

Outside-IN

# 401(k) adviser disclosures need an important update

Disclosing behavioral biases is voluntary, but no less important than making the required disclosures

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A fiduciary serves a vital role in society. In the most basic form, a fiduciary is expected to make dispassionate decisions in the sole interest of the less informed. To serve in the role requires the fiduciary to embrace the twin duties of loyalty and due care — this is the cornerstone of a prudent decision-making process.

However, fiduciaries are humans, and we have our own frames, perspectives, experiences, preferences and biases. These subjective traits passively and behaviorally influence the manner and substance of our advice and recommendations.

Over the past 20-plus years, behavioral and social scientists have pointed out many human traits that explain how we make decisions and what causes our actions. We have learned that heuristics — a gut feeling or rule of thumb — are suboptimal, frequently inaccurate and filled with self-serving preferences. Our views are shaped by cognitive, emotional, psychological, cultural and social factors. In the case of [behavioral finance](#), some of the well-established common investor biases that have been identified are herding, aversion to loss, overconfidence and hindsight.

Our reptilian brain (the portion that determines our fight-or-flight response) produces what Nobel laureate Daniel Kahneman calls System 1 thinking: It offers a fast or heuristic response. This type of intuitive processing has allowed the human species to survive for more than 300,000 years on Earth, while preserving energy for the neocortex to conduct System 2 thinking, which requires logic and abstract reasoning and takes time and energy.

To be appointed and relied upon to advise or make prudent judgments on someone else's behalf, fiduciaries should be aware of their own System 1 and System 2 thinking. In the case of System 1 biases, the fiduciary should simply be aware of their existence and minimize the use of heuristics if data and information are available to offer a more informed view.

In the case of System 2 biases, full disclosure should be an appropriate remedy. Here are a few examples: A fiduciary investment consultant favors active management over

index-tracking passively managed investment options; believes a "to" target-date-fund glide path is always most appropriate; considers fees as the single most important decision-making factor; considers commodities and precious metals as important and necessary asset classes in every diversified portfolio; strongly believes the market is efficient and manager alpha is more luck than skill; or believes one-on-one participant advice is an effective method for changing participant behavior.

A fiduciary investment adviser is in a position of power and trust. There is a knowledge and information asymmetry between the adviser and the plan sponsor, in which the plan sponsor looks to the adviser for prudent, participant-centric guidance and recommendations. It is the responsibility of the adviser to disclose his or her (or the firm's) investment or plan preferences right from the beginning. This gives the plan sponsor an opportunity to discuss the preferences with the adviser and to be aware of the frame in which the advice or recommendations would be offered.

Moreover, this would permit the plan sponsor to specify a different perspective, increased weighting or an emphasis on factors that may not be favored by the adviser when delivering guidance and recommendations.

Disclosure has always been an important and integral part of the minimum standard in establishing a trust-based relationship. Regulations have repeatedly relied on full disclosure as the first line of defense for investors. As part of their fiduciary duty, advisers must fully disclose to clients all material information that is intended "to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser — consciously or unconsciously — to render advice which was not disinterested." The disclosures discussed here are factual and required by law to guard against self-dealing, fraud and conflicts in general.

In the case of behavioral biases, disclosure is voluntary but no less important. A fiduciary's point of view or frame in approaching a professional subject matter has a material impact on the path the plan sponsor or client travels. Disclosing a fiduciary's professional preferences or biases is no different than going to an orthopedic surgeon who tells you her preference for cutting, or visiting a physical therapist who discloses her preference for a noninvasive alternative treatment plan. Their preferences and biases are understood.

Clients hire fiduciaries for their knowledge, wisdom, skill, loyalty and process, but also their leadership to and conviction to their beliefs. We owe them the disclosure of our preferences and biases that drive our fiduciary process and commitment.

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