*Retirement Plan Reevaluation and Design Issues Confronting Employers*

**Speech by Brooks Hamilton delivered to the**
**Employee Benefits/Executive Compensation Section of the Dallas Bar**

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# Introduction

Desk Side Chat with Monika Templeman,
Director of EP Examinations (Fall 2008)
Is My Plan the Right Plan?

> ***"Many plan sponsors are taking an interest in making certain they have the right plan, not only for themselves, <u>but for their employees</u>. As your business grows or changes, it is wise to re-evaluate whether your current plan is still a good fit. <u>I recommend contacting a tax professional familiar with retirement plans</u>. Deciding on what type of plan would be most advantageous is a crucial decision and <u>it is important to get the best advice possible"</u>.***

# Basic Problem

Corporate America's new retirement income strategy, launched around 1980 and based on phasing out Defined Benefit pension plans in favor of Defined Contribution 401(k) plans, is not working. How do we know? Well, consider:

**<u>First:</u>** half of all workers are not even offered a retirement plan by their employer;

**<u>Second:</u>** of the half which are, one-third of the employees eligible to participate in their employer's 401(k) plan decline to do so;

**<u>Third:</u>** of the two-thirds who do elect to participate, most contribute far too little, far too late; and

**<u>Fourth:</u>** most employees who both participate and also make material and timely contributions achieve dismal career investment returns.

Most employees (arguably >90%) are on track to retire in despair and run out of money in their seventies.

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Alicia Munnell, director of Boston College's Center for Retirement Research, puts it quite bluntly: ***"The 401(k) system has failed. As a major source of retirement income, it has shown itself unreliable - a point the financial crisis has driven home."*** Quote from a column by Anne Tergesen, <u>How to Fix 401(k)s</u>, in the Wall Street Journal December 13-14, 2008.

# Causes

While benefit gurus may differ as to whether any one factor is the primary cause of this PROBLEM, most agree that the following bundle of factors play a dominate role:

**EXPLODING LIFE EXPECTANCY:** We are living much longer. In 1900, USA life expectancy was 47.3 years; by 2003 it had soared to 77.4 years - a 64% increase, which is the greatest surge in over 5,000 years! And future increases in life expectancy may accelerate and dwarf this sharp increase. If retirement years exceed working years, what would such a demographic tsunami portend?

**SEA CHANGE IN CORPORATE STRATEGY:** A sea change occurred in America's retirement income strategy since ERISA became law in 1974, with Section 401(k) soon added in 1978. That drastic change was from a DB pension plan design typically costing a company 6% to 8% of payroll to a DC 401(k) savings plan design generally costing a company 2% to 3% of payroll. When ERISA was enacted in 1974 companies made 89% of what was then a relatively higher contribution to retirement plans; today they make just 49% of lower contributions. Result? Employees now must pick up the tab for this 40% company contribution reduction (i.e., from 89% to 49%) which has been achieved by means of a silent and stealthy cost-shifting.

**LOUSY INVESTMENT RETURNS:** Participants in 401(k) plans are achieving lousy annual investment returns. On November 3rd, 2003, John C. Bogle, founder and former CEO of the Vanguard Group and now President of the Bogle Financial Markets Research Center, addressed the United States Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security. Bogle testified that from 1984 to 2002 the overall stock market returned an average of 12.2% annually, mutual funds earned 9.3%, yet the average fund investor earned just 2.6%. This testimony may be found at http://www.vanguard.com/bogle_site/sp20031103.html.

**RUN-AWAY HEALTH CARE COSTS:** The soaring cost of health care is crowding out budgets for retirement in Corporate America's employee benefit design structure, resulting in far too little being saved for retirement, by both companies and employees, over the past generation.

**A NEW BUT "TOOTHLESS" ERISA FIDUCIARY DUTY:** ERISA has imposed a federal fiduciary duty and responsibility on corporate executives and directors who serve as *ERISA Fiduciaries*, requiring them to act exclusively in the best interest of plan participants and beneficiaries. But such executives and directors had a pre-existing fiduciary duty and responsibility to business owners. Query: has Congress unintentionally crafted and imposed an incurable fiduciary conflict of interest? Can any person faithfully serve two masters? Plan participants may believe they are safe, as fiduciary oversight is mandated by ERISA, but increasingly this appears to be a watchdog that doesn't bark.

**NOVICE DECISION MAKERS:** Since the early eighties there has been a seismic shift in how vital retirement plan decisions are made, from experienced professional and institutional providers engaged by an employer in DB plans, to the workers themselves (i.e., mostly financial novices) in DC 401(k) plans. One result is that several strains of an insidious "yield disparity" financial cancer have been detected but mostly ignored (more to follow). Furthermore, the qualitative change from a DB to a DC paradigm has also shifted inflation, market, and all similar financial and economic risks from the employer to the (novice) worker.

**SOARING LIFESTYLE EXPECTATIONS:** Finally, middle class lifestyle expectations have rapidly accelerated, and have also crowded out (along with soaring health care costs) a worker's ability, even propensity, to save for retirement. Compelling evidence is that the country's savings rate in 2005 and 2006 - that is, the

percentage of household income that consumers don't spend - slipped to a minus 0.5% in 2005, making it the third-worst savings rate in U.S. history, and then slipped even further to a minus 1.0% in 2006! A negative saving rate has happened only twice before in our country's history: in 1932 when the savings rate was a minus 0.9%, and again in 1933 when the savings rate was a minus 1.5%. Consumer spending for today's "essential luxuries" (IPods; flat panel HDTV; et cetera) has significantly diminished a worker's mental disposition to save for tomorrow's "essential necessities" (like food, housing, energy, et cetera) which retirement income will have to provide. Will the current meltdown permanently alter this behavior?

# Yield Disparity

Many in this room have devoted a professional lifetime to what has recently become a hot topic - *retirement preparation and readiness.* Thus defining what the average person should know about securing an adequate retirement income has become a lifelong quest for many of us, undertaken to help light the way, using a lamp fueled by moral virtue, down a dim path toward a dignified retirement.

Mark Twain famously said:

> *It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.*

The following thoughts and commentary are based upon several beliefs.

- Many (perhaps most) American workers will retire in despair and run out of money. About one-half of all workers are not covered by a retirement plan, and most of the half who are save too little, start too late, spend too much, retire too soon, and achieve paltry lifetime investment returns;
- Five key factors determine if we will be OK at retirement: (1) current age, (2) sum already saved, (3) future annual savings, (4) future annual investment yield, and (5) retirement age.
- ERISA has imposed the "highest duty known to the law" on retirement plan fiduciaries;
- However, corporate officers and directors who serve as an ERISA fiduciary already had a preexisting fiduciary duty to the company's owners. Thus, an unintended consequence of ERISA is that such officers/directors have been placed in an incurable conflict of interest, for no person can faithfully serve two masters.

Yield Disparity was first noticed in the early-nineties, and a few media gurus (such as Scott Burns) credit us with its discovery. Thus far three strains of Yield Disparity have been identified :

(1) Participant Yield Disparity,
(2) Market Yield Disparity, and
(3) Comparative Yield Disparity.

TYPE #1: Participant Yield Disparity is the "gap" in investment returns earned by those plan participants who do well investing their 401(k) plan funds as compared to the investment returns earned by plan participants who do poorly (most Plan participants are financial novices);

TYPE #2: Market Yield Disparity is the "gap" in the investment return between a particular 401(k) plan and the overall financial markets; and

TYPE #3: Comparative Yield Disparity is the "gap" in the investment return between a defined contribution

401(k) plan and a defined benefit pension plan established by the same company (note; both plans typically have the same ERISA fiduciaries).

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Illustration of TYPE #1:

Plan had 3,500 - 4,000 participants and over $125 million in assets: Year 1998

| | * * * Average for all Participants in each Quintile * * * | | |
|---|---|---|---|
| **Quintile** | **Average Pay** | **Annual Contributions** | **Yield** |
| First | $45,323 | 10.81% | **26.14%** |
| Second | $43,744 | 10.47% | **20.34%** |
| Third | $43,016 | 10.93% | **16.11%** |
| Fourth | $40,058 | 10.23% | **12.40%** |
| Fifth | $32,523 | 6.74% | **5.44%** |

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Illustration of TYPE #2:

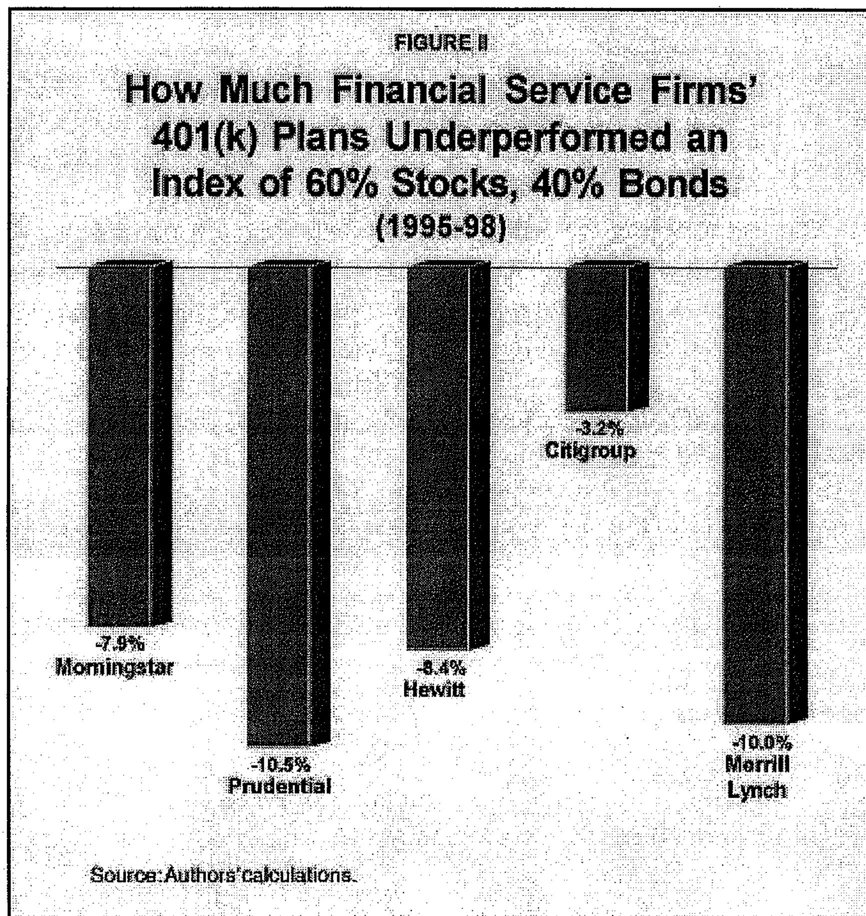

Illustration of TYPE #3:

| ITEM | 2003 Hrly Savings | 2003 Retirement | 2004 Hrly Savings | 2004 Retirement |
|---|---|---|---|---|
| Beginning | 4,446,787,767 | 14,293,645,358 | 4,590,420,865 | 17,315,035,684 |
| Ending | 4,590,420,865 | 17,315,035,684 | 4,575,555,085 | 18,283,549,458 |
| Average | 4,518,604,316 | 15,804,340,521 | 4,582,987,975 | 17,799,292,571 |
| Gross Income | 104,276,884 | 3,604,131,409 | (19,028,256) | 2,172,398,812 |
| Expenses | (189,328) | (40,605,104) | (183) | (44,630,830) |
| Net Income | 104,087,556 | 3,563,526,305 | (19,028,439) | 2,127,767,982 |
| **Yield** | **2.30%** | **22.55%** | **-0.42%** | **11.95%** |
| **Benchmark Index Funds** | **2,003** | | **2,004** | |
| **S&P 500** | **26.38%** | | **8.97%** | |
| **Plan Loss Compared to S&P Index Yield===>** | **(1,087,920,263)** | **(605,658,724)** | **(430,122,460)** | **531,171,438** |
| **TWO YEAR TOTAL $$$ LOST=====================>** | | | **(1,518,042,723)** | **(74,487,286)** |
| **$$$ Loss as % of Fund =====>** | | | **-33.36%** | **-0.44%** |
| **ACTUAL TWO YEAR INCREASE ===================>** | | | **1.89%** | **34.50%** |

The foregoing Yield Disparity illustrations were not "cherry picked" to prove a pre-conceived conviction or support a pet theory. The Plan used to illustrate Participant Yield Disparity (see page 4) was selected from several similar cases simply because investment yield data at the participant level was available to us. We have never identified the Plan Sponsor, and believe that would be irrelevant to the argument.

The five firms selected to illustrate Market Yield Disparity (also see page 4) were selected in 1999 as they were among the most popular, and thus visible, financial service organizations in the industry. They were chosen before the investment performance of their own 401(k) Plans was known. And had their 401(k) Plan investment performance been stellar, that fact would have also been published. After all, readers would have been anxious to learn the secret of their success.

Finally, FORD Motor Company was selected to illustrate Comparative Yield Disparity (see above) as FORD is one of the true icons of American capitalism.

**We invite others to join in a public discussion of Yield Disparity, as that should help reveal the basic truth - which in turn will enable all benefit industry patriots to assist others to maximize their opportunity to retire in the financial dignity worthy of a great people.**

# Your Fiduciary Legacy; Will it be

**A Constellation That Radiates Caring Conduct and Honorable Stewardship**

**or**

**A Black Hole Where Shameless Selfishness and Arrogant Indifference Lurk**

The following 6-Step Program is designed to assure that basic fiduciary responsibilities are not just met, but exceeded. Harmonize these steps to fit personal preferences so long as the end result is not affected.

| | |
|---|---|
| Value: | what is the primary value essential to our 401(k) plan? |
| Vision: | what is our vision of success that will enable us to achieve this value? |
| Metrics: | what metrics will tell us if we are making progress toward our vision? |
| Strategy: | what strategies will enable us to achieve our vision? |
| Projects: | what projects will enable us to implement our strategies? |
| Tasks: | what tasks need to be performed in order to complete each project? |

**VALUE:** The basic "value" of a retirement program may be measured by how well it provides plan participants with a reasonable opportunity to achieve an adequate retirement income proportional to their years of plan participation. Our plan value is simple: a reasonable opportunity for a full-time career employee to achieve a dignified retirement.

**VISION:** To attain this value, our fiduciary's vision will be that over 90% of eligible employees will participate in the plan; that plan participants will contribute an average exceeding 9% of their annual pay, thus capturing over 90% of the company matching contribution; and that funds allocated to these participants will earn over 90% of the market's average return. Soon a fiduciary will start thinking of this as a Triple 90% vision.

**METRICS:** To know how we are progressing, our fiduciary will utilize an age and service matrix, banded into cells at 5 year intervals, to annually measure three things regarding each matrix cell: (1) the percentage of eligible employees participating in the plan; (2) average match capture rate; and (3) average participant investment returns.

**STRATEGY:** Our fiduciary will recognize that default elections control plan attributes for most participants. Thus, enrollment will be automatic; participant contributions will begin at 5% of pay and will be automatically increased 1% of pay each year (up to the legal limit); and participant accounts will be automatically invested in a passive total market index fund conforming to MPT. Total plan fees and expenses will be controlled at less than 1% when all plan auto-pilot features are used (any sum that is greater than 1% will be reimbursed annually to the plan by the company).

**PROJECTS:** First, a fiduciary will work tirelessly and cheerfully to make certain that an Independent Participant Advocate (IPA) is appointed by the Board of Directors. In essence, an IPA will serve as a super fiduciary.

Second, our fiduciary will make certain that a targeted communications program is launched to inform plan participants as to their likely retirement income benefit based on their current age and account balance, projected contributions and investment returns, and assumed retirement age.

Third, our fiduciary will also encourage long term business planning focused on raising company contribution levels to 6% of the total annual payroll for all plan participants within ten years.

Fourth, at least every three years an economic analysis of costs will be conducted by an independent expert having no connection to the plan in order to verify that total plan costs (i.e., total economic impact) are (and have been) less than 1% regarding funds that are automatically invested. If the audit reveals that total plan costs have exceeded 1% the plan will be made whole in a manner approved by the IPA (to which the Board of Directors will have agreed in the Resolution appointing the IPA).

Fifth, annually a yield disparity analysis will be conducted by the IPA to identify the gap between those plan participants whose funds are automatically invested and those participants who have elected to personally direct investments in their plan account. That is, as some participants may reject the automatic investment plan feature and choose to personally direct the investment of their account, with plan fees and expenses that will thus likely exceed 1%, the yield disparity gap will be identified and published each year by the IPA.

**TASKS:** First, a fiduciary will cause to be placed in nomination before the Board of Directors 30 days prior to the next scheduled Board meeting the names of at least three persons deemed by the fiduciary to be qualified to serve as an Independent Participant Advocate (IPA). The fiduciary shall include biographical information on each nominee, as well as a proposal from the nominee outlining fees, terms, and conditions if appointed.

Second, as in the case of the IPA, the fiduciary will recommend at least three target communications programs designed to inform participants as to the level of their future retirement income. With regard to each recommendation, the fiduciary will include examples of communications that have been used by the provider; a client list; and a brief proposal from the provider outlining fees, terms, and conditions if hired.

Third, the fiduciary will schedule a series of quarter-day meetings with the CFO to develop a business plan designed to increase company contributions to 6% of the total participant payroll within ten years.

Fourth, once s/he has been selected, the IPA will recommend the tasks that will be required to complete the fourth Project (see above).

Fifth, once s/he has been selected, the IPA will recommend the tasks that will be required to complete the fifth Project (see above).

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The word *hope* has been prevalent of late.

Hopefully, I will not appear too audacious to trust that this 6-Step Program will help ERISA fiduciaries re-focus on fundamental Values, Visions, Metrics, Strategies, Projects, and Tasks which cumulatively will enable them to excel as a morally virtuous and prudent fiduciary!

**One indispensable asset required to achieve this goal is a knowledgeable, passionate, and committed member of the Employee Benefits Section of the Dallas Bar!**