What To Do About The 401(k)

GONE FOREVER ARE the days when you could retire with a fat pension generously provided by the employer you loyally spent most of your working life with.

Those pension plans that remain are usually found in union-dominated industries and, in some prominent cases, are bankrupting the companies that provide them. In the public sector, school district and police department retirement plans are deficit-funded with increased taxes so retirees can continue to enjoy generous inflation-protection benefits. But as a result, taxpayers are being overburdened and, understandably, are starting to revolt.

The seeds of change began in the late '80s, when companies began abandoning their pension plans and adopting the participant-driven 401(k) plan instead. Today, it has become the de facto pension plan and is found at virtually every company in the United States.

But all is not well with the pension/retirement system and the winds of change are blowing again over the retirement landscape. The volatile markets of 2008 exposed major flaws in the 401(k) plan, like the inability of plan participants to choose an appropriate asset allocation, or even to successfully negotiate market cycles without taking big losses. The investment losses also exposed the high costs heaped upon participants by insurance companies and mutual fund plan sponsors.

In response to the rising chorus of protests, Congress took up the mantle and proposed new legislation designed to improve the prospects for an individual investor's success. There is a lot at stake here. Millions of Americans will need to retire in the next 20 years and many will not have enough savings; their shortfall will stretch the government's resources to the limit, expanding our deficits and wounding our credit.

In the past, pension plans were run by professional money managers held accountable for their investment decisions. As such, they tended to be cautious and prudent custodians of your money. Your 401(k), however, has no such captain to steer the ship. Plan participants are forced to act on their own behalf as investment professionals, but without the investment experience or expertise necessary to do so successfully.

People ask whether employers should be responsible in lieu of professional managers. But plan trustees avoid recommending specific investments or strategies to their employees for fear of being sued and limit their advice mainly to generic asset allocation strategies, offering no actual professional management.

Here lies the dilemma: How do we bring better investment success to the 401(k)?

Congress has recognized the problem and debated whether to fix the 401(k) or scrap it altogether in favor of some alternative.

We will have a major problem if we fail. If the plan balances of baby boomers are inadequate to help them meet their income needs after they finish working, the government will have to step in and help broke seniors. Social Security, Medicaid/Medicare and welfare will be the fallback, even though these plans are already in serious trouble. The nation simply cannot afford to ignore the problem. That's why the 401(k) will be the continued focus as the government seeks ways to improve and insure the system against default. And

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How do we bring better investment success to the 401(k)? For one, participants need help from financial advisors.

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that means more government intervention and regulation.

New laws could bring about the regulation of plan expenses and performance management or could require mandatory participation by retirees in 401(k) plans. What would be the effect of such new laws? Well for one, the high-fee plan designed to compensate salesmen will die. In fact, I believe the current commission-based model will be regulated away in favor of a strict fee-for-service model.

The problem with the current broker-sold mutual fund/insurance company/annuity-based model is that it requires multiple layers of fees to compensate those on the delivery side of the system. The catch-22 in this system is that, though it is driven by commissions, it can't deliver quality advice.

Brokers are, in theory, supposed to adhere to a "suitability standard," not to a higher "fiduciary standard," and yet they are held to the fiduciary standard anyway without being fiduciaries. The brokerage firms and insurance companies themselves become fiduciaries by default and assume all the same risks of the broker/advisor because they also receive compensation. Stated another way, receiving ongoing compensation in the form of 12b-1 fees or commissions from the plan participants without the ability to provide meaningful advice to them is a problem.

Let's be clear: Providing generic advice on asset classes is not investment advice. Vetting the funds chosen for the plan does not mitigate trustee/fiduciary liability. Only a contracted registered investment advisor can assume fiduciary liability and provide a "fiduciary wall" of protection for trustees.

It is quickly becoming understood that the only practical solution is a fee-based system where registered investment advisors (who can legally earn fees for advice) provide advice in the form of fund selections at both the plan level and the participant level. Be aware that this places the advisor directly in the crosshairs of the regulators, because they become plan fiduciaries.

What are the options? Right now, participants randomly select funds. That means they risk over-concentration in more volatile asset classes while making feeble attempts to time the market, which leads them to sell low and buy high, or sell low and not buy at all. That was what happened in 2009, when many investors sat on the sidelines in cash, only to watch the single most dramatic comeback from a market crash in history. This arrangement must be replaced by one in which professional managers design portfolios to meet investor risk profiles and objectives.

What can we expect going forward? Beginning in 2010, plan trustees are required to inform participants in real-dollar terms on their statements how much they are paying in fees for administration, fund management and fund expenses such as management fees, trading costs, bid-and-ask spreads and more.

However, because of a glitch in the law, the plan sponsors are not required to provide that information for Schedule C on the 5500 tax form. Some will likely do so anyway, but trustees may have a hard time complying. Congress will also take up the fiduciary issue, and we are likely to see more regulation pointing toward increased liability for those plan trustees who don't bring a higher level of investment management to their 401(k) plans. FA

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