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

Part 2: Solutions

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The previous Asset Class outlined some of the significant challenges participants in 401(k) plans face in building meaningful retirement balances. There are excellent alternatives to the status quo and this article will present some of them.

1. Put ethics, not convenience or company cost, first.

I believe companies should adopt a “Code of Ethics” that includes how employees are treated and specifically how employee benefits are to be considered. Are employees part of a “family” in which respect, compassion, and reciprocal obligation are promoted at all levels, or are employees and their “benefits” viewed as just another cost of doing business?

A Fiduciary Committee made up of senior executives should be tasked with obtaining, reviewing, and discussing the key principles of the 1992 revision of the Prudent Investor Rule; determining what course of action should be taken to adhere to those principles; and screening professional advisors who will help them develop a prudently managed retirement program for all employees.

Potential advisors should be required to know the key principles of the Prudent Investor Rule and indicate, in writing, how they intend to fulfill their fiduciary responsibility under the Rule. If an advisor believes that he (or she) can pick actively-managed funds that will outperform a relevant benchmark in the future, he should be prepared to explain why; furnish a track record of all past fund selections and changes to those selections over time; calculate the net (after fee) result of his advice. If multiple funds have been used in an asset class category, the range of returns as well as a dollar-weighted average of the returns should be calculated and compared to the benchmark. If an advisor chooses instead to employ a passive strategy, he or she should be prepared to show which asset classes should be included in a well-diversified portfolio and why, and which index funds are expected to more fully and consistently capture the asset class returns net of fees. In all cases, fees, expenses, and revenue sharing arrangements should be fully disclosed.

2. Avoid one-stop-shops. Work with specialists.

In the previous Asset Class, I described the “one-stop shop” and the problems inherent in this model. Because of the high costs and blatant conflict of interests, I believe plan sponsors should select advisors to the plan that are all independent of one another. One firm could handle custody, recordkeeping, and administration, but the investment advisory services and fund management should remain independent. The only exception would be when the custodian/recordkeeper offers a competitive money market or stable value option, net of fees. This model combined with the company covering all costs but the mutual fund fees, allows the advisor to choose the most cost efficient money market or stable value alternative. Ideally, he should be prepared to explain why; and evidence that he has successfully chosen superior active funds in the past.

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3. Limit the investment options.

Offering tens or hundreds of funds is not “choice,” it’s a cop-out—an admission that even a dedicated and focused committee of plan fiduciaries can’t pick “superior” active funds in advance. By offering several funds in each investment category, these fiduciaries are confident that one will prove superior over time. The inevitable result is that participants will choose the highest performer over the past 3-5 years. No amount of investment education will quench this thirst for performance chasing.

Responsible fiduciary behavior would begin with the hiring of an independent advisor as described earlier and the advisor would work with the Fiduciary Committee to decide the most appropriate asset classes to be included in the investment selection. (Note to plan fiduciaries: the days of “equity income,” “growth & income,” etc. are over.) The table below shows the core asset classes I would consider for most plans.

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<tr>
<th>Core Asset Classes</th>
<th>Stable value</th>
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<tr>
<td>Money market</td>
<td>Stable value</td>
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<tr>
<td>Short-term bonds</td>
<td>Intermediate-term bonds</td>
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<td>U.S. large stocks</td>
<td>Foreign large stocks</td>
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<td>U.S. small value stocks</td>
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<td>U.S. REIT stocks</td>
<td>Emerging market stocks</td>
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There are excellent low cost, broadly diversified, passively-managed funds to cover each asset class. If active funds are recommended, emphasis should be on diversification, cost, and asset class purity and consistency—otherwise you’re playing a performance game participants are bound to lose. On the other hand, active funds with those features are arguably “closet” index funds, so in my view all roads should lead to indexing.

4. Offer risk-based, pre-mixed portfolios.

Even with limited funds and assets classes and good investment education, many participants will not be comfortable allocating their assets among the different fund choices. Furthermore, it’s unlikely that an investment advisor to the plan will (or even should) give personal advice to each participant. An alternative is to create pre-mixed portfolio choices that are diversified among the key asset classes.

The most popular option in this area is the “lifecycle” fund. These funds change their stock/bond allocations over time to coincide with a participant planned retirement year. I’m not a big fan of these kinds of funds for several reasons. First, they assume every investor of the same age (or retirement date goal) has the same risk and return objectives. This could lead to very costly mistakes by plan participants. A participant who needs to earn a higher return to meet retirement goals might be drawn to a fund with too little in stocks, and one who is financially closer to meeting his or her goals might end up over-invested in stocks. Retirement age, in other words, is not the only metric to consider. Risk and expected return must be included in the analysis. Unfortunately, most lifecycle funds own actively-managed mutual funds (a “fund of funds” structure) in various asset class categories, making projections of expected risk and return much more difficult. Another challenge with lifecycle funds is that fund companies define “appropriate” allocations for target retirement years differently. I found two popular “lifecycle 2020” funds in the Morningstar database with a 20% difference in stock allocation!

Lifecycle funds also allow fund companies to place their high-cost proprietary funds into the mix “under the radar.” This is an excellent strategy for the fund companies since most assets will be directed to these funds in either the investment education process or an automatic enrollment policy. Lifecycle funds also make it easier to hide underperforming funds. In other words, accountability, transparency, and objectivity are severely sacrificed with lifecycle funds.

In contrast, risk-based portfolios can avoid these shortcomings. These portfolios mix funds by assets class in a way that balances risk and return, starting with the stock/bond mix. Risk-based portfolios are a perfect place for index funds since you can achieve asset class purity and consistency; very broad diversification; low costs; and greater underlying fund stability much more effectively. Many plan recordkeepers can work with an advisor to create these customized portfolios, avoiding the need for the less flexible “fund of funds” model.

Risk-based portfolios require more time and effort on the part of the plan’s investment advisor to educate participants. This is an ongoing process that starts with the initial enrollment period and should include regular (perhaps quarterly) group meetings and written (or web-based) communication.

There are other viable solutions for improving 401(k) plans, including the elimination of “brokerage windows” that offer participants a way to gamble their retirement away. But due to space limitations, I’ll close with an example of a structure Halexon Investment Partners (TAM’s merger partner) recently put in place for a $40 million plan.

Case Study

The previous advisor had placed the plan with a one-stop shop that offered mostly higher cost active funds (several of their own) which in turn paid “revenue sharing” fees back to them and other plan providers. The result was very high cost to the participants and a constantly changing line-up of funds. We were hired as the new advisor to the plan and an independent custodian and recordkeeper (same firm) was chosen among four candidates based on services and price. Investment options were limited to index funds and passively-managed asset class funds from Vanguard and DFA (except for the custodian’s competitive stable value fund), reducing the costs to participants by more than 50%.

We developed four “pre-mixed” portfolios for investors who did not want to build their own from the individual funds. Stock allocations range from 25% to 100% and were further divided among large growth (S&P 500), large value, small value, foreign large value, foreign small value, and emerging markets stocks. We participated in all of the education and enrollment meetings for the new plan, emphasizing regular participation; patience; diversification; the matching of risk with the anticipated retirement date and risk tolerance; avoidance of market timing behavior; and all the other core investment principles we impart to individual clients. The new plan was enthusiastically embraced by participants and management alike—appropriate credit going to the latter for their willingness to think outside the box.