Rethinking the Costs and Burdens of the Contemporary 401(k) Plan Design: Pooled Profit Sharing Plans vs. Participant-Directed 401(k) Plans

Background

It's often said that the cure is more difficult than the illness. The contemporary 401(k) plan design currently offered by most employers is a case in point. Contemporary 401(k) plans take the form of participant-directed (also known as self-directed) plans in which each participant has a personal account and assumes responsibility for managing their investment choices. Over the years, this plan design has become increasingly complex, burdensome and costly as new Department of Labor ERISA regulations arose from participant self-direction and, in response, retirement industry providers sought to monetize regulatory complexities and ancillary services. Further, the industry has created the illusion that self-direction benefits participants, which it does not.

However, there is another plan structure that may be more suitable for both employers and participants. During the 1980's, a common plan structure was the 'trustee-directed' or 'pooled' 401(k) plan—which is once again gaining favor with employers. Below is an overview, comparing and contrasting, the pooled plan design versus contemporary participant-directed 401(k) plans.

The key differences between a Participant Directed and a Pooled Plan

In a *participant-directed plan*, each plan participant has an account which they are required to manage from the investment choices offered in their plan. This self-direction has implications for the employer—since, as plan sponsor, the company retains liability for: plan performance, the plan's investment selection (menu) AND participant education. Service considerations and requirements include a daily recordkeeper, a Third Party Administrator (TPA), a custodian and/or third party trustee for plan assets, as well as an investment advisor to provide ERISA 3(21) or 3(38) fiduciary investment oversight services.

Pooled plans pre-date modern 401(k) plans, however this design became less popular during the 90's as plan participants sought more control over their individual accounts—while industry providers capitalized on this transition with new costly services. Importantly, plan sponsors believed providing participants with investment self-direction would mitigate their fiduciary liabilities—*though it did not and, instead, added to employers' responsibilities.* Further, robust equities market performance during 1990's bolstered participants' account balances resulting in a general view that participants could ably manage their own accounts, though subsequent bear markets proved otherwise.

Alternatively, pooled plans have only a singular trust account in which all plan contributions are comingled—and are directed by the plan sponsor and administrated by a TPA. The plan will also have an investment custody arrangement such as through Schwab, Fidelity, etc. In a pooled plan structure, plan participants have no control over the investment direction of their plan investments, as the plan investments in the pooled account are managed by an investment manager (a 3(38) fiduciary).

The service, regulatory, administrative and cost profiles of pooled plans vs participant-directed plans differ significantly. *In participant-directed plans, required/offered services are largely geared toward participants* and typically include: 408(b)(2) fee disclosures, QDIA notifications, fee benchmarking, participant education, participant meetings, advice, financial wellness programs, enrollment meetings—most of which are underutilized, while all can place considerable demands on the employer's staff/human resources team. *Such requirements, however, are eliminated with a pooled plan design, though pooled plans are likely to achieve better outcomes.*

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Reasons an Employer should consider a Pooled Plan

1. Reduced Employer Risks and Liabilities

Since 2008, participant litigation against employers has rapidly increased (often led by class action law firms)—with lawsuits naming plan sponsors for a number of fiduciary breaches including: high investment costs, lack of education, poor investment choices, conflicts of interest, and investment losses. Under ERISA, employers assume both corporate and personal liability related to their fiduciary duties, which are more complex and numerous with participant directed plans. Smaller plans are increasingly being targeted for costly fiduciary and regulatory (investment, operational and administrative) breaches.

Therefore, a pooled 401(k) plan can be an effective way to reduce employers' exposure to the costs and burdens of fiduciary liabilities. By prudently selecting/hiring a 3(38) investment manager to directly manage the plan's investments, the employer's (plan sponsor) liability for managing investments *is eliminated.* Because there are no participant-directed accounts, there is no other liability for employers.

(Note: a 3(38) investment manager must accept discretionary control over pooled plan investments as a requirement to fully mitigate an employer's fiduciary liability for investment selection and management, however not all 3(38) managers/firms are willing to assume discretionary status.)

2. Improved Participant Investment Outcomes

There is an abundance of industry and academic data illuminating poor investment decisions and behaviors attributable to individual investors, particularly 401(k) participants in self-directed plans, which negatively impact their investment performance. In brief, participants are prone to *both poorly informed* and *poorly timed investment decisions* that significantly reduce their retirement outcomes. Notably, target-date funds which are quite commonly offered in 401(k)'s do not immunize participants from making ill-advised "in the market-or-out of the market" decisions in response to periods of economic uncertainty and market volatility.

Related to this, the pervasive use of mutual fund 'menus' (inclusive of target-date funds within the menu) offered to most 401(k) participants should likewise be examined. Mutual funds, having been designed 'for the masses' present structural impediments to participant performance outcomes, the reasons for which are advisable for plan sponsor/fiduciaries to remain aware. Issues include:

- Mutual fund portfolios typically mirror their benchmark's portfolio composition. This is because funds rely on industry search/evaluation 'engines' to attract investors, and funds must closely adhere to prescribed benchmark parameters to do so. This requires fund managers to buy many more stocks in their portfolio than they like. When a mutual fund's portfolio approximates its benchmark, the fund is at a disadvantage, and its performance will likewise mirror the benchmark's performance. After deducting a mutual fund's costs, it will underperform—it's simple math and typical of most mutual funds over extended time periods.
- Mutual funds often experience net redemptions during market declines. This means fund managers must sell stocks when the market drops to raise cash to meet fund liquidations. As a result, funds are not able to opportunistically buy into declining/lower prices when advisable or should the manager wish to do so. This negatively impacts both near-term and long-term mutual fund performance when stock prices recover.

- Mutual fund menus provided to participants routinely experience considerable 'stock overlap'. Overlap occurs, in part, because mutual fund companies treat 401(k) plans as 'omnibus' or aggregated accounts. As a result, a mutual fund manager is not only unaware of their specific 401(k) plan clients, they must also manage without regard to the holdings of any other mutual fund offered in a plan menu. Because plans offer multiple mutual funds, any number of the funds repeatedly buy and hold the same stocks. This overlap, unknowingly to participants, may negatively impact their risk, diversification and performance outcomes.
- Target-date retirement mutual funds, typically comprised of individual mutual funds, pose further structural issues in addition to those described above. Target-date funds are often *proprietary* funds managed by and benefitting a single mutual fund company within the fund company's (likewise) proprietary 401k operating platform. A fiduciary concern is also present because control over the specific proprietary funds provided within the target-date offering is ceded to the mutual fund company, which is a significant matter when one or more funds within the target date menu may not meet plan risk and/or performance objectives.

Having a pooled plan, can ameliorate these problems. Industry data also shows that a professionally managed investment portfolio, such as within a pooled plan, is likely to help employees achieve better investment results than can be expected by managing their own accounts (as they must do in self-directed 401(k) plans). In a single, managed pooled account: with investment management designed for each plan, rather than the masses, all plan participants benefit from professional investment management.

3. Reduced Costs, Services Complexities and Administrative Burdens

It costs less to manage and maintain a pooled plan. Because of the considerable reduction in (unnecessary) participant services--a pooled plan will save time, money, administrative burdens and reduce staff/human resource requirements. There are fewer regulatory requirements and complexities. A low cost TPA, investment custodian, and Investment Manager provide the required services. Investment management costs for a pooled plan are also typically lower than the costs in participant directed plans. The costs and services requirements of participant-directed plans described above, which are <u>not required in a pooled plan include</u>:

- Daily recordkeeping (at a cost typically ranging from $70 to >$100 per participant per year)
- Service provider-to-service provider mutual fund 'revenue sharing' arrangements (e.g. .20% of plan assets)
- Participant disclosures: e.g. QDIA
- 'Middle-man' advisor cost (e.g. .50% of plan assets, or flat-fee arrangements)
- Recordkeeper RFP search cost (every 3- 5 years)
- Participant advice (e.g. $25 per capita or .25% the participant's account value, per year)
- Participant education meetings (on company time)
- Financial Wellness programs (e.g. $25 per eligible participant)
- Participant underperformance (according DALBAR, and other investment industry research, the cost of individual underperformance is in excess of 3% per year from 1986-2016)

Conclusion

Contemporary 401(k) plans have become increasingly complex and costly. Employers, as fiduciaries, should consider whether their current plan structure provides the desired benefits. To accommodate participant-direction, the added costs to 401(k)'s are significant and, to the extent the plan (participants') assets pay for plan expenses, this should be a fiduciary consideration.

Employers should fully evaluate their preferences and objectives for their employees when considering plan designs. For midsize, professional or smaller companies, a pooled plan design offers compelling advantages to both employer and employee. The ERISA legal standard for employer-fiduciaries operating a retirement plan is that they must govern the plan *"in the sole best-interests of the plan participants and their beneficiaries…".* Within this context, the plan's investment outcomes are paramount and professionally managed assets, as in pooled plans, may well enhance participant investment outcomes vs. participants' results when self-directing their own investment accounts.

Further, Pooled Plans may also meet the needs of employers seeking to simplify the costs, risks, complexities and their fiduciary burdens intrinsic to operating Participant-Directed Plans.

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