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Retirement Plans: the Good, the Bad, and the Ugly

This article is intended to introduce abuses in the retirement plan market place and touch upon what plan trustees and plan participants might do about it. The article focuses on one of the most popular of the defined contribution plan, Profit Sharing 401k's. We try to illustrate the impact that bad plans can have on one's financial future and provide a sense of how the industry gets away with it.

The Department of Labor (DOL) has responsibility and authority under the ERISA legislation for profit- sharing 401k's. While the ERISA regulations may not apply to other code sections, the principles behind the regulations should invite consideration. If you have responsibility for an employer retirement plan under ERISA, are a plan participant, or have a loved one who participates, read on. If you hold investments in mutual funds and annuities in a governmental employer plan (sec 457b) or a teacher's annuity and related plan (under 403b and 403b7) there may be lessons to learn. Ditto for IRA's in the U.S. as well as RRSP's and other retirement plans in Canada.

Consumer groups, NYS Governor Elliot Spitzer, and the Department of Labor, among others, have been working recently to shine a light into one of the darkest corners of the investment industry. Plan expenses and misguided investment features are making it difficult if not impossible to achieve reasonable goals set for these plans' performance. It is too soon to tell if proposed changes in ERISA disclosure rules will be enacted and enforced. Consumer education and participant activism may be the best course to foster change for now.

The industry is responding to the calls for reform on three fronts. Brochures put out by some firms boast of "new and improved" fee schedules and disclosures. However, behind the scenes the industry is lobbying government regulators to soften the new requirements for full disclosure, often arguing that the disclosure rules will "confuse" consumers. In addition, some large retirement-plan vendors are hiring labor lawyers to rewrite their plan contracts with employers, to help shield vendors from liability. This can leave employers/plan trustees to fend for themselves as the sole plan fiduciary.

A cursory review by this writer in April 2007 of plan expenses and of what he regards as misguided investment philosophies, suggests that plan participants are still being taken advantage of, particularly by those insurance and investment firms who target the retirement plans of small and medium businesses and institutions.

What's at stake? ***One quarter, one-half, or more of a participant's nest egg.*** The folks being taken advantage of range from single moms in lower income positions to professionals distracted by other concerns to the unwitting business owners/Plan Trustees themselves. In some cases, the sales forces employed by the plan vendors are naïve about the damage being done. In other cases, they may be very aware.

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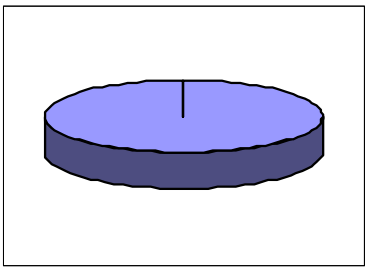
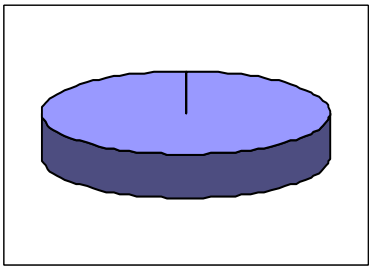
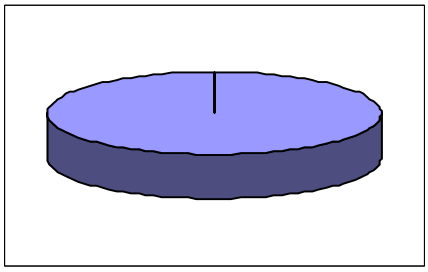
Here is an example of the cost to participants:

Let's say you are 45 years old and currently have $100,000 in a 401k plan. You also defer 5% of your salary ($2,500 not counting annual increases – in this example) into your plan. A matching contribution by the employer adds another $2,500 per year. Retirement will be at age 65, twenty years away. A ten percent rate of return is expected.

To Recap: $100,000 current balance $5,000 per year contribution 10% expected return

Assuming for the moment that none of the plans can promise superior investment skill over the other, the chart below shows the size of your nest egg in twenty years, depending on which plan is selected.

High Expense Plan	**Moderate Expense Plan**	**Low Expense Plan** [1]
$559,000	**$658,000**	**$839,000**
		

Can this be right? The nest egg in the low expense plan is 50% larger than that of the high expense plan. And 28% larger than that of the moderate expense plan?

But certainly, you might say, the extra expense of the higher priced plans buys better research, or more talented investment managers, and these translate into higher returns that justify the expense? Actually, the research that we can find argues the opposite. **Lower expense usually translates into higher rates of return for the participant.**

Well, do higher expenses provide a website with more features or better service from an "adviser" or administrator to help with forms, retirement planning calculations, investment education; mutual fund selection? And these features can't be matched by the low expense plan? Wrong again. While these features might be important, they are readily available and helpful in plans we reviewed, without regard for expenses. If one knows how to Google, there is also useful information outside of the plan platform to be obtained, with care.

So, is the prevalence of high expense plans legal? Probably. *Ethical?* Barely. *Smart Business*? For the plan vendor it is.

How can this be?

While Congress did a good thing in creating the legislation known commonly as ERISA, (Employee Retirement Security Act) it did not provide sufficient resources for enforcement of the rules, or much guidance to business owners/plan trustees on what questions to ask and where to look for alternatives to the sales force that typically comes calling. And the task of providing 401k plans to businesses by default fell to Wall Street and life insurance

industry cultures that are fraught with conflicts between the participants' financial well-being and the plan vendor's business goals.

Meanwhile, the task of monitoring existing plans has been pretty much left up to business owners who are often too busy to focus on the issue. Or the task is passed on to a company's human resource or payroll people. These folks are often overburdened with tasks that are more pressing and a dozen crises to manage. They may lack the finance background to deal effectively with a sophisticated industry's marketing machine.

Or it may have to do with the fact that the securities industry is among the world's most profitable industry, up there with energy and pharmaceuticals. Perhaps some of those amazing profits are spent on financing the election campaigns of industry-friendly congressional candidates, and lobbying elected politicians for preferential treatment.

There's more bad news.

Remember that 10% return in the example above? You probably won't get that much.

That 10% figure (or 12% or 8%, or whatever) that you arrived at by studying the colorful Plan Brochure probably came from a featured mix of two or more market indexes (maybe 75% allocated to the S&P 500 index representing 500 of the largest US companies and 25% allocated to the Lehman Brothers Investment Grade Bond index representing US bonds). And you assumed that the mutual funds you picked from each index category would likely earn the index's rate of return. You built your retirement savings plan around that assumption.

But you can't invest in an index; only in live securities like mutual funds (or as you will see in next month's letter, ultra-low expense versions of index funds and exchange-traded funds). These live investments (even in the low expense plans) deduct their expenses before you begin to earn any rate of return at all. So, an expected rate or return of 10% based on market index performance must be reduced by expenses. In the case of the high-priced plan, those expenses come to 3.5%. So, if the funds you picked do earn 10%, that's 3.5% in expenses to the securities industry and 6.5% after expenses to you.

Even if you know all this you might think that's OK – because the mutual funds in your employer's plan are destined "to be above-average performers" or even "to beat their index". You recall how the plan vendor explained that was why they were selected in the first place. And he pointed out that the funds did earn great returns.

What's wrong with that, you think? A lot.

The key phrase above is "did…earn". An array of credible studies point out that past performance is not a guarantee of future performance (that is what the mutual fund companies are required to say in their promotional material's fine print, isn't it?).

In fact, it's more than likely an indicator of below-average performance to come. While any fund can have two years to five years and sometimes ten years more of "above average" performance, after about ten to fifteen years of measured performance, 80-90% of all funds will post returns below or, way below an appropriately selected index or benchmark (e.g., your 75% stock – 25% bond mix).

Think about it–you don't want above average performance–by definition that's fifty percent of all the funds in a category-you need market beating performance- simply in order to justify the high expenses.

While it's easy to identify top managers–("index-beating managers" as opposed to "above-average ones") after the fact; it is about impossible to do so ahead of time; harder yet to identify who got lucky and who will be the next Warren Buffet.

What you probably don't know–and can't be expected to–given the marketing and media attention given to so-called market beating investment managers–is that one or more of these "top performers" will show up in your plan's menu of investment choices–just in time for their future performance to settle down to below-average territory.

In any event, you need to focus on the portfolio of funds that drive your particular account performance and not solely on the performance of the individual funds. If you are the Plan Trustee you also need to focus on how your plan participants are investing in the offerings; how often are they trading one fund for another; and where the preponderance of the contributions and account balances are being allocated. Are some participants chasing last year's hot manager while others are leaving their savings to languish in the money market fund?

And if the vendor boasts about how poor performing mutual funds are replaced with better ones- isn't he actually confirming what is being said in this letter?

In an attempt to emulate the better plans, some vendors recently added a series of a "one fund" solutions geared to your target retirement year or your avowed tolerance for market risk. While these are arguably designed to make fund selection easier for a participant, the sad fact is that many of these copycat "fund of funds" or managed portfolio solutions are saddled with yet higher expenses, or force inappropriate allocations on the investor.

It can get worse.

Consider what happens if the market doesn't produce 10% but only 7% in the decade that matters most to you. For your 75% stock fund-25% bond fund mix cited above, the high expense plan would again take 3.5% for expenses, and leave just 3.5% for you.

You might have missed this fact because you didn't know which questions to ask. During the selection process of a 401k vendor most selection committees are led to focus on the variables of "administrative expenses and burdens" and the "bells and whistles" offered on the plan vendor's 24/7 website. But in all likelihood the selection committee wasn't shown the fully disclosed and properly calculated "investment fees and expenses". **That is where the big profits for the plan vendor are hidden.**

Most employers don't know where to look for an efficient plan with features that will help the Trustee and investment committee fulfill their fiduciary responsibility, and protect the plan participants' nest eggs from poor performance and the disastrous effects of high expenses.

The whole truth about what to avoid and what to look for in a successful plan is rarely spelled out, which is exactly how the retirement plan industry wants it.

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Notes: (1) Investment related expenses: The illustration assumes that the employer plan's combined asset base is at least $1,500,000. The high expense plan assumes an average annual expense of 3.5%, typical of many plan vendors who use an annuity shell for their plans. The moderate expense plan assumes an average annual expense of 2.5% typical of plan vendors who offer open-end mutual funds. The low expense plan assumes annual average expenses of 1%, still higher than the fee for plans designed and managed by Willink Asset Management, LLC. For the plans illustrated, it is assumed that record keeping and related expenses are accounted for separately and have no material impact on the comparisons made. (2) A bibliography of source material can be provided upon request.

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