

401(k) Tactical Plan Advice for Large and Small Companies

By

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Imagine losing most of your retirement in 2001 because you bought-and-held all your retirement money in only one stock that crashed; you actually trusted your employer - Enron. Imagine your problems if you are responsible for your company's retirement plan when this happens. Things are not all that different today in many retirement plans. The average investor doesn't actively manage their portfolio to stay in step with the stock market, and wants professional help. Most of us actively manage our education, our businesses, and our families. Why would we not want to have our investments actively managed by a fee-based registered investment advisor?

Many investors use the buy-one-fund strategy. For example, about 25% of Fidelity Investments' 8 million defined-contribution members invest in only one mutual fund. Further, about 18% of retirement plan participants invest in only one fund, according to a 2002 study of 1.5 million participants in 89 large plans by Hewitt Associates. Investing retirement money is difficult to do well and many 401(k) plan participants need help.

Employers can offer their plan participants independent investment advisor portfolio management services and many participants are demanding this option. The portfolios can be either buy-and-hold or else actively managed. In either case, each participant's time horizon and risk tolerance is considered. Active management means changing the portfolio stock and bond composition, within predetermined limits, to be in step with the market being fully invested in good markets and defensive in difficult markets. Importantly, the independent investment advisor (third-party) may be a different company than the 401(k) plan provider. This was determined in opinion 2001-09A December 14, 2001 by the Labor Department's Pension and Welfare Benefits Administration and is known as the "Sun America Letter". This letter provides a prescription for the plan sponsor to offer third-party advice. Previously, each advisor had to be individually approved by the department of Labor, and the letter indicates that the plan sponsor is not taking on additional fiduciary risk. Thus, third party registered investment advisors can provide money management inside large or small 401(k) plans. Plans as small as 15 participants can benefit from this service. Retirement plan advice may be provided directly through the plan or to individual plan participants through contracts with the third-party investment advisor.

Many plan participants need professional help because plan participants: tend to stay in money market even in good markets, invests in only one fund (as discussed above) and don't manage risk, follow the herd and buy last year's

winner, don't actively manage their account(s)- even in poor markets, and want someone to manage their retirement account for them.

We estimate that 90-95% of the investment industry is buy-and-hold where once an investment is selected it is held until next year's meeting. This concept has carried over into the retirement plan participant's buy-and-hold behavior. It is well known that the stock market constantly changes and portfolios that adjust with market conditions are needed. The management activity needed to adjust portfolios to changing market conditions is beyond that of most sales oriented professionals. There are several companies that provide computer program generated portfolio to retirement plans. Most of these are really buy-and-hold strategies due to the three to twenty yearlong statistical base used to compute the results.

Investment risks are real for the average investor. Consider the loss of -37.2% from 1973-1974 in the S&P500 index. And gains for the average investor are illusive. For example, from January 1984 to December 2000 the S&500 gained 1,300. %, while the average self-managed investor gained only 141.%. (Delbar Financial Services)

Third-party investment management can be done both within established and new plans employing various mutual funds or annuity sub-accounts available through the plan's custodian. Managed portfolios are designed to meet each plan participants retirement needs. For actively managed accounts, funds in asset classes, money market, and bonds are changed as needed. The active management style is called tactical or dynamic asset allocation. The stock percentage increases as the participant's time horizon increases and when the participant's risk tolerance is more aggressive. For example, suppose a plan participant has a moderate risk tolerance, and has a Time Horizon of 7 years to retire. The maximum portfolio equity and bond percentages might be 60% and 40% respectively.

About the author

Dr. Harloff is a shareholder of Harloff Capital Management, Harloff Inc., a Registered Investment Advisor. He holds a Ph.D. in Aerospace Engineering and previously worked at NASA in Cleveland, Oh in aeromechanics and propulsion computational fluid mechanics.