

What Makes a Good 401(k) Plan?

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A successful 401(k) plan has less to do with technological bells and whistles than it does with achieving the primary purpose of a retirement plan -- helping participants achieve retirement security and making the plan as low cost, low risk and as operationally efficient for the plan sponsor and participants as possible. This is a core idea as it allows us to measure how successful a 401(k) plan is. The diagram below explains graphically what I mean.

401(K) Success Paradigm



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Why is this “success” paradigm such an important idea? Because it forces us to focus on the key issues that matter – participation, savings rates, asset allocation, etc.

And what do we know about most 401(k) plans? Most are deficient by the standards described above. Too few people participate, those who do don't save enough and don't

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even know how much they need to save, assets are allocated poorly, plans cost too much, poor investment performance is tolerated, etc. The above success paradigm serves as a multi-dimensional diagnostic tool to evaluate 401(k) plans, allowing sponsors to move beyond the simple notion that the only way to solve a plan's problems is to change its providers. The success paradigm forces us to think holistically about the health of the entire plan.

Even in the best of times, only eighty percent of eligible employees participate in a typical 401(k). In certain service industries the number is actually quite a bit lower. And only about five to six percent of the participating employee population actually saves up to the annual 401(k) statutory maximum (\$14,000 in 2005). This is precisely the reason that there is so much excitement about the various plan designs that combine automatic enrollment, automatic deferral increases and lifestyle funds because these ideas address head on the inherent weakness of voluntary, participant-directed retirement plans.

The Power of Inertia

With all the options for improving stagnant 401(k) plans, why isn't everyone clamoring to change their plan? The answer probably lies in a truism of human nature: people are creatures of habit, and change--whether good or bad--is stressful. For a company on a tight budget and in a tough economy, the case for making changes to an existing retirement plan has to be objective, logical and compelling.

The Role of Benchmarking

So what might compel a company to change? What if you could rate your plan and see how it compares to other plans on the market? What if you discovered that your plan, to put it politely, is not all that it could be?

Benchmark your plan. The value of a good benchmarking study lies in making comparisons with an established standard. It may be thought of as a "report card" identifying good and bad performers relative to a set of benchmarks, as well as identifying factors that contribute to performance differences.

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The idea behind benchmarking a 401(k) plan is simple. By using objective criteria to measure a plan, you can gage your plan's relative strengths and weaknesses. You then have a powerful tool with which to make informed decisions about improving the plan in such areas as plan design, investments, costs, education and communication strategies, and, finally, service provider competitiveness.

The Essence of A Good Plan

The first step in benchmarking a plan is to gather raw data. You'll need answers to the following questions:

- Is the plan in compliance?
- What is the overall participation rate?
- What is the overall savings rate?
- Are plan assets allocated appropriately based on the company's demographics?
- How well have the investments performed?
- Is the plan cost and operationally efficient?

In general, the more closely the plan is administered according to the terms of the plan document, the greater the number of employees who participate in it, the more money they contribute to it, the better the investment returns, the easier it is to run and the less costly it is, the more successful the plan. Here are some points to consider as you compile your data:

Compliance — A successful 401(k) plan is first and foremost in compliance. It is administered exactly as the plan document is written. It completes all necessary testing and government filings, and distributes all legally required information to participants.

Participation — This is the litmus test for a successful 401(k) plan. If too few people participate, it's not working. Average participation rates vary by industry and wage levels. White-collar industries, for example, tend to have higher participation rates than blue-collar

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and service industries like retail, hospitality, and health care. The overall participation rate across all industries is about 75 percent.

Deferral Percentage —The more money people put aside in their 401(k), the greater their chance for a secure retirement. Also, the higher the savings' rate, the easier it is to pass discrimination testing. The average employee deferral percentage is somewhere between five and seven percent.

Asset Allocation — A 401(k) is fundamentally a long-term savings and retirement plan. The difference between a 6 percent, 8 percent, and 10 percent rate of return over a twenty, thirty or forty-year time period can be enormous. Asset allocation, or the relative percentage a participant puts into cash, bonds and stock, is the fundamental investment decision and can have a huge impact on the funds available at retirement.

Investment Performance — How well (or poorly) the investment options perform, in both absolute and relative terms, has an obvious impact on participants' account balances. For example, at any given point in time, certain asset classes perform better or worse than others but that doesn't necessarily mean the investments have performed well or poorly by objective standards. Sponsors need to know how well the investments have performed against other similar funds as well as on a risk-adjusted basis. Cost is another essential ingredient of the investment equation, with higher than average cost funds effectively creating a drag on investment performance. Again, this requires benchmarking and ongoing monitoring.

Cost and Administrative Efficiency – As a plan sponsor and fiduciary, one of your primary responsibilities is determining the “reasonableness” of fees. This presupposes two things: first, that you have a handle on your plan's total cost structure, and second, that you can put these costs into some kind of context of “high,” “low,” or “average.” You can pay a lot and get a little, or you can pay a modest amount and get a lot. The reality is that 401(k)s are primarily participants' money, and since the participants shoulder the majority

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of plan costs, your primary duty is to keep costs in line. For that you need to know what the total costs are.

Finally, the plan should be run as administratively efficiently as possible. Ideally, the plan participant should be able to easily execute basic plan transactions such as initiating loans or, changing investment options, etc. You should also be able to expect accurate record-keeping, competent administration, and real-time access to aggregate plan data.