THE BEST LAID PLANS

By Chris Garrison, Pinnacle Pension Consultants

THE BOTTOM LINE

- Schools have a legal responsibility to regularly review the retirement plans they offer employees. Colleges have been sued for neglecting that duty.
- Most schools' plans have too many funds and little employee engagement.
- A retirement committee can help examine funds and fees. Employee education about plan choices can increase engagement.

Schools have little time to manage 403(b) plans and employees have little interest. Recent research may help streamline improvements and boost returns.

Why would employees invest retirement savings in expensive funds that perform no better than cheaper ones? Simply because they don't know the less expensive funds are available. This lack of knowledge is common among 403(b) plan participants. An index fund like Vanguard's S&P 500 mutual fund, for example, can be 80% cheaper than other investments in a line-up comprised mostly of annuity options. And the cost difference adds up. Per the Department of Labor, paying 1% over your career can reduce retirement savings by 28%. For the average 403(b) participant, the lost value of paying even ½% too much in fees can be significant — more than $50,000 over a 25-year period, according to Pew Charitable Institute's fee calculator.

Plan sponsors haven't fared much better, primarily because they usually don't have a transparent view of the fees in their plan or time to review fees deeply. Many don't realize their retirement plan's fees have gone up dramatically in the last five years, in many cases virtually doubling. This can spell

trouble not only for employees but also school administrators. In a 2015 landmark ruling, the Supreme Court reaffirmed that plan sponsors have a fiduciary responsibility to review their plan's investments regularly, i.e., annually.

To help business officers better understand their school's situation and evaluate whether employees are getting good value for their fees, Pinnacle launched a research initiative to study plan fee trends and identify employees who need help adjusting their plans.

Held in Trust

Ensuring proper fiduciary responsibility isn't easy. Since 2006, the Department of Labor's regulation of 403(b) plans has become increasingly complex and time consuming. The most recent regulations, in effect since 2012, are the fee disclosure regulations, which require schools to determine if the fees paid to investment managers and retirement providers are "reasonable." Unfortunately, the Department of Labor did not create a template or checklist for plan sponsors, so this interpretation is sometimes unclear. Regardless, plan sponsors are held to the high standard of the Employee Retirement Income Security Act (ERISA): they must look out for the best interest of their participants and operate their retirement plans with the skill, diligence and care of a prudent expert.

Every year, plan sponsors receive fee disclosure reports, but often the important task of reviewing fees for reasonableness falls by the wayside. The annual audit of the plan does not provide help, as auditors are required to check only that fees are accurate, not that they are reasonable. Vanguard summarized plan sponsor reaction well in a 2016 whitepaper: "While plan sponsors undoubtedly benefit from receiving more comprehensive and more uniform disclosures, many sponsors wonder what it all means for them. ... [They] understand they have a fiduciary duty to ensure that plan fees are reasonable, but they repeatedly ask how to determine reasonableness."

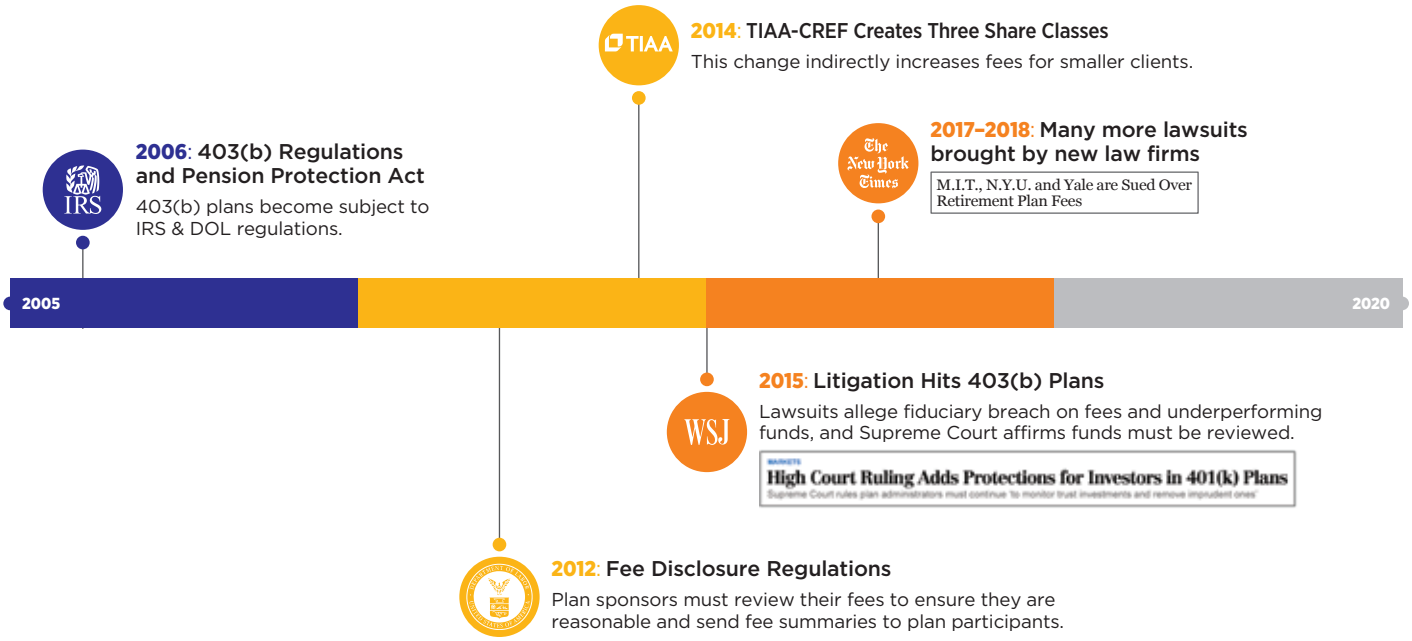
To avoid personal liability — and I stress, the liability is personal, not institutional — plan fiduciaries must review fees to ensure they are reasonable and document how they came to that conclusion. See chart "Pinnacle's Annual 403(b) Plan Review Checklist" (above) and sidebar "Understanding and Managing Plan Fees" (page 29) for more information.

Pinnacle's Annual 403(b) Plan Review Checklist

Investments	
☐ Fund Performance	Review fund performance and change funds as needed.
☐ Redundant Funds	Identify funds that do not add value compared to funds in same category.
☐ Funds' Share Class	Examine funds to see if a cheaper version of the fund can be used.
Fees	
☐ Fees and Services	Understand all fees and compare them to services received.
☐ Provider Fees	Get competitive bids or do benchmarking study every three to five years.
Employee Engagement	
☐ Diversified Portfolios	Determine if employees are using new funds to create diversified portfolios.
☐ Annual Rebalancing	Review plan to see if employees are managing their investments.

Benchmarking Fees and Funds

Last year, Pinnacle conducted the first phase of a research project drawing on the publicly filed IRS form Form 5500 to benchmark 403(b) plan fees and the number of funds offered in investment lineups. We created a database of more than 750 plans. NBOA schools comprise roughly 20% of the database. The first round of results are for schools in the Boston and



Understanding and Managing Plan Fees

403(b) plans use annuities and mutual funds, and these investment products can have multiple layers of fees. The fee arrangements with retirement providers can be equally complicated and opaque. Getting a fully transparent view requires examining a plan's fees across at least three categories – plan level fees, participant level fees, and the fees of the plan's various investment products. It is a painstaking process.

When reviewing a plan's fees, consider total fees paid, all types of fees and the range of fees or share classes of the investments used, generally mutual funds and annuities. As a plan's assets grow, plan sponsors should look into whether their plan can move to a cheaper version of the same fund, saving their employees money.

Once this exercise is complete, plan sponsors need to make sure fees are competitive by doing either an RFP/RFI or benchmarking review, and documenting whether the services received are worth what plan participants have paid. To quote Warren Buffet, "Price is what you pay. Value is what you receive."

Pinnacle's Research Findings on Independent School 403(b) Plans

	Boston Area	*New York City area*
Range of funds offered	10 to 100	10 to 66
Avg. number of funds offered	45	30
Plans with more than 15-20 investment options	85%	75%
Average fee	56 bps	51 bps

BPS stands for basis points on 1/100 of 1%. For example, 56 bps equals 0.56% or $5.60 per $1,000 invested. For the Boston area, Pinnacle studied more than 300 plans, ranging $5-100 million in value and 43-73 bps. For New York City area, Pinnacle studied more than 200 plans, ranging from $5-100 million in value and 43-64 bps.

New York City areas, but we will continue to expand the study in 2020.

Results revealed a wide range of fees and demonstrated that the vast majority of plans had significantly more than 15 to 20 funds, the maximum recommended by many experts. We also found that 403(b) plans typically had individual contracts, which create a hurdle: to take advantage of an investment line-up upgrade, each employee must move their money to a new fund. This barrier effectively traps most of the plan's assets in an outdated or "legacy" investment structure.

Evolving Plan Design

Pinnacle's research also examined the investment lineup in schools' 403(b) plans. Over the last twenty years, investment-related decisions and plan features have been heavily influenced by how retirement providers (e.g., TIAA, Fidelity, Principal, VOYA) marketed their investment products. A common practice for plan sponsors, including schools, was to simply add whatever investment funds their provider suggested, without doing any due diligence. As a result, the investment lineups of many 403(b) plans reflect more of a patchwork approach than a deliberate design.

Today, common problems with investment line-up design include (1) plans with too many proprietary funds (record keeper's funds), (2) too many funds in total and (3) funds that should be eliminated because they underperform, are too expensive, or are redundant. Research has shown employees struggle making investment decisions, and when they have too many funds to choose from, the result can be poor decisions or no decision at all, what behavioral economists call "the paradox of choice." Two of the biggest contributors to inertia in 403(b) plans are employees' lack of comfort with investing and difficulty in understanding the information they receive.

Our research found that redundant, overly expensive funds were widespread. It was not uncommon to find overlapping investment options in the same category (e.g., U.S. Large Cap Growth, International, Bond, etc.), all with the same investment strategy, with the cheaper options costing one quarter the cost of the more expensive option. Plans would bear more fruit if investment line-ups were streamlined to have fewer funds and if employees received more education to help them move their money out of the more expensive and redundant funds.

Engaging Employees

Many independent schools have yet to establish a process to review their plan's investments and fees. To address this, schools could form a retirement committee or look for third-party expertise in an investment advisor. However, even schools that have hired an advisor and rolled out a new investment line-up often find that little change takes place. Pinnacle's research revealed that when new investment options were rolled out, on average only 1–2% of the plan's assets went into these options, clear evidence of a lack of employee engagement. This happens even when plan changes are clearly communicated in advance and promoted as an enhancement to the plan. Employees simply are not comfortable making investment decisions and rebalancing their accounts, so they end up doing nothing.

In cases like these, additional intervention can help employees take better advantage of new investments and advisor recommendations. These can range from more on-campus education to one-to-one advisory services. Managed accounts, another option, are common in 401(k) plans but rare in

the 403(b) industry due to the complexity of individual contracts and investment products.

The Buck Stops Where?

To be clear, independent schools play a vital role in the stewardship of their 403(b) plans regardless of whom they may hire to improve them; schools cannot outsource all of their fiduciary responsibilities. Schools and their plan's fiduciaries will still need to meet ERISA's standard, which requires (1) they manage the plan so it satisfies ERISA's "prudent expert" standard and (2) that the plan's fees are reasonable when compared to the services received.

To ensure your school is in compliance, consider two areas. First, implement strong governance management processes by setting up a retirement committee whose sole focus is to manage your fiduciary responsibilities. The investment committee that manages your endowment invariably knows investments, but it is doubtful they want to be a plan fiduciary for the 403(b) plan. Often the first step is to move to what is referred to as an "open architecture" investment line-up, adding funds from outside investment managers, that is, expanding the investments offered beyond the record keeper's funds. Transitioning to a "best-in-class" approach — adding a greater diversity of funds from firms who specialize in specific investment disciplines and closing funds which underperform — helps schools ensure their fiduciary responsibility.

Second, reduce your school's risk and protect the plan's fiduciaries. This may entail hiring an independent consultant who is prepared to become a fiduciary to the plan and is conflict-free. Several of the settlements of 403(b) lawsuits have included a requirement that the plans involved hire an advisor.

A well-designed plan has the right combination of products, features and services that are easy and cost-effective for employees to use. An exceptional plan will have a best-in-class investment line-up and effective education program, including resources to help employees. Over the last several years, fees for plan investments and administration have been coming down. Take advantage of these trends by negotiating with your school's retirement provider and then helping employees use the new investments. N

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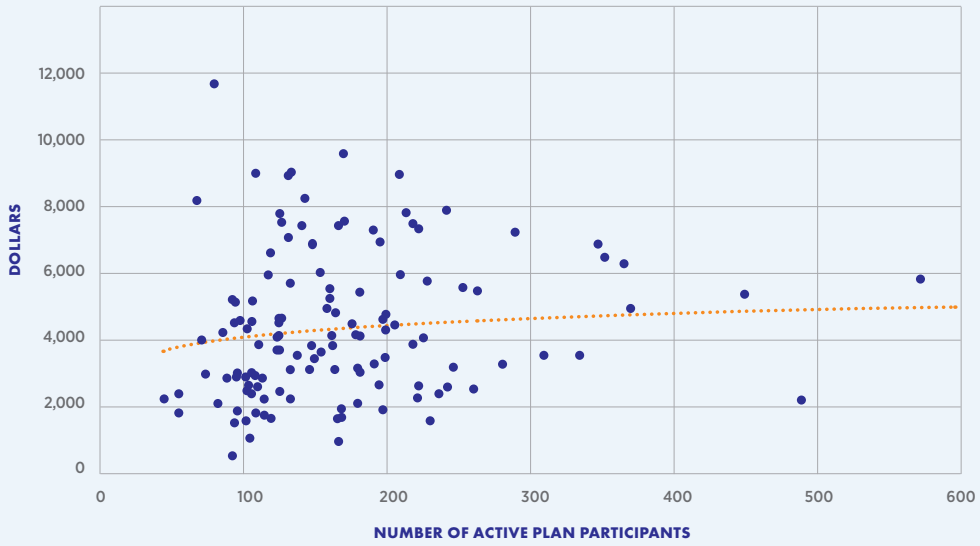
Average School 403(b) Contribution per Active Plan Participant



Free-Range Employer Contributions

School contributions to retirement plans range widely, according to Pinnacle's research. This may be another opportunity to make a plan more helpful to employees and cost-effective for schools. Is this dispersion a problem? Maybe yes, maybe no, but it's certainly worth considering as a planning opportunity.