MANIFEST FORTUNE

THE NEW FRONTIER OF 401(k) PLANS

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Introduction

Expanding horizons and capturing opportunities. That has been our heritage. Going back to the 1800's, the concept of Manifest Destiny laid forth western expansion and concluded that it was not only wise, but readily apparent (manifest) and assured (destiny). The landscape was forever changed and unprecedented prosperity ensued.

Today's retirement planning landscape is going through a transformational process of historic proportions, leaving increasingly more responsibilities to the self-reliant individual. The problem is the predominant retirement model for the average investor, the 401(k) plan in its current form, is actually impeding progress towards the American Dream and the realization of retirement security.

The path to reaching one's financial destiny, fortunately, can be built through a combination of traditional practices and new capabilities.

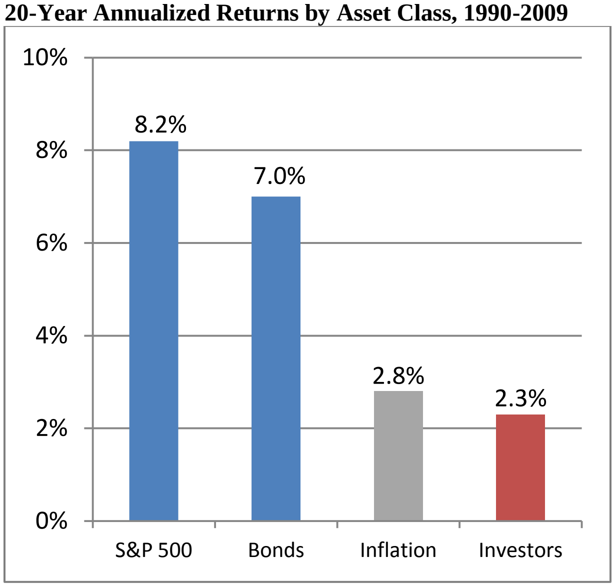
We join this discussion to explore the structure of retirement plans, examine their growing pains and inherent flaws, and conquer the opportunities of a new frontier on the way to your manifest fortune.

Individual Investor Performance

One of the more powerful revelations in the investment world is the failure of the individual investor to achieve market returns. As research has repeatedly shown, non-professional investors consistently trail the performance of passive, index-based investing. Consider a recent study by Dalbar, Inc., one of the nation's leading financial services market research firms, as shown in Figure 1.

The Dalbar, Inc. study illuminates one of the disheartening facts we already know: "do-it-yourself" investors don't beat the market. For instance, the S&P 500 gained 8.2% per year for the twenty-year period from 1990-2009, while investors earned a miniscule 2.3% per year.

Figure 1
20-Year Annualized Returns by Asset Class, 1990-2009



Source: JP Morgan and Dalbar, Inc. Data as of 9/30/10.

To quantify the difference, let's examine a hypothetical investment. Investing $100,000 in the S&P 500 would have grown to $483,666 after twenty years. Comparatively, the same $100,000 managed by a typical investor would be worth a meager $157,584 at the end of the term.

Even more illustrative is the inability of investors to keep up with the rate of inflation (2.3% vs. 2.8%). Keep in mind that the ultimate purpose of saving, the act of deferring current consumption, is to utilize those savings for future needs. Inherent in the act of saving is the notion that the dollars saved or invested will maintain their purchasing power. When returns do not keep pace with inflation, savers are actually losing the value of their savings. On average, "do-it-yourself" investors are experiencing a negative 'real' return (nominal return – inflation = 'real' return). In these instances, inflation is aptly living up to its moniker as the 'insidious thief'.

Reasons for Underperformance

The field of behavioral finance focuses on the role that emotions and other psychological factors play in investment decisions. Short-term, emotional actions typically guide the decision-making process. The simplest way to explain the discrepancy in anticipated and actual returns is: human beings are simply wired to be irrational. Many experts in the field, including Richard H. Thaler of The University of Chicago Booth School of Business, have narrowed these irrational decisions to the following subcategories:

- Return Chasing – jumping into the hot stock or sector, the 'herd mentality'
- Anchoring – clinging to past beliefs when conditions change (rendering those ideas obsolete)
- Mental Accounting – assigning subjective and different functions to various asset groups
- Confirmation Bias – selectively filtering information to support pre-determined conclusions
- Hindsight Bias – being convinced that one saw previous events forthcoming
- Overconfidence – overvaluing one's ability to manage their own finances

As an entire industry (Wall Street) has been created to benefit from the certainty that part-time investors will act in these irrational ways, it is no wonder that individual investors continue to lag the markets.

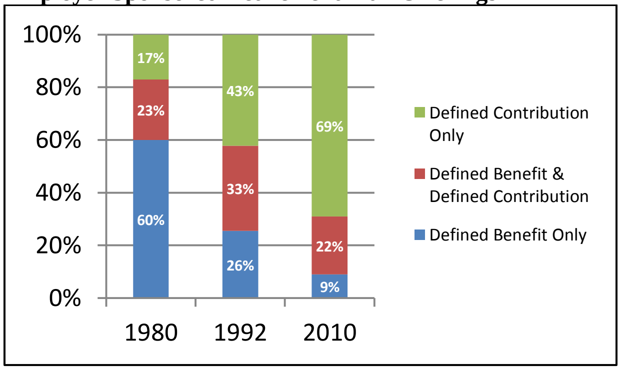
Furthermore, as investment information becomes commoditized and ubiquitous, many investors simply don't have the time, experience, or desire to react to rapidly changing market conditions in a timely and disciplined manner.

The Changing Landscape of Corporate Retirement Plans

Before the advent of the 401(k) plan, employers were primarily responsible for delivering retirement benefits to their employees through defined benefit (DB) plans. These monthly pension benefits were based on the employee's salary history, tenure of service, and age – not on investment results. Unlike today's 401(k) plans, the investments were managed by professionals and the employee had zero input into the decision-making process.

Borne out of ERISA and a 1978 Congressional amendment to the IRS code, the 401(k) plan was adopted by many companies in the 1980's and proliferated in the 1990's (see Figure 2). Inside a defined contribution (DC) plan, like the 401(k), the employee bears the responsibility of funding their retirement and making investment choices. In a DC plan, the end retirement benefit is based on the investment results (growth) of the contributions.

Figure 2
Employer Sponsored Retirement Plan Offerings



Source: McKinsey & Co.

As you can see, the burden and risks of retirement saving and the act of investing have been transferred en masse from professionals managing corporate pension plans to the average American worker trying to manage their own nest egg. In short, this dramatic shift towards the 401(k) plan and participant-directed accounts has purposefully and systematically given the "keys of the sports car to those least likely to be capable of handling the curves of the road".

Current Plan Design

With the burden shifting evermore to the employee, it is critical to give them the tools needed to be successful. After all, their retirement now rests squarely in their own hands. The paradox of the 401(k) plan is that as the employer and retirement plan providers attempted to better assist plan participants, in the form of education and investment tools, the more harm was actually done. In this good-faith effort by employers to give employees choice and discretion, many 401(k) plans have hindered the employee's ability to make good decisions.

Retirement plan design should be optimized to encourage participation and improve results; however, a growing body of literature in finance, economics, and behavioral economics suggests the design of defined contribution plans significantly influence investment behavior in a negative way, including: reduced participation and poor asset allocation decisions. [iii]

Following the twenty-five year experiment of employee education, strong evidence suggests DC plan participants continue to make choices based on the "path of least resistance" [iv], and when confronted with the overwhelming, unfamiliar and complex list of investment options, consumers tend to reduce the amount of effort they expend in order to make their decision. [v, vi]

It is still typical for an employee to receive an enrollment packet from the plan provider (usually a long list of mutual funds from which to choose), then receive the proverbial pat-on-the back and a 'good luck to you'. Armed with a website with every 'bell and whistle' to research fund options, access their account daily, and instructions on how to 'rollover' their assets when they leave their current employer, employees are still missing what they truly need – objective, professional advice in crafting an asset allocation that is tailored to their personal circumstances.

Seeking Advice

It has been argued that the major flaws of participant-directed 401(k) plans were masked by the great bull market of the 1980s and 1990s. Consider for a moment the total return for the S&P during those decades: up 403% in the '80s and up 432% in the '90s. Even the most inept of investors, both professionals and novices alike, would have found it difficult to not make money. Following the bursting dot-com bubble and the bear market from 2000–2002, it became more clear that markets don't rise without limit. If more clarity was needed, the financial meltdown of 2008 and the subsequent global restructuring ensured a quick re-evaluation of 'business as usual'.

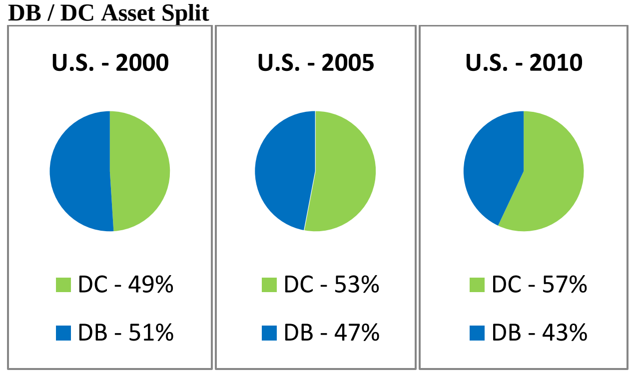
Lawmakers, knowing that entitlement reform (Social Security) is inevitable, dramatic demographic shifts are occurring (baby boomers), and individual investors are grossly underprepared for retirement by almost any measure, have taken baby steps to allow individuals to seek the professional investment advice they so desperately need.

Definitely not lost on lawmakers is the fact that DB plans (professionally managed) have consistently and continuously outperformed their DC peers ("do-it-yourself").[vii] An explanation according to Towers Watson, a global risk management and human resource consulting firm, is that "DB plan trustees …or the professionals they hire usually have considerable financial education, experience and access to sophisticated investment vehicles – advantages 401(k) plan participants lack".[vii] These quantifiable determinants stem from:

- Professional Management – Money managers do a better job than non-professionals
- Investment Flexibility – It is beneficial to have access to a wide-array of investment options, not just mutual funds (like most 401(k) plans)

Failure to create a 'better mousetrap' amid the changing landscape of retirement savings accounts (as seen previously in Figure 2 and here in Figure 3) will have far-reaching and substantive implications.

Figure 3
DB / DC Asset Split



Source: Towers Watson

Pension Protection Act (PPA)

In the most influential piece of retirement legislation since ERISA, the Pension Protection Act of 2006 (PPA) was the admission that participants in a retirement plan, much like the maligned individual investor, should have access to professional investment counsel.

Prior to the PPA, plan sponsors avoided giving investment advice for fear of the associated fiduciary liability. The only mechanism to offload this liability was the rare occasion by which a forward-looking plan sponsor hired an investment professional with a full-time, legal obligation to provide fiduciary advice – only fulfilled by a 'fee-only' Registered Investment Advisor.

With the introduction of the PPA, further liability coverage was given to the plan sponsor to make advice available to participants should either of the following conditions be met:

1) That the advice be generated by an approved computer model that "applies generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time".
2) That the availability of advice would not alter the compensation of the advisor (the 'level compensation' provision), meaning that plan providers could not charge extra for these services.

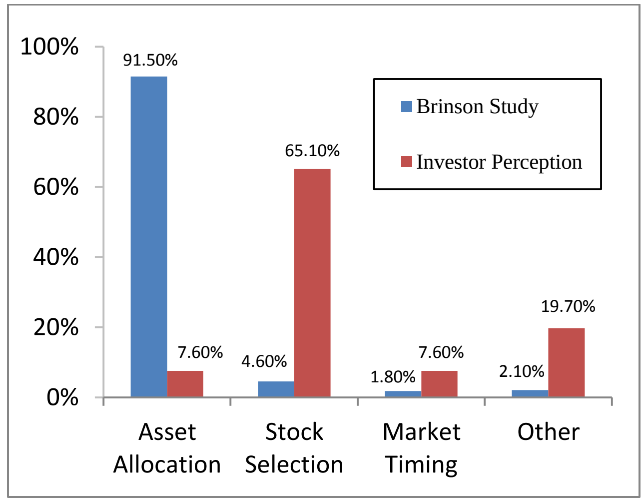
Asset Allocation

Although the PPA was a step in the right direction to guide plan participants to create appropriate asset allocations, there are still inherent shortcomings in the methods by which advice is delivered and in plan design. Often, these limitations cancel out the intended benefits of the legislation. One of the biggest issues is inertia – plan participants must still actively seek out the asset allocation advice that is now available to them.

Many plan providers, rushing to comply with the PPA, have created their own proprietary, diversification-in-a-box solution – often called "target date" or "lifestyle" funds. Besides the layering of fees in many of these fund-of-funds and the potential conflicts-of-interest they present, the inclusion of these options into the investment lineup has also added confusion for the investor. Employees, for the most part, are now provided a list of mutual funds and "target date" funds. As the number of investment choices increase, participants revert back to sub-optimal allocation decisions when confronted with "choice overload".[viii] And research continually points out that these same participants misuse the pre-packaged, "target date" funds in developing a personalized, risk-specific asset allocation. [ix] When the evaluation of investment options becomes more daunting, participants have historically reverted back to the methods that cause individual investors to underperform, choosing the investment by recent performance ('return chasing') and selecting those with familiar names.

In the seminal study on the elements of portfolio performance, Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower, concluded that asset allocation is the prime determinant of portfolio gains (see Figure 4), accounting for 91.5% of the entire portfolio return.[x] Asset allocation can succinctly be described as the mix of asset classes in the portfolio, and it is understood that certain asset classes perform better than others in different market and economic conditions.

Figure 4
Determinants of Portfolio Performance



Sources: Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower, *Determinants of Portfolio Performance II: An Update*, 1991. As adapted from W. Scott Simon, *Index Mutual Funds*, 1998.

Today's 401(k) plan design, many with 24/7 internet viewing capabilities, actually discourages proper, long-term asset allocation. Daniel Kahneman, the Princeton professor and Nobel laureate, has shown that constant evaluation of one's portfolio creates a myopic environment through which reference points are too frequently re-set, leading to hypersensitivity to short-term fluctuations. [xi]

With the inclusion of self-directed brokerage windows for plan participants, giving one the ability to 'day trade' their retirement savings in a tax-deferred vehicle, you can see why some employee benefit providers liken this to "giving a monkey a machine gun".

As illustrated further in Figure 4, there is an extreme deviation between actual factors of portfolio performance and investors' perception of those factors. Coupled with the results from Kahneman and investors' unfounded belief that market timing and stock selection are key components to return, it is easy to see how this continues to lead to short-term, emotion-based decisions in portfolio construction.

Role of the Plan Sponsor

It should be noted that seemingly benign decisions made by the plan sponsor have influential effects on plan participants, in both their contribution rates and in their investment decisions. The plan sponsor has more than a fleeting and insignificant role in determining the retirement security of their employees. These responsibilities carry with them fiduciary risk and potential liability.

Before the PPA, plan sponsors were reluctant to do anything that might expose them to liability whatsoever – so, they often did nothing. After the PPA, plan sponsors have traditionally met the minimum requirements to protect themselves from liability. What is often heard from plan sponsors is, "I have met my legal obligation as an employer, now the participants can fend for themselves".

For those plan sponsors that want to provide additional advice to their employees, ERISA does allow some liability protection in the selection of investments or investment providers. Many plan sponsors are now enlisting professionals to aid them in this process.

- <u>§ 3(21) "Limited Scope" Advisor:</u>

A § 3(21) "limited scope" advisor shares a co-fiduciary role with the plan sponsor. In effect, these are typically plan 'consultants' that provide investment platform recommendations, but do not have discretion to make actual investment decisions. These decisions are ultimately left to the plan sponsor. In this case, both parties share the fiduciary responsibility for investments and share attendant liability.

Any individual can be a fiduciary under ERISA section 3(21) if he or she exercises any authority or control over the management of the plan or the management or disposition of its assets; if he or she renders investment advice for a fee (or has any authority or responsibility to do so); if he or she has any discretionary responsibility in the administration of the plan, or is named in the plan documents.

A § 3(21) "limited scope" advisor does not relieve the plan sponsor from investment liability.

- <u>§ 3(38) Advisor:</u>

A § 3(38) advisor assumes the sole fiduciary role for selecting, monitoring, and replacing investment options. In effect, these are the plan investment managers that have full investment discretion. This enables the plan sponsor to better manage and mitigate their fiduciary risk.

ERISA Section 3(38) makes it possible for plan fiduciaries to delegate authority for plan investments to an investment manager who: (1) has the power to manage, acquire, or dispose of any asset of a plan; (2) is a registered investment adviser (RIA), bank, or insurance company; and (3) has acknowledged in writing that it is a fiduciary with respect to the plan.

Furthermore, a § 3(38) fiduciary may be those who are subject to the Investment Advisers Act of 1940, like a Registered Investment Advisor (RIA). Often precluded from acting as a § 3(38) fiduciary are those investment professionals that operate under a 'suitability standard', including brokers, broker-dealers, and some dually-registered investment professionals, which collectively represent the channels by which most 401(k) plans are offered.

Fiduciary Confusion

Is it possible to be a § 3(21) fiduciary when recommending investments to a plan, yet not be a fiduciary when delivering actual advice? YES.

A fiduciary, as defined by the Investment Advisers Act of 1940, must: 1) act solely in the best interest of the plan sponsor, participants, and beneficiaries of plan, 2) Avoid conflicts of interest and 3) Disclose all forms of compensation. In the opaque world of retirement plans, riddled with hidden fees and 'revenue sharing', acknowledging § 3(38) fiduciary status is something most brokers, broker-dealers, and agents are unwilling and unable (legally) to do.

New laws, effective in 2012, will help bring transparency and disclosure to 401(k) plans, but the only 'sure-fire' way to receive fiduciary guidance is to engage a 'fee-only' RIA that acknowledges their fiduciary status.

Next Generation Retirement Plan

All of our research leads us to the question of how to best create the next generation 401(k) plan. It should be the ultimate goal of all involved to deliver a solution that enables individuals to adequately prepare for their retirement with the best chance for success. A paradoxical event has occurred when the desire to give participants unlimited choice, access, and discretion has been shown to encumber the ability of individual plan participants to be successful. By borrowing from the proven and quantifiable benefits of the defined benefit (DB) and the defined contribution (DC) plans, we can create a 'best-of-breed' 401(k) plan for:

- PARTICIPANTS - They can now receive what they truly need: Ongoing, professionally-provided advice
- EMPLOYERS – They can now obtain what they truly want: removal of fiduciary investment liability, a more sound tool for employees to meet their retirement goals, and employees that are singularly focused on the jobs in which they are experts
- THE SYSTEM – It can get what we all desire: a sustainable vehicle capable of supporting a retirement framework that is growingly reliant upon the individual to provide for their own future

Plan Design

Research compiled by Dr. Sheena Iyengar, Professor at the Columbia University Graduate School of Business, indicates that people are more likely to participate in something when they can fully understand their options, and they respond more decisively when fewer options are presented.[xii] It should be the goal of the plan sponsor and the plan provider to simplify the investment-selection process.

This simplification should begin with individual plan participants choosing from a few (five or fewer) asset allocation models designed and managed by professionals. These professionally-managed portfolios should be constructed in a diversified manner and designated for various risk tolerances or time horizons.

The portfolios should be constructed with institutionally-priced, low-cost mutual funds and/or exchange-traded funds (ETFs) by an unbiased, unemotional third-party professional manager. Or in plans that wish to access the full investment world, omnibus accounts should be managed with the capability to use the most appropriate investment vehicle for the objective, including: individual stocks, individual bonds, CDs, mutual funds, ETFs, and others. The flexibility to utilize non-mutual fund investments often give professional managers the flexibility to target specific opportunities with lower-cost investment vehicles and to take advantage of changing economic or market conditions.

In addition, plan participants should be able to direct their investments into the model portfolios or, for those with the expertise or those receiving professional guidance, establish a brokerage window to direct their account.

Full-Time Fiduciary

Plan sponsors and participants deserve someone who acts as a fiduciary, the legal obligation to place the interests of the plan beneficiaries first and foremost, in every capacity and 100% of the time.

This dually includes the removal of investment selection liability of the plan sponsor or Trustee(s), by delegating a 3(38) fiduciary role, and the obligation of plan provider to deliver fiduciary-driven management of the assets in the plan or on an individualized, personalized level.

Knowing that a plan participant's assets may reflect only a portion of their entire financial picture, these participants should, at no additional cost, gain entrée to elite personal financial planning services to coordinate their investment, tax, estate, and retirement planning needs. Maximizing and integrating financial solutions should be made available through the provider's team of Certified Financial Planners™ and attorneys.

Conclusion

When confronted with challenges, our nation has always met them with resiliency and ingenuity. Plan sponsors, realizing the necessity to change the current retirement system, are beginning to recognize and explore a better plan alternative. Through innovation and by drawing from the lessons of past successes, it is now possible for employers to shift fiduciary liability for investment decisions (by hiring a § 3(38) investment manager) and for employees to maximize their retirement savings through access to professional guidance (opportunities previously only afforded to the wealthy). In the end, this promising and new frontier may make the future more prosperous for everyone.

Notes / Sources

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About Sunrise Advisors

Sunrise Advisors is an independent, "fee-only" Registered Investment Advisor (RIA) based in the Kansas City metropolitan area. Founded in 1993 by David P. Scott, the firm takes great pride in our conflict-free advisory relationships and our fiduciary role, including adoption of 3(38) responsibilities for qualified retirement plans. As a multi-generational, family-owned business, Sunrise Advisors partners with individuals, families, and businesses to maximize wealth management and wealth transfer strategies.

Our key areas of service include:

- Investment Management
- Financial Planning
- Family Office Services
- Custom Retirement Plans

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