Managing 401(k) Plans

September 2002

SECTION: Pg. 2

LENGTH: 1552 words

BODY:

Expert Advice On What Your 401(k) Plan Trustees Should Be Looking For

Many 401(k) plans select company presidents, human resource executives, CFOs or the like to sit as trustees for their 401(k) plan. As logical as this approach sounds i.e. key company decision makers should be overseeing the plan it overlooks a key point: Many of those chosen are ill-prepared to handle the job.

Training for plan fiduciaries from the Labor Department is, at this point, nonexistent, although the House's pension reform legislation called for the DOL to establish educational programs, albeit voluntary, for plan fiduciaries. And stories like those from Enron, Global Crossings and Rite Aid aren't boosting 401(k) participants belief in their plan trustees much either.

That leaves fiduciaries vulnerable and in many case unknowledgeable about the jobs they are expected to perform. Consider these examples:

1.Last year, First Union Bank, now Wachovia, paid $ 26 million to settle two 401(k) plan lawsuits filed by employees. In the lawsuits, the employees alleged that the bank charged them full price for financial services, although it gave waivers and discounts to outside investors for that same advice. Secondly, they said that the bank offered its own mutual fund in its 401(k) plan asset line-up to make the fund more attractive to outside investors.

The trustees at the bank, the Wall Street Journal reports, "didn't have the training or incentive to stand up and say, 'Excuse me, this isn't right,' Eli Gottesdiener, the plaintiffs lawyer in these cases told the Journal. One trustee, a human resources executive at the bank, 'didn't know the difference between the S&P 500 and the Fortune 500,'he adds."

2.Or take the case of Seagen Pharmaceuticals. In 1997, Oscar Campbell, the president and 401(k) plan trustee of the Gadsden, AL-based company, decided to withhold employee deferrals and the company match when the company ran into financial difficulties. His idea: Use those monies to make payroll until the company was in better financial shape. Then, the company could make up the $ 22,000 he had deferred to the workers affected.

When the Labor Department found out about Campbell's action last year, however, it sued, leaving Campbell confused since he did not know it was illegal. After all, he had intended to repay the money.

3.Imprudently investing money or for that mater not tracking funds carefully enough nis one area that puts fear in all plan trustees' hearts. Consider the case of Capital Consultants LLC.

The Portland, OR-based investment company convinced 27 union pension plan trustees to invest $ 150 million of plan money in a fund. What the trustees didn't know was that Capital Consultants was under investigation for investing hundreds of millions of investor dollars in high-risk private placements that purportedly fed a pyramid scheme. Allegedly, these officials ignored warnings from outside advisers about the advisability of investing with Capital Consultants. The 27 plan trustees now find themselves settling a lawsuit with the Labor Department to the tune of $ 16 million.

Investments key

Investments, poorly selected, monitored or invested are key to a trustees' oversight and more 401(k) plan trustees are taking steps to more carefully monitor their plan's offerings. In an excellent article in the May-June issue of Profit Sharing, Sandy Halim, CFA and a partner and director with Cost Effectiveness

Measurement Inc. (CEM), a global benchmarking company in Toronto, Canada, advised that fiduciaries, since they are held to the "prudent expert" standard under ERISA, should ensure that:

* The investment options are adding value relative to passive alternatives (i.e. beating their respective market indices). "Investment options do not have to be adding value every year to be appropriate. However, if an investment option continues to underperform its passive alternative, then you have two choices," notes Halim "make changes or maintain the status quo."
She recommends the second option only if trustees have a reasonable expectation that the investment will beat its benchmark in the future. "Comparing your investment options' value added to similar investment style funds is insightful because you may find that the 'style' itself is 'out of favor' at this time." That, says Halim, is a difference scenario than if your investment option is one of the few funds that is not ahead of its passive alternative.

* The performance of the investment options is not different from funds with the same basic style. Here, Halim cautions trustees to look at the wide spreads between a fund in their plan line-up and the average fund return. Say, for example, the core bond fund in your plan had a return of 14.5%, yet the average (index) return was only 9%. That's a red flag and could mean that the core bond fund manager has drifted away from its original style and is now a high-yield bond fund. "If this is the case, then action is again required, either to replace the fund or at least inform participants of the change in style," she advises.

* The fees are reasonable. Halim recommends that sponsors best do this by comparing what they pay to what similarly styled plans pay. The reason: Some options cost more than others. Considering plans with similar assets is also key, she notes, because "management fees are generally based on a declining asset-based fee schedule where the larger the asset base, the smaller the basis point cost." For a list of some companies that offer these services, see the sidebar to this article.

* Adding value. Investment costs should also be evaluated according to a managers' ability to add "value" or return relative to passive investment returns. "It may make sense to pay more for an investment option if the manager is adding a lot of value relative to passive alternatives," Halim notes.

Where to start

Whether plan sponsors decide to go to a more sophisticated benchmarking service, like those offered by CEM, or start the process themselves, it is critical to gather basic information.

To monitor investment options, gather the name of your fund, the investment option description, the assets held in the fund at the end of the period or year of analyses, the benchmark descriptions, the benchmark return in percent, the management fees charges in basis points and the management fees in thousands of dollars ($ 000) charged (see Table 1, page 3). To estimate dollars spent on management fees, multiply the basis point management fees with the holdings invested in each option.

Knowledge of administrative and fiduciary costs is also critical and a chart, like that shown in Table 2, is essential for fiduciaries to keep a leg up on the costs of their plans.

Lastly, Halim recommends that plan sponsors estimate their plan's total value added relative to passive alternatives by comparing each investment option's actual return to its benchmark return and weighting each investment option's value added by its holdings.*

Some companies that benchmark 401(k) plan costs

Cost Effectiveness Measurement, Inc. (CEM)
350 Bay Street
Suite 800
Toronto, Ontario
M5H 2S6
Canada
416-369-0568
www.costeffectiveness.com

CRA RogersCasey
Stephen J. Wagenbach

Managing Director
One Parklands Drive
Darien, CT 06820
Phone: (203) 656-5963
Fax: (203) 656-2233
Email: stephen.wagenbach@rogerscasey.com
Hewitt Associates LLC
100 Half Day Road
Lincolnshire, IL 60069
Telephone: 847.295.5000
Email: webmaster@hewitt.com
Web: www.Hewitt.com/hewitt
HR Investment Consultants
Joseph Valetto/ David Huntley
305 West Chesapeake Avenue
Baltimore, MD 21204
888-401-3089
www.401ksource.com
Mercer Investment Consulting
Barry Mclnerney
1166 Avenue of the Americas
New York, NY 10036
212-345-4500
www.merceric.com
Watson Wyatt Worldwide
Howard Crane
701 Fifth Avenue, Suite 2100
Seattle, WA 98104
206-812-7256
www.watsonwyatt.com

Table 1. Information Required for Investment Options-Example Plan

Investment Option in Millions	Asset at 12/31 Return in %	Annual Description	Benchmark Return in %	Benchmark (in bps)
Company stock	$ 50	9.0%	n/a	n/a
Large cap growth	150	10.5	S&P500	10.0%
S&P 500 Index	50	10.0	S&P500	10.0
Int'l Equity	50	14.5	MSCI EAFE	15.0
Bond Fund	150	8.0	Lehman Aggregate	7.9
Total Assets	$ 450			

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Table 2. List of Ongoing Administrative & Fiduciary Costs-Example Plan

Description	$ (in 000s)

Recordkeeping	$ 540
Communication/education	49
Fiduciary/oversight	112
Custodial & trustee	117
Audit	37
Other (Loan, hardship, QDRO, legal, etc.)	45