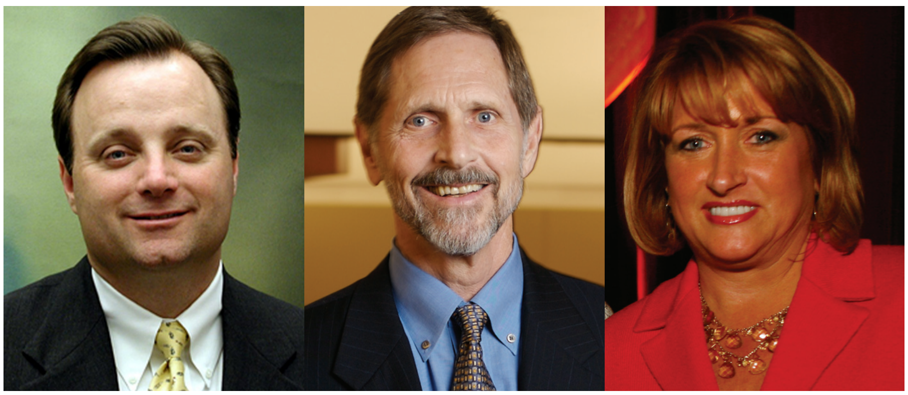
Measuring Up

Retirement plan benchmarks get more complicated, but how can an adviser keep up, and why should he integrate plan comparisons in his practice?



From left: Tom Kmak, Fred Reish, and Barbara Delaney

Determining how a retirement plan program stood up against competitors used to be as simple as determining whether or not people participated. However, as the defined contribution industry has matured, so has the number of benchmarks by which the industry measures plans; now a solid benchmarking process can include participation rates, deferral rates, how participants invest and preserve their retirement balances as well as individual wage replacement ratios. For sponsors, it now includes the services they receive as well as the fees and expenses they pay. As the defined contribution world continues to be under the microscope, proving that you add value for your retirement plans will become increasingly important. *PLANADVISER* spoke with Tom Kmak, CEO of Fiduciary Benchmarks; Fred Reish, noted ERISA attorney and Managing Director at law firm Reish & Reicher; and adviser Barbara Delaney of StoneStreet Equity about the value in benchmarking retirement plan programs, for both the plan sponsor and adviser.

PA: What are some of the fee issues being raised in the courts right now?

Reish: The single greatest concentration of litigation is over revenue sharing and, within revenue sharing, the compensation that recordkeepers are getting from the plan investments. Essentially, the claims are that, in their role as fiduciaries, the plan sponsors did not understand or were not even aware that the revenue sharing was being paid, did not understand the purpose of it, and did not evaluate those fees in a prudent process whether it was reasonable or relative to the services being provided. The only way to evaluate them is through gathering external data through, for example, an RFP process or a benchmarking service like Fiduciary Benchmarks.

PA: Fee disclosure, transparency, reasonableness, and value are all words that have been thrown around in relation to 401(k) plans, but what are the relationships among those four words?

Kmak: To me, it's just such a logical value chain—one thing leads to the other. You want fee transparency. Great. How do you do that? Well, you must disclose. Once you've disclosed, the next logical part of the chain is to ask if those disclosed fees are reasonable. The only way to answer that question is to see the value side of the equation. A 1985 Yugo does not give you the same ride as a 2009 Lexus, and they're priced differently. Every other industry has differences in value levels, and so does our industry, so it's a very natural, logical value chain in my opinion.

PA: Let's talk a little bit about the *60 Minutes* show and this piece about 401(k) fees. Earlier this year, *60 Minutes* ran a piece about 401(k) fees and that, as well as coverage of that issue in the mainstream press, have garnered quite a bit of attention. How is this affecting the dynamic in the 401(k) industry?

Kmak: It made me think of an interesting play on words: People can't see the forest for the fees. Indeed, fees are important, but there are many other things that are just as important if not more important. For example, the only way to really help solve the problem that we're having in the retirement industry is to focus on one participant at a time. Are they participating? Are they investing properly? Do they roll over their retirement balances? Do they even have a retirement goal? What I found so amazing about the 60 Minutes piece is that, while it indeed raised the level of awareness on the fee side, they completely missed several topics that are more important and just as newsworthy.

Reish: To me, it says that 401(k) plans are maturing. Their use is widespread. They're commonly accepted as the retirement plan of choice for employees and employers. As with any area that's maturing, you gain a greater understanding of the issues and, as employers have more experience, as the government has observed the situation more, I believe that the level of expectations is rising. Shows like this may do it in a negative way but, nonetheless, they help that process of increasing expectations, both on employers and employees.

PA: What does the Department of Labor have to say about benchmarking retirement plans?

Reish: Basically, the DoL has said, in a number of places, including Advisory Opinions 97-15 and 97-16, that plan committees and fiduciaries have to make informed decisions, with emphasis on the word informed. In other words, they have to educate them on the issues before them. They have to gather the information that they know is relevant for making an informed and reasonable decision.

Taking that even a step further, bulletins in 2007 say that fiduciaries have to engage in a process that's designed to elicit information necessary to assess the provider's qualifications, quality of services, and reasonableness of fees, and the DoL gives, as an example, that the plan sponsor could go out in the marketplace and conduct an RFP. Depending on the issue, I would think that you would be monitoring somewhere between at least every year or every third year, and most plan sponsors aren't going to want to go out on an RFP that frequently. In fact, no plan sponsor would reasonably want to go out on an RFP that frequently, both because of the cost and the effort.

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PA: Does benchmarking replace an RFP, or is this something that you're doing in conjunction with or in addition to an RFP?

Delaney: Long term, I think it replaces RFPs. My view about the RFP world right now is that, because we don't have a benchmarking system, we have to RFP. Right now, because we saw such a downturn in the market, we don't know who is going to get left standing. Who has capital and a long-term commitment to this business? I don't think you really know the answer to that question until usually 18 months after a bear market. So, right now, I am deferring RFPs and, instead, I am negotiating hard on fees. Of course, if a client has substantial changes on a platform, or makes mistakes that can't be fixed, or has challenges with relationships, then you need an RFP but, long term, it will be good for everyone if we have a great benchmarking tool with good data.

Reish: What do you do in between RFPs? You benchmark, but you benchmark data against comparably situated plan sponsors, and that's key. There is a fair amount of industrywide data available through a variety of reports and services that are either free or commercial. However, most of those are industrywide or at least they're for all plans kept by that provider.

What a plan sponsor needs to do is look at comparable plans because it's got to look at the relevant information, as pointed out by the DoL regulation. What's relevant for a $100 million 401(k) plan may not be the least bit relevant for a $1 million 401(k) plan. In fact, that's clearly true when it comes to issues like expenses. So, providers need to understand what issues they need to be looking at. They need to gather the data for their plan about those issues, their plan-specific data, and then they need to compare that to benchmarks for comparable plans.

For example, a law firm plan should look a certain way. It should have certain average account balances, certain participation rates, certain deferral rates, and so on. A hotel plan or a shopping mall plan will have much smaller account balances, many more employees who may not participate. A 50% participation rate may be moderate in the one case, 90% in the other. They're going to need that industry-specific data in order to be able to help plan sponsors have successful plans.

PA: Barbara, how do you use benchmarking in your practice?

Delaney: We've been benchmarking plans as part of our annual review process. We just went through the investment analytics part of that process. Then, once a year, we also do a full benchmarking. It's been strenuous at best. We use Fidelity's book, Principal's book, the Vanguard book, the PSCA book, the 401(k) averages book, and we try to take the best out of all of this data and build something that makes sense, but it is very strenuous and costly. It would be much better to have a premier benchmarking service rather than me gathering books all over my desk.

What we've been struggling with a little, and we're getting some help from outside consultants, is benchmarking our fees as fair and reasonable. NRP has developed tools based on plan size. Should you be paid more on more plan assets? Should it be scaleable? Should it be a flat fee? Flat fees actually hurt plan sponsors last year when the market went down. We had a plan sponsor that wanted to cap us at $100,000 for a $100 million plan, and we said we think it's more reasonable to have the first $100 million be seven basis points, the next $25 million be six basis points, and so on. That way, when the plan shrunk in size to $75 million, our fees were adjusted to a level that made sense for both parties.

PA: Tom, from your perspective, from the 50,000-foot level, what should a good benchmarking exercise include?

Kmak: I think the prudent fiduciary is trying to weigh fees versus value, so you have to make sure you understand fees, but not just at the total plan level. You have to go to the next level and understand at the service provider level how those fees are broken down because, even though total plan fees may look reasonable, if it's not proportionally allocated the right way, there is still liability there. Fred, am I correct in saying that?

Reish: Yes. There's a fiduciary responsibility to evaluate the revenue sharing or the flow of the money within the plan to see who is getting it. An RIA consultant gave me a perfect example a few years ago where, on the face, all of the mutual funds in the plans were reasonably priced. This was a very large plan, but there was one component of the program that was $1 million dollars overpriced that they adjusted for the benefit of the participants. Yet, viewed on a total cost basis, the plan was arguably reasonably priced but, in the example that I just gave, it's also false.

PA: How do you benchmark what's happening at the participant level?

Kmak: First and foremost, look at participation rates. Then, look at the percentage of salary that's being deferred. Also, look at how many people actually are contributing to the maximum match. That's like giving away free money. So, there are certain metrics you can look at in terms of putting money into the plan.

Second, look at metrics around how their investing behavior looks. Ultimately, you want participants to have a diversified portfolio, so that is what you should measure. Finally, take a look at what happens when participants terminate. Are they taking their pre-retirement money and buying the bass boat or the big screen TV? These are definite metrics that look at what basically happens to money in a qualified plan: You put money in, you invest it, you take it out, and each one is important. In fact, there's a mathematical example on Fiduciary Benchmarks' Web site where a 50-basis-point fee differential is clearly outweighed by someone who rolls over his money versus somebody who doesn't. So, mathematically, it can be absolutely proven that all three are critical. So, if you follow the money, you will have the right benchmarks

However, there is one new set of metrics and it reminds me of the quote from the Cheshire Cat in Alice in Wonderland: "If you don't know where you are going, any road will take you there." So, I think the best providers also are trying to make sure each employee has an individual retirement goal and they are measuring the progress each employee is making toward that goal. To me, this is *the* most critical metric and what our industry is ultimately all about.

PA: How do you benchmark the services an adviser provides to a client?

Kmak: When I look at an adviser, I see him or her as having an impact in three major areas. The first one is in the fiduciary oversight and best practice component about what's going on in the industry. These issues can really make a difference for the plan, and a really good adviser makes sure the client is aware of each of them when applicable.

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The second thing is that they do a really good job of making sure the client focuses on the right participant metrics: participation rates, investment behavior, rollover rates—those things already mentioned. A really, really good adviser can make sure that programs are in place to ensure those metrics are moving in the right direction.

Then, of course, there are some of the more typical things associated with an adviser: quarterly meetings, one-on-one meetings, or financial planning, which Barbara has mentioned has taken a back seat recently. All of those are very important services, too. So, I see advisers helping clients in three areas: support, services, and success measures.

PA: Tom, how is the Fiduciary Benchmarks service priced, and how can it help advisers with their practice?

Kmak: Our service is priced in one of two ways. You can buy an annual license that depends upon the plans, so someone like Barbara who has more plans and larger plans pays more than an adviser who is just getting into the industry and starting with small plans. The license allows you to use the service as often as you want. About two-thirds of the more than 100 advisers we have signed have chosen that model since it is an easy fixed expense. The other third of advisers buy plans one at a time, with plans under $10 million paying less than $100 for a report and plans with more than $1 billion in assets paying about $1,000 per report. We found it was important to provide the adviser community with flexibility in our pricing.

PA: Final question: Some people argue that service is a commodity in many ways and that all we need to worry about are fees. What do you say to that?

Kmak: Well, if we were at commodity status, every participant in America would be on track for a secure retirement and every plan sponsor would be safe from litigation. So, clearly, we still have plenty of room to improve and, since what gets measured gets managed, we better make sure we are measuring, or benchmarking, the right things.

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