Briefly Noted

"Meaningful Benchmark" Required to Prove Breach of 401(k) Fiduciary Duties

The U.S. Court of Appeals for the Eighth Circuit ruled that participants in a 401(k) cannot simply point to the existence of lower-price funds as proof that their employer and plan sponsor breached their fiduciary duties. Rather, plaintiffs must provide a meaningful benchmark to support their allegations.

The appellate court's opinion upheld a lower court's decision to dismiss Meiners v. Wells Fargo & Company. Corporate law firm King & Spalding described the case as being "closely watched." The reason has to do with a prior case, Tibble v. Edison International.

Three years ago, in Tibble v. Edison, the U.S. Supreme Court ruled that employers have an obligation to properly monitor 401(k) investments to determine if lower-cost investment offerings are available ["Supreme Court: Employers Must Monitor 401(k) Investment Options," *AAII Journal*, June 2015]. King & Spalding said the 2015 opinion did not specify "what is required to plead a viable claim that [fiduciary] duty has been violated." Meiners v. Wells Fargo potentially provides a clarification.

John Meiners claimed his former employer, Wells Fargo, improperly included its proprietary investment funds and designated them as the default investment option in its 401(k) plan. Meiners said the Wells Fargo target date funds (TDFs) used in the plan had higher fees than similar offerings from Vanguard and Fidelity. He also said the Wells Fargo funds incurred worse performance than the Vanguard funds.

The Employment Retirement Income Security Act (ERISA) requires that those with fiduciary responsibilities act "with the care, skill, prudence and diligence" a prudent man would when acting in a similar capacity. In its opinion, the court of appeals says a "meaningful benchmark" must be provided by the plaintiff to show that this prudent man rule was violated. Meiners did not meet this standard. Merely pointing to the Vanguard fund's better performance "does not establish anything about whether the Wells Fargo TDFs were an imprudent choice at the outset." Furthermore, the court cited case law showing that fiduciaries are under "no authority … to pick the best performing fund."

Notably, because a meaningful benchmark was not provided, the appellate court further said that it could not reasonably infer whether Wells Fargo purposely included underperforming or "inordinately expensive" funds in its 401(k) plan.

Sources: "Meiners v. Wells Fargo & Company," The U.S. Court of Appeals for the Eighth Circuit, August 3, 2018, and "In Closely Watched Mutual Funds Case, Eighth Circuit Sets High Bar for Labeling Retirement Plan Investments 'Imprudent,'" King & Spalding, August 13, 2018.

The Role of Leverage and Quality in Dividend Changes

Dividend increases are typically met with a positive reaction from investors, while dividend cuts are typically met with a negative reaction. Whether these changes signal positive or negative information, however, depends on the quality of the company and its leverage.

Companies with low-to-moderate levels of leverage—defined as liabilities to total assets—can signal positive information by raising their dividend. There is particularly a greater incentive to favor dividends over new projects when the marginal return on investment is declining.

When leverage becomes too high, a higher-quality firm can convey positive information by doing the opposite: cutting its dividend. Though this may seem counterintuitive, the firm benefits shareholders by reducing the risk of default and being able to allocate more cash to potentially profitable projects.

Overall, higher-quality non-utility, non-financial firms have a greater incentive to pay dividends when their ratio of liabilities to total assets is below approximately 0.83. (By means of comparison, the study's author calculates the median leverage ratio for such companies as being 0.49.) When the liabilities-to-total-assets ratio exceeds 0.87, "higher dividends become unambiguously bad news." About 0.3% of fiscal-year observations had leverage levels in this top range. In comparison, about 1% of U.S. publicly traded firms file for bankruptcy.

For U.S. banking firms, the leverage ratios are higher. Dividend increases convey positive information when liabilities to total assets are 1.008 or lower. They convey bad news when the leverage ratio is 1.018 or higher. The median leverage ratio is 0.87.

For lower-quality firms, the equation changes. New projects have a lower expected return. As such, there is less incentive to have a low level of dividend payouts. This is particularly the case at a higher leverage, where cash not distributed to shareholders can be seized by creditors if the company defaults. Thus, raising the dividend gives shareholders a priority claim on assets up until the time default occurs or the company is forced to reduce or end its dividend.

Source: "The Importance of Being Prudent: Leverage and the Informational Content of Dividends," Simas Kučinskas, SSRN, June 2018.

Seven Steps to Protect Against Cognitive Aging

One of the first signs of cognitive aging, the process by which cognitive abilities decline with age, is problems managing one's own finances. Even in the absence of disease, it can become progressively more difficult to balance a checkbook, properly review a credit card statement or make good investment decisions. Cognitive aging also puts a person at a greater risk for fraud and exploitation.

To help adults protect themselves, the Federal Reserve Bank of Philadelphia published seven actions to take. They are:

1. Assign trusted contacts to all financial accounts. This is a person whom a financial institution can contact when exploitation or unusual behavior is suspected.

2. Prepare a durable financial power of attorney. A financial power of attorney allows a trusted person (an "agent") to act on behalf of someone who can no longer make decisions independently (a "principal"). This is a powerful privilege and should only be given to someone who is trustworthy.

3. Prepare a will. Having a will prepared before the onset of any cognitive conditions is important not only to avoid future problems, but also because changing the will requires a person to have the legal capacity to do so.

4. Keep up on the latest scams. The Philadelphia Fed says the Federal Trade Commission (www.consumer.ftc.gov/features/scam-alerts), the National Consumers League (www.fraud.org) and AARP (www.aarp.org/money/scams-fraud/fraud-watch-network) are good sources for information.

5. Monitor your credit and your identity. Since older adults tend to apply for new credit less often, they are also less likely to monitor their credit on a regular basis. AnnualCreditReport.com (www.annualcreditreport.com/index.action) allows reports from all three credit bureaus to be accessed for free each year.

6. Consider hiring a money manager. A daily money manager (DMM) can perform many essential financial services, often at a far lower cost than an accountant or a financial planner. The Philadelphia Fed suggests contacting the American Association of Daily Money Managers (https://secure.aadmm.com) for local DMMs.

7. Consider purchasing financial account monitoring services. These are third-party account monitoring services that help to spot suspicious financial transactions. One company mentioned, but not explicitly recommended, is EverSafe (www.eversafe.com).

Source: "Combining Forces to Combat Elder Financial Victimization," Jeanne Rentezelas, J.D., and Larry Santucci, Payment Cards Center Working Paper, Federal Reserve Bank of Philadelphia, June 2018.

Recent Performance Influences Fund Choices

A mutual fund's recent returns and its relative performance significantly influence whether investors choose to buy or hold onto the fund. The magnitude of these returns and whether the fund is already owned also plays a role.

Researchers gave participants in a study a series of investment decisions to make using actual return data from a randomized sample of funds. For each fund, participants were provided with basic background data, including the previous year's return. Participants could also purchase additional data to help them make a decision.

Among the data points purchased, the previous year's market return and the two-year relative return for the fund being considered were acquired for approximately one-third of all fund choices. The Morningstar Rating for a fund was purchased by male participants 62% of the time and by female participants 39% of the time.

These indicators give background on a how a fund has historically performed, but not how it will perform in the future. The study's authors noted that these indicators are mostly "negatively correlated with the five-year expense-adjusted returns." Data on factors influencing future returns realized—including the expense ratio and the turnover ratio—were acquired at a far lower rate. Similarly, a fund's standard deviation (a measure of how volatile a fund's returns are) largely ranked near the bottom in terms of participants' preferences.

The impact of past returns on decisions was non-linear. Participants bought a decreasing amount of data as a fund's past returns were increasingly negative. They bought more information as a fund's returns rose from 0% up to approximately 50%. After prior returns exceeded 50%, interest in seeing more information decreased.

When participants were given the option of selling a fund, the probability of them choosing to hold onto a fund with a 30% loss was 45% (meaning the majority were unwilling to take a loss). When given a chance to buy a fund with a similar loss, participants chose to act only 33% of the time. The probability of buying went up to 44% and 55% when the prior year's return was 0% and 30%, respectively.

Source: "Gender Differences in Asset Information Acquisition," Matthew Taylor and David Wozniak, Journal of Behavioral and Experimental Finance, 2018.