SAVING THE 401(K) PLAN

By

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Saving the 401(k) Plan

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Executive Summary

The 401(k) plan is the most important retirement vehicle for the majority of working Americans. There are approximately 3 trillion of assets in these plans. The social importance of 401(k) plans and a decade of poor market performance have stimulated a new level of scrutiny. The press, plan sponsors, related professional groups and congress have generally concentrated on fees, participation rates and the transparency of these plans. New regulations and product offerings have sought to improve them. Unfortunately, these steps have been generally ill-informed and/or self-serving and clearly ineffective.

Some have suggested scrapping 401(k) plans in favor of a government run program or insurance company guaranteed programs. We consider such recommendations reckless and naïve. In this paper we will discuss how 401(k) plan practices can be greatly improved and the importance of repairing the existing 401(k) plan instead of scraping them altogether. We will also discuss why the 401(k) "industry" won't fix itself and why understanding and implementing some relatively simple practices of traditional plans will dramatically improve the effectiveness of these plans for participants and will create a huge business opportunity to a new class of providers.

The State of the Industry

The term "401(k) Industry" refers to the players currently involved in providing 401(k) plans and services. These would include insurance companies and mutual fund groups that sell plans to American companies, recordkeeping companies that keep track of the plans assets, custodians responsible for holding and trading assets, third party administrators that interact with the sponsors and their employees, and the sale force that solicits and offers plans.

The 401(k) industry itself is a very successful industry, particularly for the mutual fund companies that dominate all aspects of it. In fact, the lack of balance between the mutual fund industry's interest and those of plan participants is striking. Undisclosed fees, lack of fiduciary responsibility, deceptive performance reporting, and undisclosed fee sharing arrangements are all wrapped up in a record keeping system that virtually eliminates competition from non-mutual fund investment alternatives. The 401(k) plan from a mutual fund industry perspective has been sheer genius as a profit generator. They grew a multi trillion dollar industry where customers (except for some very large companies) were absurdly naïve. They didn't tell them what they were charging, they didn't tell them what they were investing in, and they didn't even assume the responsibility for the results. On top of all that they charged maximum retail fees even though plans grew to have millions of dollars in them. Is it any wonder the mutual fund industry is one the most profitable business enterprises in America?

It is clear, from the size of the assets involved, the industry is huge and that these assets represent the primary retirement savings of millions of American workers and future retirees. It is also clear that 401(k) plans are very important to our society. It has been pointed out the sheer size of these assets and their trading predictability had an important stabilizing effect on the market during the banking and stock market crisis. The societal implications, however, of future citizens being forced to postpone their retirement, for lack of funds, while being asked to pay increased taxes so government retirees can enjoy government retirement benefits, is incalculable . An efficient and effective retirement program is critical in light of this impending conflict. Unfortunately 401(k) plans are failing to meet the personal needs of participants or the societal needs of our country.

When you consider the advantages available through 401(k) plans it becomes clear it is far and away the *best option for millions of Americans*. The advantages are pretax contributions, tax deferred growth, portability, creditor protection, flexible investment choices, flexible contribution rates, control of distributions and the possibility of employer matching contributions. If such a product were created by a major broker it would be the hottest program in the country. Yet the majority of eligible Americans don't take full advantage of these plans!

With all these advantages why aren't more people fully utilizing them?

Even though the total assets in 401(k) plans are huge the amount in the average participant's account is woefully inadequate (in the range of $45,000 per participant). In other words the effectiveness of 401(k) plans has not come near meeting early expectations! The good news is that the problems are known and the solutions are straight forward…

Flawed Structure?

401(k) plans were never designed to be a primary retirement program. They initially appeared as supplements to the then-dominate employer funded pension plan system. These new plans were funded out of the employees' paychecks and utilized primarily by higher-paid executives. They did have some important advantages, however. Contributions were pretax, plans were portable and you could vary contributions.

The combination of high interest rates and the resulting overfunded pension plans in the late 70's and early 80's created a one-time profit opportunity for companies who closed or stopped funding pension plans and sponsored 401(k) plans instead. The companies and their new plan providers, the mutual fund industry, argued that because of the high rates and new participant control, better returns would be achieved and higher retirement benefits would be realized in the long run. The morality and the logic of this argument aside, the net result is that 401(k) plans were not originally designed to be our country's primary retirement program.

The mutual fund industry, however, alertly saw these new plans as potential big business. To make sure these new plans where fueled by mutual funds, *participant direction* was key. If 401(k) plans where invested at the plan level it was unlikely mutual funds would be the investment of choice except for the smallest plans. The mutual fund industry further cemented their monopoly in the 401(k) market by developing recordkeeping systems that excluded the use of non-mutual fund investment alternatives. The footprints of the mutual fund industry are all over the regulations, providing generous safeguards and loopholes for mutual fund companies and putting the fiduciary burden on uninformed plan sponsors. The dominance of the mutual fund industry created more of a mutual fund selling device than a participant oriented retirement program for American workers. In fact the current 401(k) plan structure is not being utilized for maximum benefit for plan participants and sponsors. We do not believe 401(k) plans are fundamentally flawed or that a major overhaul of regulation is necessary. Current regulations allow for changes in industry *practices* that would have enormous benefit for both participants and plan sponsors.

As a program it is hard to say the 401(k) plan has not been successful. Hundreds of thousands of plans have been created and millions of workers are contributing every payday. The reality is that they have terribly underachieved for the majority of plan participants. There are four major causes for this underachievement.

Lack of Interest
Lack of Information
Lack of Guidance
Lack of Performance

The *lack of interest* is on the part of the employer sponsors. Most company mangers are busy dealing with the day to day issues of the company and are not motivated to spend the time and money to generate interest and educate participants about the benefits of their plan and the importance of saving for retirement.

The *lack of information* is simply the result of sponsors not demanding it. It is an exceptional sponsor or employee who takes the initiative to learn all the details of the company's plan on their own. Reporting mutual fund performance instead of plan performance is nothing short of "slight of hand" behavior on the part of mutual fund industry and it is unrealistic to expect HR to step in and provide guidance; in fact they are legally advised not to. This is *not* an information supportive environment.

The *lack of guidance* is the result of the mutual fund industry calling all the shots. They frequently act as sales force, recordkeeper, and investment manager. They provide the whole package including forms and documents with little regulatory oversight. Field people have little incentive to point out this lack of oversight and obvious conflict of interest to their sponsor clients. A movement to "unbundling" these fiduciary responsibilities is an important step in the right direction, however.

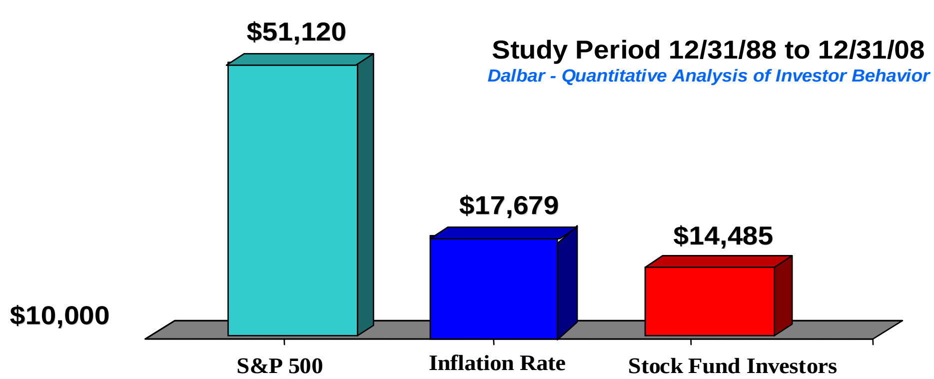
The *lack of performance* is the least talked about and most important failing of a participant-directed 401(k) plan. The early growth and popularity of 401(k) plans was largely due to a bull market that not only brought terrific performance for participants but created great enthusiasm for the market and 401(k) plans in general. The exciting performance of the market kept sponsors interested and participants demanded information. An attentive mutual fund industry rode this wave of enthusiasm encouraging reckless trading by amateur investors with ever more choices, instant quotes, and online trading.

The inevitable bear market laid bare the weakness in the system. Untrained, unskilled, busy workers are the worst class of investors that exist. Which begs the question: why do we deny American workers the same professional investment services that highly educated wealthy investors and institutions demand?

Professional Management for 401(k) Plans

It seems that there is a reluctance to discuss the “elephant in the room” when it comes to 401(k) plans. While the various issues surrounding fees and transparency in 401(k) plans are important they are relatively minor when compared to the negative effect of chronic underperformance. The total fees in question are probably not more than 150 basis points, while plan underperformance is probably in the in the range of 600 to 800 basis points per year. This concentration on the cockroaches instead of the elephants brings up many questions but it is clear that the discussion of investment performance can no longer be ignored.

Investors Have Not Done Well On Their Own!



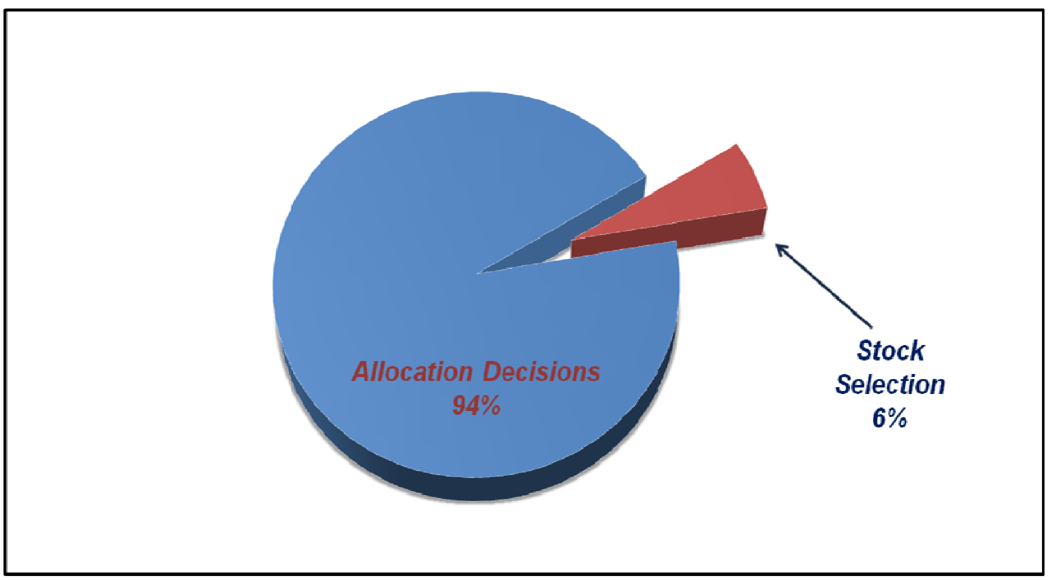
Average Annual Return	
S&P 500	8.35%
Stock Fund Investors	1.87%
Inflation Rate	2.89%

Serious advisors know that professional managers outperform amateurs over the long-term and substantially so in most cases. Undeniably, plan participants have demonstrated for over 30 years that they are extremely poor investors. Despite the fee-generating benefits of participant direction for mutual funds groups it has proven to be a determent to participant's long-term performance. It is time for professional advisors to offer 401(k) plans the same investment management skills, tools, transparency and fees we offer our wealthy clients and institutional investors. We no longer have the excuse that we don't have the technology, because we do.

The Myth of Professional Management

When suggesting a "professionally managed" plan the response is frequently "isn't our plan professionally managed by [mutual fund complex]?" The answer to that question surprises most sponsors and many advisors because the answer is "not really!" When you think about it, the mutual fund complex simply puts up a list of funds for participants to choose from. So the real question is how valuable is the list of stock mutual funds (stock pickers) when compared to the importance of the fund selection (asset allocation) which is left to the participant who is clearly not a professional.

Significantly, that question has been studied, most notably by the Brinson, Hood Beebower study in 1986 represented in the chart below. It has also been *generally* accepted, by the investment advisory community, that allocation decisions contribute considerable more to investment performance than does stock selection.



Brinson, Hood Beebower study 1986

As you can see by the chart on the previous page the relative importance of stock picking (what the mutual fund does) is somewhat unimportant when compared to what the participant does. 6% of performance comes from the professional, while 94% comes from the participant. This can hardly be called professional management and from a fee point, paying for the whole pie and getting only 6% is hardly a bargain.

If we are serious about improving 401(k) plans this imbalance must be corrected.

Bringing the 401(k) into the 21st Century

With the *unbundling* of the administrative requirements of 401(k) plans we can now treat virtually any size 401(k) plan the same way we treat an institutional client. That means full time professional portfolio management, access to virtually all asset classes, professional portfolio construction, both fee and investment transparency and the ability to use risk mitigation tools not available in participant directed plans.

Plan participants and sponsors deserve the following features in their retirement plans:

Professional Management
Relevant Portfolios
Exchange Traded Funds
Fee & Investment transparency
Assumption of Fiduciary Liability
Risk Management

Professional Management

True professional management has many advantages. Having a staff of highly trained and skilled professionals has always been preferred in virtually any important service. Despite the self serving marketing blitz to the contrary, it is understood by unbiased observers that professional investment managers substantially outperform amateur investors. Professionals have access to more information, negotiate lower fees, follow a consistent process and can use risk mitigation risk tools and techniques that are simply not available in participant-directed plans. In addition to the obvious performance benefits, managers that qualify as ERISA "prudent experts" dramatically reduce the fiduciary liability of plan sponsors.

Contribution amounts and performance are overwhelmingly the most important drivers of any retirement plan. A serious attempt to improve retirement benefits for 401(k) plan participants has to include professional management as well as better participation.

Relevant Portfolios

Traditional 401(k) plans may have as many as 25 or more choices of mutual funds. How relevant are these choices to participants who are not familiar with the make up of the choices, their contents, and their relationship to other choices and/or the overlapping of the various components offered in the plan? Granted there are brilliant employees out there who can figure all this out for themselves, but they are clearly in a small minority. Even those few are subject to the short term pressures associated with investing and the costly mistakes most individual investor make.

In an industry pandering to individual investors the most important relevant information is frequently obscured. The age of a participant or years to retirement is far more important when designing a long-term investment approach than the *vague industry created emotionally driven "risk tolerance" of a participant.* The quality of investment management is hugely more important than the number of investment choices. In fact, it is highly likely that investment results have declined as more and more choices have been created to entice naive participants. Certainly the fees for these evermore exotic choices have driven plan costs up.

To improve long-term plan results it is critical to offer only professionally management portfolios that are relevant! Relevant portfolios are portfolios designed for maximum risk-adjusted return relative to the age or time to retirement of the participant. For example, a plan that offers four portfolios based on age, with portfolios for older participants constructed to reduce volatility as participants move closer to retirement. Portfolios designed specifically to give them the best chance of achieving your retirement goals are relevant. Portfolios to chase hot new trends are not relevant portfolios.

Exchange Traded Funds

As discussed above stock selection plays a relatively minor role in generating investment performance. In addition the cost and likelihood of finding and being able to utilize outperforming managers has a very low probability. To further complicate the issue the majority of active mutual fund mangers underperform their benchmarks.

Comparing Index Investing with Active Stock Selection

Active Managers Underperforming the Index		
Large-Cap US Managers	*5-Year*	*10-Year*
Russell 1000-Blend	***55.1%***	***44.8%***
S&P 600-Blend	***77.6%***	***55.6%***
S&P 600-Growth	***90.7%***	***79.4%***
International Managers		
MSCI EAFE-Blend	***54.8%***	***48.4%***
MSCI Emerging Markets-All	***69.4%***	***48.1%***

Sources: BGI, Morningstar, MSCI Inc., S&P, and Russell as of 12/31/08

For this reason Exchange Traded Funds (ETFs) have become very popular with institutional investors that believe their energies are more productively spent getting the allocation right instead of wasting time and significant expense of finding stock pickers. Considering the greatly improved fee and investment transparency of ETFs, they should be considered as an important advantage in the modern 401(k) plan.

Fees & Transparency

Even though the concept of fee transparency has many in the mutual fund, insurance and recordkeeping business in a tizzy, registered investment advisors have always disclosed fees, and with transparency being offered by unbundled recordkeeping and administration programs the structure is already in place to meet new transparency requirements that are expected from regulators. With investment advisors starting to offer ETFs, investment transparency is now available in 401(k) plans.

Assumption of Fiduciary Liability

Fiduciary liability for a plan sponsor is extremely important but seldom understood. It should be remembered that the Employee Retirement Income Security Act (ERISA) was designed to protect participants not sponsors. Top ERISA attorneys have stated that most plans are out of compliance with a long and seldom understood list of sponsor requirements associated with participant directed 401(k) plans. An important additional advantage of professional management is that those who qualify as "prudent experts" can accept the fiduciary liability for the investment management process. This is an extremely important benefit for plan sponsors because this broad liability is deemed to be *persona*l under ERISA.

Risk Management

An important advantage of professional management is access to virtually every asset class that exists, and this includes risk management tools not available in participant directed plans. The use of risk-mitigation tools can be very helpful in reducing volatility in difficult markets. The understanding and use of these tools is an important feature as it helps participants stay the course which is critical to achieving the long-term performance necessary to create the retirement benefits participants are looking forward to.

By incorporating administrative advancements, new low cost and transparent investment tools and by appropriately employing professional management the 21st Century 401(k) plan will be a giant step toward fulfilling the retirement expectation of the American workforce.

Huge Opportunity for New Class of Providers

Converting traditional participant-directed plans to the new professionally managed high transparency plans is going to be big business. The question is who is going to do this business. It is likely the dominate mutual fund and insurance providers will not be enthusiastic about exposing their fees, outsized profits and lack of performance. Their success in exploiting an extraordinary profitable business opportunity will ironically force them to fight for the status quo, thus making them less competitive in the market place.

This lack of competitiveness will create a huge opportunity for an attentive new class of providers. Traditional 401(k) plans have become commodities with little discernable difference between offerings. As is always the case, commodity sales are based on price and the ability to deliver. The sale of a professionally managed plan is an *investment sale* requiring a different set of skills than the commodity sale. The new 401(k) plan sale will be made by an investment advisor who will understand and appreciate a more sophisticated investment process and will be comfortable telling the story.

In the past high-end advisors tended to cede 401(k) business to the big insurance and mutual fund providers, not wanting to get involved in what appeared to be a complicated and demanding specialty. They where also not willing to jeopardize their relationships with top earning executive clients by engaging in a business they didn't fully understand.

With the conversion of the 401(k) sale to an *investment* sale from a *commodity* sale and with the help a strong recordkeeper/administrator, the professional advisor will be in the prime position to harvest their relationships with corporate decision makers. Offering them a program that reduces costs, improves performance and dramatically reduces their clients fiduciary liability will be compelling. Attentive recordkeepers or a new breed of consultants will be required to be more involved in the sales process but for those who gear up to work with these highly skill and well connected advisors, the potential for growth will be great.

401(k) plans are under siege, but the process to save them is underway. Though the process may be painful for large providers the winners will be plan participants and sponsors along with the new providers who recognize the new realities and opportunities in this important industry.

Jim McMichael is a Managing Director of Main Management and president of Professional Asset Management Group, Inc., a registered investment advisor providing marketing and product development consulting to investment managers. He has over 35 years in the industry and is a Certified Investment Management Consultant (CIMC®) and an Accredited Investment Fiduciary (AIF®). He has also served on the board of a New York investment broker-dealer, was a member of GE Private Asset Management's Investment Management Executive Committee, and was a partner in a highly successful financial planning firm.