Fiduciary Duty III: Duty of Diversification

The duty of diversification follows the duty of prudence. If prudence is pursued, then diversification is an automatic. But what does diversification mean? Does it mean the plan just needs a bunch of different funds that a participant can choose from?

Let's first look at what it means to be diversified. A plan sponsor must provide a number of funds that seek to minimize the risk of large losses. A prudent expert, that the plan sponsor is expected to be, knows exactly how to do this. But as we have found over the years, many plan sponsors are not the experts they think they are as evidenced by mutual fund line-ups in their plans.

Every 401k plan is required to have a Qualified Investment Alternative (QDIA) option, which is a fund money will automatically be invested in if participants do not select funds themselves. This option is required to be diversified. Recently, we found a plan with a well-diversified fund line-up except for their QDIA. About 25% of the plan was invested in the QDIA, which is not uncommon. However, the fund was a fixed interest rate option. The rate of interest was in the 3% range and after fees it was about 2%. This was not a diversified option. With the stock market up about 30% in 2019 the plan could be subject to employee complaints. Diversified QDIA options were up 10% and more in 2019. Does a 30-year-old participant really need all her money in a guaranteed interest fund paying only 2% if she is not going to use it for 35 years? Are they diversified? If the DOL became involved, the plan sponsor and committee could be found negligent. If this was your plan, how would respond?

We know 401k plans need to be diversified but how do we know if they are? The easiest way is to have a third-party expert tell you. You will know quickly if you need to do anything. If you don't have access to the expert, you can attempt to do it yourself by analyzing each of your funds. Make sure you pay close attention to the QDIA because, typically that is where most of the money is.

Finally, what is diversification? As we mentioned before, it is not just a bunch of different funds. They must be different in terms of investment objectives, types of assets owned among other things. The following is an example of diversification. It is brief and not complete but should give you an idea what you should have in your plan.

Large Capitalization Stocks
Mid Capitalization Stocks
Small Capitalization Stocks
Balanced Funds
Short-term Fixed Income
Long Term Fixed Income
Developed Market Stocks
Emerging Market Stocks
QDIA (Age Based and glide path funds)

We hope this helps you manage your plan better and leads to better plan performance and financially satisfied employees.

If we can help, please give us a call.

Jim and Sean