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## 401(k) Plans Are Designed for Mediocrity

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HUNT VALLEY, Md. ([TheStreet](#)) -- Your 401(k) account probably contains 10 to 20 investment choices. In that group, there are likely five or more lifestyle or target date funds, which really are not specific investment options. A lifestyle or target date fund is one that manages the employees' money between stocks, bonds and cash based on the age of the participant. The closer participants are to retirement, the more they will be in bonds and cash. The younger participants are, the more funds are invested in equities.

The other funds offered in a 401(k) normally are a mix of large cap, midcap and small cap, bonds and international funds. The reason for this small, diverse group of funds is to allow people to create an asset allocation model based on the efficient market theory -- which is blatantly false.



Those who want to invest like Warren Buffett, with his frequently great returns, have to first understand Warren Buffett.

Understanding the typical investment will help people understand why 401(k)s are intentionally designed for mediocrity.

First, let's examine the lifestyle or target date funds. The concept that age dictates investments is foolish. Let's assume it's 1966 and you have \$100,000 (a great deal of money in those days) and are 50 years old. Over the next 15 years as you approach retirement this age-investing philosophy would have moved you out of stocks and into bonds at the worst possible time. Age should affect goals, but never the actual investments.

Age determines goals, and goals will determine the rate of return needed to achieve them; then investments can be reviewed to find the risk opportunity investments that may accomplish the various goals. There are thousands of investment opportunities to consider, and an investor should never assume one security as the go-to choice because times will, and will continue to, change.

As for other funds available for developing classic asset allocation, the problem lies in the next amazingly foolish concept ... that markets should be invested in only over the long term. This is based on the so-called "Efficient Market Theory."

Simply put, the theory says markets are efficient and cannot be beat, so invest and stay invested. Even though there are investors who have bested the market for decades, the theorist retort is that these people are anomalies and should not be considered.

Asset allocation is the outgrowth of "The Efficient Market" in that a person invests a portion in five or six asset classes and holds on for the long term. This concept is alien to the great investors of the world. Great investors have always been risk managers, not buy-and-hold investors.

Many will claim Warren Buffett as an example of the proverbial long-term investor. Yes, Buffett has bought and held for long periods of time, but he has also held for five years or five months. The reason he buys long-, mid- and short-term is because when he buys it is based on a risk management analysis. For example, he bought and held **American Express (AXP)** as a long-term investment. He bought **McDonald's (MCD)** as a midterm investment that could bounce up over a year or two. He bought currency contracts over a short period based on the dollar devaluation theory.

One of the most foolish statements made by 20-somethings and 30-somethings is, "I am young, I can afford to take more risk now." In essence they are saying, "I can afford a 20% drop in hopes of making a 50% gain ... because I have time." Time is the exact reason you cannot afford a 20% drop.

Let's look at this concept another way. Assume you have \$10,000 in your 401(k) and you stay aggressively invested and lose 25% of your account in a bad year (\$2,500). Those monies lost, compounded over 35 years, would have been worth \$70,256 compounded at 10% -- or \$1,476,670 compounded at 20%. Consider how losing money is the No. 1 thing to avoid. Buffet said, "Rule No. 1 is 'never lose money' and Rule No. 2 is to remember Rule No. 1."

When he was 18 years old, Buffett was devastated when he made a bad investment and lost \$500. Why then are young people today so content with losing money and staying aggressively invested?

So why is the 401(k) not designed to help participants become great investors? The answer is simply that the plan sponsors are worried about lawsuits. If they create plans that basically mimic the market, sponsors are unlikely to be sued.

Great risk management investors will go out of sync with the markets, which creates risk to the plan sponsor. Buffett lost 2% in 1998 when the market went up 20%. That would create a substantial liability risk in a year like 1998, and sponsors do not want to take such a risk.

Another reason is that most plan sponsors are afraid of the "do-it-yourselfers." Most do-it-yourself investors are not all that good at investing, but they enjoy gambling, and investing is not gambling. Finally, sponsors are afraid of the salesmanship attitude of the financial services industry. They are afraid salespeople will sell clients into many self-serving products.

401(k)s for now are condemned to mediocrity as long as liability risk is the plan sponsors' primary concern.

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