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The Seven Deadly Sins of 401(k) Plans

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America, we have a problem.

With corporate pension plans going the way of the dinosaur and the Social Security system looking weaker every year, 401 (k) plans have become the central component of most individuals' nest eggs. But these plans are peppered with flaws.

It's well known that Americans don't save enough, and voluntary 401(k) plans do little to rectify this chronic problem. But even good savers may not know that when companies set up savings plans, many rely on outside advisers that are beholden to mutual-fund companies. And these fund companies may charge lofty fees that are completely hidden from plan participants. A lack of education among employers adds to the problem.

"The 401(k) and retirement plan industry is on the brink of crisis," said Don Trone, president and founder of the Foundation for Fiduciary Studies, a nonprofit group that offers training for retirement plan sponsors and providers. "Baby boomers and generation X-ers are not going to be ready for retirement."

Defined-contribution plans such as 401(k)s -- which were originally designed to be only supplemental retirement plans -- are on the rise. In 1990, defined-benefit plans, or pension plans that companies funded, represented 69% of assets of employer-sponsored retirement plans, compared with 31% for defined-contribution plans such as 401(k)s. In 2002, defined-benefit plans were down to 58%, while 401(k)s and other defined-contribution plans were up to 42%. By 2012, 401(k)s and defined-contribution plans are expected to jump to 59%, with pension plans falling to 41%, according to research and consulting firm Greenwich Associates.

"Increasingly, the 401(k) plan may be the first and only equity investment an individual ever makes," said William Wechsler, vice president of Greenwich Associates.

A Brief History of 401(k) Plans
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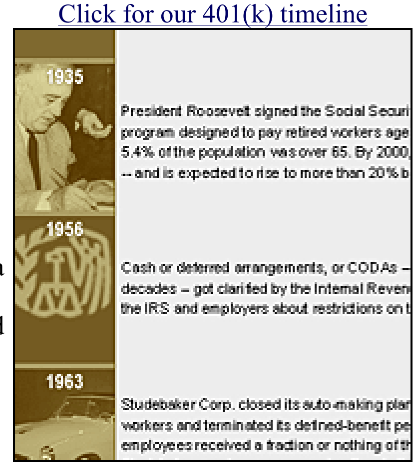

Indeed, more than two-thirds of Americans make their first equity investment through an employer-sponsored plan, according to the Investment Company Institute, a mutual-fund industry trade group. At the end of 2002, about 47 million Americans were participants in more than 432,000 401(k) accounts totaling $1.81 trillion in assets, according to the Employee Benefit Research Institute, or EBRI, a nonprofit retirement research organization.

To be sure, the growth in the investor class is a positive development. But Ted Siedle, a former **Securities and Exchange Commission** attorney who now runs Benchmark Companies, an organization that probes abuses in the asset management industry, noted a fundamental flaw: "Most 401(k) plans are terrible. The funds are lousy, the fees are sky-high, and the conflicts of interest hurt the individual."

So why are so many 401(k) plans awful, and how did they get so bad? A confluence of factors contributed to the problem, and the blame doesn't rest solely with the participant, the company, the outside consultants or the mutual funds -- although all play a part. Over the next few weeks, *TheStreet.com* will run a series of articles on the 401 (k) quagmire, culminating with a Bill of Rights that readers can present to their employers. Today's introductory column examines the Seven Deadly Sins of 401(k) Plans.

Of course, not all 401(k) plans are a mess -- some companies' plans have that serendipitous combination of informed employers who offer comprehensive investing plans via cost-conscious consultants, and asset-management firms that balance their interests with those of their customers. Before reassuring yourself that yours is such a plan, read the following Seven Deadly Sins. How many turn up in your plan?

First Deadly Sin: Lack of Education

Americans aren't saving enough. Optimally, according to Trone of the Foundation for Fiduciary Studies, the average individual should be saving 15% of his of her salary on a pretax basis -- this may come from a combination of employee-employer contributions, or fully from the individual. (For 2003, the dollar limit for 401(k) contributions is $12,000 -- that ceiling climbs to $16,000 by 2007.) A 10% savings rate might not be adequate for most workers to build a substantial nest egg, said Gerard Mullane, principal director of institutional sales at **Vanguard**. However, the current annual savings rate is 6.7%, according to the Employee Benefits Research Institute -- less than half the target rate. Plus, those numbers don't include workers who don't even enroll in their company plans.

While the collapse of the stock market may have investors thanking their stars that they didn't have more invested in the market, for younger workers with decades until retirement, the past few years will be a blip on the long-term radar screen. Older workers nearing retirement, meanwhile, should have had a high portion of their assets in safer investments. Meanwhile, the average account balance in 401(k) plans, excluding loans against the plan, is a mere $43,215, according to the EBRI.

Inadequate savings is the biggest booboo committed by individuals, but it isn't the only one. Many workers cash out their retirement plans when they switch jobs instead of rolling them over, meaning investors lose the vital benefits of compound growth over time. Others take loans against their 401(k) plans that chip away at retirement kitties. Furthermore, many workers make lousy investment decisions -- including putting too much money in their company's stock. Almost all of these issues pivot around one central theme: a lack of education, which is directly related to Deadly Sin No. 2.

Second Deadly Sin: Employers Don't Know What They're Doing

It stands to reason that many individuals have no idea how to make informed decisions regarding their investment plans, because the employers who oversee the plans often don't know what they're doing themselves. "Your 401(k) is usually organized by the personnel or treasury department -- by people who generally lack financial experience," said Gary Gensler, former undersecretary of the Treasury and co-author of *The Great Mutual Fund Trap*.

Ward Harris, founder of McHenry Consulting Group, a Berkeley, Calif., retirement-plan consultant, noted, "Most companies are busy making widgets and don't have the time or resources to educate themselves about retirement plans." Small and midsize firms, in particular, often find the burdens of educating personnel staffers in fiduciary responsibility unfeasible. So where do companies turn for help?

Enter consultants and asset management firms. Under this system, the company officials responsible for choosing the plans "get wined and dined by fund firms trying to sell them on letting them run their plans," Gensler said. What often ensues is that these outside firms provide the education and relieve the employer of the burden of paying for the administration of the plan. In exchange, the fund firm's offerings typically dominate the 401(k) plans.

There are at least two things wrong with this picture: One-half of 401(k) and other defined-contribution plans offer no advice, only "education," according to a survey by Greenwich Associates -- and the education at times more closely resembles a glossy marketing packet for the firm's mutual fund offerings. Of the half of 401(k) plans that do offer advice, most of that advice comes over the Internet. Only 16% of plans offer advice over the phone or in person, according to Greenwich. Even when the education is useful -- and firms such as Vanguard, **Fidelity** and **T. Rowe Price** offer exceptionally good Web sites -- studies show that 401(k) participants rarely use these tools.

Second, when the fund firms pick up the costs, they then pass them along to participants, who pay the administrative and service costs in the form of fees -- and because the fees are often bundled together in the 401(k) plan literature, most participants don't know how much this shift is costing them. "Payment for plan services has slowly moved from plan sponsors to participants," said McHenry's Harris, who wrote the 2001 research report, "Revenue Sharing in the 401(k) Marketplace: Whose Money Is It?" He added, "The employer is offloading expenses to you."

The employer is supposed to make decisions on investments solely in the best interest of employees, but "that isn't happening in most instances," said Ted Benna, who created and gained IRS approval for the first 401(k) savings plan. This hasn't been a burning issue among corporate America, because "companies don't have to write a check for 401(k) services," he said.

Benna did note that companies such as **IBM** (IBM:NYSE) keep a tight rein on the costs of the plans, with expenses running as low as 10 basis points, or 0.1%, compared with expenses as high as 300 basis points, or 3%, at other companies. "If employers can get a better deal, they have a responsibility to do it," Benna said.

In the overwhelming majority of cases, individuals have no idea what they are paying for their plans or even who receives their money, and that brings us to the third and fourth deadly sins.

Third Deadly Sin: Outside Consultants Are Conflicted

Roughly half of all employers' searches for mutual fund firms now involve outside consultants, according to Greenwich Associates. By and large, this is a good development, says Greenwich Associates' Wechsler. "The individual's only question -- 'What do I do with my money?' -- wasn't getting answered by the company or the money management firm, because they were afraid to. Finally, there is somebody in this whole process willing to answer the question."

That's the good news, especially if the consultants provide independent, highly informed advice that isn't influenced by anything other than the potential benefits to their retirement planning. Of course, Wechsler and others acknowledge that the consulting business is rife with conflicts of interest that align the consultants' aims more squarely with those of the mutual fund firms.

Many consultants are also in the business of selling services to the very money managers that they recommend on behalf of their clients. And since consultants conduct the lion's share of their business through a few big mutual fund firms, they are eager to maintain favorable relations with them. "It's pay to play," said Trone of the Center for Fiduciary Studies.

Some of the biggest 401(k) consulting firms provide services to both plan sponsors and money managers, including Callan Associates and Mercer Consulting. Neither firm could be reached for comment for this story, but Callan's Web site details its efforts to reduce potential conflicts of interest, including "disclosure of all business activities and relationships."

With some outside consultants, "you are potentially replacing an ignorant arbiter on investment issues -- the participant -- with a conflicted arbiter," said Greenwich's Wechsler. "It's not clear you'll end up with better results."

Fourth Deadly Sin: Fund Firms Look Out for No. 1

It's easy to understand why the 401(k) business became so popular. Individuals and employers realized the benefits of a portable plan that was funded by workers. Meantime, mutual fund firms recognized a potential gold mine from a new, steady stream of pretax investments. While a number of firms take great care to carry out their fiduciary responsibilities in a way that balance investors' needs with their own, many mutual fund firms focus almost singularly on the marketing-driven pursuit to gather and retain assets while extracting the highest possible fees, with potentially devastating consequences to your nest egg.

"The mutual fund business is a great business -- if you happen to own a mutual fund business," Gensler said. "If you invest in the mutual fund business, it's not always the greatest thing."

The potential conflict of interest regarding mutual funds and 401(k) participants is self-evident: Firms would like to keep as much of your assets in their own funds, even if they aren't the best options, and implement a fee structure that funnels as much money as possible back into their coffers.

The fund industry acknowledges that disclosure and potential conflicts of interest exist in the 401(k) industry. "401(k)s have been a good way for about 44 million Americans to put their money in the market," said John Collins, spokesman for the Investment Company Institute, "but proper disclosure has not kept up with the demand for it. Participants should have a way to know everything that they are paying."

Fifth Deadly Sin: Excessive Fees -- Disclosed and Hidden

The abstract notions of conflicted consultants and mutual fund firms crystallize around one issue: fees. The greatest myth in the 401(k) arena is that the plans are "free," said McHenry Consulting's Harris. "Much of the costs in the 401(k) business have been less than fully disclosed. I know how much the Chevy dealer made on my truck, but I don't know how much Fidelity makes for managing my 401(k) plan."

The mutual fund industry is a highly competitive one, especially in the lucrative 401(k) arena -- and firms rely heavily on brokers, consultants and other financial-service professionals to peddle their wares. In exchange for services rendered from brokers and the like, fund firms have concocted a bevy of ways to pay back brokers. Some, such as load and 12b-1 fees, are disclosed; others take the form of "soft dollar" revenue-sharing agreements, such as excessively high trading commissions, which go largely undisclosed. Harold Bradley of the American Century fund family estimates that soft-dollar payments compose about four-fifths of the fees fund companies pay on trades. American Century doesn't engage in soft-dollar deals, but the majority of fund firms do.

The use of soft dollars has mushroomed since Congress first enabled it in 1975. Typically in these transactions, fund firms use investors' money to pay for services from the brokerage industry -- research services and such that theoretically benefit the individual. Many of these soft-dollar arrangements aren't even recorded on paper, according to Bradley. The costs of these services typically turn up in trading commissions: The average commission rate is more than 5 cents a share, compared with the 0.85-cent cost of trading electronically, according to Greenwich Associates. What are participants "paying for" via these soft dollars? Research, yes. But also, according to a list compiled by Bradley, soft dollars may pay for a fund firm's accounting services, telephone bills, computers -- even membership at the tony Standard Club of Chicago. The overwhelming majority of 401(k) plan participants have no idea what their money is used for, because these deals aren't disclosed. "They're soft dollars because it's not their money they're spending -- it's yours," said McHenry's Harris.

"The entire system is based upon picking the investor's pocket -- it is a round robin of kickbacks where you get left out," Gensler said. (A forthcoming article in our 401(k) series will delve further in to the many fees -- disclosed and hidden -- they eat away at investors' retirement plans.)

During the roaring 1990s, with 15% annual gains in the stock market and 10% gains in the fixed-income market, individual investors paid precious little attention to fees, and that clearly led to excessive fee payments. "It's time to revisit excessive costs," Siedle said.

Sixth Deadly Sin: Bad or Inadequate Choices

A few years ago, the fund choices offered in many 401(k) plans were fairly straightforward. If Vanguard ran the plan, it offered Vanguard funds. If **Oppenheimer** ran the plan, it offered Oppenheimer -- the same held true for Fidelity, **T. Rowe Price** (TROW:Nasdaq) and so on. Then a funny thing happened: **Janus** (JNS:NYSE) .

"When Janus funds exploded in the 1990s, investors saw the performance and started asking, 'Why can't I get Janus? Why am I stuck with these dogs in my 401(k)?" said an official at one consulting firm. "So the company providing the plan sponsor asks the consultant or the fund firm, 'Yeah, why can't we have Janus?'"

This led to "open architecture," through which firms began including funds outside of their stable of offerings -- from Janus and a host of other outside fund firms. "Open architecture has become the *sine qua non* of 401(k) plans," Greenwich's Wechsler said. Indeed, firms such as **Charles Schwab** (SCH:NYSE) have had great success offering access to a "supermarket" of hundreds of mutual funds for 401(k) plans.

Despite the abysmal postbubble performance of many Janus funds, a wider array of fund choices has been a positive development -- even though experts say too many fund choices can pose a problem for uninformed participants. Still, a great many 401(k) plans still have inadequate fund options that make it nearly impossible for investors to build a diversified portfolio of low-cost funds.

Even with the funds from outside the plan provider's roster, the fund firm still has an interest in recommending its own funds because they collect much higher fees. "There still needs to be greater diversity of brand names," Trone said, adding, "access to a few index funds is a good litmus test to see if the 401(k) plan isn't conflicted."

Indeed, the American Law Institute in 1992 refashioned its Prudent Investor Rule to state that actively managed funds have additional costs and risks and that index funds are a practical investment alternative.

However, in part because of a lack of education among employers and participants, "the participant is paying for the plan, but they have no control over the funds or the costs -- all they know is, they're stuck with crappy funds," said McHenry's Harris.

Seventh Deadly Sin: Rules? There Are No Rules!

After reading over the previous six deadly sins, readers can't help but wonder: How did all of these problems come to pass? Primarily because the rules that govern behavior within 401(k) plans range from unclear to nonexistent.

"If the chairman of a company's 401(k) committee called the Department of Labor and asks, 'What should I do to make sure I fulfill all my responsibilities?' There would be no answer, other than act prudently," Trone said. If the same chairman then hired an investment adviser to handle the 401(k) plan and "the adviser calls the Securities and Exchange Commission and asks the same question, there would be no real answer," Trone said. "The industry has never defined the details of a prudent investment process of fiduciaries."

Greenwich's Wechsler said the rules aren't entirely firm because "the 401(k) revolution was an unplanned one."

In the wake of the devastating bear market that left many investors pushing their retirement plans back a decade or more, efforts to reform the 401(k) industry and codify the rules that govern these plans are gearing up. Trone's Center for Fiduciary Studies in Pittsburgh trains employers, consultants and advisers in fiduciary responsibility and portfolio management.

Meanwhile, lawmakers and regulators examine the issue in committees. However, while reform is needed, individuals shouldn't wait with the hope of intervention from politicians. As Bridgeway Funds' founder John Montgomery told lawmakers regarding soft-dollar commissions this spring, quoting fellow Texan Ross Perot: "If you see a snake, just kill it; don't appoint a committee on snakes."

Retirement-industry experts see the best shot for genuine change in the 401(k) industry originating from within the group that has the most at stake: individual investors. "There's not going to be any real reform that will eradicate conflicts of interest," Siedle said. "These guys in Washington might demand more prospectus disclosure, and the fund industry will roll their eyes and go along with it because they know it won't change anything.

But, Siedle added, "we have this huge retirement population -- baby boomers and younger. If we get a large and informed population that wises up, that's my best hope."

What can individuals do? In the final segment of our multipart series, we'll provide readers with a 401(k) Bill of Rights that they can present to employers -- and help get the process of reform rolling.