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26 MOTOROLA, DELL: WHEN TO GET BACK IN

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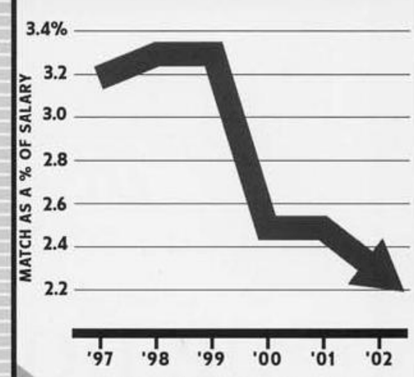

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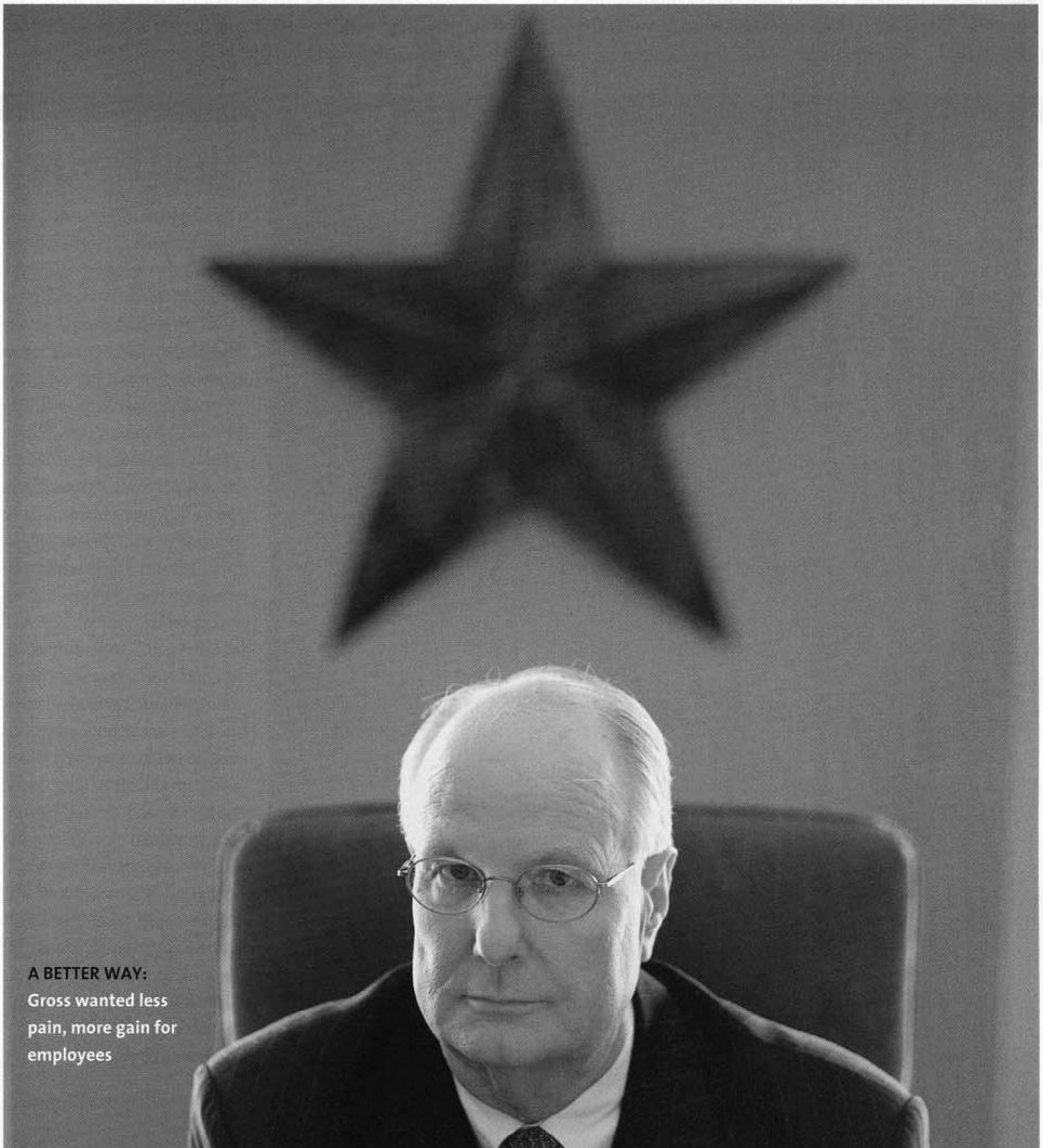
REMAKING A 401(K) PLAN

BY JOHN T. WARD

What happens when a pair of executives look into their employees' future and don't like what they see?

A YEAR AGO, SERVICE ASSET MANAGEMENT CO. (SAMCO), A Dallas-based investment banking and bond underwriting firm, had a 401(k) plan for its 100 employees that was fairly conventional—and undeniably mediocre. Only 35 percent of the workers at the privately held company had joined the plan, contributing an average of 3 percent of their salaries. The participants paid high fees of about 250 basis points (2.5 percent of assets) annually and had their choice of more than a dozen funds from Fidelity Investments. Mired in the bear market, most of the funds were turning in negative returns for the year.

William "Tex" Gross, a principal of SAMCO and president of the SAMCO Capital Markets division, hadn't given much thought to the plan since setting it up for employees in 1994—except when he occasionally ran into an acquaintance, Brooks Hamilton, a Dallas lawyer and benefits specialist.



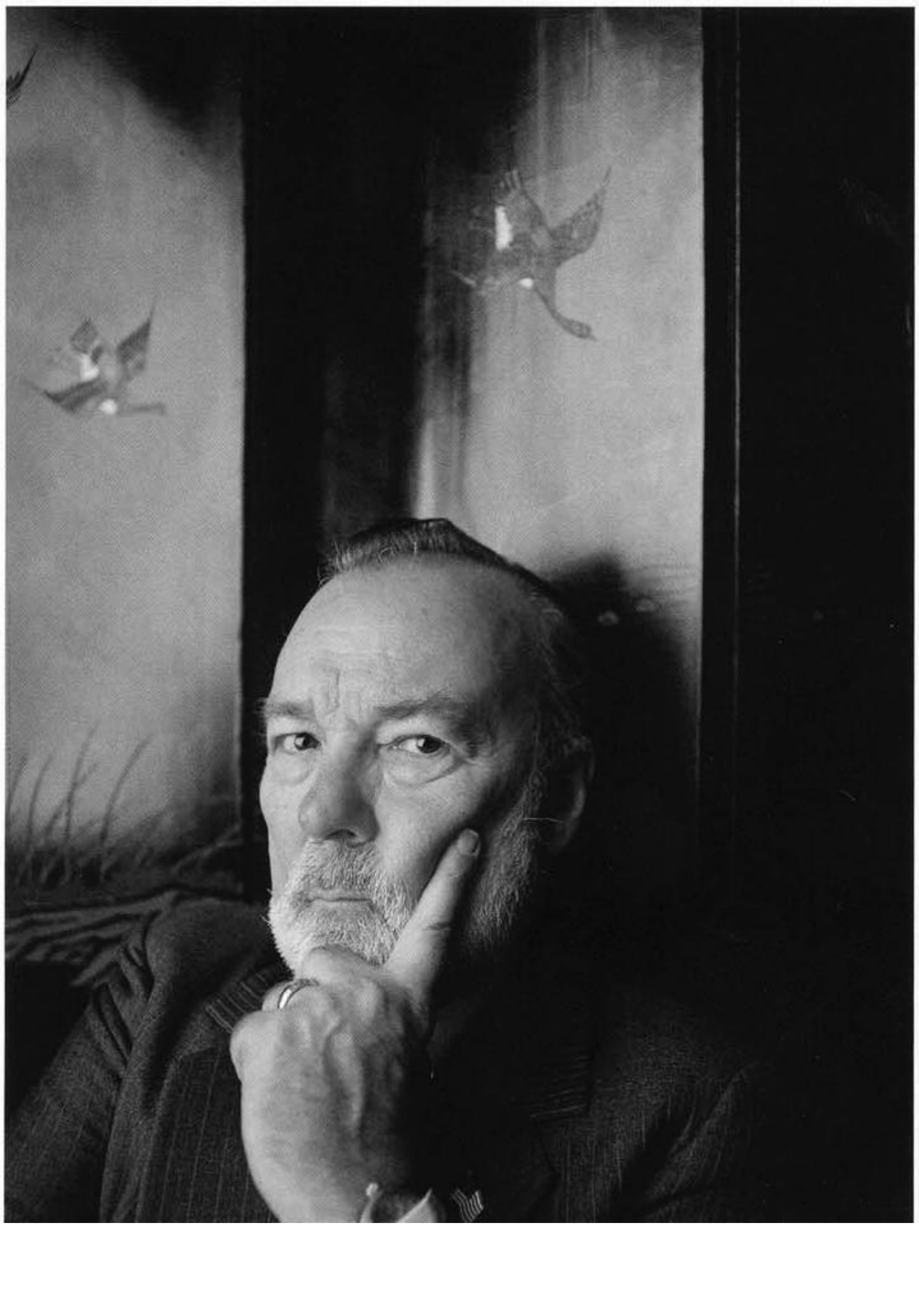
A BETTER WAY: Gross wanted less pain, more gain for employees

Hamilton kept nagging Gross to allow him to come in to talk about 401(k) plans sometime, and would bend Gross's ear with tirades about a looming retirement crisis.

Six floors below SAMCO's 20th-story high-rise offices, there were similar vague misgivings in the executive suite at Penson Financial Services, a clearing outfit for brokerage firms such as CyberTrader and Track Data Securities. (Penson and SAMCO, once part of the same company, are now formally independent of each other but have common ownership and share payroll and benefits services.) Back in mid-2000, Penson president and co-founder Daniel P. Son recalls overhearing an employee say she'd chosen Fidelity's Contrafund from among the available options because "she liked the way it sounded." "Bells went off," says Son, 64, who is trained as a certified public accountant. He says the remark made him realize that the firm's responsibilities to its workers weren't being fully met, now that Penson had grown from 9 employees to 200 in the United States (as well as another 100 located in Canada and England).

Around the same time, SAMCO and Penson were in the process of separating so that Penson could go public. The initial public offering was later scrapped when it became clear that the ailing new-issues market wasn't going to recover anytime soon, but a review of the benefits plans that had begun as part of the corporate restructuring continued. The owners of SAMCO and Penson concluded that they weren't doing enough to help their combined 300 employees make informed investment choices and that the consequences could be grave—for the employees. Asking the average employee to choose the best mutual funds "is like my surgeon asking me to direct the operation on my knees," says Gross, a 60-year-old "more-than-avid" quail hunter who had both joints replaced last summer. "We were forcing people to make decisions without training or adequate knowledge."

So Gross and Son decided to ask Hamilton to pay them a visit. The insights from the consultant were startling. Not only were the two firms' employees facing trouble down the road, explained Hamilton, but Penson and SAMCO—and



Steal This Plan

ASK BROOKS HAMILTON about the average American's retirement prospects, then stand back. Hamilton, a Dallas-based benefits attorney and 401(k) consultant, is part evangelist, part revolutionary on the topic. "I fear 401(k) plans are systematically and fatally flawed, and won't deliver on their promise," he says. Fixing the 401(k) system, according to him, requires more than tinkering. It calls for radical overhaul.

And so Hamilton has designed his "American Freedom 401(k)" to combat what he sees as the biggest flaws of the defined-contribution system: too little employee participation, paltry contributions, and lousy investment performance. Addressing the first two problems involves putting employee participation on autopilot.

CHANGE AGENT: **Hamilton would make 401(k)s look more like traditional pensions**

AVERAGE CONTRIBUTIONS JUMPED FROM 3 TO 7 PERCENT OF PAY.

plan sponsors far beyond the borders of the Lone Star State—appear to be headed into the horns of what Hamilton believes is one of the biggest potential liabilities American business has yet faced. The way Hamilton sees it, a generation of workers, having been sold by their employers on the wealth-building possibilities of self-directed retirement accounts, may find themselves having to sell off assets to survive their golden years. Or, as the figuratively minded Hamilton says in his soft twang, "You're going to have to eat your sofa."

Hamilton, of course, is far from alone in worrying that today's underwhelming 401(k) participation and insufficient market performance bode ill for retirees. Unlike most other benefits experts, though, he envisions huge class-action lawsuits by workers on the wrong end of 401(k) return disparities: a tendency of higher-income earners to choose more successful investment options than those in the bottom 20 percent of the income ladder. The legal cause of action, as he sees it, is "deliberate indifference" by plan sponsors to the fact that workers are not up to the job of managing their own retirement funds. "We have shifted all the risks and all the costs and all the responsibilities to a disinterested novice," he says.

The gloomy forecast had the desired effect: It got the attention of SAMCO and Penson officials. Gross says he came away from a meeting with Hamilton convinced that "there are a bunch of oily rags smoldering in the basement of corporate America, and sooner or later, somebody's going to have a fire."

Hamilton's solution—his fire prevention system—is a plan he has dubbed the "American Freedom 401(k)." It is structured to address what Hamilton sees as the many shortcomings of the typical plan (see "Steal This Plan," p. 66). Too few participants? Use automatic enrollment to put all workers in the plan, and make those who want out do the paperwork to be removed. Meager savings rates? Start workers out deferring 5 percent of their pay, and if they wish to put in less, again, make them say so in writing. Participant inertia? Increase the employees' withholdings 1 percent a year until they cry uncle or reach the legal contribution limit.

Those provisions get workers to pony up, but Hamilton's

The third hurdle is a bit more complicated. Hamilton's cornerstone solution is the PDI, or "professionally directed investment" account, in which 401(k) assets are managed in much the same way as are old-fashioned pension accounts, by professionals, who typically charge lower fees than retail mutual funds.

Hamilton presented features of the American Freedom 401(k) at a briefing session for Senate and House aides in January, amid the debate over 401(k) provisions after the Enron scandal:

- Automatic enrollment. Rather than making employees who want to join go to the trouble of filling out a form and sending it back, force workers who don't want to be part of the program to do the paperwork. "And we say if you want to opt out, and you're married, your spouse also has to opt out, and the form must be notarized. If you opt out of a traditional pension, the law makes your spouse sign to reject it," he says.
- Automatic enrollment with employee contributions of 4 to 6 percent of salary. Plans now typically default at a low contribution level of 2 to 3 percent.
- Fund choices by strategy, not brand name. "We have pre-mixed portfolios, managed by modern portfolio theory." American Freedom's choices: A minimum-risk fund (target return of 6 percent), a moderate-risk fund (target return of 8 percent), a balanced-risk fund (target return of 10 percent), a market-risk fund (target return of 12 percent), and an aggressive-risk fund (target return of 14 percent).
- Automatic enrollment accounts invested in a PDI. Unless the employee specifies another option, accounts are invested in the plan's moderately aggressive strategy fund that aims for a 13 percent rate of return.
- A restriction on cashing out 401(k)s when employees change jobs. "You don't have access to your traditional pension money or Social Security money if you switch jobs; why should you have it with 401(k) funds?"
- A prohibition on borrowing from your 401(k).
- Hardship loans, rather than distributions. It's now possible to get a hardship distribution, but you must pay taxes and a penalty. In addition, after a hardship distribution, you're prohibited from participating in the plan for six months or more. The plan would make a hardship loan available to employees who needed the money for specific purposes, such as medical bills. But the loan comes from the plan's trust fund itself, rather than the individual. That avoids the taxes and penalties.
- Full and immediate vesting of employer matching contributions.
- Administrative fees and expenses of the plan are paid for by the company, or else these costs are shouldered by employees but capped at 1 percent. Anything above that is paid by the company.
- A "supersaver" provision that automatically bumps up all employee contributions 1 percent each January 1 until they reach the pre-tax contribution limit, currently $11,000 a year. Again, individuals could opt out.
- Corporate matches that also increase automatically.

Many aspects of Hamilton's plan are a hard sell to employers and employees alike, and his target returns for some investment choices seem overly optimistic. His hope is to get Congress to encourage employers to use the plan in return for added protection against employee lawsuits (to which Hamilton thinks firms are more vulnerable than they realize). "It's a difficult process, telling companies to basically abandon what they've done—which is give the plan to a Merrill Lynch or Fidelity and forget about it," Hamilton concedes. "I'm trying to launch a revolution here." —*Janet Bamford*

INNOVATING RETIREMENT SOLUTIONS

plan goes on to address the documented tendency of workers to choose investments least likely to produce meaningful growth. American Freedom 401(k) comes with a default investment option that is more aggressive than the super-safe money market funds often specified for automatic enrollment plans. It shoots for 13 percent annualized returns over 10 years. And to avoid the kind of high fees often charged by mutual funds, Hamilton recommends giving the job of managing the plan's assets to a cost-conscious professional, preferably someone steeped in the art of "efficient-frontier" investing, where risks and rewards are as nearly in balance as possible. What's more, SAMCO and Penson bear the costs for the plan.

The American Freedom plan isn't proprietary. Hamilton cobbled it together using elements already available. Automatic enrollment, for example, has been sanctioned by the Internal Revenue Service since 1998 and was in use at 14 percent of plan sponsors a year ago. Though longtime adherent McDonald's recently abandoned auto enrollment because of its failure to boost contributions, it's a proven method of getting workers to save for retirement without a lot of upheaval, says Andrew Metrick, an assistant professor of finance at the University of Pennsylvania's Wharton School. "There's very little kicking and screaming, and most people stay in the plan," he says.

Less common is the plan's aggressive approach to a default investment portfolio. "The perfect defaults are the ones that come closest to making people do what they would do on their own if they had hours to choose," says Metrick. That usually means striking a balance between choices that are too conservative to build wealth and those that seem too risky, while recognizing that employees are loath to change their investment allocations once they've been set. "You want to default people into something that six months later they'll look at and say, 'This is fine,'" Metrick says.

Hamilton's timing was good: By the time SAMCO and Penson officials got around to seriously considering his plan in the summer of 2001, most of the funds available under their existing Fidelity Investments-run plan were in the red, while the proposed default model was on its way to generating an 8.75 percent annualized return, Hamilton says. Still, when the new plan was unveiled to the rank and file beginning last November, there was an unexpected backlash. Workers, it turned out, had an intense brand loyalty to Fidelity.

"Some employees said, 'Wait a minute—what are you doing to us?'" Son recalls. "We probably were not as prepared as we should have been. I didn't expect any flak because we were properly motivated."

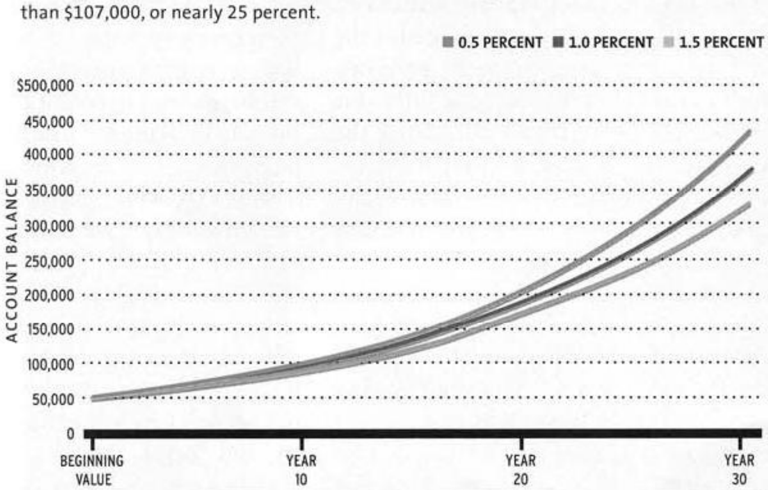
"We underestimated people's comfort level with the major mutual fund choices," concedes George A. Kirchwey, a transplanted New Englander and SAMCO Capital Markets vice president who was given the job of handling employee communications in the plan makeover. Though the Fidelity funds were at the time posting less-than-stellar results and charging what company executives considered high fees, "they were name brand," Kirchwey says.

So SAMCO and Penson officials set out to demonstrate how the American Freedom plan's investment options were chosen to produce consistently better returns, and to do so at less expense to plan participants. Nolan Jones of Dallas-based Optima Asset Management, who had been tapped to handle the money, was called in to explain the efficient-frontier investing strategy he employs. This method starts with a return target—say, 8 percent—and then loads up on investments that history shows are most likely to produce that return. Optima works with just two or three dozen institutional funds and twice yearly rebalances the holdings of its portfolios, which are designed to achieve differing levels of return and volatility. The approach also minimizes trading costs, says Jones. That meant Optima would be able to cut fees charged to participant accounts to 125 basis points (1.25 percent) or less, employees were told in meetings.

Explaining all this to people—some of whom who didn't know a value fund from a growth fund—was a challenge, Jones admits. "But the good news is the staff had a couple of folks who were CFAs [chartered financial analysts] and were able to vouch for the efficient-frontier methodology," he says. "I think they walked out of the meeting and

FEES DO COUNT

An employee with a 401(k) balance of $50,000 and 30 years to retirement will end up with drastically different retirement account balances depending on the fees paid each year to the fund managers. With fees of 0.5 percent, the balance will grow to $437,748.* However, with higher fees of 1.5 percent, the balance will reach only $330,718—a difference of more than $107,000, or nearly 25 percent.



*Assumes no additional contributions, with assets growing 8 percent a year.

Source: Hewitt Associates

said, 'Hey, this guy's worth listening to.'"

Under the proposed plan, the workers could choose to direct their contributions into one of five portfolios with 10-year average annual return targets of 6, 8, 10, 12, and 14 percent—the higher the target, the higher the risk. A sixth option, designed for those whose heads were still spinning, was the default plan (known as the "professionally directed investment" account, or PDI), with its 13 percent return target. Employees who did not specify a portfolio had their contributions automatically invested in the PDI. And though Hamilton considers it too anemic for meaningful retirement saving, the 6 percent "minimum risk" investment option was included as a real-world concession to worker demands. "[Hamilton] chafes about it," Kirchwey says. "But we offer it to give employees who are deeply concerned about it a low-risk, low-return option."

Not all the American Freedom plan's features were adopted by SAMCO and Penson. Hamilton concedes that his proposal that departing employees be prohibited from cashing out a 401(k) balance would be unpopular with workers. "I can see somebody picketing in front of an office, with a sign that says, 'They won't let me have my own money,'" he says, adding that such a stricture is better enacted by legislation. Still, SAMCO and Penson provide hardship loans from the plan, rather than from an individual's account, to help employees avoid some of the penalties such a loan would entail. The companies have also agreed to pay many of the fees of the 401(k) plan, including recordkeeping, educational, consulting, and attorney fees, and even the cost of mailing quarterly account statements. The investment management cost and custodial fees come out of workers' accounts, but the company reimburses the plan.

Nevertheless, a group of employees continued to resist the change. Last December, as the new plan was about to kick into gear at SAMCO and Penson, some two dozen objectors were allowed to stay with Fidelity, though new enrollments were barred. The American Freedom plan went into effect January 10. Results so far have been encouraging. Helped by the automatic enrollment and default 5 percent contributions, plan participation soared to 97 percent, from the mid-30s. Average contributions jumped from 3 percent of pay to 7 percent. Not surprisingly, three out of four employees went with—or did not resist enrollment in—the default investment strategy. Among them is Kirchwey, an MBA who specializes in corporate debt analysis. "I do plenty of research just to keep my job," he says. Son says he let himself be defaulted because he felt comfortable with those provisions and "because it was easier to do that than fill out the forms" to select another option.

That may be the real beauty of the American Freedom 401(k) approach, says Gross—taking the load off the shoulders of workers who lack the desire, skills, or time to do their own homework. "Not only did we give them the opportunity for more performance, but we also gave them the opportunity to say, 'You know what? I don't want to do this anymore,'" he says.

As for performance, Kirchwey says Optima has "exceeded all expectations in an extremely difficult market." In the first half of 2002, the default portfolios for Penson and SAMCO were down a combined 0.33 percent, compared with a 7.63 percent plunge in the Dow Jones Industrial Average, a 13.73 percent decline in the S&P 500 Index, and a 6 percent drop in the remaining Fidelity funds, which constitute about 20 percent of the companies' $3.8 million 401(k) plan total. The other investment options—the five strategy plans among which employees must select if they don't want to default into the PDI—were down an average of 3 percent, according to Jones. As promised, plan costs have dropped, well on their way toward a target of 100 to 125 basis points (1.00 to 1.25 percent). "As our volume goes up, we believe our savings can increase," say Kirchwey.

Of course, six months is not much of a track record to judge by. Any number of funds might outperform Optima's choices over long stretches, after all. Even so, officials at SAMCO and Penson say they're committed to the Hamilton approach.

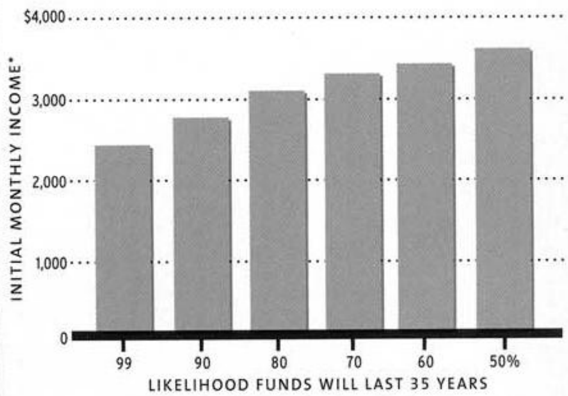
"Who knows if in 20 years Brooks's [Hamilton's] apocalyptic vision will have come true?" says Kirchwey. "We're in this for the long pull, because it's still a great idea for our employees." ■

Freelance writer John T. Ward wrote about securities class actions and investment clubs for prior issues of Bloomberg Personal Finance.

MILLION-DOLLAR CHANCES

What does a sizable nest egg buy for retirees? Using T. Rowe Price's sophisticated Retirement Income Calculator, we looked at how much a married couple, 65 years old, could expect to get out of their million-dollar account. The simulator calculates the probability that a specific portfolio (we chose 40 percent stocks, 40 percent bonds, and 20 percent short-term securities) will last for 35 years.

Our hypothetical couple can safely make initial withdrawals of $2,400 a month from their account with a 99 percent certainty that their assets will hold out for 35 years, or they can withdraw $3,600 a month if they feel comfortable with a 50 percent chance that their savings will last that long. To plug your own figures into the calculator or to play with different assumptions, go to www3.troweprice.com/retincome/RIC. As Clint Eastwood says, "Do you feel lucky today?"



*Calculations assume 3 percent annual increase for inflation. Source: T. Rowe Price