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# FOCUS ON 401(k)

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**401(k) INVESTING**

## Why Models Are Used

An accelerating trend in the large plan market is for plan sponsors to design risk-based or target maturity portfolios that use their plan's core fund options, instead of using "off-the-shelf" lifestyle or lifecycle mutual funds. In other words, they use strategic asset allocation models and, for target-maturity models, a "glide" path through the models. This three-tier approach can be schematized as follows:

**Risk-Based or Target-Maturity Asset Allocation Models**

**Core Active and Passive Investment Alternatives**

**Non Core Options (e.g., Mutual Funds, Brokerage Accounts, Employer Stock)**

Historically, plan design changes first take place in the large plan market and then eventually scale down into the smaller plan market. Over time, improvements in plan design become incorporated into the standards of prudence. Thus, understanding why many plan sponsors are choosing models over off-the-shelf products is important for all plan sponsors.

Generally, there are 12 reasons why plan sponsors choose models over lifestyle or lifecycle funds.

**1. Cost savings**. Developing models has a fixed dollar cost. Plan sponsors, recordkeepers, brokerage houses, and other vendors that have developed models for use by participants, utilize a qualified consultant to develop and review them. Model development costs are significantly less than an ongoing asset-based fee for what is essentially a study–developing models, not active asset management. Furthermore, the market has already developed cost-effective ways to deliver models.

**2. Utilization of alternative investment vehicles.** The emerging trend is for large plan sponsors to move from mutual funds to collective trusts and separate accounts for actively managed investment alternatives, and to collective trusts for passive investments.

**3. Use only "best of class" managers.** Plan sponsors desire to use prudently selected and monitored core options as the basis for an "auto pilot" diversified solution for both participants who make an election as well as those who are defaulted into an investment portfolio.

**4. Ability to monitor each underlying manager separately.** Models allow a plan sponsor to replace an underperforming manager without having to replace all the managers.

**5. Potential to monitor and modify each model individually.** Plan sponsors are not required to change all of the models in order to customize one.

**6. Open architecture.** Lifestyle and lifecycle mutual funds are often limited to proprietary funds, or by design must include them. Even flexible architecture (e.g., choosing from a list of a few hundred) is a far cry from open architecture and prevents plan sponsors from selecting the best of class for each core option.

**7. Control over the active and passive split among core alternatives.** The vast majority of large institutional investors utilize both active and passive alternatives to reduce active manager risk and control costs since passive investments are substantially less expensive (especially at the institutional level). Most target based and risk-based mutual funds are 100% active solutions, and the few exceptions are 100% passive.

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## 401(k) PLAN DESIGN

# Spate of Class Action Lawsuits Targets 401(k) Fees and Expenses

Once again, fees and expenses of 401(k) plans are in the news.

On September 11, 2006, class action lawsuits were filed across the country against several large companies – as well as officers of those companies and the members of their 401(k) committees. Some of the companies sued include International Paper Corporation, Lockheed Martin Corporation, Bechtel Corporation and Caterpillar Corporation.

**The Class Action Complaints.** The complaints allege, among other things, that the plan committees (1) entered into agreements with third parties that caused the plans to pay unreasonable, excessive fees, (2) failed to inform themselves of, and understand, the various methods by which vendors in the 401(k), financial and retirement industry collect payments and other revenue from 401(k) plans (for example, revenue sharing of 12b-1 fees and transfer agent fees)…, and (3) failed to monitor the fees and expenses of the plan.

The complaints also allege plan fiduciaries failed to adequately inform plan participants of the actual fees and expenses that were incurred by the plans.

Referring to revenue sharing as the "big secret of the retirement industry," the complaints attack the practice of investment providers (like mutual funds, their management companies and affiliates) "sharing" portions of their fees with other service providers. In order for fiduciaries to satisfy their obligation to determine whether service providers (such as their recordkeepers) are receiving reasonable compensation, the complaints allege they must determine the revenue sharing payments to the service providers. According to the complaints, when revenue sharing payments are taken into account, "… the participants and beneficiaries of the Plans paid unreasonably high fees for the administrative and/or investment management services they received."

While the outcome of the lawsuits is far from clear, the impact of litigation must be evaluated in the larger context of the focus on fees and expenses by the government, by plaintiff's attorneys, and by the private sector. Those efforts are part of a "mega trend" concerning the fees and expenses of 401(k) plans. While all costs are being scrutinized, the greatest attention is being paid to indirect payments, like revenue sharing, that occur behind the scenes.

**Evaluation of Revenue Sharing.** The balance of this article focuses on the fiduciary responsibilities for knowing and evaluating revenue sharing.

While there is no precise definition of revenue sharing, that phrase is often used to mean 12b-1, subtransfer agency, administrative and other fees paid by mutual funds, and their management and distribution companies, to entities related to the plan (for example, the recordkeeper, administrator, broker, consultant or investment adviser). While those payments are usually used to often reduce the cost of the plan, they also reduce the investment return to the participants (Payments directly from the mutual fund, like 12b-1 fees, obviously reduce return; indirect payments, *e.g.*, from the mutual fund management complex, also reduce return, since they usually result from the plan using a more expensive class share, for example, "A" retail shares versus "I" institutional shares.).

ERISA requires fiduciaries understand and evaluate fees paid by their plan, whether directly or indirectly (see ERISA §404(a)(1)). Revenue sharing is usually an indirect payment. Under ERISA, it is both a fiduciary breach and a prohibited transaction to pay more than reasonable amounts. The DOL explained that responsibility in Advisory Opinion 97-15A (the Frost Bank opinion):

"Under section 404(a)(1) of ERISA, the responsible Plan fiduciaries must act prudently and solely in the interest of the Plan participants and beneficiaries both in deciding whether to enter into, or continue, . . . [an] arrangement . . . , and in determining which investment options to utilize or make available to Plan participants or beneficiaries. In this regard, the responsible Plan fiduciaries must assure that the compensation paid directly or indirectly by the Plan to Frost is reasonable, taking into account the trustee services provided to the Plan as well as any other fees or compensation received by Frost in connection with the investment of Plan assets. In this connection, it is the view of the Department that the responsible Plan fiduciaries must obtain sufficient information regarding any fees or other compensation that Frost receives with respect to the Plan's investments in each mutual fund to make an informed decision whether Frost's compensation for services is no more than reasonable. The Plan fiduciaries also must periodically monitor the actions taken by Frost in the performance of its duties, to assure, among other things, that any fee offsets to which the Plan is entitled are correctly calculated and applied."

As the DOL language indicates, plan committees have several directives in their oversight of fees, expenses and revenue sharing:

- Be aware of all of the charges to the plan and its investments, of the revenues being shared, and of the indirect payments to any providers;
- Evaluate those charges and payments in light of the services being provided to the plan;
- Compare the charges and revenues to those in the competitive marketplace to determine whether they are within the range of reasonableness;
- Based on the work, reach a reasoned and documented (*e.g.*, committee minutes and supporting data) decision about the charges and revenues;

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## 401(k) INVESTING

# Life Annuities and Retirement

Life annuities ("annuities") are contracts that provide periodic payments for the duration of one or more individuals' lives. Annuities have been around since ancient Rome and, in the Middle Ages, were typically provided by individual speculators in return for an up front payment. Our first detailed records of annuity pools come from 17th century France. A group of individuals would each deposit a sum into a commonly held fund that made regular payments to those in the pool. Payouts increased to survivors as individuals died, and when there was only one survivor left, he received the balance of the pool. The next century, countries such as England sold annuities in lieu of government bonds, where the government would receive capital in return for a guarantee to provide payments for life. Initially, annuities were sold to everyone at the same price, regardless of age or gender. However, as it became clear that the people who bought annuities lived longer than the population at large, pricing began to reflect mortality risk. Soon, companies organized to provide life insurance and life annuities, which were backed by the capital of the company or the investors who organized the life company.

This brief history of annuities underscores the fundamental characteristic of annuities: they are vehicles that pool mortality risk. Insurance companies are vehicles that pool monies, using the funds from those who die sooner than expected to pay those who live longer than expected, and back the guarantee with their own capital so that those who live too long do not have to bear the risk of a shortfall in the pooled monies.

The value of pooling mortality risk is enormous. For example, assuming a 5% return (and using the IRS Single Life Expectancy Table), a 65 year old could expect to receive $9,240 each year for the rest of their life by annuitizing $100,000. If a person were to withdraw that amount each year from an investment that paid the same 5% return, they would run out of money after 14 years, and there is still a 60% chance they would still be alive. If the person does not annuitize, but assume they will live to 100, they could only spend $5,756 each year.* The financial value of mortality risk pooling is substantial in its direct impact on both the quality of life and its elimination of impoverishment in very old age. The value is not only through the guarantee, but avoids the risk of under consumption when every penny counts (as with the last alternative which provides only 62% of the annuity, and would still leave one impoverished if one lived past 100).

Annuitization also addresses a real world risk that is ignored by pure financial processes that only take into consideration standard risk and return projections. Age increases the risk of health issues, such as deteriorating physical or mental health, contraction of chronic illnesses (e.g., diabetes, high blood pressure), acute illnesses (e.g., stroke, cancer), and widowhood. Such are more likely to happen than not with increasing age. It results in homes and cars being sold, and moving all investment into banks and CD's. Such shocks affect a household's physical, mental and financial capacity, and liquidity and ease of management become far more important than potential higher returns and the attendant risk.+ Annuities are a strategy to deal with "shock risk" as well as the risks of outliving one's assets and under consumption.

There are many issues surrounding annuitization that make it complex. The price of an annuity is a function of age, gender (women's life expectancy is significantly longer than men's, and joint life expectancies are even longer), marketing costs (annuities are principally sold through retail channels), additions to contingency reserves, corporate overhead and taxes, profit, and adverse selection (i.e., people who buy annuities have longer life expectancies than the general population). Offering annuities through defined contribution plans, which have the power to capture institutional pricing (dramatically reducing marketing costs) is an obvious solution—except for the fact that current laws make it nigh to impossible.

Regulations governing annuities within ERISA plans are complex, subject to both ERISA and insurance regulations, impose substantial administrative burdens (joint and survivor requirements), require unisex pricing which make them substantially more expensive, carry a significant fiduciary burden (which will remain even after the "safest annuity rule" is rewritten as mandated by the Pension Protection Act), and pose a nightmare when required minimum distribution rules kick in. Other issues surround the small size of the U.S. market, the paucity of financial instruments that insurance companies can use to hedge longevity risk, the impact of interest-rate risk on annuitants, and the fact that most participants when given a choice do not choose annuities.

Nevertheless, in a world of single digit returns, mortality risk pooling through annuities is both rational and necessary for most middle income workers to avoid impoverishment at some point in retirement—at least a partial annuitization of the retirement savings to provide a foundation (along with social security) for retirement security. Yet the knowledge of this issue by most plan sponsors is small, or even non-existent. As nearly 80 million baby boomers move into retirement, they will create the scale for insurers and plan sponsors to innovate and institutionalize solutions that utilize, in part, mortality risk pooling. It is time for plan sponsors to begin their own education about these matters, if they haven't done so already. ◆

*— Ken Robertson*
*EVP, Chief Investment Officer*
*The 401(k) Company*

* See Ron Gebhardtsbauer, "Testimony before the Advisory Council on Employee Welfare and Pension Benefit Plans, U.S.Department of Labor Task Force on Leakage," June 9, 1998.

\+ See Courtney Coile and Kevin Milligan, "What Happens to Household Portfolios After Retirement," Issue Brief Number 56, Center for Retirement Research at Boston College, November 2006.

## 401(k) PLAN DESIGN/INVESTING

### Spate of Class Action Lawsuits
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- Maintain documentation in the committee's due diligence files (we recommend that records be kept for at least seven years); and
- Monitor charges and revenues at regular intervals (we recommend a thorough analysis approximately every three years).

The committee's analysis can take into account the fact that it is appropriate to use plan assets and other monies generated by the use of those assets (such as revenue sharing) for the payment of reasonable plan expenses.

For example, the class action complaints alleged fiduciaries picked Class A shares, rather than Class I institutional shares. Needless to say, Class A retail shares are more expensive than institutional shares. In effect, complaints are asserting these billion-dollar-plus plans were paying retail prices when they should have been buying wholesale. While that argument has some appeal, it does not consider there are issues other than just the cost of the investments. For example, much of the differences in pricing may be attributable to the revenue sharing that "retail" shares pay to support the recordkeeping and administration systems for the plan. Since those are operational costs, they may be properly paid from plan assets—so long as the cost is reasonable. However, it appears the plaintiff's attorneys are also arguing that the amount of revenue sharing exceeded the reasonable cost for the services received.

**Conclusion.** The moral of the story is fiduciaries, including committee members, need to fully understand and consider the revenue sharing being paid (or which could be paid) by the mutual funds and their management companies and affiliates. In addition, fiduciaries must understand how revenue sharing gets applied against the costs of the plan (for example, the recordkeeping and administration) and whether reasonable costs are less than the revenue sharing payments. If so, the plan should recapture the differences for the benefit of its participants.

As with all fiduciary decisions, the legal requirement is that the plan committee engage in a prudent process. Obtain the needed information, meet and evaluate it, obtain advice if needed, reach a reasoned, or reasonable, decision, and implement it . . . that's the fiduciary's job.◆

*— Guest article by: Fred Reish*
*Reish Luftman Reicher & Cohen*

### Why Models Are Used
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**8. Eliminate impact of fund self-dealing.** Models provide plan sponsors with the opportunity to eliminate the cost impact of potential self-dealing and conflicts of interest inherent in mutual funds that make strategic (and tactical) asset allocation decisions. Such mutual funds are not subject to ERISA's prohibitions, as the underlying assets are not considered plan assets. For example, investment managers make more money from actively managed funds than index funds, and while the decision to use most or all actively managed funds may be sincere, there is financial gain for the fund house in that decision. The process of separating the strategic asset allocation decision from the investment process ensures no such conflicts taint the process, both because that is the desire of the plan sponsor and because it is subject to the requirements of ERISA. Conflict of interest involves much more than the active/passive decision–such as the specific funds selected (some are more profitable than others), the type of fund (high yield vs. government bond), and so on.

**9. Flexibility to respond to demographic changes.** Plan sponsors may modify a model without changing investment managers, and visa versa. Significant demographic changes may occur through growth, workforce reductions, acquisitions and spin-offs. Models can be redesigned for the changed suitability factors.

**10. Potential to adapt to future improvements.** Models allow for future innovation in plan design, such as risk-based target maturity models.

**11. Avoid misuse of one-stop funds by participants.** It is well known that participants who select their own investment options will often treat lifestyle or lifecycle funds as one fund among many. Participants frequently invest in multiple lifestyle or lifecycle mutual funds, thus negating their purpose. The model structure ensures a strategy that utilizes the underlying monitored investment alternatives, and one either selects a single model or designs their own. Models help solve many of the communication and participant education issues associated with lifecycle and lifestyle funds.

**12. Customize solutions for participants who have already retired.** The model structure allows plan sponsors to create solutions for the accumulation phase separately from the payout phase (and the transition phase). While this issue has always been present, the approaching retirement of nearly 80 million baby boomers is highlighting concerns and prompting creation of new solutions for the difficult task of consuming one's retirement savings. All funds and all models include strategic asset allocation in the post retirement years, which will continue to operate unless the participant elects otherwise. Products in the market today have substantial variance in the risk and strategy in the post-retirement years. What may be prudent in the accumulation phase may be imprudent in the post-retirement phase.◆

*— Ken Robertson*
*EVP, Chief Investment Officer*
*The 401(k) Company*


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98 San Jacinto Blvd., Austin, Texas 78701
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Founder and Editor-in-Chief: Jerry Bramlett
Desktop Editor: Sandy Erwin

(512) 344-3000 • (800) THE-401k
(512) 344-3134 FAX
www.the401kcompany.com