

## Fiduciary Focus: Fleecing 403(b) Plan Participants (Part 7)

W. Scott Simon | 11-01-07 |

This column will be the last (for now) of my seven-part series on 403(b) plans. What follows is a summary of the most critical parts of those columns.

### **A Model 403(b) Plan**

The ideal 403(b) plan should (1) operate solely in the interest of plan participants and their beneficiaries for the exclusive purpose of providing them with retirement plan benefits, (2) have transparent costs, each of which is reasonable vis a vis the service provided in return, and (3) feature broadly diversified investment options designed, within a portfolio context, to reduce risk and increase return.

In the process of delivering investment products to public school teachers (and employees of non-profits) enrolled in 403(b) plans, though, the main focus is on the convenience and (unreasonable) profitability of the insurance companies that distribute such products. Little more than lip service is paid to what's best for the welfare of plan participants.

Yet, placing the interests of 403(b) plan participants first actually produces the best outcome for them. To help ensure that outcome, school district officials must jettison the absurdities currently plaguing so many 403(b) plans. Here are some suggestions for creating a model 403(b) plan.

### **Get Rid of the Multi-Provider Model**

The multi-provider model splits the 403(b) assets held by teachers into separate insurance contract accounts held at separate insurance companies. The single-provider model, on the other hand, allows school districts greater purchasing power, thereby resulting in lower and more transparent investment costs for teachers, and reduces administrative burdens

### **Get Rid of Annuities**

Annuities and other insurance products appearing on the menu of investment options in retirement plans are just too costly, with many running 200-500 basis points. Compounding this problem is the fact that these costs are usually hidden (because they're high). If a cost is hidden, it's not possible to determine whether that cost is reasonable in relation to the service or product received so that the recipient knows it's getting full value.

### **Offer a Menu of Prudent Portfolios of Mutual Funds**

Nobel laureate Harry Markowitz is the father of modern portfolio theory, not modern investment theory. The Employee Retirement Income Security Act of 1974 first applied key tenets of modern portfolio theory to the investment and management of assets by investment fiduciaries.

A basic tenet of modern portfolio theory is that properly constructed portfolios of investments are more conducive to wealth accumulation than individual, stand-alone

investments. The "proper" construction of a portfolio involves assembling mutual funds that have dissimilar price movements to each other. This produces a portfolio with reduced risk which not only decreases loss but can also simultaneously increase return.

The most effective and efficient way for a participant in a 403(b) plan (or any retirement plan) to reduce loss and thereby increase return is to invest in an automatically rebalanced model portfolio appropriate to the participant. That portfolio should comprise low-cost and broadly diversified institutional-level asset-class mutual funds and index mutual funds, providing market level returns at market-level risk. Offering a menu of prudent model portfolios of passively managed funds also generates reliable returns relative to model portfolio and asset class performance benchmarks, which greatly simplifies monitoring and reduces its costs.

To the extent that individual, stand-alone mutual funds are offered as investment options in 403(b) plans, school officials should include perhaps no more than 10-12 individual funds, each of which is broadly diversified, low cost and actually differs from the other funds offered within a portfolio context. An exhausting array of studies has shown that the more choices (of anything) people are given, the less confident they are in their selections--if they even make them.

### **Don't Allow Revenue-Sharing**

There's no need for revenue-sharing, so get rid of it. Insurance companies and other retirement plan services providers have bamboozled school districts into thinking that revenue-sharing is a way of life in 403(b) plans, but it isn't. Revenue-sharing is a legacy of the cost structure that needs to be in place to support a very inefficient system of gathering assets and distributing 403(b) benefits: individual contracts with individual participants. The current system is based on a retail model, not a wholesale one that could efficiently provide a true group benefit. There's no institutional aspect about the current system: no institutional provider and no institutional client.

### **Get Rid of Unnecessary Costs and Fees**

Jettisoning annuities as investment options in 403(b) plans gets rid of mortality and expense risk fees, death benefit charges, administrative fees, and surrender charges. There's also no need to pay commissions on investment products, any revenue-sharing fees (including subtransfer agent fees, shareholder servicing fees, and 12(b)-1 fees) or allow excessive brokerage commissions under SEC rule 28(e) "soft dollars" trading revenue, since the prudent portfolios I've suggested for a 403(b) plan need to pay for little or no "research." In addition, there's no need to pay finder's fees or placement fees.

### **Don't Allow Self-Directed Brokerage Options or Loans**

Let the small minority of plan participants demanding a self-directed brokerage option to trade exotic investments do it in their own personal non-retirement-plan accounts. A SDBO is a plan expense that other participants shouldn't have to subsidize.

Prohibit loans. Those who scream loudest for loans are the same ones who should avoid them like the destroyer of accumulating wealth that they are. This is another plan expense that other participants shouldn't have to subsidize. Note that prohibiting loans doesn't

prohibit hardship withdrawals, it just prohibits plan participants from treating their retirement account like an ATM.

### **Enroll, Educate, and Advise Plan Participants Online**

Enroll, educate, and advise 403(b) plan participants via the Internet. This requirement can be augmented by a voice response system, a 24/7 call center to handle non-investment questions (such as., "what's my pin number?") and a call center staffed by salaried financial professionals delivering impartial investment advice without selling any investment products.

School districts, of course, don't want to pay for this kind of education. Instead, the (surprisingly modest) cost for such education can be priced (in a fully disclosed way) into a 403(b) plan, which allows school districts to avoid paying for the education. All school districts have to do is to offer such educational efforts and get behind them; but they don't have to pay for them.

### **Provide Automatic Enrollment and Escalating Deferral Rates via the Internet**

Offer a centralized online information system that automatically enrolls participants and automatically increases the deferral rates for participant accounts.

### **Develop a Request for Proposal and Investment Policy Statement**

The use of a Request for Proposal brings rationality to the process of finding the proper services provider for a 403(b) plan. A well developed Investment Policy Statement is the roadmap to a plan that requires that it be so clear and complete that a competent stranger could read it and understand how the plan works.

### **Pressure Unions**

Unions should take an active roll in demanding better 403(b) plans for their dues-paying members. It goes without saying that unions shouldn't accept payments for product endorsements or any other financial support from providers that sell 403(b) products to union members.

### **Retain a Consultant for Guidance**

School district officials that wish to implement a model 403(b) plan should retain a consultant for help in guiding them through that process. Since this consultant will be--by far--the most influential person in this process, officials must be on guard for any biases it may harbor.

### **Retain Independent Legal Counsel**

Legal counsel should be truly independent in the sense of having no ties to any retirement-plan services providers or consultants.

### **School District Officials and Their Consultant Must Select the Initial Investment Options**

School district officials and the consultant they retain must select the menu of investment options for the model 403(b) plan before starting the process to select the winning retirement plan services provider.

### **Ensure the Consultant Doesn't Design the 403(b) Plan as a Supplemental Plan**

School district officials should ensure that their consultant designs the model 403(b) plan not as a supplemental retirement plan but as a stand-alone plan--whether a school district has a strong defined benefit plan or not.

### **Separate the Costs of Administering the 403(b) Plan**

School district officials must require the bidding retirement plan services providers to separate out the costs of administering the 403(b) plan. They need to make sure that providers unbundle each of the administrative services provided to the plan and match up the costs that correspond to them.

### **Require Cost-Free Conversion from the Old to the New 403(b) Plan**

If the winning retirement plan services provider conducts business in the existing 403(b) plan, school district officials must require the winner to promise in writing that it will convert all its business in the existing 403(b) plan over to the new 403(b) plan--without participants incurring any penalties, including surrender charges.

### **Require the RFP Winner to Assume ERISA Section 3(38) Responsibilities**

School district officials should require that the winning provider become (through written contract) an ERISA section 3(38) "investment manager," thereby making it an ERISA section 405(d)(1) "independent fiduciary" to the sponsor of the 403(b) plan and, by implication, to the plan participants and their beneficiaries. This means that such provider accepts full responsibility for the selection and monitoring of the investment options offered in the 403(b) plan.

### **Hope for the Future**

Under the new 403(b) regulations, school districts will clearly become plan sponsors and be completely responsible for everything that touches their plan including investments, expenses and all administrative matters. They can delegate to a provider but if that provider somehow screws up, the responsibility as well as the liability for same remains with the school districts. While school districts were always exempt from ERISA, they were never exempt from any rules at all. School districts must follow state laws on fiduciary duties as they were always required to do; they just didn't know they had to.

All elected school district officials have to do now is to know what the right thing is--the model 403(b) plan I have laid out (or something like it)--brace for a fight and then simply do what they already know is the right thing to do: implement the model.

---

W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to Understanding* is the definitive work on modern prudent fiduciary investing.

Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner and an Accredited Investment Fiduciary Auditor. Simon's certification as an AIFA qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA

retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

For more information about Simon, please visit [Prudent Investor Advisors](#) and [Prudent Investor Act](#), or you can e-mail him at [wssimon@prudentllc.com](mailto:wssimon@prudentllc.com)

*The views expressed in this article are the author's. They do not necessarily reflect the views of Morningstar. Feedback about this article may be sent to [advisorquest@morningstar.com](mailto:advisorquest@morningstar.com)*