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Managed Accounts

A new direction for 401(k) plans

BY JOANNE SAMMER

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EXECUTIVE SUMMARY

- **A growing number of companies are beginning to offer** employees professionally managed accounts for 401(k) assets. In these managed accounts, an independent investment manager handles investment decisions, makes portfolio changes as needed based on each participant's specific needs and risk tolerance, and rebalances the portfolio at predetermined intervals, usually quarterly.

- **If a company decides to offer managed accounts,** it must find the right adviser to manage employees' assets. Choosing a vendor for managed accounts requires the same level of due diligence that plan sponsors bring to finding vendors for other aspects of the plan.

- **While managed accounts are a relatively new phenomenon,** there is some heartening research about their potential appeal, particularly to the 401(k) plan participants who arguably need investment help the most—older, lower-paid and part-time workers.

- **A major factor in employees' decision to use managed accounts** will be the fees charged for this service, which are generally paid by employees out of their plan assets. For that reason, plan sponsors should make sure the fees are in line with what the market is offering.

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Companies, it seems, have tried everything to get their employees to save enough for a secure retirement. But all of the brown bag lunch seminars on the basics of retirement investing, matching contributions and even investment advice have only underscored the fact that companies can only do so much to help their employees. After all, a self-directed 401(k) account requires the employee to make the appropriate investment decisions to secure his or her own retirement.

The Pension Protection Act of 2006 (PPA) provided employers with some new options such as auto enrollment, default investments and more latitude for providing investment advice (see sidebar "Managed Accounts and the Pension Protection Act of 2006"). But historically even when companies provide investment advice, a large number of employees do not implement the advisers' recommendations. As a result, employees continue to invest too conservatively or take on too much risk. Or they don't assess their investment strategy or rebalance portfolios over time.

That is why a growing number of companies are beginning to offer their employees professionally managed accounts for 401(k) assets. According to Deloitte Consulting's 2005/2006 *401(k) Benchmarking Survey,* 18% of the 830 companies surveyed offered employees managed accounts and another 17% were considering offering them. In these managed accounts, an independent investment manager handles investment decisions, makes portfolio changes as needed based on each participant's specific needs and risk tolerance, and rebalances the portfolio at predetermined intervals, usually quarterly.

"There is absolutely more interest in managed accounts because companies are beginning to realize that self-directed 401(k) accounts are misunderstood by their employees," says Victoria Serles, CPA, national director of Private Client Wealth Management for BDO Seidman in Kirkland, Wash. "Most employees don't know how to invest and don't understand things like asset allocation." As a result, employees don't pay attention to their 401(k) accounts, rebalance them or make good investment decisions. For example, some individuals put all of their assets in a money market account, which is not a productive option for someone who wants to grow a nest egg.

It was this type of investment behavior that spurred Georgeco Inc., a construction and rental equipment holding company based in Dallas, to offer its employees a managed account option about five years ago. The company's management was concerned that employees lacked the ability or interest to make their own investing decisions to the possible detriment of their retirement goals. "Investing is a complicated field, and I've watched employees follow some questionable investment strategies," says Gary Barnes, vice president and co-owner of the company. "In general, employees tend to be ultra-conservative or ultra-risk takers, so we felt that offering access to qualified investment advisers was one of the best things we could do for most employees."

Once an employee signs up for a managed account in the Georgeco plan, he or she must fill out a risk-tolerance profile that the adviser can use to develop an appropriate portfolio. In a given year, about 40% of participants use the managed account option. "The number of users has remained remarkably steady," says Barnes.

Profile of a Managed Account User
Managed account users represent 11% of the sample population studied and exhibited the following demographic characteristics:

Average salary: $27,766
Years employed: 13.8 years
Age: 49.5 years
Percentage full time/percentage part time: 46%/54%
Average account balance: $33,776

Source: Julie Agnew, *Personalized Retirement Advice and Managed Accounts:*

Who Uses Them and How Does Advice Affect Behavior in 401(k) Plans? published by the Center for Retirement Research, Boston College, March 2006.

CHOOSING A VENDOR

If a company decides to offer managed accounts, it must find the right adviser to manage employees' assets. In fact, choosing a vendor for managed accounts requires the same level of due diligence that plan sponsors bring to finding vendors for other aspects of the plan. Therefore, Serles suggests companies assemble a due diligence team to evaluate the adviser candidates, including investment performance and the credentials of the investment professionals, and to gather information about how the managed account process will work. For example, the due diligence team should evaluate the process for establishing and maintaining the managed accounts, including how the advisers will gauge employees' individual risk tolerance, how frequently accounts will be rebalanced, how frequently the adviser will contact each participant, and how much access participants will have to advisers to ask questions about their accounts and investments.

For National Grid, a U.K. utility whose U.S. operations are based in Westborough, Mass., the vendor selection process took more than a year from beginning to end. A due diligence team appointed by the company's benefits committee spent about eight months meeting with potential vendors to evaluate their service offerings, fees and references before making a recommendation to the benefits committee. According to Matthew Powers, the utility's director of employee services, the company used the same level of due diligence to select a managed accounts vendor that it uses to select and monitor the 401(k) plan's investment options.

Of course, due diligence must be ongoing. Now that its managed accounts vendor is in place, National Grid plans to conduct a review of the vendor's performance at least annually. CenterPoint Energy, a utility based in Houston, plans to gauge the effectiveness of its managed accounts by looking at three metrics—contribution levels, the level of risk and diversification, and the amount of company stock in each account. "These indicators show how well employees are using the 401(k) plan," says Karen Moore, the company's manager of financial security plans.

If these reviews show that a provider is not performing as well as expected, the company can change providers but it should clearly explain the reasons for the change to employees. When Georgeco changed its managed account provider, it explained the reasons for the change in a letter to employees and compared the change to removing an underperforming mutual fund from the 401(k) plan's investment lineup.

Managed Accounts and the Pension Protection Act of 2006

The Pension Protection Act of 2006 (PPA) provides employers with a number of new tools to encourage employee participation in 401(k) plans. Such provisions include automatic enrollment, default investment choices and guidelines for qualified investment advice arrangements (see also " Time to Rethink Your 401(k) Plan?" *JofA* , May 07, page 50).

Automatic Enrollment. Although automatic enrollment was not unheard of before the PPA, it was difficult for employers to implement due to varying state laws and liability concerns. The PPA specifically provides for automatic enrollment and pre-empts state laws. Among other requirements, employers must notify employees of the "automatic contribution arrangement." The notice must:

- Be given before the beginning of each plan year.

- Be accurate, comprehensive and understandable for the average employee.

- Include the employees' right to change the contribution percentage—the statutory default starts at 3% and tops out at 6%—or opt out entirely.

- Provide employees with a reasonable amount of time to select investment options before the first contribution is made.

- Explain how the contributions will be invested if the employee does not select any of the available investment options in the plan.

Default Investment Elections. Under the Employment Retirement and Income Security Act of 1974 (ERISA), employers are not responsible for the investment decisions of employees in self-directed 401(k) plans, provided the plan meets the conditions of ERISA section 404(c). But with automatic enrollment, employees do not have to select their investments, thus raising the question of who is responsible for how contributions are invested. The PPA dealt with this issue by directing the secretary of labor to develop guidelines for qualified default investments. Although the PPA specifies that the default investment guidelines should be finalized within six months, at press time (10 months after enactment of the PPA) the final guidance had not been released. The proposed guidance, however, indicates that "investment management services" that meet certain requirements would be a suitable default investment alternative. The proposed guidance further stated that "an example of such a service may be a 'managed account.'" The proposed guidance can be downloaded at www.dol.gov/ebsa/regs/fedreg/proposed/2006008282.pdf .

Investment Advice. Professionally managed accounts offer employees the advantages of consulting with the investment manager and receiving advice based on their preferences. For an investment manager who provides investment advice to realize the exemption to prohibited transaction rules for investment advice provided in the PPA, the investment manager must meet the requirements for an "eligible investment advice arrangement." These include flat fees—the adviser (or its affiliates) cannot receive compensation that varies based on the investment options selected—or use of an unbiased computer model. In February the Department of Labor issued Field Assistance Bulletin No. 2007-01 that provides guidance on investment advice under the PPA. The full text is available at www.dol.gov/ebsa/pdf/fab2007-1.pdf .

The body of literature, both statutory and regulatory, governing employee retirement plans is substantial. CPAs who have not specialized in this area should consult with an employee benefits expert. Any changes to the design of a plan should always be reviewed by a qualified attorney.

—Matthew G. Lamoreaux

IF YOU OFFER IT, WILL THEY COME?

While managed accounts are a relatively new phenomenon, there is some heartening research about their potential appeal, particularly to the 401(k) plan participants who arguably need investment help the most. Julie Agnew, an assistant professor of finance and economics at the College of William and Mary, examined managed account participation for one large 401(k) plan and found that managed accounts tend to be attractive to older, lower-paid and part-time workers.

There are other reasons for optimism about managed account usage. “If you educate employees about managed accounts and how they work, I wouldn’t be surprised if half of the employees in any given company jump to enroll in something like that,” says David Bendix, CPA, PFS, president of Bendix Financial Group in Garden City, N.Y. “This type of advice is generally assumed to be available only to high-net-worth individuals, and managed accounts allow individuals to get this advice in a very cost-efficient way.” Indeed, according to the 2006 *Retirement Confidence Survey* conducted by the Employee Benefits Research Institute and Mathew Greenwald & Associates Inc., 70% of the 1,252 individuals surveyed said they would be very or somewhat interested in using a managed account for their 401(k) plan assets.

But optimizing participation may take time. After all, when a company introduces a managed account option into its 401(k) plan, not all employees will use that option right away. Participation often increases over time if the company regularly communicates about managed accounts and explains how they work. In many cases, word-of-mouth from other employees can also help boost participation. When National Grid began offering managed accounts to its 401(k) plan participants in January 2006, its participation rate for managed accounts was just 10%. However, thanks to ongoing communication and an automatic enrollment feature made possible by the PPA that now funnels new participants into a managed account unless they choose otherwise, the company has increased participation to about 25%, says Powers.

One way to enhance managed account participation is to offer a free trial, as CenterPoint Energy in Houston did when it introduced managed accounts into its $1 billion, 11,000-participant 401(k) plan in July 2006. The company’s vendor waived its fees for the 90-day trial, which allowed employees to cancel at the end of the 90 days if they were not happy with the service. Moore confirmed the managed account participation rate was on target with the campaign goal, but the company would not release actual participation figures.

THE FEE QUESTION

Of course, a major factor in employees’ decision to use managed accounts will be the fees charged for this service, which is generally paid for by employees out of their plan assets. For that reason, plan sponsors should be very careful that the fees charged are in line with what the market is offering.

Managed account fees vary considerably based on the size of a plan’s asset base. In general, participants in large plans tend to pay less for managed accounts than employees in small plans because smaller plans don’t offer vendors the economies of scale that large plans do. For example, a plan with $1 billion in assets might offer managed account fees as low as 0.25% per year, depending on the size of the assets in a participant’s account. By contrast, Georgeco’s plan has about 160 participants and about $5 million in assets. Its managed accounts pay an annual fee of 1% of assets. ❖

AICPA RESOURCES

***JofA* article**

" Time to Rethink Your 401(k) Plan?" May 07, page 50.

Web site

Employee Benefit Plan Audit Quality Center, http://ebpaqc.aicpa.org .

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