"AN INVESTMENT ADVISOR'S REACTION TO THE FIDUCIARY COMPONENT OF ERISA"

A speech by Bosworth M. Todd, Jr. at the
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Given the limited answers to the many questions raised about ERISA so far today I take some comfort from a quotation I heard at a Pension Conference in New York a few months ago. Stephen Rogers, of Dreher-Rogers, concluded one panel discussion by quoting Rousseau: "The ability to see that something cannot be foreseen is a necessary quality".

First, I would like to give you a checklist of four things we are doing as investment counselors to a number of corporate pension funds to try to conform to the new ERISA Statutes. Second, I would like to make a number of comments about ERISA based on attending five conferences on this subject over the last six months.

WHAT WE ARE DOING TO COMPLY

Here are the things we have done to comply with the Act.

1. In December we wrote a letter to each of our pension clients which said two things: First, that we acknowledged that pursuant to ERISA we are a fiduciary with respect to their plan, and secondly, that we are an investment advisor under the Investment Advisor's Act of 1940.

2. We have turned over all of the documents related to each plan, including copies of the plan, the trust indenture, and our contract, to our attorneys in Boston to review to make sure that we are in compliance with the Act. It turns out that all of our pension accounts need minor modification - primarily with respect to the area of valid appointment. We need to make sure that any given plan (1) permits the appointment of an investment manager, (2) that we have been appointed in writing by a named fiduciary, and (3) that the plan permits the investment manager to have all the powers purported to be granted, including discretion and authority to issue instructions to brokers and custodians. An invalid appointment means (1) the manager may be sued to refund his fees, and (2) the trustee may still be liable for acts of the money manager.

3. We are beginning to help each client develop a written statement, addressed to our firm, as to <u>investment policy</u>, one that we feel complies with ERISA.

4. At the moment we are working on getting ourselves a fiduciary liability insurance policy. It is not cheap and not many insurance companies are carrying it. It looks like the premium will amount to about $25 per million of assets under management. This will give you $5 million in coverage with a $50,000 deductible.

OTHER COMMENTS ABOUT ERISA

1. This is major legislation and it will create significant change in the way corporate pension funds are managed in the future.

2. Suddenly several government agencies are being asked to drink out of a firehose. This bill was written by amateurs who, when in doubt, simply outlawed the item in question - then gave the Secretary of Labor the power to waive it - but it will take time - maybe a year to get rulings from him, yet it is already in effect. The original motion was to create a separate one-stop agency and get the IRS and the SEC out of the picture. This did not take place. A compromise was created. Both agencies are still in the picture and a ruling from one agency does not bind the other. We should be pressuring Congress to consolidate this system into one agency and to clean up the awkward enforcement mechanism. In any event you can count on chronic delay in both enforcement and interpretation.

3. Very few corporate pension funds have adequately dealt with the problems created by ERISA with respect to such things as valid appointment, and a statement of investment objectives based on a detailed analysis of the plan. Therefore, we as money managers must assist our clients with this task.

4. The very lack of availability of interpretation of this 300-page law by the Government of some of its confusing provisions means we must therefore assume the most conservative interpretation of its vague language.

5. There will be more conservative management of the funds. This means 35% to 40% in bonds instead of 15% or 20%. It means thirty or forty stocks instead of fifteen or twenty. It means 3% or 4% in IBM and not 8% or 10%. It means an emphasis on quality securities in both the bond and stock category. It means the money manager will be keeping an investment diary about each of his pension plans related to investment decisions, attitudes, and philosophy relating to activity in the account. One lawyer, who made an extensive study of past fiduciary liability cases around the country, told me he found none where a fiduciary was successfully sued for being too conservative.

6. There will be a number of changes in ERISA in the next year or two removing some of the unusually harsh provisions,

possibly including this serious issue of personal liability, parties in interest, and prohibited transactions.

7. It will probably be two years before some variation of ERISA hits the public funds.

8. As you know, prudent expertise, broad diversification, and acting for the exclusive benefit of the worker is the primary thrust of ERISA's fiduciary standard. In light of this third point, does this mean in-house money management is on the way out? Frank Cummins, a Washington lawyer deeply involved in ERISA, recently said "yes" to that question. He said that because a money manager should act for the exclusive benefit of the worker he has no business as an employee of a company working for an in-house pension fund management because his actions should be solely for the employees and not the employer. There is a conflict of interest here and the penalty is the severe losses incurred. Thus I think many in-house funds may become available for management by outside advisors.

9. Under this new bill it is much easier to sue. Very few suits got brought to court under the old law because lawyers could never figure how to get paid. ERISA makes it much easier for the lawyers to figure this out. Maybe ERISA should be nicknamed "FEALI" - Full Employment Act for Lawyers and Insurors.

10. This bill was passed over the objections of every lobby group, including organized labor, but there were a lot of radicals, of the Nader type, who would have liked to wipe out the private pension system. At least ERISA should stop that thrust for now. Nevertheless, I occasionally feel that all our worries about ERISA may have all the relevance of rearranging the deck chairs on the Titanic.

11. Profit sharing plans hold more risk than pension plans of suits - from an irate blue collar worker.

12. Money managers will avoid extremes of behavior. The days of 90% or 100% in equities are over. They will seek a reasonable rather than a maximum return. They will observe the behavior of other leading pension fund managers and do likewise. It's like being in the riots in Chicago in 1968. The safest place to be is in the middle of the crowd.

13. Money managers must learn the liquidity requirements each of their pension funds face for the next five years - contributions, investment income, benefit payments.

14. Money managers will now familiarize themselves with detailed features of the pension plans they serve - is there a strong union? Is the sponsor healthy financially - is it an elderly workforce - is it a mature plan - are there overly generous provisions in the plan - how does investment experience compare with their actuarial requirements. There has been too

little effort by money managers to learn about the plans they work with. They have tried too hard to maximize return instead of looking at liquidity requirements and funding requirements and at the volatility of the sponsor's own earnings.

15. The new pension law dignifies the total return concept because of the requirement to amortize gains and losses on the equity portion of the portfolio. This should help growth stocks. It also has a built-in bias in favor of bonds since you do not have to mark bonds to market if there is a loss and be penalized by increased pension contributions.

16. The new law will force more communication between manager, actuary, and plan sponsors. Quarterly meetings will be more common and include detailed quarterly letters from the money manager with comments on the economy, the market, investment strategy, recent transactions, and a detailed performance analysis.

17. Corporate managers are beginning to bring elements of science to the art of investment management. They are beginning to use computer simulation to determine their bond-stock ratio in light of their funding requirements. Some are dismayed to find that there is not a high probability of achieving their expected returns with their present asset mix.