



## The 401(k) could rule the future of defined plans. Long live the (k)ing!

THE 401(k) IS PERFECTLY POSITIONED TO BENEFIT BOTH COMPANY AND EMPLOYEE. BUT FIRST A FEW CHANGES ARE IN ORDER.

With all the talk in the media and in Washington regarding the demise of the 401(k) plan, we thought it important to take a few moments to look into what the future might hold for these iconic savings vehicles. As consultants that work with plan sponsors across the country, we have the opportunity to observe and help influence the direction of 401(k) plans for our clients. In our 20 years, we have been in the unique position of watching the evolution of 401(k) plans as they moved up the ladder of importance from a supplemental savings account to the primary retirement benefit for many Americans.

In a decade that has seen its share of market turmoil, 401(k) investors have been tested, as have the plan sponsors who have worked so hard to make sure their employees are given the tools necessary to save and invest in a prudent manner. While we would argue that the participant's have done an adequate job of staying the course, we are somewhat concerned that policy makers in Washington appear eager to tamper with one of the most powerful savings vehicles ever

created. So while some within the beltway scheme away, we would like to take a moment of your time to provide you with our vision of what 401(k) plans might look like in the future.

Although the first 30-plus years have provided the foundation for employees to take charge of their retirement, the current "look" of 401(k) plans has really

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been an end to a means driven by employers seeking to reduce the effect of rising benefits costs and uncertain investment returns on their balance sheets while offering workers an attractive retirement benefit. Changing corporate culture has also helped move companies from defined benefit (DB) to defined contribution (DC) plans. Spurred by increasing global competition many U.S. companies have become much more flexible from a staffing standpoint and arguably less paternalistic towards their employees. In turn, employees are less likely to spend entire careers at a single employer and are more likely to desire a greater level of control over their retirement assets, creating an



environment that for many favors the flexibility and portability of defined contribution 401(k) plans over DB plans. As we enter an era when 401(k) plans are expected to be the primary savings vehicle for financial security in retirement, both employees and employers need to acknowledge that a successful outcome requires active participation from both parties to overcome shortcomings in the system. The passing of the Pension Protection Act in 2006 addressed some key shortcomings of 401(k) plans with respect to funding and asset allocation. Encouraging the use of qualified default investment alternatives (QDIAs), automatic enrollment and deferral step-up provisions were solid improvements.

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However, if Washington is listening, we would like to see a few more advances:

**FIRST** – Create greater funding incentives for participants and plan sponsors, e.g., never remove the tax favored status of 401(k) contributions and the gains during the accumulation phase; enhance incentives for companies to make greater matching contributions without limiting how much highly compensated employees can contribute; and remove altogether the burden of discrimination testing. (For the most part non-discrimination rules only cause management to seek non-qualified options to enhance their ability to save.)

**SECOND** – Continue encouraging plan sponsors to implement professionally managed asset allocation solutions and educate employees on how the funds

should be used. We often find participants using the target date funds as they would the core options, when in fact these target date funds were designed as a single-fund solution.

**THIRD** – Encourage the financial services industry to create flexible low-cost income replacement products that offer more certainty from a distribution standpoint.

The 401(k) plan of the future can expand on its virtues of employee control and portability by encouraging a greater level of funding and simplifying the way participants invest and save. For the last 20 years, the corporate 401(k) plan has changed from a proprietary model where record keeping, communications and investment management were performed by a single company known as a bundled approach. In the last 10 years the model has been enhanced to give plan sponsors and their participants daily valued record keeping along with state-of-the-art web access, high touch print and electronic communications and what has been termed “open” investment architecture. The current model has also been structured in a tiered system, from an investment standpoint with plans that offer a number (usually about 12 to 16) of core mutual fund choices in the first tier, followed by a selection of risk based or target date funds in the second tier and finally, a third tier that may offer a limited access brokerage window.

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This structure offers employees many ways to invest, but still provides a high number of decision points that participants may find daunting. We believe that the “best of class” core fund line-up is still quite viable, since there will always be a number of participants that want to control their asset allocation. However, we believe this should represent the second tier of the investment offering, and that age-based or target date asset allocation solutions should represent the first tier and primary entry point for participants using the plan. Whether or not the plan sponsor should use a set of “off-the-shelf” funds for the asset allocation solution or a customized approach is up for discussion, but for the majority of employees this feature eliminates much of the anxiety they would encounter when deciding to participate in a 401(k) plan.

Many of the record-keeping providers are rolling out asset allocation solutions that allow the plan to leverage the underlying “best of class” fund offering through sophisticated asset allocation modeling tools. These tools can take into account the participants’ risk tolerance and time until retirement, and use this data to create a customized portfolio using the funds in the core line-up. The advantage to this solution is that the plan sponsor does not have to monitor another tier of funds, and as plan assets grow they are able to create economies of scale that will provide access to lower cost share classes in the future. The plan participants get transparency on how their savings are being invested as the allocations to each fund are revealed on their statement and website. Other advantages include the fact that plan sponsors can control the underlying quality of the asset allocation solution by making changes to

the core fund line-up without disrupting the entire plan.

A major problem with “off-the-shelf” target date mutual funds occurs when a fund in the array fails to meet investment policy standards. In this situation, the entire set of funds usually must be replaced. Additionally, target date funds tend to be more expensive for the participant and asset allocation strategies near retirement can vary greatly from one fund family to another. The downside of customization alternatives, though, is that they may create more decision points for the participant, and a communications hurdle for the plan sponsor.

## Ultimately, the future 401(k) plan should encourage savings through incentives, education and easy to activate investment solutions.

Ultimately, the 401(k) plan of the future should encourage participants to focus on saving through incentives, education and easy to activate investment solutions. These solutions help ensure that money saved is prudently invested based on the time horizon with an appropriate degree of downside risk protection. Plan sponsors should be encouraged through tax incentives to provide matching contributions and automatic enrollment so that plans cover the vast majority of employees. Ideally, defined contribution plans of the future would provide the sponsor with an easy to administer plan that allows for flexibility through an open investment architecture, easy to use communications tools, and clearly defined fees for record keeping and administration. Employees should be immediately eligible to participate with eligibility requirements on matching contributions only. The enrollment process should be automatic, with age-based asset allocation solutions providing the entry point for investment purposes. Default contribution levels should be set at five percent, with two percent automatic step-ups annually until at least 10 percent of gross pay is contributed annually.



Will it be enough? It is too soon to tell. Investment returns will always be uncertain and funding retirement plans will always be expensive. Shifting from DB plans to DC plans does not change that fact. However, we believe with the proper incentives, DC plans are a viable alternative to DB plans and that their shortcomings can be overcome without a major overhaul.

For more than two decades the principals and staff at Bidart & Ross, Inc., have helped plan sponsors and employees confidently understand and take command of their defined benefits and defined contributions plans. For more on Bidart & Ross' completely independent practice of fiduciary consultancy, visit [www.Bidart-Ross.com](http://www.Bidart-Ross.com), or contact a firm principal directly at:

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