

# THE ASPPA Journal

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## Four Essential Steps to Effectively Benchmarking a 401(k) Plan

by Tom Kmak and Matt Golda

You just finished Sunday night supper. In accordance with tradition, you move from the dinner table to the davenport to enjoy the waning hours of the weekend while watching *60 Minutes*. As the previews roll, a somber Steve Kroft catches your full attention as he asks Rep. George Miller (D-CA), "Do you have any idea how much wealth has been lost in 401(k)s?"

If this scenario describes you, you are not alone. More than 15 million viewers watch *60 Minutes* each week. On April 19, these viewers were presented a troubling picture of the 401(k) marketplace. Many were undoubtedly left with questions about their plans. How good is my plan? Are my fees too high? What can I do about it?

Benchmarking a 401(k) plan can help answer these questions. But as illustrated by Mary Patch in the article that precedes this one, "*Evaluating Investment and Advisory Fees*," the plan benchmarking process can be challenging. Fortunately, however, it is not impossible. Our research has identified four essential steps to follow when conducting a comprehensive and informative benchmarking exercise:

1. Establish a valid benchmark group.
2. Perform a comprehensive review of plan fees.
3. Perform a comprehensive review of plan value.
4. Balance fees and value when assessing reasonableness.

Each of these steps is detailed below.

### Step 1: Establish a Valid Benchmark Group

To ensure appropriate context for decision making, the process begins with establishing a benchmark group comprised of similar plans. This step is very important. If a benchmark group is invalid, incorrect conclusions could be reached. Five factors should be considered when building a proper benchmark group:



#### Plan Size and Number of Participants

Plans included in a benchmark group should be of similar size and participant count to ensure matching economic profiles.

#### Date of Fees and Services Review

By considering only those plans that have bid or reviewed fees and services within the last three years, the plan benchmarking process will reflect a current, but smoothed assessment of the marketplace.

#### Allocation to Passive Index Funds

It would not be appropriate to compare a plan with 100% passive investments to one with 100% active investments. The passive plan will definitely have lower costs due to the fiduciary's belief in indexing. But, those passive costs

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may be high when compared to other passively managed plans. Therefore, it is important to compare plans with similar active/passive investment ratios.

#### Use of a Managed Account Program

Plans offering a managed account program should be compared with other plans offering managed accounts that have similar utilization. Managed accounts provide participants with an important additional service, albeit at higher structural costs. Thus, plans with similar exposure to managed accounts should be compared to each other.

#### Plan Design Provisions

A plan's participation and deferral rates can be directly related to the presence of an employer match or use of "auto" features. Accordingly, grouping plans with similar designs helps establish the context needed to truly determine if additional factors are generating better participant behaviors.

### Step 2: Perform a Comprehensive Review of Fees

Once the benchmark group of "apples to apples" plans is established, the next step is to conduct a comprehensive review of plan fees. Four levels of fees should be considered in your review:

#### Fees at the Plan Level

Fees at the plan level represent a roll up of underlying service provider fees. This review includes fees from recordkeepers, advisors, consultants, investment managers and any other plan service providers. Since some fees are paid by the plan and others are paid by the plan sponsor, *including ALL fees related to the plan regardless of WHO pays the fee is the only way to ensure accurate comparisons.* Total plan fees as a percentage of assets should be compared against the benchmark group.

#### Fees at the Service Provider Level

Even though fees at the plan level may be reasonable, ERISA requires that you examine fees at the service provider level as well. Fees at the service provider level take the form of investment fees (including service fee credits/revenue sharing, investment management fees and/or operating fees), service fees (including recordkeeping, retainer, trust, custody and other fees) and transactions-based fees (commissions and finder's fees). Again, fees should be converted to a percentage of assets to ensure your comparisons are mathematically normalized.

#### Fees at the Investment Level

Fees at the investment level represent the fees paid directly through investments in the plan. These

fees are charged as a percentage of plan assets. Investment fees are used to pay for investment management services as well as additional advisory and recordkeeping services. *When investments do not report a fee structure and a related revenue sharing component (as can be the case with guaranteed fixed accounts), you can apply an estimated fee/fee offset based on similar investments across the benchmark group.* Investment fees should ultimately be compared at the fund level in the benchmark group so fiduciaries can take appropriate action if their fees need to be adjusted.

#### Fees at the Participant Level

Fees at the participant level represent the fees for participant-elected services like loans, distributions and self-directed brokerage transactions. These fees should be compared against the benchmark group as well since these fees can also have an impact on retirement outcomes.

### Step 3: Perform a Comprehensive Review of Value

Section 404(a) of ERISA requires that the responsible plan fiduciary engage in an objective process designed to elicit information necessary to assess not only the reasonableness of the compensation or fees to be paid for services, but also the qualifications of the service provider and the quality of the services that will be provided. *In fact, the Department of Labor has specifically stated that fees are important, but they are not everything.* Thus, a proper benchmarking exercise should include a review of these three important components of value:

#### Participant Success Measures

Participant success measures evaluate how participants plan, save, invest and spend related to their 401(k). This measurement is an incredibly important component of the exercise, and it can be proven mathematically that a plan paying higher fees for better participant success measures will ultimately result in better participant retirement outcomes. For such an example, see: [www.fiduciarybenchmarks.com/successmeasures.pdf](http://www.fiduciarybenchmarks.com/successmeasures.pdf).

#### Plan Complexity

Plan complexity is an indicator of how the plan's design compares to other plan designs. Plan complexity is neither good nor bad since every plan is designed to suit each employer's individual situation. What is important to know in terms of benchmarking, however, is that a plan that is more complex can cost more to administer.

## Plan Services

While a core set of services is provided to all plans, differences do exist in the type and amount of services plans use. Services generally fall into two buckets—sponsor services and plan services. Sponsor services include things such as fiduciary oversight and best practices support. Plan services include things such as administration and participant education and communication. To effectively benchmark services, the type and amount of services provided by each plan service provider should be compared against the respective service providers in the benchmark group.

## Step 4: Balance Fees and Value When Assessing Reasonableness


Once you have established your benchmark groups, collected all plan related fees and considered the value components of a qualified plan, your next step is to document all of this information as part of a prudent fiduciary process. While there are many ways to perform this task, you should consider these important points:

- Fees should be estimated in dollars yet compared in basis points to normalize the data.
- Fees should be normalized on a per participant basis to put things into perspective. For example, paying \$25,000 more per year for a plan with 100 participants (*i.e.*, \$250 per year) is a lot different than paying \$25,000 more per year for a plan with 25,000 participants (*i.e.*, \$1 per year).
- Not all services are equally important to a plan sponsor. A plan with administrative problems may wish to examine those services versus a plan that is really trying to improve participant investment behavior. Thus, any methodology should allow you to examine the various building blocks of a retirement plan: design, funding, administration and communication.
- Finally, the representation of this information is important. Adult learning principles show that some people receive information better via words, others via numbers and still others via pictures. The best methodology will concisely represent this information all three ways.

## Summary

The national focus on 401(k) fees is intensifying. A very effective way for plan sponsors and service providers to assess those fees is to use a benchmarking process that follows four steps:

1. Establish a valid benchmark group of similar plans.
2. Perform a comprehensive review of fees (including a review of each service provider's fee).
3. Perform a comprehensive review of value (success measures, plan complexity and services).
4. Determine reasonableness of fees by balancing those fees against the value provided.

In closing, plan benchmarking is more than crunching the numbers or assigning a rating. It requires the thorough collection and consideration of a broad series of relevant plan data. For optimum results, benchmarking studies should be reviewed in conjunction with a qualified retirement plan professional who understands the competitive marketplace and the plan's specific needs, priorities and the context of any historical decisions. And while benchmarking a 401(k) plan is not easy, plan sponsors are counting on the support of their service providers in this effort to help them meet their fiduciary responsibilities and to help their participants retire. 



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