Participant Directed Accounts versus Trustee Directed Accounts: Why Employers Should Consider Trustee Directed 401(k) Plans

Although some 401(k) plan participants may be savvy investors, evidence indicates that as a whole they are woefully unprepared to make their own investment decisions. Consider the typical 401(k) plan participant—he or she has no formal training in investment strategy and is unlikely to seek out training even when offered by his or her employer. In a 2008 survey by the Profit Sharing/401(k) Council of America, it was reported that nearly 72% of participants failed to take advantage of professional investment advice when it was offered to them.[i] And let's be honest, a brief meeting with a financial advisor does not make one a wise and skilled investor. A study published in 2007 relates an anecdote in which a large employer offered investor education to its employees. The employees took a financial literacy test before and after the instruction. The test was entirely in a true/false format. Prior to receiving counseling the employees scored 54% on the test. Keep in mind that if the correct answers were evenly distributed between true and false, guessing as a strategy would have likely netted a 50% score. After counseling, the employees scored 55% on the same test.[ii] Not surprisingly, evidence indicates that participant directed 401(k) plans tend to obtain lower returns on investments than trustee directed plans. Over time, the lower returns associated with participant directed 401(k) accounts substantially reduce 401(k) account balances and, therefore, retirement income.

Let's compare the growth of two hypothetical 401(k) account balances from 1984 through 2012. $5,000 is contributed annually to each account (10% of annual income for an individual earning $50,000 a year). One account is trustee directed and the other is participant directed. The trustee directed account is invested in a passively managed S&P 500 index fund with 100 basis points in fees annually. The participant directed account experiences rates of return typical for an individual investing in actively managed mutual funds. A relatively well known DALBAR study in 2003 found that from 1984 through 2002, *the average annual return achieved by individual investors trading actively managed stock mutual funds was nearly 10% less than the average annual return earned by a passively managed S&P 500 index fund. 7.3% of the gap was due almost entirely to investor behavior—namely unsuccessful attempts at market timing*.[iii] The remaining gap was due mainly to fees associated with actively managed funds. For our purposes, however, let's assume that while our 401(k) plan participant avoids the additional fees, that his/her account achieves 7.3% less per year than the S&P 500 index minus 100 basis points in fees.

The results (see the table below) are startling.[iv] The trustee directed account, invested in an inexpensive index fund based on the S&P 500 without attempts to "time the market", outperforms the participant directed account by more than $385,000.

Independent Actuaries, Inc.

Year	R/R S&P 500	Fees	R/R Trustee Directed	Trustee Directed Acct. Bal.	R/R Adjusted for Individual Investor	Participant Directed Acct. Bal.
1984	6.27%	-1.00%	5.27%	5,131.75	-2.03%	4,949.25
1985	31.73%	-1.00%	30.73%	12,476.99	23.43%	11,694.61
1986	18.67%	-1.00%	17.67%	20,123.42	10.37%	18,166.59
1987	5.25%	-1.00%	4.25%	26,084.92	-3.05%	22,536.26
1988	16.61%	-1.00%	15.61%	35,547.02	8.31%	29,616.77
1989	31.69%	-1.00%	30.69%	52,223.65	23.39%	42,128.89
1990	-3.11%	-1.00%	-4.11%	54,974.51	-11.41%	42,036.73
1991	30.47%	-1.00%	29.47%	76,912.25	22.17%	56,910.52
1992	7.62%	-1.00%	6.62%	87,169.34	-0.68%	61,506.53
1993	10.08%	-1.00%	9.08%	100,311.31	1.78%	67,645.85
1994	1.32%	-1.00%	0.32%	105,640.31	-6.98%	67,749.67
1995	37.58%	-1.00%	36.58%	150,198.04	29.28%	93,318.77
1996	22.96%	-1.00%	21.96%	188,730.53	14.66%	112,365.80
1997	33.36%	-1.00%	32.36%	255,612.72	25.06%	146,151.17
1998	28.58%	-1.00%	27.58%	331,800.21	20.28%	181,297.63
1999	21.04%	-1.00%	20.04%	403,793.97	12.74%	209,713.45
2000	-9.11%	-1.00%	-10.11%	367,717.65	-17.41%	177,767.09
2001	-11.89%	-1.00%	-12.89%	324,996.60	-20.19%	146,371.16
2002	-22.10%	-1.00%	-23.10%	254,344.88	-30.40%	106,114.33
2003	28.68%	-1.00%	27.68%	330,439.55	20.38%	133,249.93
2004	10.88%	-1.00%	9.88%	368,333.98	2.58%	141,752.28
2005	4.91%	-1.00%	3.91%	387,833.58	-3.39%	141,862.12
2006	15.79%	-1.00%	14.79%	450,563.92	7.49%	157,674.85
2007	5.49%	-1.00%	4.49%	475,906.49	-2.81%	158,173.93
2008	-37.00%	-1.00%	-38.00%	299,112.02	-45.30%	90,388.64
2009	26.46%	-1.00%	25.46%	380,902.45	18.16%	112,257.22
2010	15.06%	-1.00%	14.06%	439,808.83	6.76%	125,014.81
2011	2.11%	-1.00%	1.11%	449,718.46	-6.19%	122,121.64
2012	16.00%	-1.00%	15.00%	**522,551.23**	7.70%	**136,717.51**

Trustee directed plans outperform participant directed plans because the typical 401(k) plan participant lacks the training and discipline necessary to make successful investment decisions. While most employers probably think they are doing their employees a service, the truth is that allowing participants to direct their own accounts generally results in reduced retirement savings. The results will vary. For some, it may mean merely delaying retirement for a few years (we've all seen the 70-plus year old greeting customers on their way into Wal-Mart), but for others it may mean living out one's golden years in poverty. The conclusion is simple – most plan sponsors (trustees) would better serve their employees by appointing a skilled investment manager to oversee plan investments.

Main 503.520.0848
Toll Free 888.643.5179
Fax 503.520.1147
15725 SW Greystone Court, Suite102
Beaverton, OR 97006-6016
www.independentactuaries.com

****

This article was written by Jason W. Douthit, J.D. Jason's work focuses on defined contribution plans and executive deferred compensation plans. He also represents employers in matters related to IRS and Department of Labor qualified plan correction programs. Jason holds a B.A. in Labor Studies and Philosophy, a J.D. from University of California at Davis School of Law, and is a member of the Oregon State Bar.

---

[i] See PSCA.org, 52nd Annual Survey of Profit Sharing and 401(k) Plans Reflecting 2008 Plan Experience, page 62 (2009).
[ii] See Journal of Pension Benefits, Autumn 2008 page 28.
[iii] See Journal of Pension Benefits, Summer 2005, page 6-7.
[iv] See http://www.standardandpoors.com/indices/articles/en/us/?articleType=XLS&assetID=1245335505851 for Index returns from 1988 through 2012. Prior years (going back to 1926) can be found at http://www.istockanalyst.com/article/viewarticle/articleid/2803347.