7 Fatal Pitfalls of Retirement Plans: Part 1

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By Eve Kaplan, CFP®

Fred and Andrea run a small business called “Apex Optical.” They want the best for their employees and themselves – including a 401(k) plan to help Apex Optical employees maximize retirement savings. Are they doing the right thing? Despite impeccable intentions, they’ve unknowingly set a huge trap for themselves and don’t realize their 401(k) plan is eating them alive.

Here are the first 2 of 7 potentially fatal pitfalls of small business retirement plans (typically 401(k) plans with $2-10 million in assets). We’ve listed clear solutions to these first 2 “potentially fatal sins.” We’ll discuss the next 5 potentially fatal retirement plan sins in March and April, 2010:

Fatal Sin #1: Fiduciary Liability. Fiduciary Liability is the elephant in the room. Apex Optical has 11 employees; 8 participate in their 401(k) plan. Several years ago Fred and Andrea were approached by a friendly insurance agent who helped set up their 401(k) plan. He took care of everything – and Fred and Andrea never looked back…until they were sued by a disgruntled employee who claimed their 401k plan was excessively expensive. It turned out Apex Optical employees were saddled with a whopping 4% annual fee – effectively reducing a 6% return to a mere 2% per year (this hurt Fred and Andrea, too, since they’re plan participants). Fred and Andrea belatedly found out they were personally liable for these poor investment returns – not the insurer offering the 401(k) plan – because the fine print absolved the insurer of any fiduciary obligation! Fred and Andrea, however, WERE personally liable because they couldn't prove they had selected a 401(k) plan in the best interest of their employees. No one told Fred and Andrea – as retirement plan trustees – that they were Fiduciaries under law, held to the Prudent Investment Rule. That made Fred and Andrea a ripe target for a lawsuit. There is an increasing number of lawsuits targeting small businesses as employees realize they've been effectively "taken to the cleaners" by their 401(k) plans.

Solution to Fatal Sin #1: Work with an Independent Advisor 3(21) Fiduciary partnered with a 3(38) Fiduciary for investment options inside the 401(k). Together – as a team – this 3(21) + 3(38) Fiduciary combination completely absorbs all Fiduciary Responsibility and removes all potential liability from the small business offering a 401(k) plan.
Why are so many small business 401(k) plans vulnerable? Business owners are focused on their core business and simply are unaware their 401(k) plans make them legally liable and are crippled by excessive fees.
Fatal Sin #2: Hidden Fees. Hidden Fees is what got Fred and Andrea into this mess in the first place. 401(k) paperwork from the insurance agent was filled with fine print and lacked full disclosure, giving Fred and Andrea the impression their 401k plan was cost-effective. Fred and Andrea proudly asserted their 401(k) plan only cost 0.5%…but hidden fees added a whopping additional 3.5% per year, including 1% administration fees, 0.75% advisory fees, 0.75% commission to traders and 1% underlying investment expense ratios. Bloomberg TV recently exposed hidden fees in their Emmy-winning TV documentary.

Solution to Fatal Sin #2: Work with an Independent 3(21) Fiduciary Advisor partnered with a 3(38) Fiduciary Investment Manager – together they not only 1) shoulder Fiduciary Liability but also 2) slash fees by one-half to two-thirds (i.e. down to the 1.5-1.8% range per year versus 3-5%). How? In March and April, we'll discuss various cost-effective investment strategies that enable a 3(21) +3(38) Fiduciary team to reduce the raging fever (fees) on small business 401k plans and bring them to a tolerable temperature.

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