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Five common mistakes 401(k) plan sponsors make

Think investors make all the errors? Think again.

It is probably no surprise that a Google search of "investor mistakes" yields 30,500 results, while a search of "plan sponsor mistakes" yields only 53.

The financial media typically focus on errors made by 401(k) plan consumers rather than those made by its architects — the plan sponsors.

However, plan sponsors can encounter pitfalls similar to individual investors when it comes to designing and monitoring their organizations' plans. These plan sponsor mistakes may result in increased fiduciary risk for plan sponsors, and lower investment returns and higher fees for plan participants. Five common mistakes include:

NOT UNDERSTANDING AND MONITORING FEES

A recent study of 401(k) plans by Deloitte found that — across over 500 firms surveyed — 401(k) plans paid 0.28 percent to 1.38 percent in fees per year, including all investment management, administration, and advice services. For a plan with $25 million in assets, this amounts to an astonishing $275,000 per year of additional fees paid between the top and the bottom of that fee range.

Although it is not an easy task for plan sponsors, calculating, understanding and assessing reasonableness of 401(k) plan fees is an important requirement under the Employee Retirement Income Security Act (ERISA).

Since 2012, retirement plan vendors have been required by ERISA to provide plan sponsors with an annual fee disclosure detailing all fees charged to the plan, but making sense of fees can still be challenging.

Providers collect revenue in a variety of ways, some of which may be embedded within the expense ratios of funds utilized in a plan.

Evaluating plan fees can be even more complex when the same firm provides both investment management and record keeping services to a plan. However, the broad distribution of all-in plan fees indicates that significant cost savings are available to plan sponsors who make the effort to carefully monitor and control plan costs.

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Sellwood Consulting Principal Kevin Raymond urges companies to look closely at their 401(k) plan offerings.

IGNORING PARTICIPANT DEMOGRAPHICS

While individual investors must evaluate their personal situation when selecting appropriate investments, a 401(k) plan sponsor must account for the varied demographics of their participant base (e.g. age, income, investment experience).

Plan sponsors are tasked with crafting a menu of investment options that provides choices suitable for a wide array of participants without overwhelming them with too many choices.

One effective way to make an investment menu accessible to participants is to break it into manageable tiers based on a participant's required level of involvement.

For example: A first tier — including premixed investment options (e.g. target retirement date and target risk balanced funds) in which both the asset allocation and underlying investments are professionally managed — is suitable for investors uncomfortable making their own allocation elections or regularly rebalancing their portfolio.

A second tier — containing a core menu that allows a participant to customize his or her asset allocation from a diverse menu of professionally managed options covering major asset classes — is suitable for investors desiring more control over their allocation.

An optional third tier — consisting of a self-directed brokerage window for plans wanting to offer participants the ability to access a broader range of funds (and sometimes individual securities) — offers participants an even higher level of possible customization.

Within these tiers, demographic factors can also influence the appropriate number, types and risk profiles of the options offered.

TOO LITTLE DIVERSITY AMONG INVESTMENT OPTIONS

According to the most recent survey from the Plan Sponsor Council of America, the average 401(k) plan offers participants a selection of 19 investment options.

Unfortunately, a disproportionate number of these are often concentrated in similar U.S. equity options with little exposure to other diversifying asset classes. For the majority of participants who elect to use just a few options, it is easy to end up with a false sense of diversification if the investment menu contains a large number of overlapping funds.

So often is the focus on investments with a "growth" objective that other diversifying options can be overlooked. In addition to growth (e.g. stocks), it is important to provide participants with access to preservation (e.g. bonds) and inflation-related investments (e.g. Treasury Inflation-Protected Securities (TIPS) and real estate), that may help to protect portfolios in an inflationary environment.

Many professionally managed portfolios including endowments, foundations and pension plans, evaluate the diversification of their portfolios across these types of objective-based categories, and plan sponsors can enhance their 401(k) plan investment menus by doing the same.

How do you know if your plan has too little diversification? Add up your U.S. equity fund options. If these represent more than 50 percent of the lineup (counting a target retirement fund suite as one option), it is likely that your plan does not offer sufficient diversification.

LACK OF A DOCUMENTED INVESTMENT POLICY

ERISA requires plan fiduciaries to act prudently. One significant way to demonstrate prudence is by maintaining clear and documented processes.

An investment policy statement for a 401(k) plan should outline plan objectives, individual roles and responsibilities of plan fiduciaries, and how the plan's investment lineup will be structured and monitored in accordance with plan objectives.

Similar to a documented investment strategy used by an individual investor, a 401(k) plan investment policy provides a framework for managing the plan and can lead to better decision-making by fiduciaries.

TAKING INVESTMENT ADVICE FROM SOMEONE WHO IS NOT A FIDUCIARY

ERISA requires any individual or firm acting as a fiduciary to a 401(k) plan to act solely in the best interest of plan participants and to carry out their duties prudently.

Plan sponsors should take special care to identify which of their service providers are fiduciaries when it comes to investment advice. A plan sponsor should cautiously weigh investment advice coming from someone who is not a plan fiduciary — especially if that person stands to gain financially from the guidance. Be careful not to let the fox guard the henhouse.

Avoidance of these five potential pitfalls will make it less likely that your plan will appear as a result the next time someone searches Google for "plan sponsor mistakes."

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