401(k) Investments

Stupid Investment Tricks: Interesting, Risky, or Downright Dumb Retirement Plan Investments

Most retirement plans today follow a rational investment process and keep it simple—a mix of good quality funds covering an appropriate spectrum of asset classes. But for every rule, there is an exception, and what follows is a sampling of the exceptions—interesting, risky, or downright stupid investments that illustrate useful lessons in retirement plans.

Yes, these stories are true. Certainly, these situations are by far the exceptions, but the very fact that the stories are true highlights the value of learning about them.

By Pete Swisher

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Interesting Anecdotes and Adolescent Investments

Fine Art on the Office Wall

A doctor (why is it always a doctor?) is an art aficionado and uses plan assets to purchase paintings as a plan investment. He decorates his office with the paintings—a prohibited transaction under ERISA Section 406(a)(1)(D), which prohibits "use by or for the benefit of a party in interest of any assets of the plan."

Gold Bullion

A participant in an "open option" plan ("open option" refers to an investment feature whereby participants may invest in any asset or with any advisor of their choice) uses a brokerage provider who allows the purchase of unusual assets and is not especially attentive to the fact that the account is part of a 401(k) plan and not a personal, taxable account. The participant buys gold bullion for his account. ERISA does not forbid any particular type of investment, so this is not *de facto* prohibited, but is it prudent under ERISA Section 404(a)? Where will it be held; what will it cost; and how will that fee be paid? And more importantly, Code Section 408(m) calls for immediate taxation of collectibles held in participant-directed retirement accounts under most circumstances, and the 10 percent penalty applies if the participant is under age 59½.

In this story, the participant was the business owner, and he pugnaciously asserted that because his brokerage provider allowed the transaction, any problems with it were the provider's problems and not his. The scenario was made possible by the fact that Code Section 408(m)(3) does, in fact, permit the holding of certain types of gold bullion (including the type involved here) in an individual retirement account (IRA), but not in a 401(k). Because 100 percent of the requests the brokerage firm has received for such accounts have been for IRAs, the error is understandable; but the point remains that the tax burden is not the broker's problem—it is the participant's.

Hedge Funds

An advisor to the 401(k) and profit-sharing plans of a mid-sized company is asked by his client to make available as an investment option in the 401(k) plan the hedge fund in which 100 percent of the profit-sharing plan is invested. The hedge fund's published returns are outstanding. The owner of the plan sponsor has a very large sum of personal assets invested with the same manager and wants to share the word of this excellent investment with his employees by providing them a fact sheet on the investment that includes an endorsement from the owner.

There are several problems with this scenario. Endorsing an investment in a participant-directed plan is, of course, a terrible idea for a business owner because it casts into doubt the availability of an ERISA Section 404(c) defense. Also, hedge funds are troublesome investments for participant-directed plans for many reasons, including liquidity, transparency, ability to trade, fee structure, reliability of performance data, availability of comparable benchmarks, ease of generating the comparative reports, and—last but not least—asset safety. The hedge fund manager's name in this case was Madoff, and the business owner lost a fortune in personal money as well as all of the millions of dollars in the profit-sharing plan. Fortunately, the advisor had persuaded him not to add the hedge fund as an investment option in the 401(k) plan.

In another example of hedge fund investments gone bad, an advisory firm referred clients to a hedge fund that went belly-up amid allegations of embezzlement. Many clients lost money, and the advisory firm was nearly put out of business. Hedge funds can be excellent investments for the right clients with the right due diligence, but they generally have no place in most small to mid-sized retirement plans, and almost never in participant-directed plans.

Raw Land

An open option 401(k) plan for a professional practice holds a parcel of land in a terminated participant's account. The land sits next to the participant's house. When the trustee is asked whether the participant gets any use out of this parcel of land, the trustee replies, "Yes, he has a barn and keeps horses there." Again, a prohibited transaction under ERISA Section 406(a)(1)(D).

An interesting twist to this story is that the participant had actually asked both his TPA and his attorney, "Am I allowed to buy real estate in my retirement plan?" The answer, of course, is, "Yes," but neither the TPA nor the attorney took the seemingly obvious next step of asking, "… but why don't you tell me what you have in mind first?" Investments like this are fraught with peril. Professional advisors should always dig for information when people ask eyebrow-raising questions, and should take pains to communicate the risks and pitfalls to avoid.

Leveraged Options

A participant invests in a brokerage account that allows margin and options trading. He invests in a series of options and futures, the nature of which is that $1 invested in a contract may control $10 worth of commodities or underlying securities. As a simplified explanation of how futures contracts and some options work, a 10 percent price fluctuation in the commodity in the wrong direction can cause the investor to lose 100 percent of his investment. Because the loss may exceed 100 percent—in fact, the maximum loss in a futures contract and certain options contracts (such as the writing of "naked" puts and calls) is theoretically unlimited—contracts require collateral. According to the DOL regulations under ERISA Section 404(c), protection is not available with respect to investments for which the possible loss exceeds 100 percent of the account balance. [29 C.F.R. § 2550.404c-1(ii)(D)] This is a point to bear in mind when conducting due diligence on commodities funds because most such funds invest at least half of fund assets in derivatives.

The Beach Condo

A doctor (again with the doctors) uses plan assets to buy a condo at the beach as a plan investment. He uses the condo himself several times per year, allows his employees to do the same, and rents it out the rest of the year. He says the condo is "lovely," waxes eloquent about sipping wine on the porch at sunset, and adds an anti-governmental rant, the point of which is that it tickles him to be able to use tax-free dollars to pay for his vacations. [Practitioner's Tip: do not include this bonus information in the VFCP filing. "VFCP" stands for Voluntary Fiduciary Correction Program, a DOL program through which certain prohibited transactions may be corrected.] The investment was sound, and the plan makes a lot of money; however, the quality of the investment decision is immaterial—again, this is prohibited under ERISA Section 406(a)(1)(D).

Operating Company

Four business partners agree to use plan assets to purchase an operating company (a restaurant) as a plan investment. This story raised several interesting points: first, it is arguably a prohibited transaction for the owners to eat at the restaurant. Though there are a number of class exemptions with fact patterns similar enough to show that dinner out might be OK if the owners pay full price. Naturally the full answer is more complicated, and the short answer is they cannot eat at the restaurant, nor can they work there in any capacity. Also the managers of an operating company that is owned more than 25 percent by an employee benefit plan are fiduciaries under the DOL's plan asset regulation. [29 C.F.R. § 2510.3-101] In addition, there are many ways besides dinner for this sort of arrangement to turn into a prohibited transaction, such as the partners investing personal money in the arrangement or having family members work at the restaurant. In the end, the investment took up a great deal of the partners' time and lost them a great deal of money before they threw in the towel and sold the restaurant.

What's a "Halal" Fund?

In 2006, an advisor added a mutual fund to his "select" fund lineup used with his clients. The fund scored No. 1 in peer group for the large growth category for performance. When asked if he had Muslim clients he looked puzzled: it turned out he was unaware that this top-performing mutual fund was a "halal" fund that employs a mandate or investment screen to disallow anything forbidden under Islam's Sharia law, such as alcohol and gambling. The advisor's response, "What's a 'halal' fund?"

The moral of the story is that due diligence, one would expect, includes being aware of any mandates constraining the investment policy of the manager and any potential costs, such as redemption fees and how they are applied. Also the DOL's interpretation of ERISA leaves very little room for the use of "faith-based" or "socially responsible" investments (SRI), unfortunately. [DOL Advisory Opinions 2008-1 and 2008-2; Pete Swisher, *401(k) Fiduciary Governance: An Advisor's Guide*, Third Edition, Chapter 16]

SEC Rule 22c-2

A different advisor chose a top performing mutual fund for recommendation to his clients. When it was mentioned that the fund had a 2 percent redemption penalty without 401(k) participant waivers, the advisor's response was, "What's SEC Rule 22c-2?"

It was common back in 2008–2009 for advisors to be unaware of the penalties and restrictions that went into effect as a result of Rule 22c-2 in October of 2007. The purpose of the rule was to reduce the potential for the types of abuse that occurred in the late-day trading and market timing scandals of the early 2000s. The rule requires mutual fund boards to consider implementing trade restrictions and redemption fees in the event of market timing (selling too soon after buying or buying too soon after selling). When the rule first went into effect a number of funds were slow to adopt provisions in their trading policies that were favorable to 401(k) plans, with the result that ordinary, non-abusive activity, such as contribution purchases followed by rebalancing sales, could trigger a penalty. Such penalties virtually have vanished as a practical matter, but for about two years, this was a serious due diligence concern.

The lesson here is that professional advisors need to pay attention to changes in the rules and how such changes affect clients.

The Stock Jockey

A participant invests his entire $300,000 account balance in the plan's self-directed brokerage option. He uses the entire balance to purchase stock of a popular restaurant company. The stock has a bad run and declines in value over 33 percent. The participant panics and sells. He reinvests his now $200,000 balance in a different restaurant company, which in turn declines roughly 25 percent. He panics again and sells, and because the first company has, in the meantime, recovered in value, he reinvests the remaining $150,000 in the first company at the same price at which he originally bought it.

This case illustrates several points. First, some people really are stupid (although the participant in this example was actually a PhD, the point stands). Second, the US is a land of rugged individualism and personal responsibility, and we like having choices. In the retirement system, this translates to participant direction, which is not allowed in many other countries. This anecdote is an extreme example of the "self-direction penalty" at work—the decreased performance that a number of studies illustrate in plans that allow participant direction.

A critical point is that it is extremely desirable for a plan like this to comply with ERISA Section 404(c). In fact, plan fiduciaries would be crazy to permit this sort of self-direction without reasonable assurance of being protected. Fortunately, the courts have shown a trend toward leniency with respect to 404(c) compliance. Nonetheless, it is worth noting that brokerage accounts make compliance more difficult. For example, consider the requirement to ensure participants are given the appropriate fee information and disclosures; and note that the fiduciaries are relying on the brokerage company or recordkeeper to ensure this information is delivered; and in point of fact it often is not in such plans.

Finally, the story raises questions about the prudence of allowing participants access to brokerage accounts and whether some limits should be set. For example, the plan fiduciaries could limit transfers into the brokerage option to 25 percent of the total account balance, assuming the recordkeeper is capable of reliably and consistently implementing this restriction.

Insurance Woes

When properly structured, life insurance has a number of viable applications in retirement plans, especially for business owners. Unfortunately, not all plans that hold life insurance have been properly structured. In one plan, a business owner had opened his plan to life insurance in the early 1990s, when interest rates were still high and universal life policies were illustrating "conservative" interest assumptions of 8 percent. The insurance agent sold policies to participants at "target premium" (the maximum premium amount at which the agent receives full commission—additional premiums increase the safety and performance of the policy but pay dramatically lower commissions); interest rates declined; the agent disappeared; and years later, the plan was left holding a dozen policies that were "imploding." Absent quick action, the policies would begin to lapse even though participants had been faithfully paying premiums for years.

Anecdotally, I have observed over the years that when the life policies are whole life (not universal life) and the agent is still actively involved with the client, all is well; the policies are sound and the participants are generally well-served. The problems come when an absent agent sold universal life at assumed interest rates of 7 percent or higher in the '80s and '90s. The problem from a fiduciary standpoint is that the trustee is responsible for the prudence of plan investment options, and arguably has some liability in this situation even though you can make the case that these life insurance purchases by participants are protected by ERISA Section 404(c). [Pete Swisher, *401(k) Fiduciary Governance: An Advisor's Guide,* Third Edition, Chapter 18]

Private Debt

A $5 million profit-sharing plan in 2005 held roughly $2 million worth of private debt issued in the form of notes payable by a mortgage company that originated high risk mortgages in California. The total rate of return to the plan at that time was roughly 9 to 11 percent per year and was steady—no defaults and no interruptions in payments—by far the best performing asset of the plan over the previous five years. The client was quite reluctant to accede to his advisor's strong recommendation to exit these investments. I never heard the end of the tale: either the client saw the light and got out before 2007 or took a bath.

This example raises a number of questions. First, is this a failure to diversify? Many advisors would instinctively say, "Yes," but in reality the courts have been relatively lenient with respect to the diversification requirement found in ERISA Section 404(a)(1)(C), allowing a plan, in some cases, to hold 50 or even 90 percent of assets in a single real estate property. [Pete Swisher, *401(k) Fiduciary Governance: An Advisor's Guide*, Third Edition, Chapter 6] But the case could be made that the lack of geographic diversification in the mortgages and the heavy concentration of plan assets in this asset type constituted a breach of the diversification requirement. Much more likely to be questioned is the prudence of the decision. In the light of our 2013 hindsight, it is easy to say that these were not prudent investments for a retirement plan, but this is an opinion and a court might or might not agree. For example, the judge in one case said, "Prudence is evaluated at the time of the investment without the benefit of hindsight." [*Metzler v. Graham,* 112 F.3d 207 (5th Cir. 1997)]

Another problem with these notes is liquidity. What happens when the plan has to make a sizeable distribution to a terminated participant? Which assets get sold, and how does this affect other participants? Finally, it raises the question of valuation. What is the true value of these notes, and on what date are they valued? A terminating participant taking a distribution might be short-changed if the valuation is low, and might be short-changing the remaining participants if the distribution is artificially high due to an inflated valuation.

Worthless Stocks

What should a profit-sharing plan do with worthless stocks? A new profit-sharing plan client held actual paper certificates of five stocks whose value was pennies per share or, in some cases, zero. The original investments in total had been perhaps $100,000. The companies still existed but were in dire financial straits. The certificates had no discernible market value but might have one in the future, so simply getting rid of them did not seem prudent, yet continuing to hold them in the plan posed multiple challenges. The client opted to distribute the stocks via in-service distribution to the owner's IRA after giving all employees the opportunity to come forward and take a share of the worthless stocks (none did because of the cost and hassle of setting up the brokerage account with an outside custodian who specializes in this sort of custody challenge).

Morals of These Stories for Plan Sponsors

1. ***Stick to a "safe" profile.*** A modern, well-governed retirement program tends to follow a few simple principles:
   a. Use institutional custodians and/or fiduciaries for asset safety and expert assistance.
   b. Stick to "boring" investments: audited funds (mutual funds, ETFs, insurance company separate accounts, or bank collective investment funds) for which comparative data is readily available. Professionally managed portfolios made up of such funds or of mainstream, publicly traded securities also are fine.
   c. Follow a prudent, conservative investment policy. Prove it through documentation.
2. ***If you offer a self-directed brokerage option, do it the smart way.***
   a. Do not allow "open option" investing whereby participants can invest with brokers or advisors or in any investment of their choice. Too many things can go wrong.
   b. Use only brokerage options that are fully integrated with the recordkeeper and/or plan administrator or TPA so that reporting and transactions are subject to reasonable safeguards.
   c. Ensure that the brokerage account does not allow access to options, penny stocks, margin trading, and certain other risky alternatives. Most brokerage options integrated with recordkeeping systems do this as a matter of course and are set up to reliably enforce the restrictions. *Ad hoc* investment in an account with a broker removes the operational guardrails.
   d. Consider placing a limitation on the percentage of assets that may be invested in the brokerage option. But if you implement such a restriction, be sure your administrator can ensure it will be consistently observed because having a rule you fail to follow is worse than not having the rule when it comes to ERISA liability.
   e. Ensure that the DOL's 404(c) regulations are followed to the letter.
3. ***Before investing in anything that sounds cool instead of boring, get expert advice.*** If it sounds different and exciting and unlike the typical story about a diverse portfolio of mutual funds, step cautiously. Get help before you proceed and assume you are at risk doing something off the beaten path unless your process is demonstrably prudent. This does not mean you should never stray from the path, only that you should take great care before doing so.

Retirement plan laws and regulations exist to protect our nation's investment of nearly $18 trillion, roughly 100 percent of the US GDP, in retirement plans of all types; given the sheer scale of the societal investment, such laws and regulations are based on sound public policy objectives. Unusual plan investments can add tremendous value to large, pooled plans such as large defined benefit plans that have the scale to do the proper due diligence. But fiduciaries for most plans—the small to mid-sized defined contribution plans that represent the vast majority of plans in the US—should stick to a conservative investment policy based on professional advice. ■