$450,000

PER PARTICIPANT…

The Value of an Independent Fiduciary

Published by
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Greenspring Wealth Management and Matthew D. Hutcheson are separate and distinct Independent Fiduciaries mutually concerned about improving the future retirement security of American workers. Questions about this paper should be addressed to Mr. Joshua P. Itzoe via email: josh.itzoe@greenspringwealth.com.

Premise

"True prudent fiduciary practices should deliver optimal results. Poor or partial fiduciary practices will deliver sub-optimal or even poor results."[1]

The previous statement is from written testimony associated with the March 6, 2007 Congressional Hearings on "Are Hidden Fees Undermining Employee Retirement Income Security?"

Although that statement is sufficiently clear and simple by itself, its succinctness may lead a reader to overlook the greater substance of its meaning. The statement reveals that many 401(k) plans are, to a full or partial degree, managed by non-fiduciaries, or more accurately, those who claim not to be fiduciaries. Service providers or individuals who resist fiduciary status also resist the high level fiduciary standards of care associated therewith. Those standards exist for the benefit of participants and beneficiaries, and are critical to producing optimal long-term results.

Apologists suggest that it does not matter whether service providers accept fiduciary status or not. We disagree. In fact, we believe that the value of an Independent Fiduciary to both a plan sponsor and participants is not only measurable, but is substantial. This paper will explore and expose the economic impact of utilizing an Independent Fiduciary, and inversely, reveal the cost of the status quo.

Prudence: An Independent Fiduciary's Stock-in-Trade

Prudence is the keystone of all Independent Fiduciary procedures, processes, behaviors, actions, etc. Without it, sub-optimal results are certain. But what is prudence?

Prudence is: *"the attitudinal environment of loyalty in which all circumstances and events are judged, decisions are made, actions are taken, consequences of those decisions and actions are evaluated, and responsibility taken for those decisions and actions."* [2]

It is within that environment of loyalty, resting upon Four Pillars of Prudence, that optimal results are produced.[3]

The Four Pillars of Fiduciary Prudence

- Fiduciary Judgment
- Fiduciary Decision
- Fiduciary Evaluation
- Fiduciary Accountability

An Independent Fiduciary's practice, founded upon those four pillars and operating with an environment of loyalty, will produce optimal results for participants and beneficiaries. We assert that the value to an ordinary thirty-five year old 401(k) plan participant over the next thirty years exceeds $450,000.

The Interplay between Fiduciary Standards of Care and Plan Costs

Are costs really that important? Yes. Morningstar's director of mutual fund research, writes, "Look for low costs—still the best predictors of performance."[4] Managing plan costs may best be accomplished by a professional Independent Fiduciary due to its inherent complexity. The compelling economic reasons will follow.

As a matter of meeting fiduciary standards of care, managing costs is the first item of business. Decision makers, whoever they may be, must at first be able to evaluate whether a particular service is sufficiently valuable to pay for. Yet the current state of the industry obscures both fees/costs and the services they underwrite, impeding a fiduciary's fundamental duty.

In 2006 the 401(k) industry generated roughly $85 billion in revenue through investment management fees and administrative charges. That $85 billion equates to over 3 percent of the combined retirement savings of the 50 million American workers who actively invest in 401(k) plans. The consequences of those fees are significant. Using Government Accountability Office assumptions, fees of 3 percent will cut retirement income by over 70 percent over a forty-year career. If the present situation persists, millions of American

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workers will be deprived of the opportunity to retire with dignity.

There are several significant inefficiencies in the 401(k) industry that illustrate the present situation, including but not limited to a lack of transparency or disclosure of fees and a misalignment of incentives on the part of employers and providers.

The two primary concerns about the current 401(k) environment are fiduciary indifference and the lack of fee disclosure. Sadly, these two issues are closely aligned.

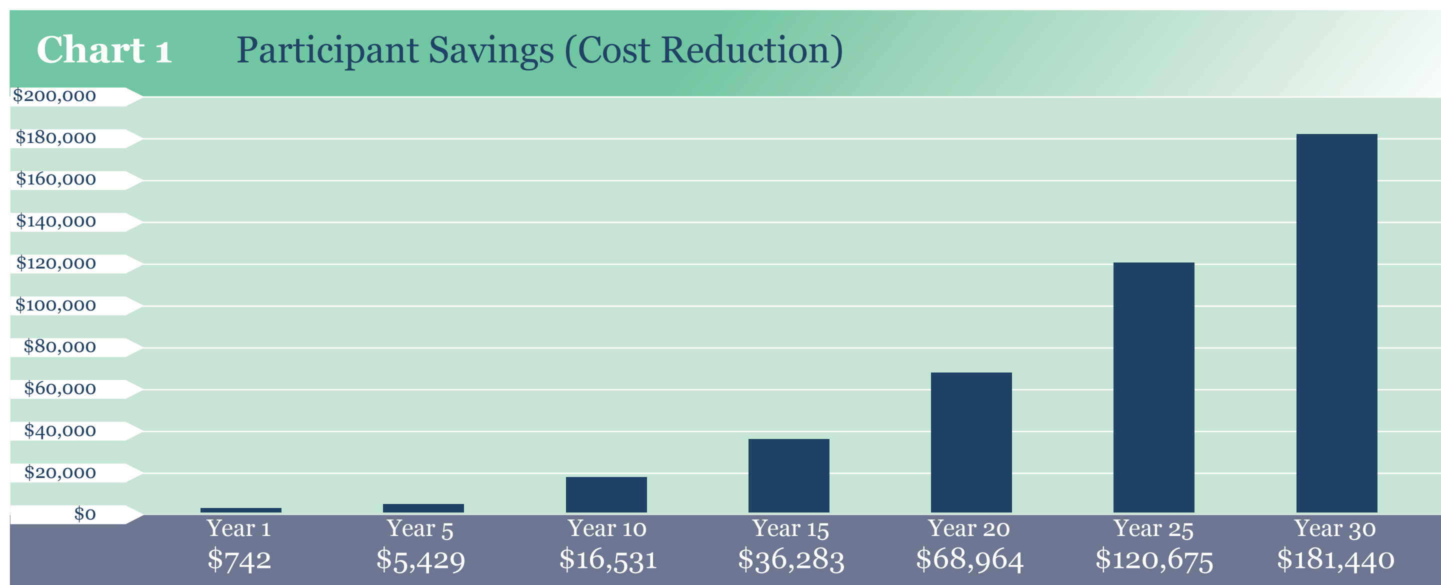
The retirement plan industry has failed to provide clear and easy-to-understand fee disclosure. Plan providers, brokers, brokerage firms, insurance companies, mutual fund companies and third-party administrators and other non-fiduciaries have all contributed to this problem. Unfortunately, the retirement security of millions of plan participants has been put at risk because of hidden fees, high expenses, conflicts of interest and poor investment returns.

However, many plan fiduciaries are also guilty for what has transpired because they have not taken their responsibilities seriously, devoted the time necessary to become educated and failed to hold their service providers accountable. Many plan fiduciaries have exposed themselves to significant liability for failing to clearly identify and understand the total cost of their plans. Most importantly, they have failed their participants by allowing costly plans to eat away at retirement savings. For example, additional plan expenses of only 0.50 percent over a 30-year period can reduce retirement income by over 13 percent.[5]

Since a fiduciary has a duty to ensure the plan only pays reasonable expenses, it follows that the fiduciary must know who is being paid and how much compensation is being received for the services provided to the plan. Only by knowing can a fiduciary decide if the plan fees are reasonable. Appointing an Independent Fiduciary to lead this process is a wise decision.

Chart 1 illustrates the effect high fees can have on a thirty-five year old participant who has an account

Table 1	Monthly Income	Annual Income
After 20 Years		
Lifetime income assuming $68,964 in additional savings		
Sixty-Five Year Old Male	$477	$5,724
Sixty-Five Year Old Female	$447	$5,364
After 25 Years		
Lifetime income assuming $120,675 in additional savings		
Sixty-Five Year Old Male	$835	$10,020
Sixty-Five Year Old Female	$783	$9,396
After 30 Years		
Lifetime income assuming $181,440 in additional savings		
Sixty-Five Year Old Male	$1,255	$15,060
Sixty-Five Year Old Female	$1,177	$14,124



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balance of $66,650,[6] makes $7,500 in annual contributions and earns a 7 percent annual rate of return. Reducing total cost from 2 percent to 1 percent yields a cost savings sufficient for this worker to retire with an additional $181,440 in assets.

The Monetary Value of a Knowledgeable Independent Fiduciary

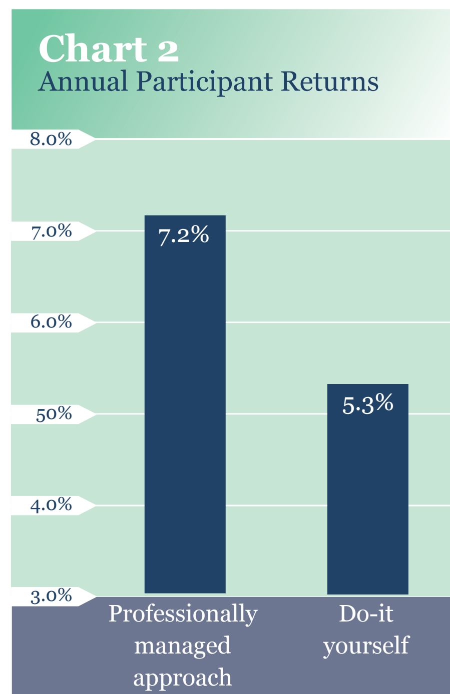
To put this into perspective, assume the participant retires at age 65. Using the additional assets, the participant could purchase an immediate annuity[7] guaranteeing a monthly stream of income for the rest of their life (see Table 1).

Consider what an additional $450 to $1,250 in monthly income could do for a retiree's quality of life. It could provide the ability to pay for additional food, medication, or a trip to see the grandkids. For some, it may even eliminate the need to choose between paying the rent or the power bill each month.

Appointing an Independent Fiduciary to identify and reduce the costs associated with a retirement plan is a prudent decision for any plan trustee. Such a professional has the expertise required to uncover both the explicit fees (such as expense ratios) as well as implicit fees (such as trading costs, revenue-sharing, etc.) that serve to reduce participant returns and threaten retirement success. In the example above, the Independent Fiduciary created over $181,000 of value during the career of this single participant simply by maintaining vigilance over plan fees. Multiplying this value creation across an entire workforce makes the argument of hiring an Independent Fiduciary even more compelling.

Protecting Participants from Themselves

On February 20, 2008 the Supreme Court ruled unanimously in LaRue v. DeWolff that plan participants can sue plan administrators for breaching their fiduciary duties. The good news is that an employer's ability to mitigate most if not all practical day-to-day fiduciary risk is well within their reach. Not only is it economically viable for a Plan Sponsor to receive protections from fiduciary risk, it is economically viable for participants as well. It is also equally simple. But how?



High costs, while a major threat to the retirement security of millions of Americans only represents part of the problem. When these costs are combined with less than optimal investment performance, participants are virtually ensured of unsuccessful retirement outcomes.

A study commissioned by John Hancock tracked the performance of 14,487 plan participants from 1997-2006 and compared the results of those participants who selected a professionally managed approach (John Hancock Lifestyle Portfolios) to those who chose to make their own investment decisions (do-it-yourselfers).[8]

The study determined that 84.2 percent of do-it-yourselfers would have fared better in a single professionally managed portfolio than they fared by selecting their own investments. In addition, participants who chose to allocate all their contributions to a single professionally managed approach outperformed do-it-yourself participants by 1.9 percent annually (7.2 vs. 5.3 percent). Do-it-yourselfers as a group ended the period with 11 percent lower account balances.

The study also demonstrated that do-it-yourselfers typically shared the following characteristics:

- Lack of Diversification: The average number of funds selected was 3.9.
- Lack of Discipline: These participants tended to allocate their balances to popular funds at the time of their enrollment and made few changes afterwards (such as systematic rebalancing).
- An Unbalanced Approach: These participants tended to allocate their accounts at opposite ends of the risk spectrum (conservative or aggressive) rather than taking a more balanced approach.

Further research paints an even bleaker picture. A recent study[9] by DALBAR Financial Services tracked

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investor's behavior in chasing market returns from 1987-2006. Over this twenty year period the S&P 500 yielded 11.8 percent per year while the average investor only earned 4.3 percent.

The data clearly demonstrates that the vast majority of participants lack the knowledge, skill and discipline to make good investment decisions. A better overall approach is for an Independent Named Fiduciary to appoint an Independent Investment Fiduciary (known as a 3(38) "investment manager") to build and manage model portfolios for participants. The investment manager accepts ERISA "discretion" over plan assets and assumes full responsibility (and therefore liability) for those fiduciary functions.[10] As well-known ERISA attorney Fred Reish points out, in this scenario the Independent Investment Fiduciary takes on "virtually all of the fiduciary responsibility."[11]

Noted fiduciaries Jeffrey C. Chang, W. Scott Simon and Gary K. Allen have asserted the value of this approach:

"Yet few 401(k) plans offer portfolios as investment options. Instead, they offer stand-alone mutual funds or individual stocks as investment options. Such options can be likened to the parts that make up a car. The participants are asked, in effect, to assemble all the parts (i.e., stand-alone investment options) on their own in order to manufacture a car (i.e., a portfolio). With a model portfolio, the parts are already assembled for the participant; all he or she needs to do is provide the ERISA-defined investment manager with enough information so that the manager can select the appropriate car from the menu of five or six investment options that comprise the cars sitting on a showroom floor. There is simply no better way to diversify the risk of a portfolio." [12]

This professionally managed approach not only benefits the plan sponsor through the transfer of fiduciary responsibility but should deliver better returns over time for plan participants.

Commenting on the LaRue vs. DeWolff ruling, attorney George L. Chimento raises a valid question:

"Are participants really better off self-managing their retirement assets, doing something they were not educated to do? Perhaps it's safer, and better for all parties, just to have an "old fashioned" managed fund, without participant direction, and to employ properly certified investment managers who can be delegated fiduciary liability under ERISA. A dividend of LaRue is that it may cause employers to step back and reconsider the current, expensive, and dangerous fad of self-direction." [13]

Earlier, we demonstrated the significant economic value an Independent Fiduciary creates for participants simply through the reduction of plan fees. However, this value is multiplied nearly 2.5 times by combining lower costs with better investment outcomes.

Chart 3 assumes the same basic information as our first illustration but uses different investment returns. In the first scenario, we assumed that a participant earned a 7 percent annualized rate of return, except costs were reduced from 2 to 1 percent. In this scenario, we compare the difference between a participant making their own investment decisions and earning a return of 5.3 percent annually with expenses of 2 percent versus the same participant choosing a profes-

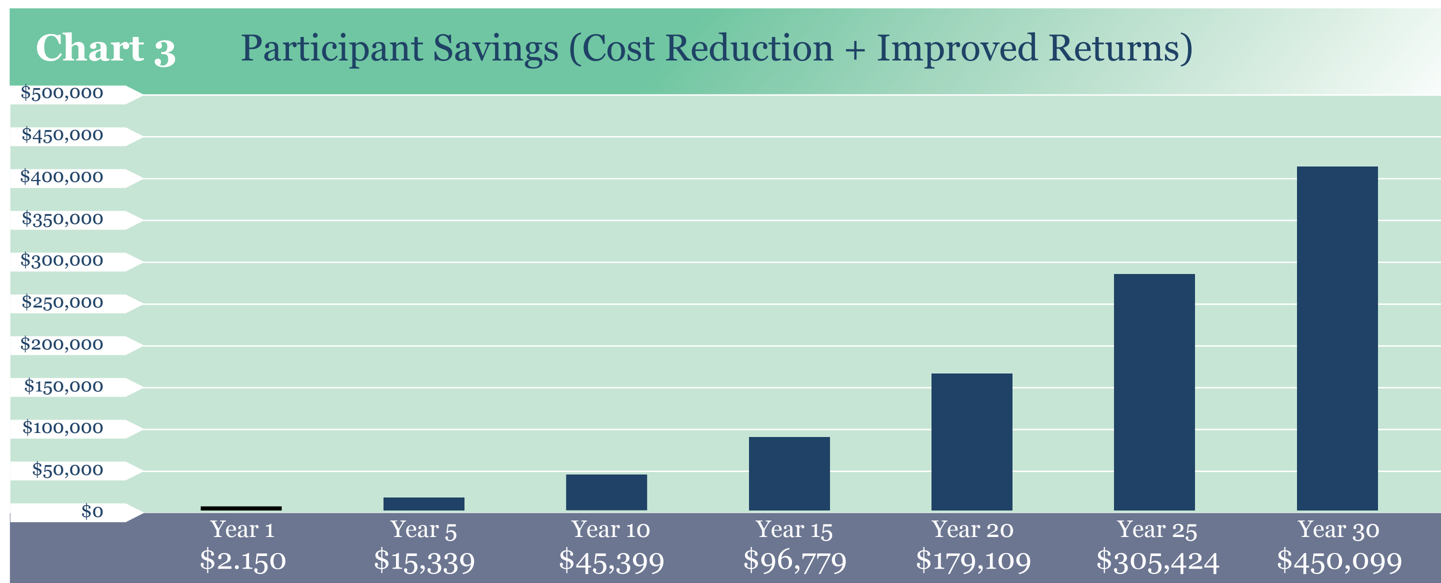

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Table 2	Monthly Income	Annual Income
After 20 Years Lifetime income assuming $179,107 in additional savings		
Sixty-Five Year Old Male	$1,239	$14,868
Sixty-Five Year Old Female	$1,162	$13,944
After 25 Years Lifetime income assuming $305,424 in additional savings		
Sixty-Five Year Old Male	$2,113	$25,356
Sixty-Five Year Old Female	$1,982	$23,784
After 30 Years Lifetime income assuming $450,099 in additional savings		
Sixty-Five Year Old Male	$3,114	$37,368
Sixty-Five Year Old Female	$2,921	$35,052

sionally managed portfolio that earns 7.2 percent annually with expenses of 1 percent. The combination of these two factors means that over a thirty-year period this participant would retire with an additional $450,099.

Table 2 illustrates the guaranteed lifetime income that could be purchased by the participant with the additional assets.

Consider for a moment how critical the decision is whether or not to hire an Independent Fiduciary. Using our example, this step could mean more than $450,000 in additional retirement assets for an average participant, representing anywhere from $1,200 to $3,100 in additional monthly retirement income for life.

Prudent plan sponsors who understand their duty to act "solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries" would be wise to engage an Independent Fiduciary. This decision alone could determine whether participants "retire with dignity or in despair" as industry expert Brooks Hamilton has stated.[14]

Retirement Income – What Participants Want Most

The powerful statistics above show the flaw in permitting participants to control their own accounts. By so doing, what they want most – i.e. retirement income – will likely be diminished. Why encourage less when more is well within the reach of all?

Conclusion

There is a special fiduciary science behind achieving optimal results in a retirement plan. Skilled Independent Fiduciaries know how to reduce risk to plan sponsors, increase benefits to plan participants, and improve the security of future retirees. The appointment of an Independent Fiduciary is excellent "insurance" for a plan sponsor. Like hiring legal counsel or seeking medical attention from a skilled physician, appointing an Independent Fiduciary is the logical, intelligent solution to dealing with the rapidly changing, increasingly litigious retirement plan environment.

More importantly, this decision may be the difference between a terrific retirement and a terrifying one. After all, who wouldn't want several thousand dollars of additional monthly income? That is the value of an Independent Fiduciary.

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End Notes

1 Statement from Congressional Testimony delivered March 6, 2007. http://edlabor.house.gov/testimony/030607MatthewHutchesontestimony.pdf

2 © 2008 Matthew D. Hutcheson, "The Fiduciary Framework™"

3 Ibid.

4 Russell Kinnel. "Morningstar Rating Hits Five-Year Anniversary: How's It Doing?" (09-10-07) http://news.morningstar.com/articlenet/article.aspx?id=205470&page=%252fstarrateperform (accessed February 27, 2008).

5 Statement of DAVID CERTNER LEGISLATIVE COUNSEL & LEGISLATIVE POLICY DIRECTOR of AARP. "Even a difference of only 50 basis points, from 0.5 percent to 1.0 percent, would reduce the value of the account by $17,417, or a little over 13 percent over the 30-year period." http://waysandmeans.house.gov/media/pdf/110/10%2030%2007/Certner.pdf

6 The EBRI/ICI 401(k) database, the largest database of 401(k) plan participant accounts, showed that the median account balance was $66,650 at year-end 2006.

7 Estimated lifetime income generated through an immediate fixed-income annuity quote available from www.fidelity.com (as of 2-22-2008). The quote assumes a 65-year old (male or female) Maryland resident purchases a single-life annuity with the additional assets accumulated due to the cost savings. Lifetime income and guarantees are subject to the claims-paying ability of the issuing insurance company.

8 The Burgess study was a commissioned study by John Hancock. The study examined the performance of 14,487 retirement plan participants from 1997-2006 contributing to their employer's defined contribution plans through an ARA group annuity contract issued by John Hancock USA. The Lifestyle group (i.e.) professionally managed approach) represents those participants that invested only in a single Lifestyle Portfolio throughout the period. The Non-Lifestyle group (i.e. do-it-yourselfers) represents those participants who chose their own portfolio mix throughout the period. Burgess + Associates and John Hancock USA are not affiliated.

9 Source: DALBAR, 2007, Quantitative Analysis of Investor Behavior.

10 W. Scott Simon. "Fiduciary Focus: Non-Fiduciary Investment Consultants," (May 4, 2006), http://advisor.morningstar.com/articles/doc.asp?s=1&docId=4432&pgNo=2 (accessed February 25, 2008).

11 Fred Reish. "Just out of Reish: Menu Monitors," (September 2005), http://www.plansponsor.com/magazine_type1/?RECORD_ID=30735 (accessed February 25, 2008).

12 Jeffrey C. Chang, W. Scott Simon, and Gary K. Allen. A Step Beyond ERISA Section 404(c): Improving on the Participant-Directed 401(k) Investment Model. Journal of Pension Benefits, Summer 2005, Volume 12 Number 4. 5-12.

13 George L. Chimento. "A victory for participants. A warning shot for plan sponsors," (February 20, 2008), http://www.theworkplace.biz/LaRue_article_nf.html (accessed February 26, 2008).

14 Hamilton, Brooks. PBS, February 23, 2006.

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