The Case for "Unbundled" 401(k) Plans

An open-architecture approach that often brings 1.) greater transparency, 2.) lower fees and better performance for the participants, and 3.) reduced financial/legal liability for the business owner

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Introduction

The ***401(k) plan*** has been an integral part of Americans' retirement saving options for almost forty years. ***However, the majority of the plans are structured in a way that disadvantages the participants and the sponsor (employer) by saddling them with high fees, underperforming investment options, and unmet fiduciary responsibility potentially resulting in financial and legal liability.***

The employers bear ultimate responsibility for the successful working of their 401k plan. The employers establish the plan; they select the service providers that will administer the plan operations; they choose or approve or at least oversee the selection of the investment options that will be included in the plan; and they agree to the fees that will be paid by the plan. The employees have no choice in the fees they are obligated to pay nor in the selection of investment choices to which they are limited.

Most business owners, though, have limited knowledge of the workings of 401(k) plans. They do not know who they should hire to provide the necessary services, which investment options should be included, and what level of fees/expenses is reasonable. So, many hire a brand name insurance company, bank or brokerage firm that offers "one-stop shopping" via what is known as a "bundled plan". The firm provides all aspects of required services and often recommends a lineup of investment choices which draws heavily from its own proprietary offerings. Unfortunately, this arrangement typically comes with relatively high costs, limited transparency, and suboptimal investment performance.

The "unbundled", open architecture, plan offers a compelling alternative. The plan sponsor works with an advisor to select the individual service providers based upon expertise and cost. Investment options are chosen solely on the basis of overall performance prospects and expenses for the participants. Costs and responsibilities are transparent which should allow the business owner to dramatically reduce their potential liability.

The 401(k) Plan Defined

A 401(k) is a defined contribution plan established and overseen by an employer that allows employees to defer a portion of their earnings on a tax-deferred basis into an investment account with a defined menu of investment options. Very closely related are ***403(b)*** plans for nonprofit institutions and ***457(b)*** plans for employees of the government (most of what is stated in this paper in regards to 401(k) plans is applicable to 403(b) and 457(b) plans). The total annual individual contribution limit for 2019 is $19,000 with an additional $6,000 permitted for employees over the age of 50. Employers are also allowed to provide a match for a portion of their employees' contributions.

All 401(k) plans are governed by the Employee Retirement Income Security Act of 1974 (ERISA). The legislation that enabled their creation was the Revenue Act of 1978 that allowed for the tax-free deferral of a portion of income which became Section 401(k) of the Internal Revenue Code. The concept was expanded in 2001 to allow contributions of after-tax money into a Roth 401(k).

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A recent study estimated that there is currently $4.269 trillion held by 60.3 million participants in 509,990 401(k) plans and $878.0 billion held by 16.4 million participants in 175,141 403(b) plans. [1]

A 401(k) plan is established by the employer who is the "plan sponsor". The employer has a fiduciary and legal responsibility for administering and overseeing all aspects of the plan including creating a plan document, recordkeeping, selecting investment options, safekeeping of the plan assets, and ensuring that fees paid by the plan are reasonable.

The plan sponsor may hire one or more professional service providers to assist with these various functions. These may include the following:

- A record keeper to track the amount of money that is in each participant's account and will often provide a website for the sponsor and the participants to access information on the plan and to reallocate their balances among the various investment elections.
- A third-party administrator (TPA) to assist with ensuring the plan is in compliance with the provisions of the plan document and with ERISA law. A custodian to hold the plan assets and execute the directed trades.
- An investment advisor or broker to assist in the process of selecting the investment options for the plan.

The advisor may also play a role in educating plan participants on general aspects of retirement savings and characteristics of the plan investment options.

The service provider role is dominated by large insurance companies, banks and brokerage firms. The top 10 record keepers account for an estimated 72.0% of all assets in defined contribution plans and the top 20 account for an estimated 90.5% of the total (Please see ***Exhibit 1***).[2]

The Bundled Plan

These providers offer primarily ***"bundled"*** 401k plans: the large insurance company, bank or brokerage firm will provide a "one-stop shopping" solution to the plan sponsor. The record keeping, administration, custody and investment advisory roles will be provided by the single firm or that firm will partner with other providers to deliver a packaged solution. The costs are often borne primarily by the plan participants through the fees that are paid on the mutual funds included in the plan and direct debits to their investment accounts.

EXHIBIT 1

Top Record Keepers Ranked by Total Defined Contribution Assets

		($ Millions)
1.	Fidelity Investments	$ 1,449,078
2.	TIAA	625,200
3.	Empower Retirement	525,000
4.	The Vanguard Group, Inc.	514,160
5.	Alight Solutions	410,354
6.	Voya Financial	381,347
7.	Bank of America Merrill Lynch	220,504
8.	Principal Financial Group	219,900
9.	Prudential Retirement	215,744
10.	Wells Fargo	212,571

Source: "Plansponsor 2018 Record Keeper Survey"; https://www.plansponsor.com/research/2018-defined-contribution-survey/

[1] "Plansponsor 2018 Record Keeper Survey"; /www.plansponsor.com/research/2018-defined-contribution-survey/

[2] Ibid

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Although the bundled plan provider will highlight the advantages of the plan structure, namely no cost for the business and a single point of contact, this type of 401(k) comes with several significant disadvantages:

- They are typically relatively expensive with those costs paid by the employees in the plan. The service providers are usually paid both by fees charged directly to the participants' account balances and by revenue sharing of the expenses on the mutual funds that are included in the plan. In our experience, seeing A share mutual funds, which are the most expensive retail share class, as the primary option even in plans with multimillion-dollar balances is relatively common.

- The structure of how those expenses are collected and allocated ("behind the scenes" sharing of mutual fund fees) lends to confusion as to how much is actually being charged and how the revenue is being distributed. Increased regulation in this area has attempted to address this issue, but most plan sponsors/business owners express confusion and frustration. Since 2012, plan record keepers are required to provide an annual fee disclosure, called a 408(B)(2) report; however, the expense data is often presented in an unclear manner.

- There is the potential for conflicts of interest in the selection of the investment options included in the plan. Since many of the leading service providers (and/or their partners in the bundled plan) also are in the mutual fund business, seeing the recordkeeper's (and/or their partners') mutual funds as the primary options in the plan is relatively common. Also, since the fees are often collected through revenue sharing of the mutual fund expenses, only funds that participate in a revenue sharing arrangement will be considered as candidates.

- There is little flexibility to switch a service provider without disrupting the entire plan structure. Since the services are bundled, choosing a different custodian or recordkeeper requires moving the entire plan to a new set of providers.

Business Owner's Potential Liability

The potential conflicts of interest in bundled plans that may manifest themselves in high fees and suboptimal performance of the investment options represent a serious liability for the business owner. The business owner has a fiduciary responsibility to act solely in the best interest of the plan participants. That includes ensuring that fees are not excessive and investment performance is satisfactory. The business owner agrees to the expenses and investment options, but the employees are the ones who must pay them and invest in them.

There have recently been a number of class action lawsuits filed against plan sponsors for excessive fees and/or inappropriate investment options in both the private and public sector. Targets have included major U.S. corporations including Boeing, Cigna Corp., Delta Airlines, Inc., Lockheed Martin Corp., and Oracle Corp. Many have chosen to settle the lawsuits rather than go to court with payments reaching as much as $62 million for a single settlement. In the last couple of years, several universities were sued over excessive fees in their 403(b)

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plans. The schools included Duke, Emory, Johns Hopkins, the Massachusetts Institute of Technology, and Yale. The focus may not remain only on large organizations with significant defined contribution plan balances; recently a class action suit alleging excessive fees was filed against LeMettry's Collison Inc. ***The Minnesota-based private company had only $9 million in its 401(k) plan.***

The Unbundled Plan

The ***"unbundled"***, or ***"open architecture"***, plan offers a structure that addresses many of the drawbacks of the bundled plan option. In an unbundled plan, the plan sponsor individually hires the third-party administrator (TPA), record keeper, custodian and investment advisor. Each of those service providers is a specialist in their respective function. The fees paid to each provider (whether paid by the sponsor or by the plan) are separate and direct. There is no "behind the scenes" revenue sharing. Certain large plan providers advertise that they offer unbundled plans because they include the option of using a TPA and/or permit some nonproprietary fund options in addition to their own funds (which provide the core of the lineup). However, we consider these to be "bundled-light" plans.

The unbundled structure offers a number of important advantages to a plan sponsor and the employees:

- ***The fees are completely transparent.*** Since the expenses are paid directly, how much is being paid and to whom is relatively obvious and creates a much easier process by which to compare costs against alternative providers.
- ***The investment options that are available for inclusion in the plan are virtually unlimited.*** Since the service providers are usually not in the investment product business, the plan sponsor can include practically any mutual fund or exchange traded fund (ETF) in existence.
- ***Investment management fees can be a small fraction of what they are in a bundled plan.*** Since the sponsor is not limited to a provider's menu of funds, low-cost index funds and ETFs from firms such as Vanguard or BlackRock can make up all or much of the investment line up.
- ***There is a likelihood of better investment performance for the plan assets.*** As with the fees issue, if the investment options are being chosen solely based on the best interests of the participants, then funds/ETFs with the best overall performance can be chosen.
- ***The best providers can be hired for each role and there is much more flexibility to change a provider.*** As an example, employing a TPA that specializes in 401(k) plans can result in the design of an optimal plan structure that may eliminate expensive issues such as being "top heavy". If the service providers are independent, then there is flexibility to change one of them due to unsatisfactory performance without disrupting the entire plan structure.

Bundled Versus Unbundled Costs and Performance

Our experience in providing plan sponsors with fee analysis has consistently shown that ***an unbundled plan with low-cost providers and investment options can have total costs that are 20-50% lower than those in an existing bundled plan.*** Much of the savings typically comes through the inclusion of lower cost investment options. Since mutual fund fees are not being used for revenue sharing, an unbundled plan can utilize low-cost index funds and ETFs. These cost savings should more than offset the new direct payments for the TPA, custodian, and investment advisor. Additional cost savings is typically achieved through the use of a lower-cost TPA and record keeper that specializes in working with 401(k) plans.

We have included examples of the potential cost differences between bundled and unbundled structures for three sizes of 401(k) plans: a $1 million plan with ten participants, a $10 million plan with one hundred participants, and a $100 million plan with one thousand participants (See Figure 2). Although these examples are hypothetical, the cost data are based on our real experience working with plan sponsors/business owners.

Although cost is an important determinant in investment selection, performance is equally important. As virtually any fund or ETF in existence is a candidate for inclusion in an unbundled plan, the plan sponsor, working with the investment advisor on the plan, is able to balance cost with performance rather than being restricted to a limited menu. In our work with plan sponsors, we have routinely seen situations in which ***low-cost, high-performing alternatives have shown better average historical performance of as much as 500 basis points annually.***

Exhibit 2

Cost Comparison of $1 Million Bundled Versus Unbundled Plans With 10 Participants

	Bundled	Unbundled
Third-party Administration	$ 4,000	$ 1,500
Recordkeeping	9,000	1,500
Custodial Fee	1,000	700
Investment Management Fee	4,500	1,200
Investment Advisory	5,000	5,000
Total	23,500	9,900
Percentage of plan assets	**2.35%**	**0.99%**

Cost Comparison of $10 Million Bundled Versus Unbundled Plans With 100 Participants

	Bundled	Unbundled
Third-party Administration	$ 15,000	$ 4,500
Recordkeeping	15,000	4,500
Custodial Fee	6,000	6,000
Investment Management Fee	40,000	12,000
Investment Advisory	30,000	30,000
Total	106,000	57,000
Percentage of plan assets	**1.06%**	**0.57%**

Cost Comparison of $100 Million Bundled Versus Unbundled Plans With 1,000 Participants

	Bundled	Unbundled
Third-party Administration	$ 50,000	$ 32,500
Recordkeeping	50,000	32,500
Custodial Fee	50,000	50,000
Investment Management Fee	400,000	120,000
Investment Advisory	150,000	150,000
Total	700,000	385,000
Percentage of plan assets	**0.70%**	**0.39%**

Note - Costs are meant to be representative and are based on expererience with actual plans.

Conclusion

The unbundled 401(k) plan structure offers a number of advantages for both the plan sponsor/business owner and the employees over the bundled alternative. For the employer, fees are transparent and typically lower; the investment options available for inclusion in the plan are virtually unlimited; service providers can be hired for their specific expertise; and a service provider can be replaced without disrupting the entire plan. The employees should see a significant improvement in what are probably the two most important areas: lower expenses and better investment performance. ***The unbundled plan structure offers the potential to reduce or eliminate a significant fiduciary liability for the plan sponsor/business owner and to dramatically improve the odds of employees accomplishing their retirement savings goals.***

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