

A NEW PARADIGM FOR 401(k) FIDUCIARIES:
A VALUE DRIVEN, RESULTS ORIENTED PROCESS
FOR RUNNING 401(k) PLANS

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Working Paper No. 16

November 15, 2006

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On September 11, 2006 a single St. Louis-based law firm filed a series of class action lawsuits that has been described as “an all-out assault on the fee structure employed by most 401(k) plans.” The targets of these lawsuits are some large plan sponsors and the fiduciaries of their 401(k) plans.

The essence of these lawsuits is that the fiduciaries had only vague notions of how they were spending the participants’ money and the participants were receiving little or no value for that money. In short, the fiduciaries did not work “solely in the interests of the participants and beneficiaries...for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan.”

These lawsuits should not be taken lightly for these litigators have stumbled across the Achilles heel of 401(k) fiduciaries—a compliance and procedure, rather than a value and results, driven approach to running 401(k) plans.

On the surface, this compliance/procedure driven approach looks picture perfect for it includes:

- creating a rigorous procedure for selecting and monitoring investment options;
- documenting committee meetings that discuss the running of the plan;
- making sure that the fees that are paid are competitive;
- having the plan’s counsel and consultants periodically update the fiduciaries on trends in the 401(k) arena;
- selecting a well-respected recordkeeper that understands the needs of and is well-equipped to service a plan of their size and complexity.

What this dot the “i”s and cross the “t”s approach lacks is the requirement that providers demonstrate in a quantitative fashion how they are providing value to the participants. Value must be defined in terms of creating the desired behavior. The fact that full-blown autopilot programs (automatic enrollment, S.M.A.R.T. feature, and the appropriate targeted maturity fund) are such a hot topic today is proof that the compliance/procedure driven approach was ineffective at getting employees to assume responsibility for their retirement security.

The benefits to the fiduciaries of a value driven, (quantitatively measured) results oriented process are many and include a paper trail demonstrating:

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- the fiduciaries' understanding of how the employees are using, misusing, or not using the plan;
- the steps taken by the fiduciaries to address the uncovered issues;
- the extent to which current findings from behavioral finance, cognitive science and consumer buying behavior are incorporated into both the plan's design and the communications;
- how the tensions between the needs of the employer and those of the employees are addressed.

The obvious question is: If the benefits of a value driven, results oriented process for running a 401(k) plan are so powerful, why isn't this process routinely used on a widespread basis? There are several reasons for this and they include:

- 401(k) committees often do a de facto delegation of their responsibilities to their attorneys, investment advisors, and recordkeepers. What the fiduciaries forget is that each of these groups frames 401(k) issues from different perspectives. It is up to the fiduciaries to act like a "prudent man...familiar with such matters" by integrating the varying viewpoints into a meaningful program that benefits participants and encourages eligible non-participants to enroll in the plan.
- Fiduciaries often ignore the fact that recordkeepers are sales organizations, not unbiased advisors. Sales organizations hype what they offer, deemphasize or disregard totally what they don't, promise what they can't deliver (or at least not cost effectively), and religiously stick to their business model in order to maximize profits.

Recognizing the limitations of the recordkeeper creates inconveniences for the fiduciaries since it forces them to bring in other professionals and creates a new challenge: coordinating the flow of data between two (or more) organizations that often have competing and/or conflicting agendas.

For example, few recordkeepers, even the largest, routinely provide detailed plan utilization analyses by demographic segments. Such analyses are the fundamental components of quantitatively driven process.

Even if such analyses get produced, it is highly unlikely that the provider has the technology to easily target and deliver the appropriate customized and personalized message to the employees in a given segment, such as all participants between the ages of 35 and 44 in the Seattle location who are not on track for a comfortable retirement and who also are over-concentrated in employer stock. For fiduciaries to implement the appropriate campaign—increase your contributions, decrease your allocation to company stock, and diversify more—would likely require hiring a new, technology savvy communications vendor.

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- Perhaps the most powerful obstacle that has prevented value driven, results oriented processes from taking hold lies in the tensions that exist between the employer's desire for "happy campers" and the employees' need to understand that achieving retirement security is their responsibility, requires financial sacrifices, and may be fraught with uncertainty.

Walking this tightrope, however, is the responsibility of the fiduciaries. "Burying their heads in the sand" and hoping the problem goes away only sets the stage for more class action lawsuits.

There is, however, no reason why the tension between sponsor and employee needs cannot be addressed in a non-inflammatory manner. Most employees would probably welcome help from their employers, especially if it comes in the form of gap analyses, targeted maturity funds, and anything else that saves them time and takes the pain out of the retirement planning process.

What participants don't want is what they all too often get: thick enrollment books, sales pitches (or perceived ones) from providers, and double talk saying how easy it should be for them to save for retirement as their employer freezes their defined benefit plan and introduces a "consumer driven" (i.e., higher deductible) health plan.

Class action lawyers in increasing numbers will be hunting 401(k) fiduciaries that keep using a compliance/procedure based process for running their plans. That's the bad news. The good news is that if the fiduciaries switch to a value driven, results oriented process, they will have the advantage of the best and most effective defense. This approach proactively recognizes the needs of both sponsors and employees, sets priorities, and then develops the strategies and tactics needed to achieve them.

In his classic, *The Art of War*, Sun Tzu wrote about 2500 years ago: "Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat." The current approach of many 401(k) fiduciaries is tactics without strategy. A value driven, (quantitatively measured) results oriented process, by combining both strategy and tactics, provides value for participants and piece of mind for fiduciaries.