The Ideal Retirement Plan for Your Practice

[Editor’s Note: This is a guest post from Konstantin Litovsky, a blog advertiser and the founder Litovsky Asset Management, a wealth management firm that offers flat fee retirement plan advisory and investment management services to solo and group medical and dental practices. Konstantin specializes in setting up and managing retirement plans, including 401(k) and Defined Benefit/Cash Balance, and serves in an ERISA 3(38) fiduciary capacity. Remember that a SIMPLE IRA is not the same a regular old traditional IRA.]

Your CPA informs you that profits for the year will top expectations, and that you should start thinking about using a retirement plan to shelter some of that income from taxes because you will be in the highest federal and state brackets. After doing some research, you find that there are two types of plans available for a small practice: a Safe Harbor 401(k) with profit sharing and a SIMPLE IRA.

Table 1. Summary of key provisions for SIMPLE IRA and Safe Harbor 401(k) with profit sharing. ‘Safe Harbor’ refers to the matching formula used by this type of plan.

401(k) vs SIMPLE IRA

How would you go about selecting the right plan for your practice? Here are some rules of thumb that can be helpful:
1. – A SIMPLE IRA might be a better plan for your practice if (together with your spouse) you can contribute less than $40k a year (or ~$20k just for the owner) and/or the cost of 401(k) employer contributions is high (with less than 70% of plan contributions going to the owner and spouse).

2. – On the other hand, 401(k) with profit sharing might be a better plan if (together with your spouse) you can contribute close to the plan maximum (~ $75k if both you and your spouse are under 50) and your 401(k) employer contribution is reasonable (with more than 70% of plan contributions going to the owner and spouse).

3. – If your practice has a large staff with nearly everyone participating in the SIMPLE, and/or you have highly compensated staff, the cost of doing a SIMPLE IRA might be high, so even if your 401k plan % to owner is lower than 70%, you might actually be better off with the 401(k) in that scenario.

The decision can be straightforward if you fit into any of the above scenarios, but what if you are somewhere in the middle? What if you can contribute the maximum, but your employer contribution expenses are relatively high? Being in the highest tax brackets might still justify selecting the 401(k) over SIMPLE despite the higher expenses. What you’d need to do first is to get a plan design illustration from the TPA that takes into account your practice demographics to see what your potential plan contributions and expenses would be. Once you have an illustration, your retirement plan adviser should do a 401(k) vs. SIMPLE IRA side-by-side analysis that takes into account your specific situation so that you can select the right plan for your practice.
Choosing a Retirement Plan Provider

After doing the analysis with your retirement plan adviser, you decide that a SIMPLE IRA is not going to allow you to save enough, and that you want a custom-designed 401(k) plan instead. Once you start looking around for a retirement plan provider for your practice, it does not take long to realize that plans offered to small practices are sold as a product rather than custom-designed for each practice based on your specific practice needs. When looking for the lowest cost option, small practice owners often opt for plans with lower recurring administrative fees, and end up paying significantly more than they anticipated over the long term because most of the cost is hidden in the asset-based fees charged for plan investments and services. Moreover, many retirement plan providers are large record-keepers which don’t have much interest in working with small practice retirement plans, so their service quality for small plans can be significantly lacking, and this will end up costing you money.

If you could get the best plan services for the right price, what would be the components of an ideal retirement plan?

Konstantin Litovsky

# 1 Highest Service Quality

Will your calls and emails be returned promptly, or will you have to wait for days or weeks to get an answer? How will your plan providers treat you after you’ve signed up for the plan? Will you have a direct line to your plan administrator and/or your plan fiduciary/investment adviser, or will you be dealing with layers of intermediaries? Just because you use a ‘low cost’ provider does not mean you should compromise on the quality of service.
# 2 Open Architecture Service Providers

‘Open architecture’ means that a plan can be assembled using independent providers vs. ‘bundled’ plans which come with all of the services already integrated. Almost all bundled platforms make money from asset-based fees and you have no control over the quality of the service providers.

A typical participant-directed 401(k) plan will have a Third Party Administrator (TPA), a record-keeper and an adviser (who takes on the role of a plan fiduciary). You do not want your TPA to accept revenue sharing (which is a standard practice with bundled plans) because this makes them biased towards using platforms that carry high expense mutual funds that pay revenue sharing fees. Your TPA should also be independent of the record-keeper because any issues with the plan might be overlooked if your TPA works for the record-keeper.

Another reason to have the TPA separate from the record-keeper is because plan design is done by a single person, so just because you hired a large record-keeper does not mean that the person doing your plan design is experienced or competent. A large record-keeper usually specializes in working with larger, vanilla plans, and they have less expertise and interest in serving smaller plans (such as those for medical or dental practices), that require a lot more attention to detail and a customized approach to plan design. The key to having the best plan is to make sure that your plan is designed and administered by a competent team, so for the best results, select your TPA separately from your record-keeper, with the greatest care taken to select the TPA. There are plenty of open-architecture record-keepers that work with any TPA.

# 3 Customized Plan Selection and Design
Which plan will work best for your practice? Should you start with a SIMPLE IRA or would a Safe Harbor 401(k) with profit sharing make more sense in your particular situation? When do you need to upgrade to a different plan design to allow higher contributions ($54k for a 401k plan in 2017)? Can a Defined Benefit /Cash Balance plan work for you? Instead of using a cookie-cutter plan design typical for large record-keepers, a customized plan design might work better for your practice, and can potentially save you significant money by minimizing your employer contribution while maximizing your own. If you’ve gotten a single illustration from your TPA (or worse yet, none at all), chances are it is not the best design for your plan. Have they considered any changes to your practice going forward? Have they used too aggressive a design so that any changes in your plan demographics (such as hiring an older employee) will make it top-heavy requiring you to make extra employer contributions to employees later on? A smaller practice might need a number of design iterations based on your practice demographics and potential future changes, so this is something to consider when working with your TPA.

# 4 Fixed plan Fees and Expenses

There is no reason to pay any asset-based fees for your plan. Small plans pay some of the highest asset-based fees, which will be a significant cost over the long term. The best way to avoid paying asset-based fee is to use open architecture providers who charge fixed/flat fees for their services, including investment advisers, TPAs and record-keepers.

# 5 Low Cost Index Funds

There cannot be any compromise here – low cost index funds should be the only investments in your plan. Vanguard funds
contain most asset classes necessary to build a globally diversified portfolio inside your plan. There is no need to pay more than about 0.15% on average for your plan’s investments. While some participants might want self-directed brokerage windows, this is not necessarily a good idea, since everything that you will ever need (about 25 funds across multiple asset classes) can be added to the plan investment lineup.

# 6 Full Fiduciary Oversight

Your plan has to receive a minimum level of service that is necessary to help you and your employees achieve your retirement goals. You might be an investment pro, but your employees are not, so at the very minimum your plan needs the services of an ERISA 3(38) fiduciary (also called ‘investment manager’). An ERISA 3(38) fiduciary’s role is to select investments for the plan and to take full responsibility for investment selection. And ERISA 3(38) fiduciary can also create and manage a number of model portfolios so that plan participants can simply invest into one without having to worry about constructing one of their own. Your employees are definitely a lot less sophisticated than you are, so model portfolios can help all plan participants achieve better investment results.

# 7 An Adviser (Fiduciary) To Put It All Together

Platinum Level Scholarship Sponsor

Why is it so difficult to buy an ideal plan? For one thing, most companies that offer retirement plans specialize in working with larger clients, and smaller plans simply don’t
bring enough revenue for them. Sometimes smaller plans are ‘loss leaders’ – they need to get many of them to turn a profit, so they engage in marketing tactics to bring in any and all plans without providing the right level of service to the smaller plans. Even when the right services are provided, the cost for small practice plans is usually high because of asset-based fees.

The biggest issue is that few if any of the companies offering retirement plans are working in your best interest. What is needed to get you the best plan money can buy is actually very simple: you need to be working with an adviser who always acts in your best interest so they will be looking for the best solution for you. If all of the above conditions are met, you too can have the best retirement plan for your practice cost-effectively.

[Editor’s Note: If you have no employees (or your only employees are your spouse and minor children), selecting and managing a retirement is dead simple- just use an individual 401(k). If you have employees and you’re sure you want to use a SIMPLE IRA, it’s not a lot more complicated. But if you have employees and want to put away as much as you can, it’s time to get some professional help. There are basically 3 types of firms involved in this–a TPA, a record-keeper, and a financial advisor–although occasionally two or even all three roles will be played by one firm. Mr. Litovsky’s firm functions as the advisor. A (3)38 advisor has a fiduciary duty to the sponsor (you, the practice owner) as well as your employees. If you only hire a (3)21 advisor, the sponsor (you) still retains the fiduciary responsibility. Some WCI readers have chosen NOT to pay the additional costs of a (3)38 advisor OR a (3)21 advisor, figuring that if they just fill the plan with low-cost Vanguard index funds and target retirement funds, their risk of being successfully sued for breach of their fiduciary duty is awfully low. Like with all financial advisors, you want to do the math on the fees. An AUM based fee is not the
end of the world, as long as the total fee is no more than you can get from a flat-fee advisor offering comparable service. Unfortunately, that’s usually not the case, especially as the plan grows. As one of my financial advisor friends likes to say, “AUM fees are the best kind of passive income there is.”

What do you think? Have you instituted a practice retirement plan? What type did you select and why? How do you pay your TPA, recordkeeper, and advisor? Comment below!

How To Reduce Your Practice Retirement Plan Cost

[Editor’s Note: This is a guest post from Konstantin Litovsky, a long-term advertiser here at WCI and an expert in designing low-cost small practice retirement plans. Long-time readers will remember this subject being discussed in the past. If you are an employee, you are basically stuck with the retirement plans offered by your employer, although you can lobby for change. If you are self-employed without employees, an individual 401(k) is a straightforward do-it-yourself retirement plan. However, once you have employees things get a little bit more complicated and it is time to seek professional help. In this post Mr. Litovksy describes what you should be looking for with that help. While the described best solution/advisor obviously has a very close resemblance to himself and his firm, I agree with him that getting a low-cost plan filled with low-cost investments and the best available features is critical as is meeting your fiduciary responsibility to the plan participants. Enjoy the post.]
It is well-known that the majority of retirement plan providers that serve the small and mid-sized retirement plans are bundled platforms that make most of their money via asset-based fees. Many plan providers do not offer the best available solutions to small solo and group practice plans, and this often means subpar plan design and lack of any fiduciary or compliance services, which leads to higher plan cost and can potentially result in unnecessary expenses [such as litigation-ed] later on. Even those providers who are open-architecture tend to charge significantly higher fees for small solo and group practice plans relative to what the larger plans pay for the same services. However, it is definitely possible to get the best available plan services at a lower cost. The problem is that the information on how to lower your plan cost and improve the service quality can be hard to come by because plan providers are not fiduciaries, and they are not working in your best interest, so they don’t have to get you the best plan money can buy. Below are five ways to significantly reduce your plan cost, especially if your practice has an older plan with significant assets.

# 1 Eliminate All Asset-Based Fees

Konstantin Litovsky

It is really unfortunate that asset-based fees dominate the retirement plan industry, and you pay a higher fee just because your assets grow, not because you are getting any extra services in return for the higher fee. For example, Group Cash Balance plans are often charged a 1% fee by investment advisers even though the plan portfolio is managed so conservatively that the asset-based fees will significantly diminish the investment returns over time. Not only are asset-based fees unfair, but they might be costing you hundreds of thousands of dollars in extra fees without much to show for
it. There is no reason to pay any asset-based fees for your plan services (aside from the expense ratios of your investments), so always choose plan providers who only charge a fixed/flat fee. [Or at a minimum compare the total AUM fee you are paying and compare it to available flat-fee based providers.-ed]

While some record-keepers and Third Party Administrators (TPAs) do charge asset-based fees for their services, you can always find a provider who charges exclusively a fixed/flat fee. With investment advisers the asset-based fee is much more widespread, but you should still be able to find an adviser (in a fiduciary capacity) who would be willing to work for a fixed/flat fee. Use this calculator to estimate the fees you are paying, and compare with the fees that fixed/flat fee providers charge to see the difference over time. Many record-keepers charge a relatively small asset-based fee (which can be around 0.05% or so), but you can often elect to pay this fee from of your practice cash flow, not from your plan assets. Paying plan fees from the practice cash flow is always better because this is a tax-deductible business expense.

[Editor’s Note: It seems appropriate to take a moment to make a brief editorial note here about the various players involved in a retirement plan:

- **Plan Administrator/Plan Sponsor** – This is the owner of the practice, i.e. you. Fiduciary duty unless delegated to a 3(38) fiduciary.
- **Plan Participant** – This includes your employees and also yourself. This is who the fiduciary duty is owed to.
- **Recordkeeper** – Processes transaction requests, submits trades to custodian, updates participant accounts, and provides information to plan and participants. No fiduciary duty.
- **Third Party Administrator** – Ensures compliance with tax
laws and plan documents. No fiduciary duty. Can be (and often is) the same firm as the recordkeeper.

- **Custodian** – Actually holds the assets that are owned by the plan, like a bank. Think of a firm like Charles Schwab or Vanguard. No fiduciary duty. Often the same firm as the recordkeeper and TPA.

- **3 (21) Fiduciary/Plan Advisor** – Named after a section of code, in this set-up the plan advisor is a partner with the plan sponsor where they are both have a fiduciary responsibility to the participants. Shared fiduciary duty. i.e. The advisor selects a list of five large cap funds and the plan sponsor picks which one goes in the plan.

- **3 (38) Fiduciary/Plan Advisor/Investment Manager** – In this set-up, the plan sponsor has delegated the fiduciary responsibility to the advisor. Thus, while the plan sponsor still has a duty to select and monitor the advisor, he has passed the fiduciary duty to the advisor. Fiduciary duty. i.e. The advisor chooses the actual investments in the plan.

- **Financial Advisor** – Some plans also have someone who gives participants investment advice. Often a broker without fiduciary duty.

# 2 Lower The Cost of Your Investment Options

It is always a good idea to hire an independent ERISA 3(38) fiduciary adviser for your plan, and this will ensure that you will have someone working in your best interest who will take full responsibility for selecting investment options and building model portfolios for your plan (and who will take on a discretionary fiduciary role when managing investments in a pooled 401k or a Cash Balance plan). An ERISA 3(38) fiduciary should be able to select low-cost index funds and build model portfolios for your plan with an average expense ratio of around 0.15% vs. an average expense ratio of anywhere between
1% and 2% for a typical small practice plan. Not all ERISA 3(38) fiduciaries are created equal though, so you need to make sure that your adviser believes in using low-cost index funds and that they are compensated exclusively via a fixed/flat fee.

# 3 Improve Plan Design

Is your TPA using the best possible design for your plan? To allow maximum available contribution to owners/partners, does your plan use a cross-tested or a pro-rata contribution allocation formula (a pro-rata formula would result in a significantly higher employer contribution to non-owner employees)? Does your TPA review your plan design periodically to make sure that your employer contribution is minimized? Is your salary set correctly to minimize your employer contribution while maximizing your own? The cost of extra employer contribution from a suboptimal design can be significant, especially for a small practice plan.

For a group practice 401k plan, can every partner select their desired level of profit sharing contribution, or is it ‘all or nothing’? Is your group practice plan a profit sharing only plan? It is always better to convert this type of plan to a 401k plan because you can maximize your plan contribution with a lower salary and also have the ability to do Roth salary deferrals and catch-up contributions for those over 50. Making sure that your plan design is optimal for your practice can allow you to make higher contributions at a lower cost, and including the best available features (such as Roth 401(k) contributions and in-plan Roth conversions) will allow you to use the plan as a perfect tool for long term retirement and tax planning.

# 4 Use Open-architecture Platform Versus A Bundled Platform

In a bundled platform it is impossible to replace/remove
providers who either don’t perform or are too expensive because everything is integrated into a single platform. Open architecture platform on the other hand allows you to select the best providers (including ERISA 3(38) fiduciary, TPA and record-keeper) and providers can be removed and replaced when they are not doing their job. Also, a bundled platform does not have adequate checks and balances as all of the parts are working for the company that hired them, not for you. It is very important to select independent providers, especially the TPA and ERISA 3(38) fiduciary who will be looking out for your best interest and who are not compensated by third parties. In most cases you can get better pricing (and better services) by selecting each provider separately rather than going with a bundled provider, and using open-architecture providers will also let you significantly reduce (and even eliminate) asset-based fees.

# 5 Correct (and Prevent) Fiduciary and/or Administrative Breaches

Having your plan audited by the IRS or DOL can potentially lead to costly penalties and fines, and will require you to take corrective action to fix any fiduciary and/or administrative issues, so why not do it proactively at a fraction of the cost? While much touted excessive fee lawsuits are still rare (though they are on the rise for smaller plans as lawyers are getting the hang of it), there are many other errors – as simple as an incorrectly filled out form 5500 – which can raise red flags for the IRS, and catching plan errors is getting much easier as everything is now computerized and automated. If your plan is flagged for one error, all of the other potentially significant fiduciary and administrative breaches will come to light, often resulting in hefty fines.

Developing and implementing a prudent fiduciary process is a big part of avoiding fiduciary and administrative breaches. Work with your ERISA 3(38) fiduciary and your TPA to create a blueprint for plan governance, and assign roles and
responsibilities to all plan providers and plan trustees. Errors often happen because of lack of communication between plan providers and the plan sponsor, so always make sure that plan providers are on the same page and are talking to each other and to the plan trustees about any potential issues. Your ERISA 3(38) fiduciary should create and implement an Investment Policy Statement for your plan, and your TPA should review all parts of the plan periodically (including your plan’s brokerage windows, especially if your plan allows multiple providers) for fiduciary and administrative breaches, and provide ongoing monitoring to ensure that the plan sponsor is abiding by the terms of the plan document and that the plan is operating in compliance with all applicable laws and regulations. Having proper fiduciary and compliance oversight will eliminate any potential issues with the IRS going forward, and will significantly reduce the risk that your plan will be audited and fined.

What do you think? Have you implemented a retirement plan for your practice? What pitfalls did you encounter? Did you follow Litovsky’s recommendations? Why or why not? Comment below!

Small Practice Retirement Plans Part 2

Konstantin Litovsky

[Editor’s Note: This is a guest post from Konstantin Litovsky, a financial advisor specializing in small practice retirement]
plans. While this is not a paid post, he is a paid advertiser on this site. Part 1 ran yesterday and discussed practice demographics, plan design and plan architecture for small practice plans. Part 2 discusses investment management, describes essential services for small practice plans, and also offers recommendations on the criteria that can be used by practice owners to select the best small practice plan providers.

Investment management

Most of the assets in small practice plans belong to the practice owner and most of the practice owner’s assets will be invested in the plan, so it is important for the owner(s) to receive good investment advice.

1) If your practice has a participant-directed plan, the plan sponsor should provide employees with adequate information to make good investment decisions. Small practice employees are generally not sophisticated investors, so to get the best results (for as low as $15 per employee per year) employees can be provided with personalized advice through one of a number of companies that offer access to live financial planners who can talk directly with each of the plan participants. Large companies rarely offer this level of service, opting for electronic communications and re-enrollment.

An even better solution for a small practice is using a pooled plan. Because investments are managed by an ERISA 3(38) fiduciary (‘investment manager’), not only will you eliminate your fiduciary liability with respect to providing education to plan participants, but by taking responsibility for the investment management process, an ERISA 3(38) fiduciary will also eliminate your fiduciary liability as far as investment selection and management for the plan.
2) Most large and small plans alike pay asset-based fees for plan services. In a small practice plan, the cost of asset-based fees is borne mostly by the owners, since most of the plan assets belong to them. While small plans often pay some of the highest asset-based fees, there is no need to have any asset-based fees in your plan. There are plan service providers (including investment advisers and TPAs) who specialize in working with small plans and who charge a flat fee for their services. Asset-based fees are a bad deal for any retirement plan, and you can and should eliminate all asset-based fees (aside from the fees charged by low-cost index funds) from your plan.

3) Many record-keepers are now offering fiduciary services that are known as ERISA 3(38) and ERISA 3(21). Do you really need these services? DOL has very specific instructions for plan sponsors, including this one: “lacking that expertise, a fiduciary will need to hire someone with that professional knowledge to carry out the investment and other functions.”

[Editor’s Note: I find it ironic that the government won’t pass laws that require financial advisors to have a fiduciary duty but has no problem putting that burden on practice owners.]

A 3(21) fiduciary is a co-fiduciary (with the plan sponsor retaining full fiduciary liability) and their role should be limited to providing participant advice. An ERISA 3(38) “investment manager” is a person who would be managing your plan’s investments on a discretionary basis (if you have a pooled plan) or selecting plan investments and managing model portfolios (if you have a participant-directed plan). While some would argue that ERISA 3(38) fiduciary is nothing more
than a gimmick and that small practice owners should have no fear of lawsuits for fiduciary breaches, the role of a good adviser for a small practice plan cannot be overstated. [More discussion on 3(21) vs 3(38) fiduciaries can be found here.-ed]

Services essential for small practice plans

When a typical small company wants to start a retirement plan, they usually do the following:

- Find the biggest and most well-known record-keeper, many of which also offer TPA services including plan design and administration.
- Provide a census to the record-keeper and get a single plan design illustration.
- Sign the contract, set up accounts with the record-keeper, enroll the employees and consider everything done.

It would be great if every plan was this easy to set up, but for a small practices this is rarely the case. There are many missing steps in this approach, some of which can make a big difference for a small practice. Here are some of the critical services that are rarely offered to small practice plans:

1) An analysis showing whether the 401k plan is better for your practice vs. a SIMPLE IRA, including an estimate of how cost-effective the proposed 401k plan design is given your tax bracket and employee contributions as compared to SIMPLE IRA and/or other plan designs.

2) Access to the TPA (a person) who actually designed your plan so that you can ask questions about your plan design and
plan options and get a speedy response. When working with large record-keepers you will talk with a salesperson who might know something about plan design, but they will not work in your best interest to find the best solution for you.

3) Address ‘controlled group’ and ‘affiliated group’ concerns. IRS wants all eligible employees to be covered by a retirement plan, and if you own or co-own multiple practices with employees or have multiple entities within a single practice that separate employees from the owners, you have to make sure that the retirement plan does not exclude eligible employees. This can be a complex issue so your TPA and adviser will have to help you make this determination.

4) Design study. A small practice owner will need to know for sure which design will work best under various types of assumptions about the future. You don’t want to end up with an expensive plan that you will end up dropping later. You also need to consider whether a participant-directed or a pooled plan will work best for your practice. A design study is a key step before you can make a decision to adopt a plan.

5) Include plan features with practice owners’ personal needs in mind. For example, if you want to make ‘backdoor’ Roth contributions, your plan document has to allow incoming rollovers, and if you want to do in-plan Roth conversions, outgoing rollovers must also be allowed.

6) Have your plan design re-evaluated if there are changes in practice demographics. This is something a good TPA should do periodically and proactively. Any plan design inefficiencies and problems should be addressed quickly.

7) Consider whether a Cash Balance plan might work for your practice. Many practices will eventually open a Cash Balance plan, but one has to be very careful because the providers who sell these plans might not have your best interest in mind,
and you might not get the best design that addresses your personal needs. Even younger owners (38-40) with employees might benefit from a Cash Balance plan despite what you read elsewhere, but you will need to work with an independent actuary/TPA as well as an adviser who understands plan design and how to put it all together.

**What actually matters for a small practice plan?**

Record-keepers can be better or worse, but the choice of a record-keeper is not as important for a small practice plan as it is for a large plan. Here’s what really matters for small practice retirement plans:

1) Hire the right retirement plan adviser who would act in a fiduciary capacity (that is affirmed in writing), provide you with ongoing advisory and support services and charge you a flat (and not an asset-based) fee. Your record-keeper and your Third Party Administrator are not fiduciaries. You need to always make sure that your adviser and plan providers do not have any conflicts of interest and that they are acting in your best interest — otherwise you can end up with a plan that might not be a good fit for your practice.

2) Hire the right Third Party Administrator. Record-keepers come and go, but a good TPA stays. Your TPA (together with your adviser) will make sure that you have the best design and that your plan stays compliant with all of the rules and regulations. A good TPA who has experience working with small practices also knows how to design plans for small practices in such a way as to avoid any potential future issues. Your TPA will also stay on top of any changes to your practice demographics and will tell you when a new plan design is warranted. Record-keepers often make mistakes, and you will be responsible and potentially penalized (as a plan fiduciary) for any mistakes they make. Having a standalone, independent TPA is important to make sure that your plan is operating
smoothly and that any mistakes are caught early.

3) Educate yourself as much as possible on retirement plans. For example, any asset-based fees can be a significant cost for your plan, so you will need to understand the value of paying flat fees and replacing any asset-based fee providers, even though at first glance it might seem that the asset based fee is not significant because your plan does not have much assets. Also, open architecture providers who are specialists in working with small practice plans can provide better value especially if you want extra oversight and personalized services for you.

What do you think? Who do you use as a record-keeper, third party administrator, and/or plan advisor? Do you feel a plan advisor is warranted? What did you pay for your plan? Comment below!

The Best 401k Plan: Pooled or Participant-directed?

[Editor’s Note: This is a guest post by Konstantin Litovsky, one of my regular advertisers who has helped a number of regular WCI readers make changes to their workplace retirement plans. He is also a frequent participant in the comments section on the blog and has frequently answered questions for me via email. This is not a paid post (I don’t do those) but we obviously have a financial relationship.]
When we talk about retirement plans, specifically the 401(k) plans, we always have in mind participant-directed plans in which all plan participants get their own personal account and are responsible for managing their own investments. It turns out that participant-directed plans aren’t the only 401k plans available. A common type of plan that was popular back in the 80s – called trustee directed or ‘pooled’ 401k plan – is staging a comeback, and for some very good reasons. In this article we’ll discuss pooled 401k plans and explain why they might be a better choice for smaller practices than participant-directed 401k plans.

**Participant Directed Vs Pooled Plans**

In participant-directed plans every plan participant gets their own account and is responsible for managing their own investments. In participant directed plans, the plan sponsor is ultimately liable for plan performance, as well as for investment selection and participant education. Participant-directed plans require the services of a Third Party Administrator (TPA), a custodian and an investment adviser (either a 3(21) or a 3(38) fiduciary).

Pooled plans have a single trust account managed by the plan sponsor (the trustee). All plan contributions are commingled, and are tracked by the TPA. A discount brokerage such as Ameritrade or Vanguard is typically used as a custodian. Plan participants do not get to manage their accounts, and have no say in the investment direction of the plan investments. The investments in a pooled account can be managed by an investment manager (a 3(38) fiduciary), and no other services that are typically provided by participant-directed plans (such as enrollment meetings, participant education, and individualized advice) are necessary.

**Why Use A Pooled Plan?**
Since 2008, participants are able to sue (and are increasingly suing) plan sponsors for fiduciary breaches due to high investment costs, lack of education, bad investment choices and investment losses. Because smaller plans rarely get the benefit of quality fiduciary advice, they are exposed to liability due to fiduciary breaches. A pooled 401k plan can be a great way to reduce your fiduciary liability. As long as you have a 3(38) investment manager taking care of the investments, your own liability for managing investments is eliminated, and because there are no participant-directed accounts, there is no other liability for you as a plan sponsor (other than prudent selection of the investment manager). There is no need to worry about 408(b)(2) fee disclosures, QDIA selection and disclosures, fee benchmarking, participant education and advice – services that a plan sponsor for a typical participant-directed 401(k) plan has to provide for the benefit of the plan participants. Please note that not all 3(38) investment managers will want to have discretionary control over your pooled plan investments, and anything less than an investment manager who is a 3(38) fiduciary will not eliminate your fiduciary liability for investment selection and management.

In addition, having a plan with a professionally managed investment portfolio can help you and your employees achieve better investment results, especially if you do not want to worry about managing your own investments. In a participant-directed plan every participant has their own account, so they have to manage their own investments. Even with the best advice provided to participants, each participant still has to follow through and make the right choices. Having a single managed account eliminates this problem, and all plan participants will benefit from getting their investments professionally managed.

**Comparing Costs**

It costs less to manage and maintain such a plan. Because
there are no participant services to provide, a pooled plan will save you time, paperwork and money – there are no asset-based fees for custodians (Employee Fiduciary charges 0.08%), you can use a stand-alone low cost TPA for administration, and a discount brokerage such as Vanguard can be used as a custodian/record-keeper. Vanguard has one of the best selections of low cost index funds available, so that alone will ensure that your investment expenses are low. Investment management in such plans can be offered for a flat fee (rather than an asset-based fee), and because the money is in a single account, the cost of managing assets in pooled plans is lower than in participant directed plans.

A Pooled Plan In My Practice?

Pooled plans will not work for everyone, but a practice with one owner may be a good candidate for this type of plan. All plan participants will get the highest level portfolio management services (the next best thing to hiring a wealth manager), and since there is only one account, your employees will be thrilled because most of them have no idea how to manage their investments. A pooled plan is a better deal than simply having a 3(38) fiduciary oversee plan investments in participant-directed plans. A typical 3(38) fiduciary might pick investments within a plan, but they rarely offer discretionary portfolio management (or managed model portfolios) inside participant-directed plans, and if discretionary investment management is offered, the cost is usually high (typically via an asset-based fee). While there are some 3(38) investment managers who can provide competitively priced investment management services for participant-directed plans including investment selection and model portfolio management, most advisers offering 3(38) fiduciary services will not provide individualized advice to plan participants, which is one of the best ways to limit your fiduciary liability while helping your employees achieve better investment performance inside a participant-directed plan.
Thus a pooled plan is probably the best and the most cost-effective way for a small practice to get the benefit of a professionally managed retirement plan with the highest fiduciary liability protection possible.

**All Participants Have The Same Portfolio**

It turns out that having the same portfolio for a 30 year old and for a 60 year old is not a problem. Having a single conservative allocation for all plan participants can be a good idea over the long term, and it is not necessary to be overexposed to stocks or to have an aggressive portfolio for younger employees. This counter-intuitive result comes from the fact that a conservative portfolio might provide better risk adjusted return than a very aggressive one. While the actual outcome depends on many factors, we can demonstrate this effect with the [Vanguard Monte Carlo simulator](https://www.vanguard.com/montecarlo) that uses actual historical data. (Try using a 100% stock allocation portfolio and comparing it to a 50% stock allocation portfolio.)

Over the past 30 years, a 50% stock/50% bond allocation turned out to be as good (or better) than a 100% stock allocation assuming periodic withdrawals, so if someone retired 30 years ago, a 50:50 portfolio would have done as well (and possibly even better) than a 100% stock portfolio, and with significantly less risk. While a 100% stock portfolio might have done better if no withdrawals were made, periodic withdrawals make all the difference because 100% stock portfolio is much more volatile, so making withdrawals during market crashes would have taken away from future returns. A pooled plan is likely to see continuous contributions, which can help rebalance during the down years, but over time those contributions will be rather small compared to the value of the overall portfolio. In a pooled plan, withdrawals might be
made from the portfolio for various reasons (and at various times), such as when an employee is terminated or when making hardship withdrawals, so another reason to keep a more conservative allocation is to avoid a situation where large withdrawals are made from a portfolio that lost value during a market crash (which can happen when a long-time or a highly compensated employee leaves).

One way to think about conservative vs. aggressive portfolios is that it is better to get close to ‘market’ return (represented by an index such as S&P500) with much less volatility than having the potential for a higher than market return but also for a much bigger loss, which can be a significant disadvantage when making withdrawals, especially during prolonged periods of market underperformance. While you might see higher returns with a 100% allocation, you will also see bigger losses, so a conservative allocation might actually do better because you don’t have to worry about getting out of the market at the wrong time as much as you would with an overly aggressive allocation. While it may seem that getting out of the market is simple, doing so at the wrong time can lead to large losses over a prolonged period of time because recoveries can often take a decade or longer. Thus, a single conservative allocation can be a good solution for a pooled plan from both the plan operation and investment management perspectives.

Pooled Plans Aren’t New

These plans have been around for a long time, but fell out of favor because in the 90s plan participants started to demand more control over their individual accounts. Market gains in the 90s created unrealistic expectations that anyone could manage their own portfolio like a pro, but the two recent bear markets have proven otherwise. A small number of dedicated and knowledgeable advisers including some CPAs and TPAs are using pooled plans with their clients, so pooled plans remain an open secret. Unfortunately, some advisers,
including CPAs who provide investment management services, are using pooled plans as a way to charge high asset-based fees, which is not a good deal for the practice owners. This is not an ideal type of plan for larger companies where the owners prefer to manage their own accounts and can afford to hire the right fiduciary to oversee the plan, but smaller companies, especially medical and dental practices, can benefit immensely from what pooled plans have to offer.

[Editor’s Note: Pooled plans are not that different from the defined benefit/cash balance plan my practice uses, except it is a type of 401(k). We put in $2500-15K per year, it is invested in a set asset allocation we have no control over (52% stock in our case), and upon leaving the group, it can be rolled over to an IRA. One of the biggest downsides is that it is hard to mix and match a plan like this with the rest of your retirement accounts. I prefer having more control over my own asset allocation, but most investors, probably including your employees, honestly don’t know what to do with that control. It sounds paternalistic, but if they aren’t willing to take the time to learn a bit about investing, they’re better off handing the reins to somewhat else who will do something reasonable, especially if that asset management comes at a very low price.]

What do you think? Do you have a pooled 401(k)? Would you consider one? Comment below!

How to Run a Successful Retirement Plan For A Medical
[Editor’s Note: This is a lengthy, but extremely useful guest post by Konstantin Litovsky whose firm provides flat-fee comprehensive financial planning and retirement plan consulting to small business owners. He would like to Nora Bethman, CEBS, QKA, ERPA, Douglas Carlsen D.D.S., and Nina Litovsky for their help in reviewing this article. We have no financial relationship.]

Whether you have are looking to open a new plan or upgrade the plan you already have, there are four things you need to consider that can significantly improve the quality of your plan: having the right plan design, minimizing plan cost, managing your fiduciary liability as a plan sponsor and selecting the right plan services that can both minimize your fiduciary liability and help plan participants achieve better investment results.

Plan Design

While larger businesses can adopt a single plan that does not change over time, smaller businesses might go through several retirement plans depending on the owners’ personal and business needs, thus you need to be aware of your retirement plan options and take action when change is necessary. If your practice has employees, you may want to maximize your own contribution without having to spend too much on employee contributions. For most practices, a New Comparability (also known as cross-tested) 401k plan with the maximum contribution of $53k ($59k for those over 50) will be a good starting point. If you want to contribute significantly more than $53k a year, you might consider a Defined Benefit plan or a Cash
Balance plan if you have employees and/or partners.

Selecting a Third Party Administrator

The first step in establishing your plan is to find a good Third Party Administrator (TPA). When working with a TPA, you need to be clear what TPAs do and what they don’t do. TPAs do a lot of necessary work for your plan including plan design, administration and recordkeeping, but you can’t expect them to provide every service that your plan requires. Most TPAs specialize in working with 401k plans, a small number work exclusively with Defined Benefit Plans (DBP), and some work with both. A typical TPA might start you off with a standard Safe Harbor 401k plan, since that is the most common type of plan they work with. Most TPAs don’t work with Defined Benefit plans, and they will not tell you that your practice might be a good candidate. A typical TPA might not even offer you a New Comparability analysis unless you specifically ask for it. It is not your TPA’s job to recommend that you upgrade your plan when you can afford higher contributions. Your TPA will not provide you with investment advice so don’t expect them to help you select and manage your investments. An independent, stand-alone TPA is always the best choice, provided that you work with a retirement plan adviser who can evaluate which plan can work for your business and whether it makes sense to upgrade your current plan. A good adviser can direct you to the right TPA, and together with the TPA they can make sure that you have the best plan that fits your personal and business needs.

One-size-fits-all Plans

Some plan providers offer a one-size-fits-all plan with a single plan document for every company that adopts this plan. Such plans can be inflexible since it is not possible to customize the plan document to come up with a plan design that may be a better fit for your practice.
(Updated 9/9/16 — Some older plans might not even allow for a cross-tested design as the profit sharing is allocated on a pro-rata basis. Others might include options that you do not necessarily want to allow in a small plan, such as loans and hardship withdrawals (each of which would incur extra administrative cost and added compliance burden).

**Plan Cost**

When choosing a plan, you need to consider the total cost of your plan including the cost of mutual funds. What determines the cost of retirement plans, and how can you minimize plan cost for your practice?

**Fees**

To properly evaluate whether a particular plan provider or adviser is offering the best deal, you need to understand how they are making money. There are really only two ways in which plan service providers make money: fixed fees and assets under management (AUM) fees. Fixed/flat fees may depend on the number of plan participants and the types of services offered. For example, TPAs charge a one-time set-up fee or a fixed administrative fee that increases with the number of plan participants. Custodians charge a custody fee which is an AUM fee of around 0.04%-0.08%, but never higher than that. There shouldn’t be any other fees charged by a TPA or custodian. On the other hand, advisers to plans and mutual funds charge AUM fees. AUM fees are always bad for you. According to a Deloitte study the smallest retirement plans pay the highest AUM fees. AUM fees can be minimized by selecting low expense ratio index funds and by using advisers who charge flat/fixed fees for their services that are not tied to plan assets. While AUM fees can be cheap when your plan assets are low, such fees become a significant expense as your assets grow, so a detailed side-by-side analysis has to be performed to evaluate which compensation model can minimize your plan expenses (assuming the same services are provided to
Revenue Sharing

Revenue sharing should not be an issue, but it is, especially when you are not sure whether your adviser or investment committee selected a fund because of revenue sharing from this fund or because this fund is actually the best choice for your plan. We do not believe that actively managed funds can outperform indexes, and high quality index funds offer no revenue sharing of any kind because their expense ratios are already very low, so there is no reason at all to use funds that offer revenue sharing.

Bundled vs. Unbundled

Bundled plans offer all-inclusive (‘all-in’) services, which can be convenient because you don’t have to worry about locating multiple providers for your plan. However, this convenience comes at a price. When you adopt a bundled plan there is rarely an option to make changes either to the plan document, TPA selection or mutual fund lineup, which can be a big disadvantage if you want to redesign your plan or use mutual funds that charge lower fees. Usually, such plans have limited fund choices and multiple layers of fees. While the fee disclosure rules have made it easier to identify the fees charged by bundled plans, there is rarely adequate fiduciary oversight to help you minimize your plan’s expenses.

Unbundled means that the plan is assembled from different pieces that can be customized and replaced as needed. There are many high quality independent providers who can integrate seamlessly and who work together just as well as providers working for bundled plans. With maximum flexibility and transparent cost structure, unbundled plans can be made much cheaper than bundled ones. It takes knowledge and skill to put together a high quality plan, so an unbundled plan managed by an experienced plan adviser is ideal.
Fiduciary Liability

This excellent article discusses the concept of fiduciary liability in great detail. The following is a summary of several important takeaways for plan sponsors.

Since LaRue v. Dewolff (2008), plan participants are able to sue plan sponsors for monetary damages for breaches of fiduciary duty, which includes higher than normal fees, using higher expense funds to offset administrative cost, lack of adequate participant education, and lack of documented procedures for complying with ERISA. If a participant experiences losses and subsequently sues the plan sponsor, the plan sponsor is fully liable for monetary damages. Whether large or small, it only takes one employee to sue to cause significant financial liability if your plan is not managed properly. In Braden v. Wal-Mart Stores, the plaintiffs were awarded $13,500,000, and the settlement also describes the steps the company would have to take, including:

- Retaining an investment adviser who has acknowledged ERISA fiduciary status in writing, and to review the adviser annually for conflicts of interest.
- Providing web-based investment education to plan participants.
- Eliminating retail mutual funds, funds that pay 12b-1 fees, and funds that provide revenue sharing to plan’s trustee or record-keeper from the plan investment options.
- Adding more passively managed funds.

You may think that you don’t need to worry about fiduciary liability because your plan is small. The Department of Labor (DOL) has stepped up investigations of plan sponsors of all sizes. The DOL routinely goes after plan sponsors to recover losses due to fiduciary breaches. The good news is that taking
care of your fiduciary liability is easy and shouldn’t cost much at all. A retirement plan is supposed to be operating for the benefit of the employees, not just the employer, so if this is indeed the case, plan sponsors do not have to fear fiduciary liability. All that is necessary to run the plan for the benefit of the employees is to offer the right level of services to the plan, and to have a documented fiduciary process.

**Fiduciary Adviser Safe Harbor**

Fiduciary Adviser Safe Harbor allows the plan sponsor to appoint a Fiduciary Adviser who provides investment advice to plan sponsor and participants, thereby limiting plan sponsor liability. There are two types of Fiduciary Advisers that should be considered, though in reality, only one will afford your plan the full benefit. The 3(21) fiduciary will be a co-fiduciary in an advisory role, meaning that the final decision for investment selection rests with the plan sponsor. A 3(21) fiduciary will typically not provide portfolio management services. Often, the 3(21) contracts are written in such a way as to relieve the adviser of any real fiduciary responsibility for your plan. A 3(38) fiduciary (or ‘investment manager’) will accept liability for investment selection, monitoring and portfolio management. Only a 3(38) adviser will relieve the plan sponsor of their fiduciary liability for making investment management decisions.

**Plan Services**

Some plan sponsors think that they do not need a fiduciary to help them with plan design, investment selection and management, and other plan services. They contend that this costs too much and that they can do all of this themselves to save money. They may ask themselves, “Why bother with a fiduciary adviser?” Plan sponsors need to remember that as fiduciaries they are financially liable for any fiduciary breaches or mistakes, and that the longer their plan is in
operation, the higher the risk that something can go wrong if the plan is not managed properly. A good 3(38) investment manager, in addition to helping your plan with investment management, should be able to help the plan sponsor develop a process which should not only limit the plan sponsor’s fiduciary liability, but also help the plan sponsor save money by lowering plan expenses and helping plan participants achieve better investment results. The following are some of the services that the adviser for the plan should provide:

- Creation of Investment Policy Statement to document investment selection and portfolio management guidelines.
- Due diligence for minimizing plan costs.
- Due diligence for investment selection.
- Discretionary portfolio management, model portfolio creation and maintenance.
- Ongoing monitoring of plan and investment performance.
- Education and investment advice for plan participants.

Even when the above services are provided to the plan, the plan sponsor still has the duty to monitor all service providers to make sure that they are doing their job. So the fiduciary liability of the plan sponsor can never be completely eliminated. While traditional wealth management firms might charge a significant asset-based fee for the above services, it is not necessary to pay asset-based fees for any of your plan’s services. Asset based fees cost much more when plan’s assets grow quickly, so it is important that your plan’s asset-based fees are minimized. Today, more advisers charge fixed/flat fees for their services, and this could be the most cost-effective option for your plan.

**Fiduciary Adviser vs. Investment Committee**

Some plans are managed by a provider who offers ‘all-in’ (or
bundled) services, including plan design, administration, recordkeeping and investment advice, and the provider charges an ‘all-in’ asset-based fee. Such providers (usually an insurance company) often have an investment committee to make investment recommendations. What are the benefits of having an investment committee vs. a 3(38) investment manager? Typically, ‘all-in’ providers do not act as fiduciaries for your plan. An investment committee is at best a co-fiduciary, meaning that the plan sponsor retains all of its fiduciary liability for investment selection and performance. Having an investment committee might be worse than not having one. Would you trust the management of your portfolio to your colleagues? Investment committees are not trained in investment management. The members of such committees are not portfolio managers, and make the same mistakes the general public makes. They are apt to chase performance instead of relying on a single low cost index fund allocation. The issue here is not only that advice coming from such committees may be subpar (which won’t help the plan participants achieve better investment results), but won’t limit the fiduciary liability of the plan sponsor either. To provide adequate fiduciary services for the plan you need to hire a real fiduciary – someone who can serve in a 3(38) capacity as an investment manager. Some ‘all-in’ providers also offer 3(38) services to their plans. You need to be very cautious of such arrangements. The 3(38) fiduciary has to be independent from the plan provider so that they can do what’s necessary to minimize your plan cost and to provide the highest quality services to your plan.

Helping Plan Participants Do Better

A retirement plan can be a costly way to receive a tax deduction if your portfolio is not managed adequately. Your plan needs to offer the right level of services to make sure that plan participants accumulate enough savings for retirement because most plan participants will not do well on
their own. The most recent DALBAR study found that in the 20 calendar years ending in December 2011, the Standard & Poor’s 500 Index had a 7.8% compound rate of return, while in the same period, the average investor in US equity mutual funds earned just 3.5%. Dentists and other medical professionals often view themselves as being above average in all respects. That may be true for their professional lives, but when it comes to investing, being overconfident leads to the type of results that DALBAR has discovered – that a typical investor significantly underperforms the market, whether investing in stocks or bonds.

The problem of investment performance is compounded when a plan has employees who might be much less sophisticated than the business owners when it comes to investments. As a business owner, you cannot simply assume that just because you provide your employees with a retirement plan that they will make the best decisions when it comes to investing their money. This is why having professionally managed model portfolios in a 401k plan is critical. Using managed portfolios not only limits your fiduciary liability, but also allows your employees to achieve better investment results. In the case of a Defined Benefit or a Cash Balance plan, the pooled account where all of the participants’ money is held has to be professionally (and conservatively) managed to avoid over- or under-funding the plan.

How to Run a Successful Retirement Plan

Here are some guidelines on how you can have a successful plan, especially if your practice has employees:

1) **Work with a competent TPA and/or an adviser** to make sure that your plan is designed to address your personal and business needs, and that your plan is upgraded in a timely fashion when your needs change.
2) **Minimize your plan’s asset-based fees.** When hiring plan providers including TPAs and advisers, make sure that AUM fees you pay are necessary and competitive. While paying AUM fee for portfolio management may seem like a deal with no assets in the plan, the fees you pay will grow quickly as your assets grow. Whenever possible, use flat fee providers so that your fees are not tied to plan assets, and always be aware of what your fees will be in the future.

3) **Use index funds and risk-managed model portfolios.** Lower cost index funds beat higher cost actively managed ones, and higher cost funds take away your return without any added benefit. Studies have shown that a small number of high quality investments work best, and model portfolios that manage risk can help investors stay the course during market crashes. With professionally managed portfolios, plan participants will achieve much better results than if they manage their own investments.

4) **Provide individualized investor education.** Make sure that your employees have access to the best advice available to help them with their investment management. One-on-one advice can also protect you as a plan sponsor from fiduciary liability as general advice is not sufficient when it comes to helping employees make the best investment decisions.

5) **Make sure that your plan advisers don’t get paid to sell products,** and that all of their recommendations are made with your best interest in mind. As a plan fiduciary, you are responsible to make sure that your plan is run in accordance with existing laws and regulations. While you can outsource much of your fiduciary liability by selecting an appropriate adviser, you are still liable for making sure that the adviser you select is doing their job.

*What do you think? Have you implemented or changed your retirement plan? Do you agree or disagree with Mr. Litovsky’s recommendations? Comment below!*