Volume 7, No. 4

SENIOR CONSULTANT

The Voice of the Investment Management Consultant

Five "Best Practices" for 401(k) Plans

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There are many considerations with which employers have to deal when they sponsor a corporate retirement plan. The most popular plan today is the 401(k) plan, named after the section in the Internal Revenue Code ("IRC") where it is referenced. The typical 401(k) plan allows employees to defer a portion of their pay, pre-tax and generally, the employer matches a portion of the employee's savings. From the employer's perspective, implementing the retirement plan is just the first step. Many industry watchers have commented that 401(k) plans are the next big litigation opportunity for lawyers throughout the country. There are many reasons for this, including:

1. Poor equity market performance in the recent past.
2. More and more employees approaching retirement age and realizing they don't have enough money to retire
3. Plan sponsor confusion – small-medium size businesses not fully understanding their fiduciary responsibilities

It's important for companies to take stock of what they have in terms of their current retirement plan and periodically review whether it is still in-line with corporate benefit objectives. At Sapere Wealth Management, we utilize five key "best practices" with our clients, as a guide to ensure we have a comprehensive and competitive retirement plan.

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Best Practice #1. Define Plan Fiduciaries, Understand Responsibilities and Implement Processes to Deal with Requirements

Often, many executives at small-medium size businesses don't necessarily realize they are plan fiduciaries, as well as retirement plan and/or investment committee members. A fiduciary is anyone who has "discretionary" control over plan assets. This includes, but is not limited to, individuals involved in choosing the plan administrator, as well those involved in deciding what investments are offered to employees.

Each plan should identify who the plan fiduciaries are. ERISA places a number of duties on plan fiduciaries and imposes joint and personal liability in the event any of these duties are breached. In other words, plan fiduciaries (company executives, committee members, etc.) are personally liable as fiduciaries to a retirement plan. Their personal assets are at risk.

Employers must follow the "Prudent Expert Rule" by acting with skill, prudence and diligence. ERISA fiduciaries are held to the highest standard and need to operate the plan for the "exclusive benefit" of plan participants [ERISA Section 403(c) and 404(a)(1)(A)]. There are several things an employer can do to help minimize their fiduciary liability:

1. implement and maintain an investment policy statement,
2. annually benchmark the retirement plan (particularly with respect to plan expenses),
3. implement a coordinated employee education plan, and
4. consider outsourcing their investment fiduciary responsibility (IRC 402(c)) to an "investment manager."

Best Practice #2. Maintain a Diverse Set of Investment Offerings and Provide Employees with Structured/ Pre-Set Portfolios

Developing a diverse menu of investment offerings is the place to start in minimizing fiduciary obligations. There are many reasons for this, but one surrounds the uncertainty of the investment markets. It is very difficult, if not impossible, to determine what asset class (stocks/bonds), what investment style (growth/value) or what investment manager will do best in any given year. Everyone can "Monday morning quarterback." Everything is 20/20 in the rear view mirror. In order for employees to be able to construct a diversified portfolio, a diversified menu of investment offerings must be available. Choosing investments is indeed a fiduciary responsibility [ERISA Section 404(a)(1)(B)]. Plan participants can't make good investment/asset allocation decisions unless

plan sponsors make good investment menu decisions.

Next, the prudent employer should consider adding pre-set or custom portfolios for employees. Many employees, including executives, don't have the time, knowledge or inclination to implement a custom investment strategy. Many large employers have added or are considering adding "managed portfolios." Here, a plan provider makes available specific asset allocation assistance to employees. This is typically done via a third party investment provider with a range of different portfolios incorporating different asset allocations, ranging from conservative to aggressive.

In addition, many employers can review their investment line-up and, in fact, reduce the number of individual funds they are offering to plan participants. Combining these two approaches allow for less confused employees and ultimately more confident employees.

Making pre-set/custom portfolios available helps the employee with their investment strategy and helps to ensure they have a diversified and disciplined investment approach. Only then will they obtain peace of mind and be on their way to a secure retirement.

Best Practice #3. Education and Communication

Generally speaking, employees who are participants of a 401(k) plan are most frustrated with the lack of education or communication. In 2001, The Principal Well-Being Index™ found that 76% of workers are not confident with their retirement plan preparations. *Plan Sponsor Magazine* (July 2001) indicated that 85% of all investors would prefer to have someone else do their investing. Furthermore, 50% did not have an asset allocation plan. A full 65% did not believe they could lose money in a bond fund, while 20% felt the same about stocks.

Employees need to understand not only the importance of a diversified portfolio (in order to deal with market uncertainty/market risk), but they also need to understand the importance of saving. The fact of the matter is that many employees are underfunded when it comes to adequate retirement savings. People need to save more and invest more wisely. According to their 2003 Retirement Confidence Survey, EBRI found only 37% of workers have tried to calculate how much money they will need to save for retirement. Based on numerous studies, it is also apparent that employees/investors don't know what to expect from an investment return perspective within given asset classes. This leads to poor asset allocation decisions and poor savings decisions.

Employers can facilitate employee learning through a comprehensive and honest education/communication program. Honest in the sense of adequately demonstrating the needed savings levels for retirement security. Included in this communication should be clear discussions about replacement ratio targeting, risk/return characteristics of various portfolios and the need to stay invested for the long term. All parties involved with the retirement plan – employer, employee, plan provider/administrator and advisor/consultant – have a role to play in employee education. The end goal should simply be adequate diversification from an investment perspective and employee confidence from a retirement security standpoint.

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Best Practice #4. Assist Executives in Dealing with the Limits of Qualified Retirement Plans

Many employers implement supplemental retirement plans to deal with the contribution limitations within qualified retirement plans (e.g., 401(k) plans). Executives are limited in three simple ways: (1) income which can be counted, (2) dollar amount of maximum salary deferral and (3) the amount that lower paid workers contribute on-average to the plan. Left to just the qualified plan, many executives would not have an adequate nest egg at retirement.

Executives or higher paid workers need a specific, integrated savings and investment strategy to ensure they have saved enough to replace their pre-retirement earnings. This includes social security, employer retirement plans, private savings and non-qualified/deferred compensation plans.

Interestingly, based on U.S. Department of Commerce statistics, the Personal Savings Rate in the U.S. has steadily declined over the last 10 years. In 1990, the Personal Savings Rate was 7.8%, while in the first quarter of 2000 it was 1.1%. However in a recent survey by Ibbotson and EBRI, when employees were asked where they will draw their retirement income, employees overwhelmingly (70%) said personal savings. Therein lies a conflict and contradiction. Employers should consider these plans not only as a means to help the executive with their retirement planning in a tax-advantaged way but also strategically as an additional way to attract, retain and reward key employees. Taking an active role in helping executives obtain secure retirements through education and benefit solutions will not go unnoticed.

Best Practice #5. Maintain and Monitor

The employer's work doesn't stop at implementation of a retirement plan. The plan, just like a business plan, needs to be evaluated and monitored on an on-going basis. The investments need to be reviewed, employee appreciation and satisfaction needs to be monitored and plan design and expenses need to be evaluated.

We recommend to our clients that they approach their retirement plan like they approach their business. In a business, you create a business plan; in a retirement plan, you create an Investment Policy Statement (IPS) and an Education Policy Statement. In a business, you execute a business plan to maximize profitability; with a retirement plan, you implement operational measures to maximize plan benefits. Finally, with a business, you monitor business progress on an on-going basis; similarly with a retirement plan, you monitor retirement plan success.

Employers can partner with retirement plan professionals to assist in the maintenance and on-going evaluation of their plan. Successful plans should have plan fiduciaries protected, employees educated, plan performance elevated and the plan appreciated. ■

About the Author

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Notes

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