Fatal Pitfalls in Small Business 401(k) Plans: Part 3

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By Eve Kaplan, CFP®

Americans don't save enough for retirement, small businesses dominate the US in terms of sheer employee numbers, 401(k) plans are their primary retirement vehicle and small business 401k plans typically are low in quality and high in cost. Low quality 401(k) plans are costing small business owners and employees hundreds of millions of dollars each year!

As you recall, Fred and Andrea are the well-intentioned small business owners of "Apex Optical." Instead of "doing right" by their employees with their 401(k) plan, they were stumbling through a plan riddled with problems. Here are the last 2: conflicted advice and 2nd rate service.

Fatal Pitfall #6 – Conflicted Advice: The elephant in the Financial Services world is the "F" word – "F" for "Fiduciary." A small minority of financial professionals are Fiduciaries because they act solely in the best interest of the client – and don't sell commission-based products or split fees. Fiduciaries are obligated to reveal potential conflicts and fully disclose how they're compensated. Registered Investment Advisors (RIAs) are Fiduciaries but brokers and insurance agents are not. 401(k) plans administered by brokers and insurance agents can't claim to put plan participant interests before their own. Fred and Andrea didn't realize mutual funds in their 401(k) plan were selected because mutual fund companies split fees with plan administrators to get their funds included. They also didn't realize their underlying mutual fund expense ratio was a whopping 1.75% per year.

Fatal Pitfall #7: 2nd Rate Service: Fred and Andrea’s experience with their 401(k) plan was typical of brokerage and insurance-house administered 401(k) plans: a sales person visited them, set up the plan and disappeared. Once the sales person earned his commission, there was little incentive for further service. A better choice would have been a Registered Investment Advisor (RIA) servicing their plan since a RIA receives an ongoing fee for ongoing service to the plan.

In Fred and Andrea’s old 401(k) plan, they were overpaying for a hodge-podge of expensive mutual funds cobbled together to benefit fee-splitting agreements between mutual fund companies and plan administrators. They found out they were liable for this sub-standard plan when a disgruntled employee actually sued them for breach of Fiduciary responsibility (he charged they were offering him a sub-standard 401(k) plan). Fred and Andrea didn’t know they were passing up a potentially higher average rates of return with low cost mutual funds bundled into professionally managed (and rebalanced) portfolios.

Finally, Fred and Andrea discovered layers of hidden fees in their 401(k) plan that totaled 4% per year – including the 1.75% they personally were shouldering in underlying expenses imbedded in their mutual funds.

Fred and Andrea fought back by starting a new 401(k) plan with an Independent Registered Investment Advisor Fiduciary. This plan – in Fred’s words – “runs like a BMW but costs the equivalent of a low-end KIA.” Fred and Andrea now pay 1.7% per year for their new 401(k): 1.4% of admin fees (a deductible business expense) and 0.3% in underlying expenses for their professionally managed mutual fund portfolios.

Fred, who’s older and more risk averse, selected a 40% stocks/60% bonds portfolio with access to 10,000+ individual securities. Andrea, younger and more risk tolerant, selected a 65% stocks/35% bonds portfolio. Both are automatically rebalanced – Fred and Andrea never have to go into their

401(k) plans and tinker with "allocation."
Well-intentioned owners and participants who faithfully set money aside in their 401(k) plans deserve better. There is an alternative to expensive, unattractive 401(k) plans….it's "BMW-grade quality at KIA-level price" 401k plans offered by an Independent Registered Investment Advisor who is a Fiduciary.

Fred and Andrea now have a better 401(k) plan in place for themselves and their employees at Apex Optical – and they haven't looked back since.

To recap, here are the 7 pitfalls Fred and Andrea found in their 401(k) plan: 1) Fiduciary Liability (Fred and Andrea didn't realize they could be a lawsuit target, but off-load this liability by setting up a new plan with an Independent 3(38) Fiduciary), 2) Hidden Fees (Fred and Andrea thought their plan cost 0.5% but found out it cost 4% per year), 3) Assuming actively managed funds (that cost most) consistently can outperform diversified, passive funds, 4) Paltry performance (hodge podge of funds – no professionally managed portfolios), 5) Paralyzed participants (employees not able to figure how what combination of funds they need to invest in), 6) Conflicted advice (plans administered by insurance and brokerage companies that utilize fee-splitting) and 7) 2nd rate advice (Fred and Andrea works with a salesman, not an advisor).

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