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# The Best of Times for 401(k) Plans?

By N. Scott Pritchard

*There have been significant improvements in 401(k) plans over the past 10 years, but further enhancements can go a long way toward helping American workers retire with confidence and security.*

*Through interviews with industry professionals, the author explores solutions to the challenges that still face employers and retirement plan participants.*

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"It was the best of times, it was the worst of times."

That famous opening line from Charles Dickens' *A Tale of Two Cities*, describing life around the time of the French Revolution, also aptly sums up life for most investors during the tumultuous time frame from October 2007 through the autumn of 2008.

Stocks around the world hit new all-time highs in October 2007… "the best of times"… but were in a freefall by autumn 2008 ... "the worst of times." What has since been christened "The Great Recession" was not close to running its course.

Amidst all of that chaos, my white paper, "The Tyranny of Choice – Why 401(k) Plans Are Failing and the Cure to Save Them," was published in the Autumn 2008 edition of the *Journal of Pension Benefits*.

The paper was my attempt to further the dialogue on how to improve the state of the 401(k) plan. As the title implies, the "cure" was in no longer forcing participants to make choices they have no interest in making.

I advocated for a shift to professionally managed portfolios that removed the burden of the critical asset allocation decision from participants who never wanted that responsibility to begin with.

I also advocated for a shift from conventionally managed (active) mutual funds to evidence-based (passive) funds.

Interviews with almost 50 ERISA attorneys further confirmed my belief that each of these steps would go a long way toward fixing 401(k) plans.

Given the economic and market environment of the time, I assumed the paper would be lost in the shuffle.

But I was wrong. I apparently touched a nerve.

Other retirement plan professionals, financial journalists, and plan sponsors started contacting me directly. The feedback was consistent: You're onto something.

I was even flattered to find that executives of one of the country's leading recordkeepers had used "The Tyranny of Choice" as a resource in reinventing their participant experience.

So now in 2018, with years of working on 401(k) solutions behind us, are we in "the best of times" for 401(k)s? Have these plans been fully fixed, and are they working optimally for employers and employees?

To answer those questions, I spent the past few months interviewing plan sponsors and a broad spectrum of 401(k) professionals (Employee Retirement Income Security Act (ERISA) attorneys, plan auditors, and recordkeepers). We talked about where 401(k) plans have been, where they are now, and where we see them heading in the future.

The consensus was that we have made progress. More plans than ever now offer professionally managed portfolios. The use of evidence-based investing (aka passive or indexing) has increased significantly and more plan sponsors are working with fiduciary advisors. (All-time highs in the stock market certainly have not hurt, either.)

That said, the interviews revealed that two key challenges remain unsolved:

1. Most employers still do not understand their fiduciary responsibilities and what it means to prudently run a retirement plan—leaving them susceptible to serious financial risks.
2. Participants still need more help maximizing the advantages that 401(k) plans offer.

Let's explore each challenge in detail.

## Challenge #1: Helping Employers

Business owners are very knowledgeable about their chosen area of expertise. Whether an attorney, physician, or other professional, you probably have years of experience that make you a true authority in your field.

Unfortunately, it is unlikely that you have ever taken a class on Fiduciary Prudence 101. Yet sponsoring a retirement plan is a significant responsibility and exposes employers to significant personal liability.

Although all plan sponsors are governed by the Prudent Expert Rule of ERISA, very few are familiar with the law's key details. For example, the rule requires that employers act "…with the care, skill, prudence, and diligence, under the circumstances then prevailing, that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

That is a pretty heavy burden for employers to bear.

> As David Johanson, an ERISA attorney with Hawkins, Parnell in Napa, California, said, "There continues to be a major lack of understanding of the basics of fiduciary oversight among employers."
> Ashley Smith of Dixon Hughes Goodman in Asheville, North Carolina, added that, "Running a retirement plan is just not what most employers are in the business of doing."

But ignorance is not bliss for plan sponsors. Lawsuits against employers for a lack of proper fiduciary oversight have become commonplace over the past few years. These suits have spread even beyond corporate 401(k) plans into the world of 403(b) plans sponsored by high-profile colleges and universities.

The facts and circumstances vary from suit to suit, but the common thread is the lack of fiduciary oversight. In some cases, employers allowed their plans to pay excessive fees. In others, employers continually offered participants investment options that habitually underperformed.

Were these employers knowingly and maliciously dodging their duties? No. They simply did not know what they were supposed to be doing.

But the bottom-line result has been that countless plan participants have less in their accounts than they should, which translates directly into a lower standard of living for them in retirement. And in our litigious society, someone has to pay. Settlements in some cases have exceeded $100 million.

Those numbers are starting to get people's attention. The plan sponsors paying those penalties do not want to cut those checks again, so they are putting better governance in place. But plaintiff's attorneys are also taking note, and we are starting to see fiduciary lawsuits move down-market—including one suit against an employer with a $9 million plan.

Can litigation drive progress? Certainly. Maybe these lawsuits will awaken employers to their fiduciary responsibilities. Maybe retirement plan professionals will step up their game and be better advisors and consultants in leading clients through a prudent, well-documented process.

Or, maybe there is an evolution similar to what we saw for retirement plan participants with the Pension Protection Act of 2006 (PPA). Lawmakers realized that many employees were not taking advantage of their company's retirement plan. Maybe it was ignorance or just inertia, but many people were not saving for retirement.

The PPA launched a wave of automatic features that have had huge positive impacts on 401(k) participants. Automatic enrollment, auto-escalation, and Qualified Default Investment Alternatives (QDIA) have overcome ignorance and harnessed inertia to work for the benefit of participants. Rather than having to actively enroll, set a deferral rate, and manage investments, a participant who is too busy, or too disinterested, to take action can now be enrolled in the plan and set on a disciplined course of increasing contributions and invested in a diversified portfolio. We are already seeing the positive effects of the PPA, and those benefits will only increase with time.

Could similar automatic features be implemented for plan sponsors? While plan sponsors will always retain some level of responsibility for fiduciary oversight, is there a way to put many of the required tasks on auto-pilot?

The closest things I have seen to fiduciary auto-pilot solutions are Multiple Employer Plans (MEP) and the hiring of a full-service ERISA 3(16) Plan Administrator.

### The MEP as Auto-Pilot

MEPs have been around for years and typically have been used by associations for their member organizations. Using this approach, there is one "Plan Sponsor" that runs the MEP, and the various employers who join it are called "Adopting Employers." Each Adopting Employer, in essence, delegates the day-to-day tasks of operating its retirement plan and may even save money through the shared economies of scale.

MEPs began to build momentum a few years ago, and we even began to see Open MEPs, in which any employer could join regardless of a commonality with the other participating employers (such as membership in an association).

Unfortunately, increased regulatory scrutiny of the Open MEP structure has cast uncertainty on whether unrelated entities can legally partner in a retirement plan. This question remains largely unanswered, which seems to be prohibiting any further growth in MEPs.

> Skip Schweiss, President of TD Ameritrade Trust Company, says, "Lawmakers in Washington, DC see the benefits of Open MEPs and we just need some clear direction from them on how MEPs can operate. So far, we haven't gotten that."

### Outsourcing the Plan Administrator Role

Section 3(16) of ERISA describes the role of "Plan Administrator" as the primary responsible party for a plan. Generally, the employer (aka the plan sponsor) forms a committee to oversee the plan, including the hiring of service providers. The committee typically hires a third-party administrator (TPA) to design the plan document and to ensure ongoing compliance. A recordkeeper (often the same entity as the TPA, but not always) is hired to maintain participant accounts, and a separate custodian is used to hold the assets in trust.

Employers can never fully divest themselves of their fiduciary duty to serve the best interests of participants in a company-sponsored retirement plan. But if they can document that it would be prudent to outsource their role as the plan administrator to a qualified third party capable of serving as an ERISA 3(16) plan administrator, they can largely insulate themselves from the day-to-day oversight of the plan.

To see how such a decision could be shown to be prudent, consider some of the key daily duties that fall on a plan administrator:

- Approval of distributions to terminated participants

- Approval of loans and hardship withdrawals
- Distribution of applicable plan notices
- Monitoring the timeliness of contributions
- Hiring and firing of service providers
- Monitoring of fees to ensure reasonableness.

For employers with experienced staff who can dedicate the time to these tasks, plan oversight can be manageable.

But for many employers, these tasks are assigned to a staff person who wears a lot of different hats—and administration of the 401(k) plan is typically far down that staff person's list of priorities. This often leads to inattention to the details and haphazard execution.

For those employers, outsourcing the Plan Administrator role may make sense. The tasks are then done by an experienced professional who specializes in administering 401(k) plans. Meanwhile, the staff resources previously dedicated to overseeing the plan largely can be allocated to other, perhaps more profitable, tasks.

A word of caution to the plan sponsor interested in hiring a 3(16) Plan Administrator: Not all 3(16)s are created equal.

As employers' interest in outsourcing plan administration has grown over the past few years, so has the number of companies offering 3(16) services. The challenge is that some providers offer only limited services. They will serve as a 3(16) only for a short menu of tasks, leaving much of the oversight on the employer.

For employers seeking to fully outsource plan administration, my advice is to seek out a 3(16) Plan Administrator that provides full delegation of all plan administration tasks. Yes, the employer still has to monitor the 3(16) Plan Administrator, but the day-to-day role can be delegated with improved oversight and, in many cases, lower costs.

Will broader adoption of MEPs or increased engagement of outsourced 3(16) Plan Administrators completely solve the general lack of proper fiduciary oversight among plan sponsors? No. But, just like auto-enrollment and auto-escalation have done for participants, both solutions can remove a burden from plan sponsors that most of them do not want to begin with.

In addition, employers are also increasingly hiring ERISA 3(21) fiduciary advisors and 3(38) investment managers, as advocated in "The Tyranny of Choice" 10 years ago. These professionals do not perform any of the 3(16) Plan Administrator duties, but they can reduce employers' fiduciary liability by consulting with plan sponsors on prudent best practices and providing one-on-one advice to participants. Additionally, 3(38) investment managers actually take on full discretion for investment selection and monitoring, removing that particular fiduciary liability from the plan sponsor.

## Challenge #2: Helping Employees

Each 401(k) plan expert I interviewed acknowledged that we have come a long way in helping plan participants save for a secure retirement. For example, more participants than ever before are using professionally managed portfolios. "Auto features" such as automatic enrollment, automatic escalation, and QDIA have helped inertia to work for participants rather than against them.

But these professionals also acknowledged that participants still need more help in addressing three main problems:

1 Professionally managed portfolios are underutilized and/or used incorrectly.
2 Contribution rates are still too low.
3 People need help making the transition from the saving/accumulation phase of their working lives into the spending/decumulation phase of living in retirement.

### Using Professionally Managed Portfolios

How do we get more employees into professionally managed portfolios?

A recent study by the Employee Benefit Research Institute [VanDerhei, Holden, Alonso and Bass, 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2015, *https://www.ebri.org/pdf/briefspdf/EBRI_IB_436_K-update.3Aug17.pdf* (Aug. 3, 2017)] found that nearly 65 percent of plans offered target date funds, but that those funds hold only 20 percent of plan assets.

While professionally managed portfolios are being offered as an option in more and more retirement plans, inertia has kept many participants from actually changing their investment election over to a managed option. Even many of those who have adopted a managed portfolio are using them incorrectly.

Participants tend to instinctively know they need to be diversified. But as I addressed in my second white paper, "Overcoming the Real Problem with 401(k) Plans: A Case Study" [*Journal of Pension Benefits*, Summer 2009], participants do not always understand that a single managed portfolio can provide full diversification. Indeed, they are often hesitant to select just one investment, even when that portfolio is fully diversified. As a result, participants often select multiple portfolios that are unnecessary and that feature significant overlap in terms of investment holdings.

For example: I have seen individuals investing in target date funds of a 2025 vintage, a 2030 vintage, and a 2035 vintage at the same time. Conversely, a participant may invest in a fully diversified risk-based model and layer on additional funds in various asset classes (a separate Large Growth fund, a Large Value fund, etc.). Both mistakes create unnecessary duplication and reduce diversification of the portfolio.

The best solutions for getting more people into professionally managed portfolios are two-fold:

1. A focus on "choice architecture."
2. Re-enrollment.

### Choice Architecture

Dr. Richard Thaler of the University of Chicago was awarded the Nobel Prize in Economics in 2017 for his work in Behavioral Economics. One area of his research focused on how the ways in which options are presented to people can actually influence the choices they ultimately make.

**Exhibit 1**

**INVESTMENT ELECTION**

***I authorize all contributions to be invested as follows:***

| **(Choose either Option A or Option B – not both)** | **All Contributions** |
|---|---|
| **OPTION A - You may choose to invest 100% of your contributions in one of the following portfolios (choose only ONE):** | |
| All Equity Portfolio (100/0) | ☐ |
| Growth Portfolio (80/20) | ☐ |
| Moderate Growth Portfolio (60/40) | ☐ |
| Conservative Portfolio (40/60) | ☐ |
| Defensive Portfolio (20/80) | ☐ |
| **OPTION B - You may design a CUSTOM portfolio by choosing from the following funds:** | **Please indicate whole percentages.** |
| Fund A - U.S. Large Cap Growth | % |
| Fund B - U.S. Large Cap Value | % |
| Fund C - U.S. Small Cap Growth | % |
| Fund D - U.S. Targeted Value | % |
| Fund E - Real Estate Securities | % |
| Fund F - Large Cap International | % |
| Fund G - International Small | % |
| Fund H - Emerging Markets | % |
| Fund I - International Real Estate | % |
| Fund J - Total Bond Market | % |
| Fund K - Inflation-Protected Securities | % |
| Fund L - One-Year Fixed Income | % |
| Money Market | % |
| | |
| | |
| **Total – Must equal 100%** | **100%** |

My experience is that presenting professionally managed portfolios as the primary investment option is very effective in getting plan participants to select those portfolios. Participants wishing to select and manage their own investments still have that flexibility, but properly framing the decision is a critical consideration.

With the choice architecture above, roughly 92 percent of participants we advise select one of the five risk-based models, rather than choosing to build their own portfolios.

It is also important to note that participants are limited to choosing either Option A or Option B. And within Option A, they are limited to choosing only one portfolio.

Some plan sponsors express hesitation in limiting choice, but Thaler's research reinforces our experience that certain restrictions can ultimately drive better behaviors.

### Re-Enrollment

A more direct way of driving participants to professionally managed portfolios is through re-enrollment. Rather than leaving the ongoing investment decisions up to each participant, re-enrollment liquidates all current investments and automatically reinvests each participant into a professionally managed portfolio—typically an age-appropriate target date fund or risk-based model. Participants can proactively change how they are invested after the re-enrollment, but inertia leads most to stay with the default professionally managed option.

Typically, a popular time to do re-enrollment is during the transition to a new service provider, but plan sponsors are increasingly using it to periodically "reboot" participant investment elections.

Some plan sponsors view re-enrollment as being overly paternalistic or too intrusive. But with participant bases that may have gotten stagnant with their investment elections, it can be just the thing to promote better investment allocations for participants.

### Increasing Contribution Rates

Similar to getting people into better investments, increasing the amount of their own money that participants contribute to their 401(k) plans takes more than just education. While telling employees that they need to do something may work, automating it for them results in a much higher probability of success.

Auto-enrollment and auto-escalation have proven to be some of the most impactful aspects of the PPA. They have gotten people enrolled who otherwise may not have participated, and they have put them on a disciplined course of increasing contributions. But considering that the average automatic enrollment percentage is 3 percent and the average auto-escalation is 1 percent per year (with a cap at 6 percent), it is still not enough savings to get most participants to a meaningful retirement.

These auto-features require more creativity. Perhaps start deferrals at 6 percent instead of 3 percent. Maybe the cap rises to 12 percent.

Plan sponsors and their TPAs also could be more creative with matching. Instead of traditional matching formulas like the standard 100 percent on the first 3 percent of salary deferrals and 50 percent of the next 2 percent, maybe it becomes 50 percent on the first 6 percent and 25 percent on the next 4 percent. The net cost to the plan sponsor would stay the same in both cases (4 percent), but the incentive for the participant to defer more increases significantly just by having a more creative plan design.

Bill Gray, an ERISA attorney with Ogletree Deakins in Atlanta, has effectively used the concept of "inverse matching" with some of his clients. For example, rather than match 100 percent of the first 3 percent and 50 percent of the next 2 percent, the employer could match 50 percent of the first 2 percent and 100 percent of the next 3 percent. As with the example in the previous paragraph, the net cost to the plan sponsor remains 4 percent, but the incentive for a participant to increase their salary deferral is increased.

Creativity with matching formulas could go even further, pushing the salary deferral needed to maximize the match even higher as long as the effect on compliance testing is still considered.

### Transitioning to an Income Stream in Retirement

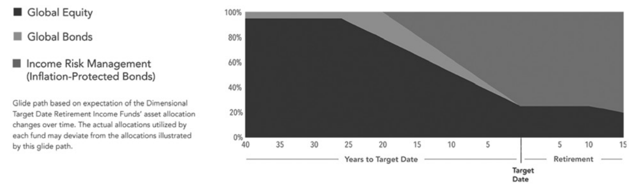
Typical 401(k) participants work hard and contribute as much as they can throughout their careers, all the while watching their balance grow. They reach retirement age, receive the proverbial "gold watch," and sail off into the sunset.

But what of that 401(k) balance? How do participants turn that lump sum into cash flow to fund the rest of their living days?

> As Laura Andrew, an Employee Benefits attorney with Smith, Gambrell & Russell in Jacksonville, Florida, said, "Many participants approaching retirement have no idea how to convert their 401(k) balance into an income stream. They need help."

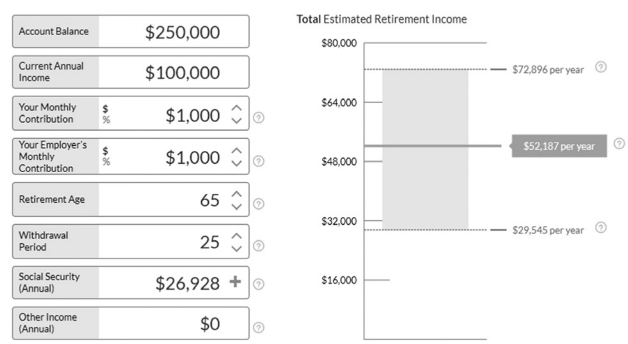
Unfortunately, there has not been a lot of help available in this crucial area. The average participant rolls their balance to an IRA but has no idea how to manage that balance so that it lasts for the next 20 to 30 years.

**Exhibit 2**




Yes, participants can buy an annuity that guarantees them a set monthly income, but annuities typically carry high fees and no flexibility. What if income needs to change? (Sorry, the contract does not allow for that.) What if the person passes away significantly before his or her life expectancy? (Sorry, the money typically goes to the insurance company, not to a spouse or children.)

**Exhibit 3**




Fortunately, some innovation is developing around this issue. My research found numerous articles and papers on the topic, and the most promising solutions appear to be those that present a participant's balance not as an asset total but rather as an annual amount of income. One example is Dimensional Fund Advisors' Target Date Income (TDI) Series, which manages the assets in a liability-driven investing (LDI) framework, similar to a defined benefit pension plan—giving the income a relatively high degree of certainty.

The participant's equity holdings are reduced over time and replaced with inflation-protected bonds that limit the volatility of an income stream as the participant enters retirement.

Dimensional's retirement income calculator shows a participant how much s/he can reasonably withdraw each year in retirement without the fear of outliving the money.

Presenting this type of scenario gives participants much-needed clarity and confidence about what they can expect in retirement.

## Conclusion

In some ways, we are in the best of times. 401(k) balances have never been higher. With industry innovation, we have been able to get more participants into professionally managed portfolios, more passive investments in those portfolios, and more plan sponsors being insulated from fiduciary liability.

Yet, there is still room for significant improvement. We know that saving for retirement is a challenge for most participants, and they need more help. But we realize that plan sponsors need help as well. Offering a retirement plan is a lot of work—and we need to make that job easier for employers.

The solutions offered in this article are not groundbreaking. They do not require massive upheaval of the industry, and they are not expensive.

The solutions are practical and achievable. But like the progress we have made with retirement plans over the past 10 years, they will require a dissatisfaction with the status quo. One plan sponsor at a time can choose to improve its process and its oversight. They can choose to offer participants more help.

Only then will we truly be in the best of times for 401(k) plans. ■