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# Overcoming the Real Problem with 401(k) Plans: A Case Study

BY N. SCOTT PRITCHARD

*This case study details the experience of two plan sponsors that made every effort to fulfill their fiduciary duties, yet found that participants still struggled with managing their investments. Fortunately for the plan sponsors and participants, an innovative solution evolved.*

## Executive Summary

In the post-Pension Protection Act (PPA) world, many plan sponsors already recognize the value of having an independent advisor guide the investment process within a 401(k) plan. However, even plan sponsors that have already been following that model for almost a decade have found that there are still some inherent problems with the design of the prototypical 401(k) investment offering. The case study that follows details the experience of two plan sponsors that made every effort to remain ahead of the curve and still found that participants struggled to successfully manage their own investments.

Was the problem one of the following issues most commonly associated with today's average 401(k) plan: High-cost investments? Hidden fees? The absence of investment advice? A lack of education?

No. *Participants* were the problem. More specifically, the way participants managed their investments was the problem.

The very people for whom the plans were created were the problem, and through no fault of their own. The design of the typical 401(k) plan simply left the critical investment decisions to someone who had no training, very little time and often very little interest in managing a portfolio.

"The Tyranny of Choice," our white paper published in the Autumn 2008 *Journal of Pension Benefits*, introduced the concept of advisor-managed portfolios as a solution to this pervasive problem. As a follow-up, this case study will detail the positive impact advisor-managed portfolios have had for two plan sponsors and their participants.

## Historical Perspective

The 401(k) plan as we know it today may have been created by ERISA in 1974, but it really wasn't *born* until the mid-1990s. Driven by a roaring bull market, advancements in recordkeeping technology, and the "sales machine" of Wall Street, retirement plan participants began clamoring during that decade for the "freedom" to chart their own course.

New Web-based platforms offered participants daily access to their investments and spawned the ability for participants to day-trade their 401(k). As the market roared upward, it didn't seem to matter that the average participant knew very little about investing.

Then the bubble burst. In the wake of the tech bubble of 2000, participants (and many supposed

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“investment professionals,” for that matter) realized just how little they knew about investing.

But still, very little changed in the 401(k) world. Everyone realized participants needed more help, but plan sponsors continued to resist offering any type of advice for fear of fiduciary liability.

Even the passage of the Pension Protection Act (PPA) in 2006, which many hailed as the most significant pension legislation since ERISA, has not done enough to save participants from themselves. Even now, almost three years later, regulations implementing permissible investment advice to participants have not been finalized due to the intense lobbying efforts of the very same providers whose conflicts of interest pollute most plans.

And then...2008. The historic downturn in the stock market has emphasized, now more than ever, that participants need help.

### Seeking Participants' Best Interests

Fortunately, along the way there have been some plan sponsors that have bucked the conventional wisdom of “good enough” and have truly sought to serve the best interests of plan participants.

Our firm has been blessed to work with two such plan sponsors since the late 1990s. Independent of each other, but at roughly the same time, two similar law firms (“Law Firm A” and “Law Firm B”) realized their participants were struggling to save for retirement and that their 401(k) plans could be improved.

Each of them engaged our firm, Capital Directions (CD), as an independent Registered Investment Advisor to conduct Recordkeeper searches. Our research led us to a large independent Recordkeeper whose platform offered relatively open architecture, the lack of proprietary fund requirements, and a stated commitment to fee transparency.

As knowledgeable and experienced as the members of the Benefits Committee at Law Firm A and the Pension Investment Committee at Law Firm B (hereafter referred to as “the Committees”) were, they also recognized that as attorneys they did not necessarily meet the “prudent expert” standard for managing investments.

To meet that standard and to receive the desired fiduciary liability protection, each firm then engaged CD to serve as a fiduciary advisor. Our firm’s responsibilities included selecting the available investment options from the Recordkeeper’s platform, monitoring those investments, regular reporting to the

Committees, and periodic participant communication and education.

Guided by Modern Portfolio Theory (MPT) and choosing from the options available through the Recordkeeper, we selected diversified investment line-ups for both plans. Much like the typical investment menu today, participants had access to an extensive list of individual funds that delivered asset-class exposure, as well as a menu of lifestyle funds. The Recordkeeper made every effort to fully disclose all expenses of the plans. The Committees and Trustees were insulated from the fiduciary liability associated with participant investment selection by delegating that responsibility to us.

In virtually every aspect, both plans were “state of the art” in the late 1990s and would even be far ahead of the majority of plans today. Yet something still wasn’t right. Participant returns continued to lag market benchmarks. These “good” plans were not producing the best results.

### The Study

So, we began to look under the hood. We collected participant data on each plan and analyzed every participant’s investment allocation.

What we found was disturbing. There was evidence of return-chasing, incorrect usage of lifestyle funds, over-concentrations in cash, and instances of generally poor diversification. Even after years of extensive education on how to build a diversified portfolio and how to utilize the lifestyle funds, many participants still did not properly use the tools at their disposal.

As we see with many retail investors, participants based their investment decisions on which funds had the best historical returns. This return-chasing (as reflected in the actual participant allocation in **Figure 1**) led participants to invest in funds that, with the cyclicity of the markets, invariably underperformed going forward.

The lifestyle funds were an attempt to avoid that type of behavior by removing the burden of the investment decision from participants. However, as

**Figure 1**

|                                |                   |
|--------------------------------|-------------------|
| Vanguard Value Index           | 149,640.63        |
| Schwab International Index Inv | 89,637.22         |
| <b>Totals:</b>                 | <b>239,277.85</b> |

Figure 2 illustrates, many participants did not grasp the concept.

| <b>Figure 2</b>                       |                          |
|---------------------------------------|--------------------------|
| <b>Investment Fund Activity:</b>      | <b>Beginning Balance</b> |
| Participant Loan Fund                 | 12,368.39                |
| Morgan Stanley Inst Real Estate       | 8,161.70                 |
| Managers Special Equity Managers      | 1,942.48                 |
| Vanguard Growth Index                 | 2,919.70                 |
| T. Rowe Price Mid-Cap Growth          | 5,485.78                 |
| Vanguard Value Index                  | 2,478.16                 |
| Schwab S&P 500 Index Inv              | 6,484.52                 |
| Vanguard LifeStrategy Growth          | 3,849.26                 |
| Vanguard LifeStrategy Moderate Growth | 1,851.89                 |
| Vanguard LifeStrategy Conserv Growth  | 1,772.17                 |
| Vanguard LifeStrategy Income          | 1,616.93                 |
| Morgan Stanley Inst Core Plus Fl      | 1,390.14                 |
| Schwab International Index Inv        | 2,276.05                 |
| <b>Totals:</b>                        | <b>52,599.17</b>         |

This participant's thinking appeared to be that if one lifestyle fund was good, then four would be even better.

This was not an isolated instance. For example, one firm had 107 participants using lifestyle funds. 75.7% of those participants were using the funds incorrectly. Just as in Figure 2, participants either held multiple lifestyle funds or held a lifestyle fund alongside other individual funds.

In an effort to correct the misuse of the lifestyle funds, we asked the Recordkeeper to limit participants to selecting only one lifestyle fund. Leery of the potential liability from limiting participant choice, the Recordkeeper refused.

Believing, as many people still do today, that education was the problem, we redoubled our efforts. We conducted more on-site meetings focused on explaining the components of the plans and how to properly utilize them to build a diversified portfolio, with a special emphasis on proper use of the lifestyle funds. To reach those participants who didn't attend the meetings, we sent out memos and e-mails.

At that point, as the fiduciary advisor and the plan sponsor collectively, we could have washed our hands of the situation and said "Well, we've done all we can

and all that we are required to do by ERISA. The rest is up to the participants."

Unfortunately, the reality is that many plan sponsors do stop right there. The demands of running any business are numerous and challenging. Committee members are simply volunteers who take time away from their daily duties to serve. The acceptance of "good" at this point in the process is what keeps many plans from moving to "great" and truly making a difference in the lives of participants.

According to an ERISA attorney at Law Firm A, "We knew our plans fulfilled all of the requirements of ERISA, but we recognized that some isolated problems remained. The most glaring challenge was that despite our efforts to offer the best plan available, most participants simply did not want to manage their own assets."

### Our Stark Realization

As the fiduciary advisor to both plans, we were frustrated that our efforts to provide a broad line-up of investment options and copious education were not producing the results we wanted for many participants.

Yet there was an exception. The small minority of law-firm partners who chose to self-direct their retirement assets outside of the plans and engaged CD to manage their assets for them were achieving better returns than their peers inside the plan. By having their investment selection made by a professional advisor, those participants were avoiding the plight of return-chasing, misuse of the lifestyle funds, and generally poor diversification.

The truth was obvious: the difference was in who made the investment decision. The average participant was left solely on their own, while those who self-directed to us gained the benefit of an independent, knowledgeable advisor making the selection for them.

### The Search for a Solution

Our solution began to take shape when we focused on how we could provide all participants in the plans with the same quality of service and counsel that the participants who self-directed to CD received.

With over 700 participants at the two firms, it was not feasible to have the same type of involved relationship with every participant to the same extent as our individual clients of CD. So we had to create a platform in which advisor-managed portfolios were "baked in the cake" in the investment lineup.

While plan sponsors and participants nationwide were increasingly embracing lifestyle funds as an

attempt to remove the investment burden from participants, we knew from our studies of both firms that the vast majority of participants did not understand the intent of the lifestyle funds and used them incorrectly. So we sought to find a way to provide fully diversified portfolios that participants would have to use as “all or nothing” options. In essence, we wanted to save participants from themselves by preventing them from undoing the do-it-for-me intent of the managed portfolios.

We also recognized that participants want simplicity. For years, studies by behavioral economists have shown that participation rates tend to decline as the number of choices in a 401(k) plan increase. For example, research by Dr. Sheena Iyengar, of the Columbia University Graduate School of Business, shows that participation rates peak when only two choices are offered and participation rates are at their lowest when 59 different funds were offered.<sup>1</sup>

At the same time, we had to seek to comply with ERISA Section 404(c) by offering participants a minimum of three options. We settled on five options as an ideal number that would offer a broad enough range to accommodate the full spectrum of risk tolerance, while keeping the choices to a minimum.

### The Composition of the Advisor-Managed Models

To reflect the fact that we were removing the burden of investment management from participants we

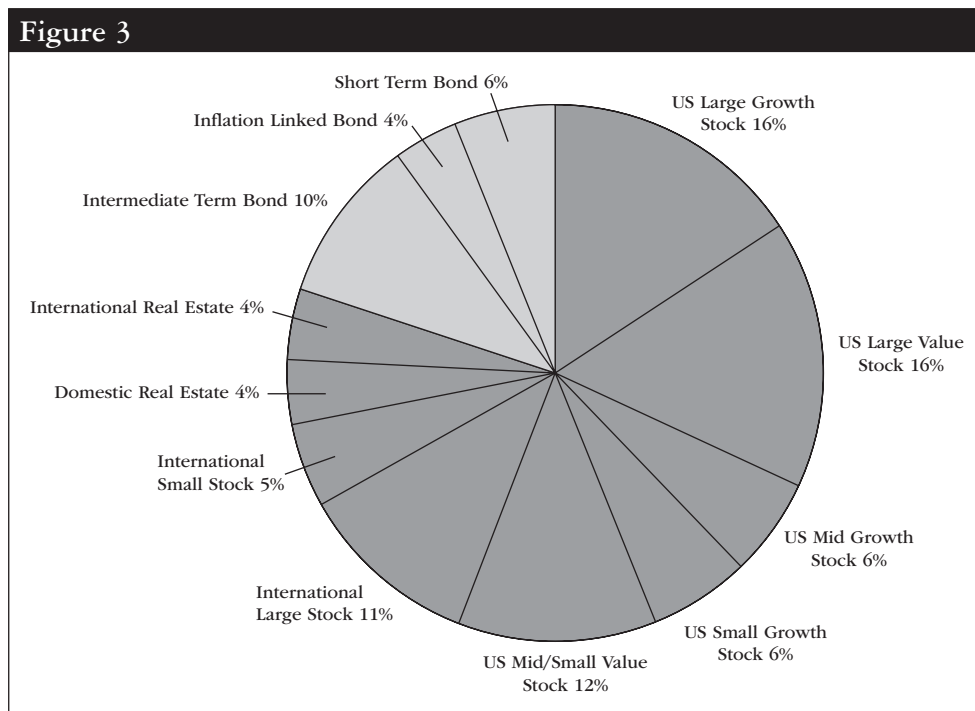
labeled the five options “Advisor-Managed Portfolios.” Each of the models was constructed to provide broad exposure to numerous asset classes, in keeping with Modern Portfolio Theory (MPT).

In order to accommodate the diverse risk-return needs and time horizons of a large participant population, the portfolios covered the full risk spectrum:

- All Equity (100% stocks)
- Growth (80% stocks/ 20% bonds)
- Moderate Growth (60% stocks/ 40% bonds)
- Conservative (40% stocks/ 60% bonds)
- Defensive (20% stocks/ 80% bonds)

As reflected by the Growth portfolio in **Figure 3** below, the typical portfolio provides exposure to nine different equity asset classes and three fixed-income asset classes. Compared to the average portfolio we saw in our studies of both plans, this represents far greater diversification than virtually any participant achieved on his or her own.

Another key to the portfolios was CD’s access to certain institutional mutual funds that were previously not available on the provider’s platform. The asset-class funds of Dimensional Fund Advisors ([www.dimensional.com](http://www.dimensional.com)) are available only through approved fee-only advisors and CD is fortunate to be one of those approved firms.



DFA's funds are passively managed, but are not true index funds. Instead of adhering to a particular stated index, DFA provides disciplined exposure to each asset class. And by not attempting to select which stocks in a particular sector will outperform, but by holding all available stocks in a sector, DFA is able to provide broad exposure in each asset class at very low cost.

### The Decision Process of Each Firm

When presented with the Advisor-Managed Portfolios solution, the Committees of both firms recognized the critical shift this represented. While the plans would still be self-directed, participants would no longer be forced to manage their own independent investment choices.

The Chair of the Committee for Law Firm B said, "We saw this as a great opportunity to access advisor expertise and the best institutional asset-class funds available, all while lowering the all-in costs of the plan."

### The Recordkeeper's Involvement

Once we received the mandate from each firm to implement our approach, the next step involved the cooperation of the Recordkeeper. The primary challenge was that DFA, unlike almost every other fund company, did not share revenue. The Recordkeeper did not initially grasp the concept of receiving a straight, hard-dollar fee. Although we showed them that their total revenue would not be impacted in a hard-dollar arrangement versus "soft-dollar" revenue sharing, the concept was so foreign that we thought it may be a stumbling block to the implementation. To their credit, the Recordkeeper eventually grasped the concept and agreed to take advantage of our access to DFA's low-cost, institutional funds.

With CD acknowledging in writing that we accepted responsibility as a fiduciary under Section 3(21) of ERISA, the Recordkeeper also agreed to limit participants to choosing only one of the Advisor-Managed Portfolios. Given the propensity of participants to choose multiple lifestyle options from the old investment line-up, this had to be a key feature of the new approach.

### Building in Some Flexibility

We firmly believed that all participants would benefit from the prudence of the Advisor-Managed Portfolios, but we also wanted to accommodate the occasional participant who still wanted to craft his or her own strategy. So we created the options as follows:

- *Option A:* Choose one of the five Advisor-Managed Portfolios.
- *Option B:* Build a custom allocation from the same individual funds used in constructing the Advisor-Managed Portfolios. For example, a participant who wanted to be 70% equities / 30% bonds instead of the Advisor-Managed 80/20 or 60/40 could do that using the same institutional, asset-class funds.
- *Option C:* Full self-direction through a brokerage window, giving the participant access to the full, public investment universe, or the ability to independently engage an outside advisor.

### The Implementation

With the mandate from both firms and the cooperation of the Recordkeeper, we conducted enrollment meetings to explain the approach and the transition. Participants were introduced to the concept and given a brief Investor Profile Questionnaire that identified their personal risk tolerance and time horizon. Based on their score on the Questionnaire, they were directed to one of the five Advisor-Managed Portfolios and only had to complete a one-page enrollment form to select their Portfolio.

The response from participants was tremendous. Recognizing that they no longer had the responsibility for developing, implementing, and monitoring an investment strategy, participants repeatedly voiced their relief.

- "I'm a busy attorney, not an investment professional. I've always wanted someone else to do this for me," said a partner at Law Firm B.
- A Law Firm B administrative staffer added, "I just wish we had done this a long time ago."
- A paralegal at Law Firm A said, "Wow, this would have kept me from making a lot of the mistakes I've made in the past."

And the relief was evident in the acceptance of the Advisor-Managed Portfolios. 86% of Law Firm B participants selected one of the five Advisor-Managed Portfolios. The adoption rate for Law Firm A was 81%.

"Our participants realized the responsibility, and consequence, of making their own investment choices. With this approach, we were finally able to offer a solution that provided them easy access to professional advice. And participants were thrilled," said the Executive Director for Law Firm B.

The end result was that we were able to bring professional management back to the investment of

retirement assets. Participants were freed from a burden they didn't want. The plan sponsors were able to provide an advice solution while receiving protection from the fiduciary liability. We were able to take plans that were very good to begin with and make them even better for everyone involved.

### Conclusion

As stated in our previous white paper, "The Tyranny of Choice," "...participants don't need more education or more choice. They need more help."

Our experience and the empirical evidence of our studies at both law firms confirm that. Unfortunately, even when offered a quality menu of investment options and extensive education, the majority of participants do a poor job of managing their own assets. It's not a lack of intelligence or ability. It is often simply reflective of a lack of interest and a lack of available time.

Fortunately for the participants of both firms, their Committees and Trustees recognized this challenge and proactively provided a solution. And not a moment too soon.

The trauma in the markets in 2008 undoubtedly caused tremendous damage to the portfolios of millions of 401(k) participants who were left on their own. While participants in the Advisor-Managed Portfolios suffered their share of the worst annual returns in the market since the 1930s, they undoubtedly benefited from the prudent diversification provided by these portfolios. And they will likewise benefit when the markets recover. ■

### Note

1. "The Effects of Choice Proliferation on Retirement Savings Behavior," Dr. Sheena Iyengar, Columbia University Graduate School of Business, June 2008.



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