Qualified Plans Rock Through Bear Market

The rising demand for advice is changing the 401(k) business.

By Jeff Schlegel

The past several years haven't been kind to the 401(k) plan. Paltry returns for many of the mutual funds and company stocks that comprise the bulk of 401(k) assets, lawsuits against 401(k) plan sponsors, and the current investigations into mutual fund industry abuses and their potential impact on retail investors have all reflected negatively on 401 (k)s.

But as one of the workhorses in retirement planning, 401(k) plans will weather the storm, albeit with different expectations for investors whose shrinking portfolios and shattered confidence means they'll need more handholding and guidance. And it's a different world for plan sponsors, too, as high-profile lawsuits filed by employees over their 401(k) plans has more employers seeking third-party advice in running their plans and providing guidance for its participants.

Either way, the growing demand for help could translate into new business opportunities for advisors in the 401(k) market. "As people have lost a lot of money and confidence, they've throw up their hands and said, 'Ugh, I don't know anything about this stuff,'" says Malcolm Greenhill, a principal at Sterling Futures, an independent financial advisory firm in San Francisco. "So it makes sense they'll turn to people they think have competence in this area."

Greenhill offers fee-based 401(k) advice to Bay Area companies, some of who sponsor plans with unlimited choices from the likes of Charles Schwab & Co. Often, that's too much choice for employees to sift through and understand. Sponsors offering these plans are trying to do the right thing, he says, but they're opening themselves up to liability issues. "Those types of plans require a lot of education because it's easy for employees to make foolish mistakes."

Greenhill devises model portfolios and offers individualized advice for participants who want it. These types of arrangements aren't overly profitable, but they're a means to an end. "The reason I'm doing it is because it's wonderful positioning," he says. "What you want is for some of the executives and employees you're advising on their 401(k)s to eventually become your clients."

Increasingly, some of the people he advises are more than happy to hand over the keys to their 401(k)s to Greenhill and let him make the decisions. "I've definitely seen a trend over the past year or so where employees want me to do the allocation for them," he says.

Along those lines, one of the growing trends in 401(k)s is the demand for professionally-managed plans where plan providers enlist the services of independent third-party advisory firms to create actively manage portfolios for participants. NewRiver Inc., a financial data technology firm in Andover, Mass., predicts this option will be made available to at least 5 million plan participants in 2005, with about one million expected to sign up for these programs. In a survey of the 50 largest defined contribution plan sponsors, NewRiver found the factors behind greater interest in offering professionally-managed plans include increased participation and better asset-allocation for employees, as well as reduced fiduciary risk for sponsors.

Until recently, Employee Retirement Income Security Act laws forbade plan providers from dispensing advice to employees participating in a 401(k) plan because of conflict of interest concerns. Providers could offer online tools with generic advice, but that only goes so far with the majority of investors who lack the time, interest or knowledge to use them. And employers could enlist outside advisors to come in and provide education seminars and the like for their employees, but again, periodic financial pep talks often had little effect. Too often, the end result spelled trouble due to poor asset allocation and heavy reliance on company stock (a problem exacerbated by the fact that many companies substituted stock for cash as part of the company match).

When equities tanked, they took down with them the mutual funds and company stock that underpinned many employee retirement plans. Investor rage led to lawsuits against the like of Enron, Williams Co. and the former Worldcom, since renamed MCI. The notion of employer responsibility for maintaining prudent 401(k) plans is a pressing concern for many sponsors, and a 2001 decision by the U.S. Department of Labor opened the door for plan providers to offer direct advice to plan participants as long as it was done through outside independent advisors not affiliated with the provider.

"We're seeing more desire among sponsors for the use of advisory-type services," says Michael Butler, senior vice president at Nationwide Financial Services, which has written more 50,000 defined contribution plans (the majority being 401(k)s). “We’ve always offered tools such as risk-tolerance questionnaires and the like, but people tend to do them once and forget about them, and they often fail to rebalance their portfolio in changing market conditions. These management services are more actively involved.”

Nationwide is among several financial services giants that’ve rolled out professionally-managed 401(k) options. The roster also includes Fidelity Investments, Merrill Lynch & Co., Wachovia Corp. and American International Group Inc. In most cases, the companies partner with independent firms such as Ibbotson Associates or Morningstar that provide model portfolios based on individual participant’s goals and risk profile.

For example, Wachovia provides Morningstar with a list of roughly a dozen funds from its 401(k) offerings, with some of them being its own Evergreen funds. Based on information gathered via the web or from a call center, Morningstar consultants construct individualized portfolios for each participant. Because the average-sized 401(k) portfolio is only $40,000, Morningstar president John Rekenthaler doesn’t think this service cuts into the paychecks of the financial advisor community. “Financial advisors serve higher net-worth clients,” he says. “We’re serving the rest of the folks.”

In Nationwide’s case, it linked up with RIA Services Inc., a Garland, Texas company that brought together four registered investment advisory firms from around the U.S. to provide portfolio management specifically for Nationwide 401(k) plan participants. These money managers use computer-based modeling to select portfolios from among 600 funds in the Nationwide plan, including those offered by Nationwide itself. Plan sponsors appoint one of the four money managers for its participants to use if they choose to partake that option, and those who do let the managers invest their 401(k)s for them. Participation rate in the program is about 50% during its first year.

These plans don’t come cheap—participants pay management fees on top of existing fund expenses. With RIA Services, the fee can reach 1.5% for an actively-managed 401(k) plan. According to the company, that’s still 60% less than what wealthy clients normally pay for individually-managed accounts.

On a smaller level, The Scarborough Group has provided actively-managed 401(k) accounts to individual investors since 1988. Working independently of sponsors or participants, the Annapolis, Md.-based advisory firm manages $1.5 billion in assets from roughly 5,000 participants in more than 100 401(k) plans. “We talk individually with each plan participant to come to a consensus of who they are and where they should be from an investment perspective,” says company president Michael Scarborough.

The company uses Ibbotson for basic asset-class research, then uses its own advisors to construct 401(k) portfolios for each participant. Scarborough charges a flat $365 fee, so the larger the account the less onerous the fee. The company says the retention rate has held steady at about 85%.

Now Scarborough is test marketing the licensing of its back office services to help independent advisors who are actively involved in the 401(k) business. “Larger providers are entering the business and could potentially take market share from the smaller advisers,” says Scarborough. “We think our services can help the independent advisors compete in the 401(k) arena.”

Despite the market turmoil from the past several years, mutual funds remain the largest asset class among 401(k) plans. According to recent figures from the Employee Benefit Research Institute, as of 2002 equity funds comprised 40% of total 401(k) account balances. But the recent onslaught of news concerning the shenanigans in the mutual fund industry regarding late trading and market timing issues might give some investors pause about the use of mutual funds in their 401(k) plans.

“To us, this is bigger than Enron because it’s the trustee of your retirement fund that’s allowing these things to happen,” says Jeff Swantkowski, senior vice president at Kanaly Trust, a wealth management firm in Houston. “We’ll have to see how these investigations play out and whether this is a big blow up for mutual funds.”

Swantkowski, who advises individuals on their 401(k)s, believes the snafu could be an entrée for exchange-traded funds to play a bigger role in defined contribution plans. “Mutual funds are like insurance policies in that they’re sold rather than bought,” he says. “Not many people are pitching ETFs right now, which is why they’re not making much inroads among plan sponsors. But as ETFs become more prevalent, I think people will appreciate their low-cost structure and perhaps think twice instead of just dumping 401(k) money into Fidelity Magellan.”

Despite the recent black eye given to 401(k)s concerning performance and other issues, most advisors believe they’re still among the best retirement vehicles. “People got burned and they blamed their 401(k)s,” says Scott Kays, president of Kays Financial Advisory Corp. in Atlanta. “The real problem lies with bad investment strategy and getting away from basic asset allocation, not with the 401(k) itself.”

For his clients, Kays advises that they invest up to the full company match (if that option is still available) in their 401(k), which is generally in the area of 3% to 8 %. Then he advises investing to the max in a Roth IRA, and then going back to the 401(k) if there’s anything left to sock away. “Our approach didn’t change even during the recent bear market.”