

## Fiduciary Focus: The Pension Consultant Shell Game

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W. Scott Simon | 09-29-05 |

The staff of the U.S. Securities and Exchange Commission issued a report on May 16 titled "[Staff Report Concerning Examination of Select Pension Consultants.](#)" The U.S. Department of Labor, in coordination with the SEC, issued a fact sheet on June 1 titled "[Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries.](#)" I suggest that those of you who are investment advisors to 401(k) plans read both documents to help you better understand the shell game played by many pension consultants.

Here's how that shell game is played. Many pension consultants market their services (e.g., identify plan investment objectives, allocate plan assets, select money managers to manage plan assets, select mutual funds as plan investment options, monitor the performances of plan money managers and mutual funds, etc.) to sponsors of 401(k) plans with the hope of becoming the designated "gatekeeper" to a plan.

The gatekeeper designation is important to a pension consultant that has won it at the expense of its competition because it allows the consultant to exact a "toll" from a money manager (including mutual fund families and brokerage firms) that seeks to provide, for example, the mutual funds for a 401(k) plan's investment options.

That toll is composed of money and other forms of compensation paid by the money manager to the pension consultant--compensation *in addition* to the explicitly stated consulting retainer paid by the sponsor of a pension plan to the pension. In fact, the disclosed annual consulting fee paid to a pension consultant by the plan sponsor often pales in comparison to the undisclosed toll paid to the consultant by money managers. (Sometimes when the tolls are particularly high, the consulting fee is totally waived, which makes it appear that the consultant is providing its services for "free.")

So what are the services that pension consultants provide and what makes them so valuable that trustees and other fiduciaries of pension plans (ultimately, though, usually

plan participants and their beneficiaries) must pay so dearly for them? Two services identified by the SEC report include 1) "selecting mutual funds that [401(k)] plan participants can choose as their funding vehicles" and 2) "monitoring performance of money managers and mutual funds and making recommendations for changes."

The first of these services provided by pension consultants involves searches to find the "best" mutual funds (or money managers) for sponsors of 401(k) plans. While many plan sponsors will admit in private that such exercises provide very little value, they nonetheless fork over large amounts of money to pension consultants to conduct them. They engage in this behavior for the simple reason that it is behavior their competition engages in. The pension consulting industry has done an excellent job at inculcating a herd mentality, to its benefit, among plan sponsors. In reality, though, many pension consultants are just expensive numbers gatherers and survey providers.

Far too many pension consultants are given an annual contract for, say, \$100,000 to run their computers for a few seconds to produce a spreadsheet that gives investment performance versus a peer group and a benchmark. Four quarterly reports and some meetings on why the funds and/or managers did what they did--and voila!. That just about sums up much of the pension consulting business. Value added? It sure is difficult to think so.

There is an alternative for plan sponsors looking to save either their own money or the money of their participants. In the latter case, as fiduciaries of their plans under the Employee Retirement Income Security Act of 1974 (ERISA), sponsors have a legal obligation to avoid unreasonable expenditures of plan assets. For a paltry \$125, then, they could buy a Morningstar.com subscription (in the interests of full disclosure: I swear that I am not a commissioned salesman for Morningstar) and assign some junior staffer in the finance department to spend four hours each quarter producing reports to salt the files with information. It would take about 20 minutes to teach someone how to do it. The only really hard part would be formatting all the information to make it look pretty. All in all, it could probably be done for less than \$1,000 (instead of \$100,000) with the same results.

The second service identified by the SEC report that pension consultants provide and that I have focused on involves "monitoring performance of money managers and

mutual funds and making recommendations for changes." Along with searches for the "best" funds and managers, monitoring is the bread and butter of a pension consultant's existence. But the very oxygen that allows a pension consultant to exist is style drift.

Style drift is a phenomenon that occurs when a money manager picks stocks that differ in style from the manager's stock-picking style. Suppose that the manager of an active mutual fund specializes in picking growth stocks, but in its efforts to outperform the market, picks some value stocks instead. The manager has "drifted" outside its stated investment style and stated investment objective of the mutual fund that it manages. A prominent example of this phenomenon involves former Fidelity Magellan FMAGX mutual fund manager Jeffrey Vinik, who, in attempting to beat the market in 1996, changed Magellan from being a growth-and-income stock fund into one that held 20% bonds and 10% cash.

Vinik was forced out by Fidelity for his mistaken bet on the future direction of the market. That "mistake," though, also provided a field day for pension consultants. Since Vinik's style drift led Magellan to underperform its benchmark, such consultants advised plan sponsors (as part of their monitoring "service") to replace Magellan with other funds, thereby potentially generating additional revenue for the consultants. (By the way, the language in the prospectuses of many active funds allows fund managers considerable discretion to hold investments that differ from their respective investment styles.) Style drift is the primary justification for the existence of many pension consultants. By taking away the possibility of style drift in an investment product (i.e., index funds and asset class funds), you largely take away the usefulness of (and justification for) retaining such consultants.

The SEC report examined 24 unnamed pension consultants that are also SEC-registered investment advisors. Under the Investment Advisers Act of 1940, any such consultant is a fiduciary to its clients. According to the U.S. Supreme Court case of *S.E.C. v. Capital Gains Research Bureau, Inc.*, (375 U.S. 180 (1963)), the Advisers Act "reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser [e.g., a pension consultant]--consciously or unconsciously--to render advice which was not

disinterested." An advisor owes its clients a duty of "utmost good faith, and full and fair disclosure of all material facts" as well as an affirmative obligation "to employ reasonable care to avoid misleading clients."

Undisclosed tolls paid by money managers to pension consultants that are then shifted to, for example, participants in 401(k) plans are most assuredly "conflicts of interest which might incline an investment adviser [e.g., a pension consultant]--consciously or unconsciously--to render advice which was not disinterested." Because trustees and other investment fiduciaries of retirement plans such as 401(k) plans are fiduciaries under ERISA, they must be on the lookout for this shell game that is played by far too many pension consultants.

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