complaint correspondence, etc.

In summary…Advice Providers Share Fiduciary Responsibilities

Offering advice in a defined contribution plan is an important decision that must be made prudently and in the best interest of participants and beneficiaries. The decision to select an advice provider, whether part of a bundled plan or as a stand alone contractor, is a fiduciary action. Once the advisory services provider has been selected, this firm must be willing to accept a fiduciary role in the plan for the advice they provide to participants and beneficiaries.

Employers should not avoid a decision to offer advice because of an assumption that this could result in additional fiduciary liability. Following a prudent process for selecting an advice provider will minimize any potential risk.

About the author…

Mary Willett, CRA, CRC, Willett Consulting, has more than 20 years experience in the field of public employee retirement benefits. She is the past director of the State of Wisconsin Supplemental Retirement Plans and started her own consulting business in 2002. She was the 2001/2002 President of NAGDCA and currently serves on the InFRE Board of Standards. She currently is working with Nationwide on plan sponsor education initiatives.