CIEBA
The Committee on Investment of Employee Benefit Assets

# Mandating Investment Options in Defined Contribution Plans

## Issue

H.R. 3185, the *401(k) Fair Disclosure for Retirement Security Act of 2007* calls for defined contribution plans to "include at least one investment option which is a nationally recognized market-based index fund and which, as determined from time to time under regulations which shall be prescribed by the Secretary, offers a combination of historical returns, risk, and fees that is likely to meet retirement income needs at adequate levels of contribution."

## Points to Consider

- No single index fund is likely to '… offer a combination of historical returns, risks and fees likely to meet retirement income needs…' for all participants in all circumstances.

- Asset allocation funds, such as balanced funds and target-date funds, may include both passive and active funds. Based on the language of H.R. 3185, these funds would not satisfy the requirement in the bill.

- Mandating any particular investment option or particular style of investment is bad policy and sets a negative precedent. Investment strategies change over time, but a mandate locks plans into a particular type of fund that may not be the best choice for participants. Further, such a mandate opens the door for policy makers to add other mandates that may not be appropriate for participants.

- In the past, some European and state defined benefit plans had rigid investment guidelines, prohibiting some types of investments and requiring others. Many of these regimes have been discarded because they had a negative impact on plan returns.

- Plan fiduciaries are responsible for choosing investment options that meet ERISA's prudence standards. Practically, these fiduciaries need to retain flexibility in the selection of individual investment options to ensure that the *combination* of funds span the risk/return spectrum and are sufficient to meet participants needs. Plan fiduciaries are in the best position to determine whether passive and/or active investment choices are best for their plan participants.

- If Congress mandates a specific investment option, many participants will assume that this is the 'right' (government-sanctioned) option. Specifically, they may reject diversified options that, over the long-run, would be better for them.

- While passive funds generally have lower expense ratios, expenses are only one component that fiduciaries consider in assessing fund options.[1]

The Committee on Investment of Employee Benefit Assets (CIEBA) is the voice of the Association for Financial Professionals (AFP) on employee benefit plan asset management and investment issues. CIEBA is a nationally recognized forum for ERISA-governed corporate pension plan sponsors on fiduciary and investment matters. CIEBA members represent 110 of the nation's largest corporate retirement plans, managing $1.5 trillion in assets on behalf of 17 million plan participants and beneficiaries. Contact: Judy Schub at (301) 961-8682.

01/24/08

[1] Conventional wisdom is that passive investments not only have lower fees, but *always* outperform active investments. A special run by Lipper shows that over the past 30 years (divided into 5 year periods) actively managed funds outperformed passively managed funds 1/3 of the time. In addition, there are periods of time when broad index funds underperform their benchmarks.