Evaluating 401(k)Providers:
Separating Commodity From Value-Added Services

One of the most important fiduciary duties of a 401(k) plan sponsor is to select a competent service provider – which can be easier said than done. Understanding each service that makes up a 401(k) plan and applying appropriate benchmarks to those services to measure their value is essential to the selection process. Only then will you be ready to choose a 401(k) provider based on the value of their services.

Commodity vs. Value-Added Services

Some components of 401(k) services are appropriately thought of as a commodity – differentiation is based primarily (if not exclusively) on price. Other services are considered "value-added," often tailored to specific needs and objectives of the client. Providers are differentiated by the value of services received by the plan – and price is sometimes a lesser consideration.

Here are the services that comprise a 401(k) plan:

- Custody: plan assets are held in a trust within which trades are executed
- Recordkeeping: contributions, earnings and investments must be monitored on a participant-level; custodian must be directed to execute trades
- Third-Party Administration (TPA): responsible for plan design, plan documents, and annual ERISA compliance (discrimination testing, Form 5500 preparation)
- Investment Advice: selection of an investment menu and/or offer; participant investment recommendations

Custody and Recordkeeping are "Commodity" Services

Like any commodity, assuming comparable quality, the key measure for these services is price. The cheaper you can find competent custody and recordkeeping services, the better for participants. While accuracy, execution and speed matter, speed doesn't vary much provider-by provider and those with accuracy issues are run out of business by trade error reimbursements or lawsuits.

Investment Advice and TPA services fall into the "value-added" category – the expertise of a service provider can significantly impact a plan's value to participants and the plan sponsor. That means it may be reasonable to pay more for these services if the incremental cost of a more expensive provider is outweighed by their value.

Instead of evaluating a provider as a whole, the recommendation is to use a two-step approach for assessing TPA services and investment advice. This means 1) choosing a benchmark for each service and 2) evaluating each service against the benchmark.

Third-Party Administration (TPA) Services

It also makes sense to consider the value of TPA services for participants and plan sponsors separately.

When you add custody, recordkeeping and TPA services together, you have a "platform" for 401(k) investing. To maximize participant investment returns, a platform should be as efficient as possible to keep costs down. For this reason, price may be the most reasonable benchmark for evaluating the value of a TPA to your participants.

Retirement plans are generally established with specific contribution goals in mind (typically they include maximizing the owner's share of total contributions and offering an employer contribution to employees to incentivize participation, etc.). A well-designed 401(k) plan meets these objectives at the lowest cost, sometimes saving an employer tens of thousands of dollars in the process. For this reason, it makes sense to use employer contribution expense as the benchmark for evaluating the value of a TPA. A well designed plan can minimize company contribution costs and reduce the "missed saving opportunities" for owners that can occur when a TPA does not have design expertise.

Investment Advice

Investment advice may seem like the most daunting service to benchmark, but it doesn't need to be. For purposes of benchmarking, investment advice is defined as both investment menu selection and participant-level investment advice. Participant investment returns are a function of the investment advice they receive.

The use of index funds and Target Date Funds (TDFs) in retirement plans has grown dramatically over the past ten years. Index funds offer inherently-diversified market returns at a low cost, while TDFs offer a professionally-managed mix of funds that grows increasingly conservative the closer a participant gets to retirement. A Target Date Index Fund (TDIF) is a TDF that uses a mix of index funds.

TDIF returns can be used as the benchmark for 401(k) investment advice. That's not to say a financial advisor can't deliver investment returns for participants in excess of TDIF returns (after all expenses are considered) – but they are a reasonable measure of the minimum expected return.

Service	Benchmark
Custody	Price
Recordkeeping	Price
TPA Services – Participant	Price
TPA Services – Sponsor	Employer contribution expense
Investment Advice	TDIF investment returns

Don't Shop by Check Box

Often, for lack of an understanding of the inner workings of the plan, sponsors shop for 401(k) service providers by checkbox -they pick providers based on the breadth of the services they offer. What's the value of a feature no one uses? None. That's why the checkbox approach is flawed – there needs to be a correlation between expense and value.

First and foremost, it should be the goal of every retirement plan to facilitate retirement security for its participants. Expert service providers can help a 401(k) plan meet that objective, but costs need to be matched to value added to the plan.

To view the original article: http://www.employeefiduciary.com/evaluating-401k-providers-separating-commodity-value-added-services/