Fixing the 401(k)—Before It’s Too Late

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I recently had the pleasure of helping to install what I believe to be a model 401(k) investment program for a major winery in Sonoma County. In the process, it occurred to me (once again) how poorly most 401(k) plans are structured and why, without significant change, so many participants in these plans will have far less at retirement than they should. In a nutshell, high costs, poor investment choice, and bad investment behavior are the major challenges.

I believe major changes in 401(k) plan structure and management are necessary to address these challenges and change must start at the top—with responsible, forward-thinking corporate owners and executives who view a 401(k) plan not as a competitive necessity to attract and retain employees, but as an important retirement benefit that rewards employees for loyal service and serves as a legacy of the company’s ethics and values.

In this effort, companies must align themselves with advisors who share their values. In the current environment this means an almost 180 degree shift in strategy from “what sells” to what is clearly in the best interest of the plan participant. If positive changes do not occur soon, I think it’s up to the U.S. court system to step in and hold plan fiduciaries, (including financial advisors) financially liable for breaching an important legal duty. No new laws need to be enacted. Congress does not need to mess this one up.

Fiduciaries, in fact, have had an exceptional resource at their disposal since 1992. That year, the American Law Institute published a well researched and well written guide for plan fiduciaries entitled, The Restatement of the Law Third: Trusts; The Prudent Investor Rule. Corporate decision makers and their advisors ignore this restatement of prudent investing at their own financial risk.

What’s Wrong With 401(k) Plans and What Can We Do About It?

In this and the next Asset Class issue, I will summarize what I believe are the major problems with the typical 401(k) plan and offer some sensible solutions. I think this effort is important to all investors because the problems in the 401(k) area reflect problems common to the investing population at large. It’s also the case that many individuals have 401(k) or similar “self-directed” plans with their employers.

Individuals tend to speculate more than invest; they make emotional rather than rational decisions; they are sold investment products from Wall Street marketers with little knowledge of better alternatives; and they incur far higher costs than they should. Restated for 401(k) plans, the problems that weigh most heavily against a participant building a meaningful retirement balance over time are:

1. Overall plan costs are much higher than necessary and significantly weighted to plan participants, not the company.
2. There are often far too many investment options; they change too frequently; and they tend to promote bad participant behavior.
3. Advice to participants is either nonexistent or ineffective when applied to what are generally inferior investment choices.

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High Plan Costs

In their efforts to save time and reduce the overall costs to the company, too many corporate retirement plan fiduciaries choose the “one-stop-shopping” options offered by the major mutual fund complexes, Wall Street investment firms, or insurance companies. These firms essentially give away the administration and record-keeping services, which are typically paid for by the company, in order to gain the business. They aren’t doing this out of the kindness of their capitalistic hearts, of course. They make up those fees on the investment side. And who pays those fees? The participants, of course. In order to get paid enough for these services, the one-stop-shops offer their own mutual funds with sufficiently high management fees to offset the recordkeeping costs and build in a substantial profit. If their own funds lack a superior recent track record (an elusive beast, for sure), the one-stop-shops will simply “screen” outside fund companies for top recent performers who also just happen to pay them “revenue sharing” fees (i.e. an “incentive”) to use their funds.

Complicit in all of this is usually an “unbiased” pension consultant or investment advisor who, not surprisingly, is also compensated by those ubiquitous revenue sharing fees. Further complicating (and obscuring) matters is the fact that transparency relating to fees is pretty rare in the 401(k) business. Most often it appears that the recordkeeping, administration, and investment advisory services (at least at the company and general participant level) are free and the only “real” cost are the mutual fund expenses—and they are, as the argument goes, no higher than what a participant would occur outside the plan. This is an absurd claim, of course, since the participant has no choice in the matter and the advisor has no incentive to control these costs. On the contrary, the fact that index fund choices are few and far between in 401(k) plans demonstrates that cost and odds of investment success take a backseat to advisor compensation in most plans. And one needs only to look at the expense ratios of the index funds that are included in these plans to see where priorities, and the truth, lie.

Ever-Changing Investment Options

Most corporate 401(k) plans not only use expensive actively-managed funds in order to pay their advisors through revenue sharing, they also use them to project an appearance of superior quality—as measured by recent performance. This has the affect of making the plan look more attractive to employees while providing a false sense of fiduciary security.

Think about this: How difficult do you think it is to define a set of investment categories and screen for the top five performers in each one over the past five years? Stumped? Okay, it takes maybe fifteen minutes. Now, what is the likelihood that all 25-50 of those funds go from a 4 or 5-Star rating to your measly old 2 or 3-Star rating over the course of a year or two? Not too likely. But some will. This inevitability defines the “value” most advisors bring to a 401(k) plan. They do a fifteen-minute screen at the start of the relationship; prepare detailed reports on each fund for the fiduciary committee to pore over at their quarterly meetings; and then do an additional fifteen-minute screen every year to replace the inevitable laggards with new hot funds from among the thousands available. And the fiduciary committee beats its collective fiduciary chest knowing that they always have those 4-5-Star funds providing excellent management to their participants.

While the corporate fiduciaries and their advisors are beating their chests, participants are wondering which of the five funds in each of umpteen categories they should choose. Since the company and the investment consultants have made it clear that it’s all a performance game, the plan participants naturally gravitate to the funds with the highest recent return! If the fund they chose happens to be a laggard this year, they simply sell out of that one and buy the fund that did the best last year. And if the fund does poorly for two or more years, it’s likely that the company and its consultant will make the participant’s “buy high, sell low” decision for him by replacing it and automatically investing the assets in the new “winner.”

Companies like DALBAR and Morningstar have documented very well the high costs of such destructive investor behavior. One solution to the problem is to offer “lifecycle” funds—pre-mixed portfolios of funds that change asset allocation as investors near retirement. While not a bad concept (we believe there’s a better choice), it’s being corrupted by fund companies who view it as a way of introducing their high-fee proprietary funds into the mix while obscuring performance comparisons. Since most participants are steered this direction, the fund companies win again—at the participants’ expense.

Poor Investment Advice

Advisors will rationalize their recommendation of a broad selection of actively-managed funds by saying that plan sponsors demand “more choice”—prompted, they say, by the participants’ demand for “more choice.” It’s a vicious circle, of course. Wall Street and the fund companies create and promote more choice by launching a seemingly endless stream of mutual funds (there are now almost 7,000—more than the number of individual U.S. stocks); the ever-changing list of “superior” funds insures that more choice always appears necessary; and more choice creates the need for an advisor to screen through it all on a continual basis in order to find the next new “superior” fund.

No, more choice is simply a cop-out on both a plan sponsor’s and advisor’s part from taking responsibility to act as prudent fiduciaries. Educational materials preach basic principles such as broad diversification and the avoidance of market timing. But under these “fund supermarket” structures, it’s a bit like turning a toddler loose in a candy store, walking away, and hoping he doesn’t go from one jar to the next until he falls over sick to his stomach!

The Prudent Investor Rule, Modern Portfolio Theory, and the growing popularity of indexing are a curse to many advisors. Any advisor who would recommend a more prudent approach to the investments (i.e., recommend low-cost index funds, with no revenue sharing, diversified across asset classes) must convince the corporation to not only pay the recordkeeping costs, but also pay the advisor a reasonable fee for his services. The overall plan costs are usually lower, but the corporation’s cost just went up.

So what’s an advisor to do? Most keep playing the active-fund merry-go-round game and act like they’re adding value. Some, like TAM, opt out of the game until a corporate fiduciary with an open mind and a true sense of fiduciary duty comes along and asks for help. This will continue to be our strategy until the courts start opening some more minds—and doors—for us.

Next Issue: Solutions