The 401(k) Sucker Punch

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If I were tasked with the responsibility of creating a really terrible 401(k) plan, here's how I would do it. The first critical decision would be to retain a broker as an adviser to the plan. An insurance company could do the job as well, but brokers have a lot more experience acting against the best interest of their clients.

Merrill Lynch would be an excellent choice. With Merrill on board, I would be confident the plan will include a significant number of its proprietary funds. These funds pack a double punch. They have high fees. Their performance is often at the bottom of the pack. One study compared proprietary funds to independent funds over a ten year period ending June, 2002. The Merrill Lynch funds ranked eleventh out of the twelve funds studied. Since my goal is to really hurt plan participants, this is a great move. Over a ten year period, I could reduce the value of the plan participants' accounts by almost 50%.

I wouldn't stop there. I would insist the funds available to plan participants be retail funds because these funds have higher costs than institutional shares. I would do this even though I could easily negotiate lower than retail share costs for plan members.

I would also include as many actively managed funds as possible, because these funds will pay "revenue-sharing" to the broker. I will limit or exclude entirely index funds because they won't "pay to play." I know most actively managed funds will under perform comparable index funds in any one year and over the long term, so I can be pretty confident plan participants will suffer a further decrease in their expected returns.

Finally, I would include twenty or more fund options and I won't provide individualized investment advice to plan participants. Too much liability. Let's see if they can figure out how to put together a globally diversified portfolio of stock and bond funds in an asset allocation appropriate for their age and capacity for risk. Fat chance!

That should do it.

I know what you're thinking. This can't be legal. That's what participants in Honda's 401(k) plan thought. They brought a class action setting forth those facts (In Re Honda of America Mfg., Inc., ERISA Fees Litigation). The District Court in Ohio tossed the complaint. The court found that ERISA, the statute that's supposed to protect plan participants, doesn't require the inclusion of "any particular mix" of funds in the plan.

As for the claim that Merrill Lynch included higher cost retail funds when it could easily have substituted institutional funds, the Court found no requirement the fund advisers "search the market to find and offer the cheapest possible fund."

Wait a minute. Isn't Merrill Lynch a "fiduciary" of the plan? Doesn't it have a legal obligation to act solely in the best interest of plan participants?

Merrill advised the Court of its position as follows: "...Merrill Lynch was not acting as an ERISA fiduciary in connection with the conduct alleged in the complaint." According to Merrill, it was Honda that was the sole plan fiduciary since it had "exclusive authority" to select the plan's investment options. What a remarkable coincidence that Honda alone decided to include so many of Merrill Lynch's proprietary funds in the plan.

Brokers and insurance companies tell a far different story to employers when pitching their business. They throw around the "fiduciary" word with abandon and mislead employers into believing they will share legal responsibility in the event of a lawsuit concerning plan choices.

One major insurance company (John Hancock) comforts its clients with a "fiduciary warranty", complete with an impressive looking seal. The problem is the disclaimers on the back of the warranty which are more extensive than the "warranty" itself. The disclaimers provide ***"...***This Warranty and Indemnification does not, and is not intended to, impose or imply any fiduciary status or responsibility with respect to the Plan or any other person."

Of course, the disclaimer makes the "warranty" about as meaningful as a warranty on a new car, which excludes parts and labor.

This cat and mouse game is a national disgrace. It fools employers, who are not getting the protection for which they bargained. It penalizes employees who end up with a fraction of what they should have in their retirement plans.

There are many employers who really do care about their employees. For those employers, here is a checklist to insure a first class 401(k) plan:

1. Require the adviser to the plan to confirm in writing that he or she is serving as a fiduciary "under section 3(38) of ERISA." Accept no other language.

2. Insist the plan include a limited number of pre-allocated portfolios consisting solely of index funds, passively managed funds or Exchange Traded Funds, at different risk levels;

3. Require the adviser to the plan to agree in writing that it will meet with every plan participant to be sure the participant has selected a portfolio suitable for his or her level of risk. Advisers who have accepted 3(38) liability will not shy away from providing this kind of advice. Brokers and insurance companies will -- and for good reason.

Employers who follow this advice have the best of both worlds. They have significantly reduced their liability and have acted in the best interest of their employees.

Let's start a revolution!

Source: http://www.dailyfinance.com/story/investing/the-401-k-sucker-punch/19310100#