MORNINGSTAR

Fiduciary Focus: The Pension/401(k) Hybrid

W. Scott Simon | 3-21-06 |

More and more corporations in America are changing the structure of the retirement plans they offer to their employees. In many cases, this means that a company will "freeze" its defined benefit plan and, in its place, provide plan participants with enhanced benefits in a defined contribution plan such as an existing (or a new) 401(k) plan at the company. IBM, for example, announced recently that it will freeze its defined benefit pension plans and enhance its 401(k) plan as of Dec. 31, 2007.

Advantages and Disadvantages of Freezing a Defined Benefit Plan

In making this kind of change, a company achieves two primary goals: (1) a sharp reduction in the appreciable costs the company incurs for maintaining a defined benefit plan and (2) a shift in the burden--and therefore the risk--of investing employee retirement savings from the company to the participants in a 401(k) plan.

While achievement of these goals is, indeed, advantageous to a company, the flipside is that they are often deemed harmful to existing plan participants (and future employees). When a defined benefit plan is frozen, employers stop making contributions on behalf of existing plan participants (although all retirement benefits the participants have accrued in the plan are preserved fully). A frozen defined benefit plan, of course, is closed to any newly hired employees so they will never get the chance to become participants in it.

The perceived harm to participants doesn't stop there. Shifting participants out of a defined benefit plan into a 401(k) plan makes them primarily responsible for investing their own plan accounts. This is softened, though, by the fact that a company will usually provide enhanced benefits to the participants in an existing or a new 401(k) plan. These benefits include annual contributions made on behalf of a participant that typically range from 2% to 8% based on the participant's pay and years of service (whether or not the participant makes contributions), plus annual contributions matching the participant's contribution of up to 5% of pay.

Despite this, many believe that shifting plan participants out of a defined benefit plan into a 401(k) plan means that a company is "throwing its employees out into the cold." This is based on the underlying concern that participants simply don't have the investment skills and understanding possessed by professional investment advisors managing a company's defined benefit plan. It is feared, as a result, that participants won't be able to accrue a pot of money large enough to finance a comfortable retirement lifestyle.

Two Unpleasant Choices Facing a Company

A company faces two unpleasant choices as it goes about deciding whether to freeze its defined benefit plan.

The first choice is to retain the plan and continue to incur significant costs. Many companies find this unacceptable because they really have no other option than to control the runaway costs of

maintaining their defined benefit plans. These costs are caused by longer life expectancies, people continuing to retire at the same (or earlier) ages, and shifts in demographics and labor productivity from the past when more and more employees were supporting few retirees to the present when fewer and fewer employees are supporting many retirees.

The second choice is to jettison the defined benefit plan and incur the wrath of plan participants who perceive that they are getting the shaft. Many companies find this unacceptable because they are concerned about resentful employees being forced from the comforting womb of a defined benefit plan into the cold, cruel world of a 401(k) plan. And if resentful employees were not enough, companies that do make the decision to freeze their defined benefit plans are vilified in the mainstream media as treating their employees heartlessly.

It need not be this way. There is a third choice.

The Third Choice Open to a Company

The third choice open to a company needing to terminate its defined benefit plan, while little known, is often the best choice for all concerned. That choice is for the named fiduciaries of the company's existing (or new) 401(k) plan to (1) ensure that the plan is a trustee-directed plan (instead of a participant-directed plan) and (2) retain a bank, insurance company, or registered investment adviser and require it to manage all the plan's assets as an ERISA section 3(38)-defined "investment manager."

Participants in 401(k) plans benefit from this one-two punch because it relieves them of the burden of trying to figure out how to invest their 401(k) plan accounts. In addition, participants get the same level of money management that a traditional defined benefit does since professional investment managers will be investing their plan accounts for them. That means participants receive a defined benefit plan "experience" within a defined contribution plan. This helps create those conditions that will give a plan participant, over the long run, the best chance of accumulating the most amount of money while taking the least amount of risk so that the participant can retire as comfortably as possible. That should be the goal of every 401(k) plan in America.

Fiduciaries of 401(k) plans and the company sponsors of such plans benefit from the one-two punch of having a trustee-directed 401(k) plan with an ERISA-defined investment manager in at least four ways. First, it helps counter the perception that, in shifting to a 401(k) plan, a company has not done right by its employees. In fact, when a company establishes a trustee-directed 401(k) plan and retains an ERISA-defined investment manager, it has chosen to provide its employees with professional investment management equal to the kind that manages defined benefit plans. Second, the fiduciaries of the 401(k) plan sponsored by a company can off-load some of their legal responsibilities to the ERISA-defined investment manager because they are no longer responsible for the selection and monitoring of plan investment options. Third, the fiduciaries don't have to comply with the myriad rules of ERISA section 404(c) in a trustee-directed 401(k) plan because participants are not allowed to direct the investment of their accounts in such a plan. Finally, even when a company does decide to freeze its defined benefit plan, it is perceived in a more favorable light (in addition to being relieved of the uncontrolled escalation of funding the plan).

A Participant-Directed 401(k) Plan

Most 401(k) plans are "participant-directed." This means, if certain ERISA legal conditions are met, that it is the plan participant who directs the investment of its own account. And that, folks, is exactly the problem: Many studies show that as a participant's involvement in the investment decisions concerning its plan account increases, the likelihood of investment success decreases. Allowing participants to direct their own 401(k) plan accounts is generally not a wise decision if the goal is to help them retire as comfortably as possible. Participants simply make too many bad investment decisions.

One study that bears this out has been conducted annually for over 20 years by DALBAR Financial Services, a Boston-based financial consulting firm. The 2003 study, for example, found that during the period of 1984-2002 the average annual return of the S&P 500 index was 14.3% while the return of the average stock mutual fund was 11.5%. The return of the average investor in a stock mutual fund, however, was just 4.2%. This investor underperformance of the S&P 500 index by an average of just over 10 percentage points per year included nearly the whole period of the most sustained stock market boom of the 20th century.

The nearly three-percentage-point gap between the return of the benchmark index (14.3%) and the return of the average stock mutual fund (11.5%) is explained by the costs of investing in mutual funds, including explicit costs such as commissions and annual expenses, and implicit costs such as trading costs. The most effective and efficient way for a plan sponsor to close this gap is to provide low-cost, broadly diversified institutional level model portfolios of passively managed mutual funds as plan investment options. Reducing investment costs and diversifying broadly using mutual funds that are designed in accordance with leading academic research (including the Nobel Prize-winning work of modern portfolio theory) to be both prudent and diversified goes straight to the bottom line of increasing a participant's investment return--and, therefore, creating a more comfortable retirement for it.

But what about the much more significant 10-percentage-point gap between the return of the benchmark index and the return of the average investor/participant found by DALBAR? That gap can be attributed solely to the poor investment decisions made by the investor/participant. In the words of the DALBAR study: "Investment return is far more dependent on [investor] behavior than on fund performance."

A Trustee-Directed 401(k) Plan with an ERISA-Defined Investment Manager

Much of this 10-percentage-point gap in performance between the return of the market benchmark and the return of the average participant can be eliminated by transferring the responsibility for investing and managing its account from the participant to an ERISA-defined investment manager within a trustee-directed 401(k) plan.

In a trustee-directed 401(k) plan, plan participants are removed from the driver's seat of being primarily responsible for investing their own plan accounts as they would be in a participant-directed, 404(c)-compliant 401(k) plan. Participants in a trustee-directed 401(k) plan are replaced by plan trustees who become directly responsible for investing participant plan accounts.

Those trustees can then name fiduciaries who, in turn, can delegate the responsibility for their day-to-day decision-making for the prudent investment of retirement plan assets to an ERISA-defined investment manager that accepts, in writing, such responsibility as a fiduciary. (The named fiduciaries

of a 401(k) plan always retain the overall responsibility for prudently selecting and monitoring the investment manager.)

An ERISA-defined investment manager such as an RIA would agree to assume full discretionary investment authority with respect to all the assets of a 401(k) plan by, ideally, utilizing as many as five or six different model portfolio investment options whose asset allocations differ according to the risk tolerances and investment time horizons of the plan's participants.

Utilizing the third choice of using an ERISA-defined investment manager within a trustee-directed 401(k) plan does not mean that the manager invests the entire amount of the plan's assets by utilizing a single asset allocation as though there were only one participant or only one appropriate asset allocation for all the participants. In fact, the investment manager is responsible for selecting and monitoring the investments of an individual sub-account for each plan participant in accordance with the participant's needs.

Summary

A company deciding whether or not to freeze its defined benefit plan need not choose between retaining the plan and incurring significant costs or jettisoning it and incurring the wrath of plan participants who believe that they are being left out in the cold, not to mention the damaging negative publicity of the mainstream media in search of the next big story.

Companies have a third choice: Freeze their defined benefit plan and replace it with a trustee-directed 401(k) plan that uses an ERISA-defined investment manager who assumes discretionary authority to select and monitor the plan's investment options. This approach removes the single most destructive element from the decision-making process in a retirement plan: *the emotion and guesswork of plan participants with the power to invest their own accounts*.

Taking the responsibility for investing their 401(k) accounts out of the hands of plan participants makes eminent sense from their standpoint for at least three reasons:

1. Plan participants don't have to figure out how to invest their own 401(k) plan accounts.
2. Participants that have professional ERISA-defined investment managers investing and managing their 401(k) plan accounts get to experience the prudent investment management practices of a defined benefit plan within a defined contribution plan--particularly when plan sponsors contribute handsomely to such accounts.
3. Participants have better odds of accumulating the most amount of money while taking the least amount of risk so that they can retire as comfortably as possible. This helps save participants *from themselves*. These odds are increased significantly when an ERISA-defined investment manager uses low cost, broadly diversified model portfolios of passively managed mutual funds appropriately tailored to each participant's individual circumstances. This helps save participants *from the perils of active investing*, which include unnecessarily higher costs and greater risk. No fiduciary of a 401(k) plan should be in the business of providing plan participants with investment options that have higher costs and greater risk.

Implementing a trustee-directed 401(k) plan with an ERISA-defined investment manager who assumes discretionary authority to select and monitor the plan's investment options makes eminent sense for fiduciaries of 401(k) plans and the company sponsors of such plans for at least four reasons:

1. This approach helps counter the perception that, in shifting to a 401(k) plan, a company has not done right by its employees.
2. The fiduciaries of a 401(k) plan are relieved from personal liability for their day-to-day responsibilities of selecting and monitoring the plan's investment options.
3. Plan fiduciaries need not comply with the myriad rules of ERISA section 404(c) because participants are not allowed to direct the investment of their account in a trustee-directed 401(k) plan.
4. Even when a company does decide to freeze its defined benefit plan, it is perceived in a more favorable light--and it still gets to save the significant costs of maintaining the plan.

The little known third option of a trustee-directed 401(k) plan with an ERISA-defined investment manager provides companies with a hybrid alternative between keeping a defined benefit plan and suffering financial peril, and junking the plan and possibly enraging its own employees. A prudent, professionally managed 401(k) plan may be just the answer for companies looking to combine the best features of both a defined benefit plan and a defined contribution plan. Companies that decide to implement this third option may get an added bonus: a positive story in the media describing the prudent retirement plan solution they have provided to their employees which, in fact, is in the best tradition of a true employer-employee partnership.

W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to Understanding* is the definitive work on modern prudent fiduciary investing.

Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner® and an Accredited Investment Fiduciary Auditor™. Simon's certification as an AIFA® qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

For more information about Simon, please visit Prudent Investor Advisors and Prudent Investor Act, or you can e-mail him at wssimon@prudentllc.com