# Commentary

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## A Critical Time for 401(k) Plans

The topic of investment risk is currently receiving increased attention and intense scrutiny in the media. We are concerned that so much media attention focuses on the ephemeral nature of market value volatility while overlooking the significant real risks of a different nature that face every 401(k) plan participant. The long bear market has eroded the market values of most 401(k) accounts invested in equities. The benchmark Standard & Poor's 500 stock index declined 10.87% in September, 17.28% in the third quarter, 28.16% for the last nine months and 20.49% for the year ending September 30, 2002. The three-year annualized rate of return was a painful loss of 12.89%. The NASDAQ composite index fared far worse. Typical 401(k) plan participants, experiencing the change in market mood from irrational exuberance to a now evident loss of faith, are taking a critical look at the very nature of 401(k) plans and discovering the various risk factors involved. However, lost in the current mood of gloom and doom, is the remarkable fact that the ten-year annualized return for the Standard and Poor's 500 stock index was precisely 9.00% on September 30, 2002, equal to the widely-promised average long-term return that stocks have historically delivered.

It is a truism that the only numbers that really matter in determining the value of the return from an investment are the price paid on acquisition and the price received on sale (apart from any dividends received). The intermediate market values during the period the investment is held are merely transitory and ephemeral and do not affect the rate of return realized. For 401(k) plan participants, there is a need to distinguish between the risk of failing to meet a targeted expected rate of return over the period from contribution input to benefit payout and the risk of experiencing unusual market price volatility along the way.

It is far more important for 401(k) plan participants to understand and focus on the nature of other risks inherent in the investment, actuarial and tax aspects of managing the accumulation and distribution of a 401(k) or similar account. These include asset allocation optimization risk, inflation risk, longevity risk, event risk such as disability or death, early withdrawal diversion risk, plan-specific administrative lockout risk, corporate sponsor stock risk, distribution incidence risk and tax effectiveness risk.

401(k) plans typically offer participants a choice of investment funds including stocks and bonds. The initial choice of funds, the allocation of contributions between the funds and the ongoing active management of the fund choices, accumulated balances and contributions all require skill to achieve optimal returns and a satisfactory trade-off between investment return and risk. Individual participants generally have inadequate information available to monitor the effectiveness of their asset and contribution allocation decisions and may not appreciate the nature of the risks to which their accounts are exposed.

Inflation risk is always a factor that in effect provides an offsetting return to any nominal rate of return achieved in a 401(k) account. Although currently running at a historically low level, inflation is a powerful negative long-term force that has a devastating effect on the purchasing power of fixed pensions or regular distribution amounts from 401(k) plans. Longevity risk is one of the least understood risks faced by 401(k) plan participants. Traditional defined benefit pension plans contain an inherent guarantee against the longevity risk of outliving the actuarial expectation of the number of years of lifetime after retirement. As increasing numbers of 401(k) participants enter the payout phase, the risk of outliving one's money is a fear that is now a reality for many.

401(k) participants also face considerable event risks. In the event of death or disability, accumulated account balances often fall short of providing adequate income to meet needs or maintain living standards that would otherwise have been expected in retirement for the participant or dependent survivors. All too often, changes in employment result in the early withdrawal of account balances and their diversion from intended retirement purposes. Rollover provisions are sadly underutilized.

The Enron debacle brought intense publicity to the inherent risk in holding the stock of the corporate sponsor in a 401(k) plan and being restricted by the specific plan provisions from being able to sell or exchange the corporate stock for a less risky alternative investment.

There are also considerable unseen risks in exercising the decisions regarding the incidence of payout distributions from a 401(k) plan account. Not only are market value risks and longevity risks important considerations in choosing the amount and timing of distributions, but also there are complex tax issues and risks involved. While 401(k) contributions and account accumulations enjoy tax deferral treatment, once the payout phase begins, federal and state income tax issues present risks that sub-optimal choices might be made.


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