Chapter 3

Demographics

Fiduciaries are instructed to choose their target date funds on the basis of workforce demographics. So say the Department of Labor (DOL) and prominent ERISA attorneys like Fred Reish and Marcia Wagner. Frequently cited demographics include salary, savings and age. In principle, demographics are intended to lead the fiduciary to an appropriate glide path: the establishment of appropriate risk for young people and how that risk should adjust through time as an employee ages.

Risk tolerance is the most important demographic cited by authorities, but this is an attitude that can only be inferred. This chapter provides insight for this inference.

Focusing on the Most Important Demographic

This is a complex mandate that can be substantially simplified, following Einstein's advice to "Make everything as simple as possible, but no simpler." Simplification begins with noise reduction. Our sole focus should be on those who default their investment decisions, since most assets in TDFs are there by default. **What is the distinctly decisive demographic that characterizes defaulted participants? It's a lack of financial sophistication.** This can be confirmed with a financial literacy quiz, but the mere fact that participants can't make an investment decision is strong evidence. This doesn't make them dumb. Will Rogers said, "Everyone is stupid, but about different things." Most individuals outside the financial profession know little about investing. Educating them is not the answer. An appropriate glide path is.

The Appropriate Risk Decision for the Unsophisticated

But what is appropriate for the naïve? If 2008 taught us anything it's that TDF participants believe they are safe, especially as they near retirement. Participants in 2010 funds had no idea they could lose 25% of their savings, and they will never understand what happened. In other words, the risk tolerance of the unsophisticated is very low. **When you're walking in the dark every stumble is scary**. The naïve need to be protected, especially as they near the end of their careers. This argues for conservatism near the target date – the more, the better. A 2012 survey of investment consultants by

the Center for Due Diligence reveals a very low risk tolerance on behalf of those near retirement.

Choosing a Target Date Fund

How safe should participants be? Therein lies the big disagreement among TDF providers. Equity allocations near the target date range from zero to 75%, with the balance of assets typically in long-term bonds which are, of course, risky too. The decisive demographic argues for the low end of this range, invested entirely in safe T-bills and short-term TIPS at the target date. It's the ultimate in safety. You can judge whether or not this is too safe, but please be aware that this safety is intended to be in place only for the last year of employment, after which most withdraw their accounts. It is not intended to be an asset allocation in retirement. The view is that you can't be too safe when it comes to protecting the vulnerable, the unsophisticated.

The most important fiduciary decision is deciding on the glide path. Once that is in place, the criteria for selecting a specific manager can be established, as described in Chapter 5.

Legal Guidance

Perhaps more than any other regulatory agency, the Department of Labor (DOL) lives in the world of demographics. One only need look at the index of topics on the DOL website: employment, personnel, grievances, wages, and so on and so on. The DOL lives in the world of the Bureau of Labor Statistics: numbers and numbers. So, when you browse the DOL's article archives, you see lots of demographic tables. The DOL understands slicing and dicing, but not necessarily drawing conclusions.

ERISA cases have been consistent in stating that investment objectives have to be specific to the individual investor. How can the DOL possibly apply that to ALL the participants in a large 401(k)? Not possible. So take an average. A good mathematician

(if we can find one) will tell us that averages are skewed by the high and low ends. Is it possible to establish glide paths that will cover all your participants? No.

Is it possible to customize glide paths that fit every possible set of individual facts and circumstances with any precision? Of course not.

Ethical Perspective

The discussion above has a section entitled "The Appropriate Risk Decision for the Unsophisticated." Synonyms for the word "unsophisticated" include inexperienced, naïve and childlike. Parents must make many decisions for children because children aren't sophisticated enough to make them for themselves. All of us are unsophisticated about many things so we often trust experts; again, our physician is the classic example. The Doctor-Patient relationship, just like the Parent-Child relationship, is a fiduciary relationship. We trust that our physician is competent and acting in our best interests. We are vulnerable to the decisions they make and the risks they might take in our treatment. Ideally, we are protected by the extensive mandatory training required to become a physician and by the American Medical Association Code of Ethics.

The plan sponsor – plan participant relationship is no different legally or ethically. Studies have shown that a majority of plan participants are unsophisticated when it comes to investing. Retirement plan fiduciaries would likely argue that they have no fiduciary training and that they are not fiduciary experts. Unfortunately, ERISA holds them to the status of a prudent expert and obligates them to fulfill their fiduciary responsibilities. While this situation might seem absurd, there is a caveat to this obligation that states: "Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert." Reg. § 2509.95-1(c)(6)