401(k) Plan Design Trends and Insights

By Sheldon M. Geller

CPAs often seek reliable information about 401(k) plan design, investment options, record keeping, and fees. The "BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans: December 2014" provides a better look at 401(k) plans in practice, covering audited reports filed for the 2012 plan year. The analysis is a welcome one, as 401(k) plans have become one of the largest components of U.S. retirement assets and are the primary retirement plan sponsored by many employers to attract and retain qualified workers.

Key Findings

Key findings of the BrightScope/ICI profile include the following:

- ***Investment choices.*** The average 401(k) plan offers twenty-five investment choices, including thirteen stock funds, three bond funds, six target date funds, and one money-market/stable value fund.
- ***Mutual funds.*** Mutual funds hold more than half of total plan assets, except in the largest plans, many of which hold collective trust funds.
- ***Asset class.*** Approximately 40% of plan assets are held in stock funds, 15% in balanced and target date funds, 10% in bond funds, 15% in money market funds/stable value portfolios/guaranteed investment contracts, and 20% in individual securities.
- ***Target date funds.*** Seventy percent of plans offer target date funds, but only 13% of plan assets are held in target date funds.
- ***Index funds.*** In smaller plans, 10% of plan assets are held in index funds, versus more than 20% of plan assets in larger plans.
- ***Employer contributions.*** The vast majority (83%) of plans have employer contributions, 50% of which have employer matching contributions, and 37% of which have employer nonelective contributions. The most common matching contribution formula is 50% of contributions up to 6% of pay, and the second most common is 100% of contributions up to 6% of pay.
- ***Automatic enrollment.*** Among plans with automatic enrollment, 60% default to a contribution rate of 3% of pay, and 12% default to a contribution rate of 5% or more.
- ***Record keepers.*** Insurance companies are the most common record keeper for smaller plans, whereas asset managers, including mutual fund companies, are the most common record keeper for large plans, as well as all plans combined.
- ***Proprietary funds.*** Sixty-seven percent of plans include investment options proprietary to the plan's record keeper in their investment menu; these proprietary investments held 25% of total plan assets.
- ***Plan costs.*** The average total plan cost is 0.91% of plan assets, including administration, record keeping, investment advisory, and audit and investment management fees. Investment management fees (e.g., expense ratios) include domestic stock mutual fund expenses averaging 0.95% for plans with less than $1 million in assets and 0.48% for plans with more than $1 billion in assets.

Practical Considerations and Observations

Employers who automatically enroll employees, determine the default contribution rate and any escalation thereof, and select the default investment display increased participation without adverse affects. The National Association of Professional Agents (NAPA) reports that automatic enrollment usage has increased to 61.7% of plans in 2015, with only one-third of these utilizing automatic contribution escalation.

Larger plans invest more assets in index funds than smaller plans do. Larger plans also have the leverage to negotiate better fee arrangements, whereas smaller plans rely on fees paid through investment expense ratios. Index funds customarily do not generate revenue to pay fees and therefore are less likely to be included in smaller plans.

Smaller plans are more likely to use an insurance company for record keeping because they are more likely to pay fees through pooled separate accounts, investment expense ratios,

and wrap fees. Larger plans are more likely to use mutual fund companies and banks because they have the leverage to negotiate lower fees, are more knowledgeable about products, can formalize plan governance and, in some cases, pay fees.

Record keepers often advocate for the inclusion of their proprietary funds, often offering a better fee arrangement or designating an age-appropriate target date fund as a qualified default investment alternative. The bundling of record keeping and investment services presents conflicts of interest, however, as it can adversely affect fund performance and result in excessive fee arrangements, particularly in the absence of fiduciary advisor oversight. A 2014 Pension Research Council study indicates that only 13.7% of poorly performing proprietary funds are replaced, compared with 25% for nonproprietary funds. Furthermore, the Callan 2015 Defined Contribution Trends report shows that larger plans are moving away from proprietary funds, declining from 47.5% in 2013 to 28.7% in 2015; a further decrease to 23.6% is expected in 2016.

Fiduciary Decision Making

The top priorities for employers in 2016 are likely to be communication with participants, fund manager due diligence, fiduciary compliance, and plan fees. Employers need to consider marketplace trends and avoid conflicts of interest when making fiduciary decisions regarding the maintenance of their 401(k) plans. In addition, case law has been inconsistent with respect to the finding of ERISA fiduciary status and the resulting fiduciary liability underlying claims involving life insurance service providers and revenue-sharing payments. Therefore, employers need to understand the service and fee arrangements they enter into with nonfiduciary record keepers.

Fiduciary decisions are not about justifying actions that may be legally defensible, but rather about acting for the exclusive benefit and in the best interest of plan participants. ❑

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