Volume 5, No. 2

SENIOR CONSULTANT
The Voice of the Investment Management Consultant

[G r a p h i c o m i t t e d]

New DOL And Congressional Pension Reform Initiatives Create Insatiable Demand for Qualified Professional Investment Counsel, Consulting Ranks Poised for Extraordinary Growth

Stephen C. Winks

The collapse of Enron has raised many questions, requiring long, overdue pension reform, which are finally being addressed by broad-reaching legislative proposals and Department of Labor rulings. This pension reform introduces a new level of advice by "fiduciary advisors" or "qualified investment advisors" for plan participants and institutionalizes advice in ways that impact the entire financial services industry. The demand for comprehensive, expert advice, institutionalized by legislative fiat, far exceeds the number of qualified financial advisors capable of providing high level, professional investment and administrative counsel. The proposed legislation and recent DOL rulings make qualified expert advice an extraordinary growth opportunity for financial advisors and financial services firms.

Though pension reform will impact the defined benefit market, it will redefine the 401(k) market. The average 401(k) plan account balance is nearing $100,000, where it is economically viable for an advisor to engage their professional investment and administrative counsel for an on-going advisory fee. Therefore, the need for 401(k) plan participants to gain access to on-going professional investment counsel has become both an attractive venue to win business as well as the driving force behind pension reform.

WITHIN A 12-MONTH PERIOD ..., WE WILL SEE MORE CHANGES IN THE 401(K) MARKETPLACE THAN HAVE OCCURRED CUMULATIVELY OVER THE PAST 28 YEARS

Since 1974, with the passage of ERISA, plan sponsors have been reticent to engage a third party to provide investment advice to plan participants because they feared they would assume fiduciary liability on the advice rendered. Further, plan sponsors were not excited about incurring the cost of an objective third party providing investment and administrative counsel to plan participants. All this is about to change. Within a 12-month period, going back to the SunAmerica ruling by the Department of Labor on December 14, 2001 to the period after the mid-term elections in November of this year, we will see more changes in the 401(k) marketplace than have occurred cumulatively over the past 28 years. Just consider the following changes which have or are very likely to occur:

- The Department of Labor's SunAmerica ruling of December 14, 2001, established for the first time that plan assets can be used to pay for plan participant advice.
- Plan sponsors can absolve themselves of the fiduciary responsibility associated with the advice rendered to plan participants by engaging "fiduciary advisors" (Bingaman/Collins, S-1677), also referenced as "qualified investment advisors" (HR 3762), who assume fiduciary responsibility and are not associated with the company running or administering the plan. The plan sponsor is responsible for selecting the "fiduciary advisor" and making sure that the "fiduciary advisor" is in compliance with the services and counsel required by stature and regulatory rulings.
- 401(k) participants over 50 years of age can contribute up to an additional $5,000 in "catch-up contributions," and salary-reducing 401(k) contributions will be increased from $10,500 to $15,000.
- Quarterly accountability and performance reporting is required for each participant, and the penalty to the plan for non-compliance is $1,000 per day.
- Quarterly "investment education notice" is required to be provided by the fiduciary advisor to plan participants, which include an explanation of generally accepted investment principals.
- Full annual disclosure requirement that establishes:
  - All advisory fees.
  - Enumeration of all advisory fees incurred directly or indirectly by the investor and/or paid to the advisor from all sources.

[Graphic omitted]

- The relationship between the advisor and investment management firms recommended.
- Limitations in the scope of advice offered.
- Specification of services offered by advisors.
- An understanding of the plan participant that they may engage their own investment and administrative counsel at their own expense.
- A written agreement from the advisor establishing they are acting as a fiduciary and are assuming fiduciary responsibility.

The acknowledgement of fiduciary responsibility, the delineation of the role of the financial advisor, the services provided, the limitations of counsel, the disclosure and enumeration of all compensation as well as more structured accountability and reporting on investment recommendations, and on-going client education will all become the new base point expectation for 401(k) plan participants. This is because plan sponsors can now engage an objective third party not involved with an investment manager, plan administrator or recordkeeper, to provide investment advice to plan participants without the plan sponsor having to either assume liability for the advice provided or having to pay for the advice. The advice can now be paid from plan assets. This changes the larger financial services industry in important ways because it introduces institutional quality counsel to the retail and mass markets.

All investors, whether they are 401(k) plan participants or not, want unbiased, comprehensive, expert advice. The "fiduciary advisor" specializes in addressing and managing the full range of investment needs of 401(k) plan participants. For an additional fee paid by the plan participant, the "fiduciary advisor" can advise their clients on all their assets. There will be multiple levels of service available to plan participants, ranging from (1) no advice to (2) technology-driven, self-service advice limited to plan assets at no cost, to (3) the assumption of fiduciary responsibilities in providing investment counsel on all the plan participant's assets, including those outside the 401(k) plan. This would include assumption of fiduciary responsibility, client education, accountability in addressing a broad range of investment and administrative values as required under regulatory mandate, to be paid by the plan participant and/or from plan assets. This clearly delineates the role and value of the consultant from a commission salesperson that assumes no accountability for results. This greatly elevates the stature of the investment management consultant and creates fertile ground for innovation in elevating the processes, technology and methodology necessary to add value. Pension reform is not calling for low level advice built around a wrap fee program, it is calling for fiduciary responsibility to be assumed and high level, value-added investment counsel. The unbiased and unconflicted good judgment and counsel of a financial advisor adept at institutional-quality portfolio construction, utilizing advanced technology with established professional credentials is rare within the financial services industry. Yet, this is required of a "fiduciary advisor." This delineation of advisory services clearly differentiates the consultant from a commission salesperson who, up until now, has been the only reference point most consumers have had to advice.

PENSION REFORM IS NOT CALLING FOR LOW LEVEL ADVICE BUILT AROUND A WRAP FEE PROGRAM, IT IS CALLING FOR FIDUCIARY RESPONSIBILITY TO BE ASSUMED AND HIGH LEVEL, VALUE-ADDED INVESTMENT COUNSEL

The "Fiduciary Advisor"

The role of "fiduciary advisor" requires the financial advisor to exercise discretion and professional judgment in the creation of investment policy and investment strategy for each plan participant, but the execution of advice is on a non-discretionary basis, requiring each plan participant to approve every action. Five years ago, this would have been a challenge. Yet, today using existing technology, an extraordinary level of advice can be rendered in accordance to the requirements of one being a fiduciary advisor. For example, using Rowe Decision Analytics' electronic investment policy capability as a base point, with the right data feeds, all disclosure requirements under ERISA to include the role of the advisor, the services provided, the delineation and enumeration of advisor compensation, the advisor's relationship with investment managers, the role of investment managers and the role of the plan participants can all be incorporated into each participant's investment policy statement. By using unitized managed accounts to fund 401(k) programs, real-time account information is made possible, and by using web-based (not web-enabled) subaccounting, trade and order routing, and reporting technology, it is possible for the fiduciary advisor to provide real-time attribution analysis whenever the client wishes. This renders conventional paper reporting obsolete, even as a record. By using Tom Roginski's Pegasus gating and portfolio compliance technology which ties investment policy to the portfolio management system, it is possible for the fiduciary advisor to manage by exception a very large number of client accounts within the specific mandate of each plan participant's investment policy, agreed upon by each participant. Any investment recommendation that would take the plan participant's account outside of the parameters established in investment policy would be electronically suppressed or flagged for immediate action. This level of investment counsel is extraordinary in the context of the retail advice offered in financial planning or more narrowly focused commission brokerage, or insurance sales. The regulatory focus is on addressing and managing a broad range of investment and administrative values necessary for the investor to achieve their goals and objectives which are different for each plan participant. There is no focus on selling or promoting a particular financial product. The traditional investment management consulting model built around modern portfolio theory and ERISA provides a conflict-free, decision-making framework. The best performing, lowest risk, lowest cost investment option always prevails in each style-based

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[Graphic omitted]

investment mandate, given investment strategy (asset allocation) establishing the full configuration of investment management mandates. Each financial product is viewed in the context of the investment alternatives within their investment management style-specific peer group. This is a closed loop decision-making model focused on the client addressing and managing a broad range of investment and administrative values, rather than an open loop decision-making model that is common in commission brokerage, focused on selling or distributing a limitless number of financial products based on the allure of their sales stories.

The fiduciary advisor would be unique within the financial services industry, as up to this point in time, the typical financial advisor spends most of their time cultivating prospective clients because they do not get paid unless they move the prospect or client to make an investment decision. In the 401(k) market, the clients, or 401(k) plan participants, are provided by the plan sponsor who engages the fiduciary advisor's services. Thus sales skills, which heretofore have been the ultimate determinant of success within the financial services industry, are not a terribly important credential for the fiduciary advisor.

Because the plan sponsor is responsible for choosing the fiduciary advisor who will advise their plan participants, it is very likely credentials other than a securities license will be required. The fiduciary advisor will be compensated based on a fee, not commission, and must demonstrate that they are actively and continuously looking at each participant's account for ways to improve performance, reduce risk, and enhance the tax efficiency, liquidity and cost structure of not just the participant's 401(k) assets but likely all their assets as a whole. The plan sponsor is required to review the fiduciary advisor each year. Lou Harvey of Dalbar and Steve Drozdeck of The Progress Center are developing a training program for "fiduciary advisors" which will lead to certification. Dalbar is also developing an objective plan-sponsor- and plan-participant-driven service rating for fiduciary advisors where plan participants can rate the level of advice and service provided by a certified fiduciary investment advisor. This means plan sponsors will not only have objective criteria such as one completing the "certified fiduciary investment advisors course" to assure the advisor understands fiduciary and professional responsibilities, but there will also be an objective service rating by plan participants to establish how well the fiduciary advisor serves them. An 8 or 9 rating out of a possible 10 would suggest extraordinary support. Dalbar is the only firm that the SEC has authorized to develop client-driven service ratings that can be used by financial advisors in marketing without violating SEC advertising rules. Thus, there is a level of accountability for the fiduciary advisor beyond the plan participant which evaluates the level advice and counsel being provided by fiduciary advisors. Dalbar (www.dalbarinc.com) and The Progress Center (www.TheProgress Center.com) will play an important role in respectively helping the plan sponsor review fiduciary advisors and training fiduciary advisors.

THE FIDUCIARY ADVISOR WILL BE COMPENSATED BASED ON A FEE, NOT COMMISSION, AND MUST DEMONSTRATE THAT THEY ARE ACTIVELY AND CONTINUOUSLY LOOKING AT EACH PARTICIPANT'S ACCOUNT FOR WAYS TO IMPROVE PERFORMANCE, REDUCE RISK, AND ENHANCE THE TAX EFFICIENCY, LIQUIDITY AND COST STRUCTURE ....

The financial services industry will be challenged, assuming fiduciary responsibility because, up until now, the industry has avoided the responsibility for advice that its advisors rendered. By simply disclosing conflicts of interests, the conflicts do not go away. Thus, many commission brokers, insurance agents and financial planners, who are primarily compensated by commission, will have difficulty reconciling their self-interest in getting compensated by commission and their role as fiduciaries in always putting the client's interest first. It has long been the formal policy of most financial services firms that fiduciary responsibility is not assumed by the advisor or the firm when advice is rendered, because the advice rendered has been considered incidental to trade execution. This next generation of pension reform makes advice a virtue, rather than a vice, encouraging advice to be provided, rather than discouraging it.

Indeed, five years ago, the now famous Tully Committee (a five-person committee composed of Warren Buffett, the most successful investor of our time; Dan Tully, then chairman of Merrill Lynch; Chip Mason, founder of Legg Mason; and the representatives of two investor groups) report on Compensation Practices to then SEC chairman Arthur Levitt, found, "If the retail brokerage industry were being created today from the ground up, a majority of the committee that developed this report would not design a compensation system based on completed transactions. The most important role of the registered representative is to provide investment counsel, not to generate transaction revenues. The prevailing commission-based compensation system inevitably leads to conflicts of interests among the parties involved." The Tully Committee Report was instrumental in the larger financial services industry acknowledging the embedded conflict of interest of commission brokerage and acceptance of fee-based advice as a core business strategy. In acknowledging their fledgling investment management consulting efforts (kept alive by the personal initiatives of pioneering senior investment management consultants), consulting, adding value and fee-based advice were no longer considered a small niche business.

This next generation of pension reform, in fact, takes consulting into the financial services mainstream as evidenced by how commission brokerage will be managed in the future. Investment managers engaged by financial advisors will be instructed to seek best possible trade execution as now required under UPIA, ERISA and MPERS. If trades are done with the advisor's firm or an affiliated firm, then a

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record must be kept and trades managed to assure plan participants are achieving prices that are better than the volume weighted average daily price (VWAP) which is the standard for best execution. We will even see firms like Foliofn give away the traditional trading profits of a commission brokerage firm by splitting the spread between the bid-and-asked price of a stock with the buyer and seller, and thus, providing far better than best execution.

Assume the spread is one-eighth or 12½¢ per share. With Foliofn, the buyer and the seller would each get 6¼¢ per share better price with a 1¢ per share transaction cost for crossing trades. This would be a 8¼¢ per share better price per share than having to pay 3¢ per share for conventional trade execution. Trading cost will be reported annually to the plan sponsor under pension reform, as it is now done by senior consultants engaged in institutional consulting. This level of reporting can be done electronically without significant effort on the part of the advisor and establishes an important point of differentiation with the conventional commission salesperson who continues to work in a commission brokerage culture, not accustomed to engaging their professional investment counsel for an on-going fee.

Importantly, compensation disclosure extends to insurance professionals and requires insurance agents, who provide no on-going support, to report the proverbial $100,000 or so in compensation they earn for simply transferring a 401(k) plan to another platform. Insurance agents must also disclose the services or lack of services they offer at the plan sponsor level. This will clearly shift the balance of the scale to investment management consultants who can speak knowledgably about 401(k) and who can assume fiduciary responsibility.

> THE PROPOSED FIDUCIARY ADVISOR WILL REDEFINE THE DEFINED CONTRIBUTION MARKET ..., BY REQUIRING A LEVEL OF PROFESSIONAL INVESTMENT AND ADMINISTRATIVE COUNSEL AT THE PLAN PARTICIPANT LEVEL THAT CAN ONLY BE PROVIDED BY AN ACCOMPLISHED INVESTMENT PROFESSIONAL WHO IS CAPABLE OF ASSUMING FIDUCIARY RESPONSIBILITY

The proposed fiduciary advisor will redefine the defined contribution market, not just by requiring a second level of advice beyond the plan sponsor for the plan participant but by requiring a level of professional investment and administrative counsel at the plan participant level that can only be provided by an accomplished investment professional who is capable of assuming fiduciary responsibility. This creates a conflict between the mutual fund and insurance industries which own huge market-share in the 401(k) market and the brokerage industry which is rich in financial advisors. The mutual fund and insurance industries do not like the fiduciary advisor language proposed in pension reform or the proposal that fiduciary advisors must assume fiduciary responsibility because it creates a high hurdle which thousands of insurance agents and independent advisors must overcome if they would like to serve the 401(k) market. There is the general misconception promoted by the mutual fund and insurance industries that mutual fund and insurance companies themselves actually render advice to individual investors which has, in fact, led to the need for pension reform. Mutual fund and insurance companies manage money, but by definition, cannot render advice or manage money in an investor-specific way. Only financial advisors, working with specific individual investors to establish their needs, goals, objectives and risk tolerances, and then developing an investment strategy that is consistent with the client's goals and objectives can render investor-specific advice. The fiduciary advisor is essential for the plan participant to be well served, yet the mutual fund and insurance industries would propose "do-it-yourself" financial engines, like mutual fund-only wrap fee programs as the means of helping plan participants make informed investment decisions. This would not allow fiduciary responsibility to be assumed by the mutual fund company, passively acting as an advisor which would keep the plan sponsor responsible for the participant's investment decisions facilitated through non-accountable advice. It would essentially defeat the purpose of pension reform. Wrap fee program technology with low level clerical assistance exists today but is not remotely close to the professional investment and administrative counsel implied by the proposed fiduciary advisor who assumes fiduciary responsibility. Importantly, the same mutual fund and insurance companies who resist the "fiduciary advisor " language are also very interested in soliciting the business of highly successful senior consultants who are serving the 401(k) plan sponsor. The mutual fund and insurance industries must decide if they are going to compete with financial advisors by directly soliciting 401(k) business which is in conflict with their working with financial advisors who serve as intermediaries. The "fiduciary advisor" language requires Putnam, Vanguard, Fidelity and the other major 401(k) plan service providers to work collaboratively with fiduciary advisors and evolve their relationships with plan sponsors. This means the financial advisor is going to play a far more important role in the 401(k) market than in the past.

Given the fiduciary advisor will become very important to plan sponsors in achieving a high level of plan participant satisfaction, fiduciary advisors who make the 401(k) plan specifically relevant to each plan participant will have huge leverage in influencing plan design and investment management consulting services at the plan sponsor level. This suggests investment management consultants active in the 401(k) market segment at the plan sponsor level might be better positioned to expand their practice to include fiduciary advisors and reframe from providing redundant advice at the plan sponsor level. In doing so, by definition, they provide a much higher level of value added service than firms which just serve the 401(k) plan sponsor. More importantly, these consultants have fulfilled the promise of the plan sponsor

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offering a 401(k) plan by making sure each plan participant takes full advantage of their 401(k) plan, maximizing each participant's retirement benefits. This is also an extraordinary opportunity for large financial services firms to create a 401(k) division which specializes in 401(k) plans and may be the beginning of large financial services firms offering specialized services designed specifically for each of the ten major market segments of the institutional (foundations and endowments, defined contribution, defined benefits, profit sharing, public funds and Taft Hartley) and individual (mass, retail, high net worth and ultra high net worth) markets. Because it is process – or what you do with financial products – that adds value, not financial products in and of themselves, and because each market segment requires a distinctly different process, pension reform in 401(k) will likely facilitate the industry moving from today's product management organizational structure, where it is not possible to add value, to a process management organizational structure designed to add value. The fiduciary advisor delineated in 401(k) reform may well be the catalyst which makes it clear that a specialized 401(k) process is necessary in order for a financial advisor to add value for a 401(k) plan sponsor and/or a 401(k) plan participant. This specialized expertise is also needed in order to add value for each of the other nine major market segments of the individual and institutional investor markets and will take the form of market segment-specific training, portfolio construction and support.

If the purpose and objective of the financial advisor is to add value, then the proposed pension reform in 401(k) plans will greatly elevate the level of advice the financial services industry will support and, in turn, the counsel of the financial advisor provides is greatly elevated. Up to now, high level advice was provided only because of the personal initiative of pioneering investment management consultants who developed the processes, technology and methodology necessary to address and manage a broad range of investment and administrative values as required under UPIA, ERISA and MPERS. Pension reform legislation substantially changing the level of advice made available to 401(k) plan participants is the beginning of the larger financial services industry institutionalizing support for a much higher level of advice. Heretofore, it has not been possible for the vast majority of financial advisors, not actively engaged in investment management consulting, to provide high level investment and administrative counsel. Through the development of enabling processes and technology, the creation of training programs and the measurement of client satisfaction against professional standards, an unprecedented level of professional investment and administrative counsel can be provided. The focus of pension reform is not on the advisor or the product manufacturer (mutual fund industry) but on the consumer. It takes an Enron-like incident to mitigate the extraordinary clout of the mutual fund and insurance industries. While mutual fund and insurance firms profess they offer advice to investors, it is, in fact, only possible for professional financial advisors to render advice. Thus, the proposed pension reform in 401(k) plans is of huge importance to the consumer and the investment management consultant. For the first time, the investment management consultant will be able to clearly delineate their services from thousands of financial advisors who do not have the interest, skill set or motivation to address and manage the broad range of investment and administrative values required under ERISA, UPIA and MPERS. Because it will be so clear by disclosure that the typical insurance agent, financial planner or stockbroker is limited in the depth and breadth of advice they can provide, pension reform creates extraordinary demand for high level advice and investment management consulting. Utilizing advances in technology, pension reform will usher in a Renaissance among qualified professionals in the depth and breadth of the advice they provide. By better serving the investor, the advisor wins, the industry wins and the investor wins. For the first time, the interests of the advisor, the investor and the industry are aligned. This is the ultimate objective of public policy and a sign of particularly well-conceived pension reform. ■

Notes

Senior Consultant

The Voice of the Investment Management Consultant

James P. Owen
Co-Founder

Stephen C. Winks
Co-Founder, Publisher & Editor-in-Chief

Sydney LeBlanc
Consulting Editor

Mamie Woo McNeal
Production Editor

Eddie Bryant
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Keith Phillips
Morgan Stanley Dean Witter

Bob Rowe
Morgan Stanley Dean Witter

Dick Smith
Capstone Investment Group

Jim Yanni
Yanni Partners

Senior Consultant

1457 Crystal Springs Lane
Richmond, Virginia 23231
Ph 804-795-1642 ■ Fax 804-795-7703

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