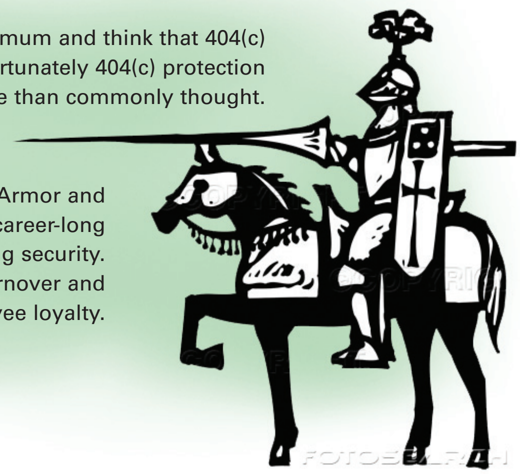
Optimizing Your 401(k) Plan

Reasons why and tips on how to maximize your company's plan for everyone involved.

By Jim Phillips

Some employers do the minimum and think that 404(c) is going to protect them. Unfortunately 404(c) protection is a lot more elusive than commonly thought.

Be a Knight in Shining Armor and establish a link between career-long service and life-long security. You can cut liability and turnover and improve employee loyalty.



It's time to shake up the status quo. Defensively-based plan management is shortchanging employees out of millions of dollars in retirement savings. Use this template as a powerful tool to help fulfill your legal and moral obligations. Identify and address your plan deficiencies now.

In ERISA there's an embedded concept known as *Duty of Loyalty*. This is the responsibility of anyone in a plan-level decision making capacity to act in a dedicated way to foster retirement benefits for plan participants and their beneficiaries. We interpret *Duty of Loyalty* as a mandate to do everything you reasonably can to ensure that the largest numbers of eligible individuals are able to retire with the greatest amount of financial security that their risk tolerance and circumstances will allow.

If you already perform a comprehensive annual review, some of these ideas may help to make it even more effective. If you're behind the curve, then make the commitment today to get serious about your *Duty of Loyalty*, and start enjoying:

- Reduced liability for the employer and the plan's individual decision makers
- Better testing results, perhaps increasing the amount your Highly Compensated Employees ("HCEs") can contribute
- Greater employee satisfaction with this part of the benefits package
- Enhanced efficiencies in plan operations, saving time and money
- Greater and broader wealth accumulation within your plan
- Enhanced corporate reputation, with recruitment and retention benefits
- Friendlier discussions when you get cornered at the water cooler

Action vs. motion: Don't accept mediocrity in this segment of your business' operations.

Please note: As you read through this template, your task may seem overwhelming. It's not. You aren't expected to possess all of the specialized skill sets needed. There is an expectation that you will use experts and resources to support your fiduciary actions, including:

- Knowledgeable employees could be invited onto your committee
- Plan recordkeeper or TPA
- Plan broker
- ERISA attorney
- Paid advisor

Review Basics

Who?
Usually fiduciary committee.

When?
At least annually. Mid-quarter works well, as it allows for compilation of metrics through prior quarter-end, and may improve attendance by key members who have more quarter-end time demands.

How?
Written report with documentation of all decisions.

What?
Content encompasses all relevant plan factors, including those listed on the next page.

Mission

Start the review with a statement of your plan's mission and make decisions accordingly. Make your mission consistent with ERISA and your organization's intentions.

Recent Events

Chronicle and discuss as necessary. These might include:

- amendments
- investment/provider changes
- HR/committee personnel changes
- demographic changes
- compliance issues
- audit activity
- progress toward stated goals
- discrimination testing results

The last item, testing results, offers a good segue into a review of plan participation and participant contributions.

Participation Review

Your mission statement (and ERISA) should point you toward the ideal of enrolling all eligible employees. Identify your non-participants and formulate an action plan. Collect relevant information, including:

- name
- compensation
- job title or description
- location
- age
- communication challenges

Look for patterns and formulate an action plan to communicate with each non-participant, in groups or individually. Illustrate for your non-participants the:

- availability of any company match
- availability of any federal tax credits
- availability of loans
- availability of help selecting investments
- retirement income gap they will face
- fact that only they or their beneficiaries can take their money out

If you have a widespread problem, have an internal discussion about using auto enrollment to pull non-participants into the plan. Your efforts could be worth millions. Converting "zeros" is hard but rewarding work, and it is part of your *Duty*.

Contribution Review

Analyze your most recent discrimination test results. Identify your low contributors and focus extra efforts on this population. Devise a plan to encourage all your Non-Highly Compensated Employees ("NHCEs") to contribute as much as they can afford. Provide personalized illustrations of the potential benefits.

Your HCEs need to maximize their 401(k) contributions, as Social Security will replace an even smaller part of their pre-retirement income. If your testing results currently limit them, discuss:

- the costs and benefits of adopting a Safe Harbor contribution feature
- an alternate testing method
- adoption of an alternate method of defining your HCE group
- a campaign to raise NHCE contributions

If you can add one or two percentage points to your plan's average contribution rate, the benefit could add up to millions of dollars of additional retirement security for your employees.

Allocation Review

Because more than 90% of an investor's return is determined by their asset allocation, we aren't fulfilling our *Duty* if we aren't providing effective allocation help. We all know that the average participant will not get this critical decision right without help, so form an action plan and make it happen. An allocation should be based upon a participant's risk tolerance and time frame. Age allows us to infer time frame, but age and risk tolerance don't necessarily correlate well.

- Consider *requiring* all participants to complete a risk assessment questionnaire
- Reconcile allocations to available risk tolerance and age data
- Look for allocation concentrations at the high- and low-risk ends of the menu
- Offer asset allocation models for conservative, moderate and aggressive temperaments
- Provide effective education on the importance of suitable allocation

If improved allocations add one or two percentage points to your plan's annual returns, the benefit could add up to millions of dollars of additional retirement security for your employees.

Investment Review

The design of your investment menu can impact participation and contribution rates, as well as rates of return so it is absolutely critical. Perform your review against the backdrop of your Investment Policy Statement ("IPS"). If you don't have an IPS, adopt one. Templates are available, including one from the PSCA's Web site, www.psca.org. Be specific, but retain flexibility. Some IPS elements to consider include:

- overview of the plan
- investment objectives
- selection of asset classes
- monitoring and reporting
- education and communication
- purpose of the IPS
- roles and responsibilities
- selection of managers
- investment replacement
- coordination with document

Under ERISA, you are also held to a *Duty of Care*. This is an unusually high standard — that of an expert in plan and investment matters. You are required to use the principles of Modern Portfolio Theory ("MPT") in your work. If you don't have this expertise in-house, you need to educate yourselves and/or use an outside expert to support your decision making.

A diversified representation of the major asset classes is a must. Consider your employee population and plan features. For example, unless your population is uniformly investment savvy, you might wish to avoid esoteric or highly volatile options. Another example: If your plan offers asset allocation models as investment options, include enough asset classes for proper model construction. Here's a list of some of the available asset classes:

Equity Investments

- Large-cap
  - Value
  - Blend
  - Growth
- Mid-cap
  - Value
  - Blend
  - Growth
- Small-cap
  - Value
  - Blend
  - Growth
- Other
  - Global/Int'l
  - Specialty
  - Company Stock

Hybrids

- Balanced
- Lifestyle
- Target Maturity

Income Investments

- Short-term
  - U.S. Gov't
  - Invest. Grade
- Intermediate
  - U.S. Gov't
  - Invest. Grade
- Long-term
  - U.S. Gov't
  - Invest. Grade
  - Other
  - Global/International
  - Mortgage-backed
  - High Yield
  - Inflation Protected

Consider additions and deletions and whether any special participant education is warranted.

If you offer Company stock as an investment option, discuss these and related issues:

- Does it belong in your plan?
- Should you limit allocation %?
- Do you have enough insurance?
- Does it create insider trading issues?
- Have you consulted ERISA counsel and a good securities attorney?

Select a manager for each new class and decide whether to retain your existing managers. For most plans, the term "manager" is largely interchangeable with "mutual fund," although it's possible to have a manager without a mutual fund or to have a mutual fund without a manager. In any case, look for above-average, risk-adjusted, relative net performance over relevant reference periods.

Above average
Better than 50th percentile ranking.

Risk-adjusted
Use MPT metrics such as alpha, Sharpe Ratio and standard deviation.

Relative
Use peer comparisons, e.g. against all Large-cap Blend funds.

Net
Utilize performance figures that have been netted of all costs.

Performance
Mean return.

Relevant reference period
Weigh more heavily the fund's performance under the current manager or team. Examine performance over a range of market and/or interest rate cycles.

Other review points could include:

Fees
Review the investments' and service providers' expenses for their reasonableness. They don't have to be the lowest, but they must be justifiable. Look carefully for all costs if you have a group annuity.

Stewardship
Are there any ethical or legal issues haunting your providers?

Asset bloat
Have any of your funds increased in size to the point where their future performance may be impaired?

Style drift
Are your funds still in their original asset classes or have they morphed into something else? (e.g. drifted from Large-cap Blend into Large-cap Growth, or Large-cap Blend to Mid-cap Blend)

If your menu is likely to cause confusion, clarify any ambiguities. If you have multiple entries in an asset class, explain why. If you have a target maturity fund that invests in zero coupon bonds, educate your participants about unusual price volatility.

Does your plan offer automated asset allocation models or another form of managed accounts? If so, evaluate their risk and reward characteristics. If not, why not?

If changes are deemed necessary, follow the process outlined in your IPS. This presumes your plan vendor affords you the flexibility you need to carry out your fiduciary mandate. For example: If you need to replace your International Fund, will your vendor provide a satisfactory list of alternatives? If not, consider a move to "open architecture" for the flexibility it brings to your investment selection and replacement process. Properly communicate changes to all plan participants, including terminated employees who still have a balance in the plan. If improved investments add one or two percentage points to your plan's annual returns, the benefit could add up to millions of dollars of additional retirement security for your employees.

Compliance Review

Cover any items not yet discussed, possibly including:

- Are you satisfied with the job of your recordkeeper or TPA?
- Are there any outstanding issues?
- Have all contributions and regulatory filings been made on-time?
- Have any required notices been distributed? (Safe Harbor, SOX, SAR, SMM, etc.)
- Are you covering everyone who is technically eligible?

Consider the advisability of having an operational compliance audit performed every few years by your ERISA attorney or other outside specialist.

Education Review

This is the lynchpin of the "3 Es" — Encouragement, Education, and Empowerment. Education will do more to improve your plan's performance and to reduce your headaches than you might imagine. Perform a continuing education needs assessment.

- What have you done in the way of participant education over the past year?
- What has been learned about the effectiveness of the content and delivery method? Remember, motion is different from action. We want to actually help the participants!
- Target your efforts where they're needed. If you have a participation problem, target that. If you have a contribution problem, target that. If you have a problem with participant investment elections, target that.
- Some education should be population-wide, while some should be group specific.
- If language is an issue, find a way to make it work. This not only makes common sense, but in some instances it's federally mandated.
- *Make your efforts relevant to the audience.* An older HCE might want to know about being able to contribute $20,000. However, a worker earning $20,000 would better benefit from learning about federal tax credits available toward their contributions.
- Ask representative segments of your population what sort of training they would like to receive. Think about inviting spouses to some types of education sessions.
- Provide education on risk. Help participants evaluate their individual risk temperament and to match it with an investment allocation.

You can be a Knight in Shining Armor to the people who depend upon you.

- Take clues from participant behavior. Get statistics from your plan vendor on website use. If there is little web use, it may be because they don't know how. Ask HR what the most common questions are. If you have too many loans outstanding, address the pitfalls. Be proactive.

Don't underestimate the importance of targeted education. It will lead to a greater amount of wealth accumulation in your plan, and that helps you fulfill your *Duty of Loyalty*.

Goals

Set goals for the coming year and assign tasks as necessary to carry them out. Make them relevant to your organization and population. Some goals could include:

- Raise participation rate by ____ percentage points
- Raise NHCE contributions by ____%
- Implement fund menu improvements
- Implement a system to help participants select a suitable investment mix
- Form a 401(k) Education Advisory Group to report recommendations to the Committee
- Conduct or contract for a compliance audit to identify any areas of weakness
- Secure training for Committee members and/or retain an expert to support the Committee's decision-making process

Conclusion

You can be a Knight in Shining Armor to the people who depend upon you. The average Social Security benefit is currently $959 per month. We all know you can't enjoy a secure retirement on that amount. Begin a campaign now to enroll your zeros, to bump up your average contributions, to rationalize your asset allocations, and to improve your investment menu.

Don't rubber-stamp the status quo! Use this template to improve your plan and show your employee population how much you care about their long-term well-being! Your hard work to Encourage, Educate and Empower your workforce could have a big dollar payoff, for them and for you.

Jim Phillips is the President of Retirement Resources. He may be reached at jim@ret-res.com.