Spring 2019

Clarity for Due Diligence in 401(k) Qualified Retirement Plans

Erin O'Reilly
Western Kentucky University, erin.oreilly554@topper.wku.edu

CLARITY FOR DUE DILIGENCE IN 401(K) QUALIFIED RETIREMENT PLANS

A Capstone Project Presented in Partial Fulfillment

of the Requirements for the Degree Bachelor of Science

with Honors College Graduate Distinction at

Western Kentucky University

By

Erin E. O'Reilly

May 2019

*****

CE/T Committee:

Professor Ron Rhoades

Professor Andrew Head

I dedicate this thesis to my parents, Arnold and Jennifer O'Reilly, who are a great inspiration to me. I would not be who I am today without my parent's encouragement and support. Also, I also dedicate this work to Dr. Rhoades and Professor. Head who helped greatly in acquiring the data and editing this thesis.

ACKNOWLEDGEMENTS

First and foremost, I would like to express my gratitude to my first reader, Dr. Rhoades. He has been an amazing professor and is who I have to thank for creating my passion for financial planning. I could not have asked for a more knowledgeable, patient, and caring mentor. I would also like to thank Professor. Head for being my secondary reader. Dr. Rhoades and Professor. Head have made the Financial Planning Department what is today by providing real life experience and scenarios to their students, while always offering real life help and advice along the way. If I had not had them as professors, I probably would not have pursued the Financial Planning Certificate. This certificate has helped me to land my dream job and be ahead in pursuing my dreams to become a CFP®.

Next, I would like to thank my co-workers at ARGI Financial Group for giving me real life experience and advice in the financial planning field. I would also like to thank them for encouraging me to build upon my education and pursue financial designations.

ABSTRACT

My focus for this project is to educate myself and my peers on the process of analyzing a 401(k) plan, specifically the due diligence that should be performed when analyzing a retirement plan. Specific aspects of this project will involve: (1) explaining the different roles needed to administer a 401(k) plan; (2) discussing an advisor's role in a 401(k) plan; (3) analyzing fiduciary duty levels; (4) reviewing the appropriate types of investments to include in a 401(k) plan; (5) providing suggestions for financial wellness programs; and (6) discerning the appropriate level of fees for each service. I seek to provide clarity for the overall due diligence process that should be performed by a plan sponsor before the plan enters into an agreement with an advisor.

It’s important for plan sponsors to be educated on qualities of an efficient 401(k) plan. At some point everyone will have to think about planning for their retirement and it is good practice to know in your early years if you are investing in an efficient way through your employer sponsored plan.

VITA

EDUCATION

Western Kentucky University, Bowling Green, KY May 2019
B.A. in Marketing – Mahurin Honors College Graduate
Certificate in Financial Planning
Honors Capstone: *Clarity in Due Diligence for 401(k) Qualified Retirement Plans*

Breckinridge County High School, Harned, KY May 2015

PROFESSIONAL EXPERIENCE

ARGI Financial Group, May 2018-Present
Financial Planning Intern

Landmark Financial Advisors, February 2018-May 2018

Financial Planning Intern

AWARDS & HONORS

Magna Cum Laude, WKU, May 2019
Velma & Clarence Evans Scholar, 2018-2019

PROFESSIONAL MEMBERSHIPS

Alpha Delta Pi, Epsilon Delta
Beta Gamma Sigma, WKU

INTERNATIONAL EXPERIENCE

Mystic Landscapes of the Emerald Island
Ireland Study Abroad 2017

PRESENTATIONS

O'Reilly, E. (2019, March). *401(k) Due Diligence*. Poster.
presented at the WKU Student Research Conference. Bowling Green, KY.

CONTENTS

SECTION ONE

The first aspect of a 401(k) plan is to identify the key roles needed to administer a plan. A 401(k) plan must have a Third-Party Administrator, Recordkeeper, and Custodian. Although not required, most plans also have an advisor to assist participants and plan sponsors. Participants are employees of the company that are participating in the 401(k) plan, and a plan sponsor is the employer who offers employees the option to invest in the plan. These terms will be used frequently throughout my thesis.

A Third-Party Administrator, sometimes referred to as a TPA, manages the compliance for a 401(k) plan. Compliance for a plan includes tax filing statements, managing plan documents, and performing annual non-discrimination testing. TPA's perform behind the scenes paperwork for plans, and do not really come in contact with participants besides to send plan documents or to prepare loan paperwork for participants if needed.

A Recordkeeper administers the website for participants to log-on and view their 401(k) balances and statements. The website should be user-friendly to where participants can easily change contribution rates, transfer funds between investments, and check current account balances. This website is also used for plan sponsors to upload payroll data and to track employer and employee contributions to participants' accounts. More often than not, the TPA and the Recordkeeper functions will be administered by the same firm. It is important to choose a Recordkeeper with a great website that is easy to log onto so participants will be more likely to contribute and understand how to use the site. A Recordkeeper should also be easily accessible for questions from participants regarding the website logon information and plan documents.

A Custodian is responsible for holding the money in the 401(k) plan. They act as a bank and move funds from the company's bank account to participants' individual investment accounts based on the amounts participants choose to contribute. The Custodian is also responsible for the transaction of placing trades in participants' investment accounts.

An Advisor's role in a 401(k) plan is to provide services to both the plan sponsor and to the plan participants. In most instances, the adviser is a fiduciary, which means that the advisor must always have the participants' best interest in mind.

Under federal law, the prudent investor rule applies to 401(k) plans. Both the plan sponsor and the advisor (if any) to the plan, as fiduciaries, possess the obligations under the prudent investor rule to not waste the participants' assets and to minimize idiosyncratic ("diversifiable") risk. This is accomplished by providing low-cost and diversified investment lineups for the plan.

An advisor may also possess the contractual obligation to educate participants on their options for investing in the company's 401(k) plan, and to be accessible for individual advice if needed. A company should care about their employees' financial success and take steps to help them achieve their retirement goals. An advisor can help add value for employees by providing financial education workshops or seminars.

As stated earlier, 401(k) plans are not required to engage advisors. However, advisors can bring great value to the plan through the application of their expertise, and advisors can reduce the liability of the plan sponsor. Most Americans do not have an adequate amount saved for retirement, and if they are saving it is generally through their 401(k). For this reason, having a great 401(k) plan is extremely important for employees and their future financial success. Normally, it is the plan sponsor's job to help participants sign up for their retirement plan and to review the plan each year diligently. Having an advisor for the plan can relieve the plan sponsor from making investment decisions and can also relieve some of their legal liability from the plan. This is accomplished by an advisor having 3(21) or 3(38) liability, which will be discussed in the following section.

SECTION TWO

Now that we have discussed the different roles that must be filled to administer a 401(k) plan, we'll shift to what one should be looking for when choosing an advisor. First and foremost, an advisor should be acting as a fiduciary. A fiduciary is legally bound to make the best investment decisions for their clients, which in this case are plan participants. There are two different levels of fiduciary duties under the Employee Retirement Income Security Act of 1974: 3(21) and 3(38).

A 3(21) investment advisor recommends fund lineups, gives advice, and oversees plan assets. This type of relationship is considered to be a co-fiduciary relationship; it is a limited role, as under this type of arrangement it is ultimately the plan sponsors choice to accept or deny the advisor's recommendations. 3(21) fiduciary services allow the plan sponsor to ask for an advisor's advice about the current 401(k) investment lineup but depends on the plan sponsor to make decisions and carry out tasks based upon the advice. For example, if a 3(21) advisor suggested switching one Target Date Fund out for another, it would ultimately be up to the plan sponsor to carry through with the decision and to communicate that decision to the company's investment committee.

A 3(38) advisor is fully responsible for fund selection, monitoring, and investment replacements. These advisors must evaluate a large variety of investment options, including low-cost and low-fee investments such as Exchange Traded Funds, Index Funds, and Target Date Funds. 3(38) advisors shift the decision making to the advisor rather than the plan sponsor.

With 3(38) fiduciary level, advisors are able to carry out tasks and directly make fund decisions. In the example mentioned earlier, a 3(38) advisor would be able to make a fund change decision without asking the plan sponsor; it would be the advisor's job to inform and educate the plan sponsor (or the plan's investment committee, if the plan sponsor has formed one) of why this change was necessary. These advisors take the full responsibility for investment decisions and should offer to lead investment committee meetings to review and update changes that may need to be made to the plan. A 3(38) advisor should feel confident enough in the recommendations they are providing to plan sponsors to be able to defend these decisions in court if they were ever asked to testify on a plan's efficiency. 3(38) relieves the plan sponsor of some legal liabilities when it comes to making sure their 401(k) plan is up-to-date, but this level of liability still requires the plan sponsor to monitor and evaluate their advisor at least annually.

A plan sponsor should evaluate their comfortability with investment making decisions when choosing between 3(21) and 3(38) liability. With more liability advantages and investment decision-making also comes a higher fee for 3(38) advisors. If a plan sponsor is confident in their current plan, does an adequate job monitoring the investment lineup, and has a fully functioning investment committee, then seeking 3(21) advice may be the best option. However, if a plan sponsor would like to take a more hands-off approach with the plan and know they are working with a fiduciary advisor, they may want to seek a 3(38) advisor to help service their plan and to educate their participants and investment committee members.

SECTION THREE

In this section, the types of investments that should be included in a 401(k) plan will be discussed. First and foremost, the investment selection has to be diversified. A diversified investment lineup is crucial to mitigate risk across different industry sectors in order to not have "all of your eggs in one basket". Investing in the stock market has historically been the best long-term investment vehicle available. However, predicting which industries or countries will provide the highest return in any given year is almost impossible to determine, which is why a diversified investment lineup is necessary.

There is a minimum of eleven asset classes that should be offered to have a properly diversified fund lineup: Domestic Large Cap Blend, Domestic Mid Cap Blend, Domestic Small Cap Value, International Emerging Markets, International Developed Markets, Real Estate, Inflation Protected Bonds (TIPS), Government Bonds, Intermediate Term Bonds, Stable Value/Money Market, and Target Date Funds. A combination made up of all these asset classes would provide a very diversified portfolio for an individual investor. One important aspect to consider is the more risk you take on, the more reward you are expecting to receive and on the flip side, less risk normally means less return for investors.

Domestic Large, Mid, and Small Cap are U.S. stocks of large, medium, and small sized companies. An example of Large Cap stock would be Apple, a Mid Cap stock would be Dollar Tree, and a Small Cap stock would be Etsy. Generally, Large-Cap stocks are less risky because they are more established companies and Small-Cap stocks are normally riskier but will provide a higher return on average.

It is important to have exposure to international stocks because the U.S. stock market historically acts inversely to international stocks. International stocks are generally divided into two categories: Emerging Markets and Developed Markets. Emerging Markets include countries that developing quickly, such as China, Brazil, India, Russia, etc. Developed Markets include countries that are economically established, such as Australia, Austria, Belgium, Canada, and Cyprus. Again, higher returns or higher losses can be expected to come from Emerging Markets because they are riskier than Developed Markets.

Bonds provide more security and less risk to investors because you are essentially loaning a company money and earning interest over the years from that company when you invest in a bond. Bonds can be short-term, intermediate-term, and long-term. Typically, you expect to earn more interest on long-term bonds because you are lending your money for a longer period of time, which means you expect to be paid more. Inflation Protected Bonds (TIPS) protect your money from rising inflation to assure your return is above the inflation rate. Which bonds an individual should invest in depends on an investor's time horizon/goal to accomplish with that money. For example, you would want to invest in a short-term bond if you were wanting a decent amount of return for money that you were planning to buy a car with in two years.

Money market funds are similar to keeping your money in cash. You can normally expect to earn 0.5% - 2% interest rate on your money depending on bank rates or if you're investing in an online money market fund. Online money market funds generally pay higher interest rates than brick and mortar banks and are also FDIC registered. These are safe investment vehicles that are risk-free, but do not protect against inflation.

Target Date Funds are the most common and most utilized funds found in 401(k) plans. These funds have become the default enrollment option for the majority of 401(k) plans due to their simplicity in nature. According to Investment News, Target Date Funds hold more than

22% of 401(k) assets and 73% of plans offer Target Date Funds in their investment lineup. Target Date Funds are popular for 401(k) plans because they are very simple and easy to understand for the average investor. These funds operate by taking the age of the investor and diversifying the funds based upon the year the individual plans to retire. For example, a 23-year-old investor would most likely be in a fund called "Target Date 2061" which means year 2061 would be when they plan retire at age 65. This fund would invest the 23-year-old in mostly stocks due to the long-time horizon of not needing this money until age 65. Having funds available that is easy for participants to understand the meaning behind the fund name is proven to increase participation rates within 401(k) plans. It is much easier for someone with little investment knowledge to pick a fund named "Target Date 2061", rather than picking a fund named "Vanguard Wellesley Income Fund". Target Date Funds can be very good templates for investing and encouraging participation, but they must be monitored to make sure the individual is comfortable with the amount of risk they are taking. Not one size fits all for investments.

A mutual fund is an investment fund made up of pooled money from investors who rely on a mutual fund manager to monitor and trade their investments. Mutual funds are typically composed of diversified securities selected by the fund manager, which typically include a mixture of stocks, bonds, and money market accounts. Due to the slight management of the fund, there are normally fees paid in either a front or back-end load fee. Front-end load fees are paid upfront when you initially buy the investment, and back-end load fees are paid when you sell your fund. Mutual funds are by far the most popular investment vehicles and have been around since the 1920s.

An exchange traded fund (ETF) is a security that can hold many different individual stocks or bonds under one fund name. An ETF is similar to a mutual fund in that it also is a security that holds many individual stocks and/or bonds under one roof. One difference between a mutual fund and an ETF is that mutual funds trade at the end of the market day, so they do not trade in real time as stocks or ETFs do. ETFs typically track a specific index, such as the S&P 500 or there are ETFs to invest in certain industry sectors such as commodities or real estate, etc. The main advantages for investing in ETFs are as follows: they typically have low fees/low trade costs and they trade in real time like a stock does, which means you don't have to wait until the end of the market day to place a trade. ETFs started to become popular in the 1990s and are considered to be the modern day (and better version) mutual fund.

Although ETFs have gained popularity in the last few years, they are still considerably underused by investors. According to Charles Schwab, ETF assets have grown to $3.28 trillion, while mutual fund assets total around $18.66 trillion. There is currently around $5.3 trillion invested in 401(k)s nationwide, with the majority of these assets being invested through mutual funds. As discussed earlier, Target Date Funds are the most common funds found in a 401(k) lineup and are often the default investment for participants. One reason ETFs are not commonly found in 401(k) plans is because Target Date Funds have historically been mostly composed of mutual funds. ETFs have many advantages when compared to mutual funds for the individual investor in a brokerage account, but not many advantages when placed in 401(k) lineups. As stated earlier, one big reason for this disadvantage is the lack of ETF exposure in Target Date Funds. ETFs and mutual funds are basically interchangeable when it comes to 401(k) plans as far as tax efficiency and trade costs/load fees, but typically mutual funds will be found instead of ETFs. When dealing with mutual funds or ETFs in 401(k) plans, it is crucial to look for low trading costs for an ETF and no-load funds for a mutual fund.

The combination of asset classes for the individual investor is based on their risk tolerance, which is defined as an investor's reaction/comfort level with market ups and downs. Risk tolerance should consider the investor’s age, time horizon, and their financial goals. For example, if an investor is 29 and is saving for retirement, they should be more heavily invested in domestic and international stocks because they have a long time horizon to capture gains and bounce back from losses. Despite an investor’s age, they also have to consider their individual personality and attachment to money. Even if an investor is 29 and “should” be investing primarily in stocks, if they cannot sleep at night due to the amount of risk they are taking with their money then they may have to scale back on risk and invest in less risky investments such as bonds.

It is crucial to help participants understand how they are invested and why they are invested. Participants should be invested in a way to best meet their retirement goals and aspirations. Now more than ever participants are relying on their 401(k) plans to completely fund their retirement. In the past, most Americans were able to feel at ease about retiring because they were fortunate enough to have a pension plan provide for their expenses after they stopped working. According to CNN, in the early 1980s 60% of companies offered pension plans to their employees. Today it is estimated that 4% of companies offer their employees pension plans, while 14% of companies offer both pension plans and 401(k) plans. These statistics prove that most Americans are saving for their retirement by utilizing a 401(k) plan, which means participation and clarity when investing in these plans are more important than ever.

SECTION FOUR

One key differentiator for a company looking to help their employees be successful financially is to offer a financial wellness program. It is an employer's responsibility to offer resources to help their employees be in great shape physically, through healthcare incentives like the go365 app and financially, by offering a financial wellness program. As I have stated several times, the majority of Americans are not prepared for retirement. Many Americans even live paycheck to paycheck each month. Most public-school systems and collegiate universities do not require a course on financial basics. For whatever reason, most people are completely lost when it comes to planning for retirement or building long-term wealth. This is why it is crucial for companies to take responsibility and offer their employees a chance to understand the financial benefits they are being offered by a company match through their 401(k) plan and to receive clarity on other common financial issues, such as college planning or budgeting techniques.
An employer can accomplish these issues by establishing a financial wellness program. A successful program should include on-site and open enrollment, individual advice, educational videos, company benefit seminars, and physical accessibility for enrollment or legal issues.

An on-site enrollment program means that advisors are coming to your company to enroll your employees in the 401(k) plan. It is best practice to have an open-enrollment feature on the plan to where an employee can choose to join the plan at any time during the year as long as they are eligible. When advisors come on-site to enroll your employees it is important to make sure they are explaining the benefits your company offers, such as a contribution match up to a certain percent. For certain companies that have third shift workers, such as a hospital or a factory, it is important to select an advisor that is willing to accommodate all shifts and come on-site multiple times during the year to enroll new participants.

During on-site enrollments, advisors normally provide individual advice if asked. This advice can range from establishing a participant’s risk tolerance or aligning their financial goals with the appropriate investment line-up. Typically, advisors who service a 401(k) plan may offer a discount for personal financial planning if a participant wishes to receive a deeper analysis of their current and long-term financial situation.

Another key aspect to look for in a financial wellness program is for advisors to produce educational videos on simple and common financial questions. Video examples would be the difference between a Roth IRA and a Traditional IRA, budgeting techniques, taking advantage of employer’s 401(k) match, the importance of establishing an emergency fund, general market updates, education planning, and debt services advice. There should also be videos available specific to the plan, such as how to change your contribution rate, etc.

Financial advisors should offer to host seminars for employees to learn more about company specific benefits that are offered to them. Some examples would include deciding which health insurance plan to enroll in, stock options, assistance in understanding disability and life insurance offered through the company.

In addition to all of these services, an advisor must be physically accessible to assist the plan sponsor. It is important to choose an advisor who has the ability to come on-site multiple times a year and provide the financial wellness services discussed previously. The plan sponsor would also want accessibility to the advisor to resolve any legal issues that may arise regarding the plan. Having an advisor that is accessible and timely when aiding the plan sponsor is one of the key aspects to seek in choosing an advisor for your 401(k) plan.

SECTION FIVE

It is crucial to examine and understand fees associated with each investment option available in your 401(k) plan. Typically, Exchange Traded Funds, Target Date Funds, and Mutual Funds will be the funds you will want to include in your investment lineup. Investment fees for low-cost Exchange Traded Funds or Target Date Funds in a 401(k) plan should have an average expense ratio of around 0.04% to 0.60%. These fees can vary substantially, but it is important to look for funds that are passively managed. Passively managed funds utilize more of a buy-and-hold strategy and are typically rebalanced annually. Actively managed funds normally have much higher fees because you're paying a fund manager to pick and choose stocks they believe will perform best in the current market. Historically, passive management is more likely to outperform active management for long-term investments, such as a 401(k) plan.

When deciphering advisor fees from a 3(38) or 3(21) advisor, the fees to be paid should be clearly stated. These fees are typically paid from participants' account balances, normally as a low basis point percentage around 0.06% to 0.08%. Advisors should not be compensated through commissions earned directly by selecting certain funds for the plan. When commissions are received in this manner, it creates potential for an ethical dilemma because advisors may be tempted to suggest funds that provide them with a larger commission bonus. 3(38) advisors are not allowed to be paid from commissions on funds, which is why plan sponsors should seek advisors offering this type of fiduciary service.

Implementing a financial wellness program with investment and financial literacy education can expect to have a fee attached that varies on the total plan size and how often the plan sponsor would like advisors to host these educational seminars. A range can be expected to be 0.80% for plans with very small total plan assets, down to 0.10% for plans with larger total plan assets. As with most things, when you are buying in bulk you receive a discount. So, when an advisor has a larger plan, fees will typically be lower.

After discussing a very broad level understanding of how a plan sponsor should be evaluating fees, the most important concept to remember is to employ an advisor you trust to act in your best interest. An advisor has a responsibility to make your job easier by being accessible to explain questions you may have regarding your 401(k) plan and how to improve it, so you know your participants are set up to receive the most out of their retirement plan.

CONCLUSION

Americans deserve a 401(k) plan that will help set them up for financial success, and a plan sponsor deserves to have a peace of mind that they are providing an efficient plan to their employees. A “great” plan is made up of the following attributes:

1. The plan sponsor must make sure their platform/website is user-friendly and dependable for their participants. If participants have difficulty using the website, they will be discouraged to participate in the plan.
2. The plan sponsor must decide on their comfortability level and capability with investment decision making. After they have identified how much assistance they would like with administering the plan, they should seek a 3(21) or 3(38) advisor to assist with investment recommendations or decision making.
3. The plan sponsor with help of an advisor must make sure the investment options in the plan are diversified, low-cost, and are suitable for the plan participants.
4. The plan sponsor is responsible for reviewing the plan annually to make sure the fees being charged are appropriate for the plan size. If a fiduciary advisor is servicing the plan, they are legally bound to not waste plan assets by choosing investments with large commission fees.
5. The plan sponsor should choose an advisor who offers a financial wellness program for their participants. A great financial wellness program should include open-enrollment, educational videos, seminars for participants, individual advice, and the ability to be physically accessible if needed.

Following these five steps will help tremendously in providing clarity for the 401(k) due diligence process. Ultimately, a plan sponsor and advisor’s goal should be to provide the best financial plan possible to help participants achieve their financial goals and aspirations, while also gaining an understanding in how their investments play a role in achieving those goals.

REFERENCES

Rhoades, Ron A. "The Dreadful State of School Districts' 403(b) Plans: How We Fail Our Teachers, and How We Can Fix This in a Bipartisan Way." *Western Kentucky University*, 2019.

O'Reilly, Erin E. "401(k) Education Training at ARGI with Jeanne Fisher." 12 Jan. 2019.

"3(38) Advisors and Different Types of Fiduciaries - What's in a Name?" *Brighton Jones*, 12 Dec. 2018, www.brightonjones.com/blog/338-investment-manager-fiduciary.

Malito, Alessandra. "Everything You Need to Know about 401(k) Fees." MarketWatch, MarketWatch, 7 Apr. 2018, www.marketwatch.com/story/everything-you-need-to-know-about-401k-fees-2018-03-30.

Dierking, Dave. "ETFs In Your 401(k): 6 Reasons Why They Honestly Don't Make Much Sense." *Seeking Alpha*, 28 June 2018, seekingalpha.com/article/4184510-etfs-401-k-6-reasons-honestly-make-much-sense?page=4.

Schwab.com. "ETF vs. Mutual Fund." *Schwab Brokerage*, www.schwab.com/resource-center/insights/content/etf-vs-mutual-fund-it-depends-on-your-strategy.

Iacurci, Greg. "7 Investment Trends in 401(k) Plans." *Target-Date Funds*, www.investmentnews.com/gallery/20180503/FREE/503009999/PH/7-investment-trends-in-401-k-plans&Params=Itemnr=2.

"Just How Common Are Defined Benefit Plans?" *CNNMoney*, Cable News Network, money.cnn.com/retirement/guide/pensions_basics.moneymag/index7.htm.