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Uncommon Knowledge About Retirement Plans

What it pays to know about both qualified and non-qualified benefit programs.

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In my dealings with the CFOs and HR directors of many mid-size corporations, two of the same needs, desires, and problems often emerge.

The first of these is the desire to offer a cost-effective 401(k) qualified plan that employees are reasonably happy with. This wouldn't seem terribly difficult to achieve--yet my analyses of many firms' existing 401(k) plans often reveal that they (or their employees, or both) are spending hundreds of thousands of dollars more in plan maintenance costs than they need to.

The second is the desire to offer highly-paid employees an attractive non-qualified plan that meshes well with the company's qualified plan. Yet in

jointly analyzing companies' qualified and non-qualified plans, I often encounter arrangements that work together just about as well as Jesse Helms and Ted Kennedy. These arrangements also tend to generate needless additional costs.

This article is intended to spotlight these two common problems in some detail, and to suggest some little-known (but very effective and fairly simple) solutions--both of which normally result in lower costs and a sustained or improved level of service.

Problem #1:

As the person in charge of your organization's qualified 401(k) plan, you've been generally satisfied with the job the outside plan manager has done in managing the plan. The cost to your corporation is zero, which obviously makes it more than cost-effective. But as a plan participant yourself, you've been somewhat disappointed with its performance. Your own assets in it aren't growing as quickly as you'd expected, and you know that others in the company feel the same way. You're beginning to grow suspicious---you know as

well as anyone that there's no free lunch--but you're not sure what to look for.

The Solution: Do a Fee Analysis

Benefit services firms make their money from fees charged to plan participants, plan sponsors, or both. In many cases, these fees are clearly disclosed, both in prospectuses and in statements and other reporting documents. But sometimes the true costs of managing a plan may be partly disguised--or, at least, difficult to determine. In such cases, the actual cost (to your company, its employees, or both) may be far higher--perhaps even *several times* higher--than it needs to be.

The most common cost is the **fund fee**--also called a fund management fee, asset charge, or asset management fee. This is calculated as a percentage of the total assets in each participant's account, and deducted annually from that account. This is where many fund management firms make most of their money.

Fund fees tend to range from as little as twenty basis

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points to as much as 2.5% or more. Fifty basis points to 1.5% is typical.

If 2.5% doesn't sound terribly out of line, remember that the benefit services firm isn't charging 2.5% of the annual **growth** of the plan's assets, but **2.5% of the fund's total assets**. Let's consider an example:

Suppose that you're in a plan that charges a 2.5% fund fee. A year ago you had \$28,600 in your 401(k), and today you have (before the fund fee) \$32,032. The company managing your 401(k) would deduct \$800.80 from your account for its services over the past year, leaving you with \$32,231.20. Now think about how much this fee would cost you over a forty-year career.

If this plan has 271 participants and total assets of \$16,200,000, then the benefit services firm will pocket over \$400,000 this year just for managing your company's 401(k) plan. And if it has other charges beyond the fund fee--which it probably does--it may be making a good deal more. To put it mildly, this is hardly cost effective for you and your fellow plan participants.

From simply reading your quarterly account statement, however, you might never find out just how much you're paying in fund fees--because neither the \$800.80 nor the 2.5% figure might appear anywhere on it. Instead, the fund fee might be figured into--i.e., deducted from--your earnings. That is, although your account actually grew by 12% last year, the growth reported on your statement might be 9.5%--the real growth minus the fund fee. In such a case, your 401(k) may appear to be performing sluggishly because its "performance" actually includes a hefty deduction for management charges.

And fund management charges are only one part of the picture. Frequently there are other costs as well. These may include:

Fees charged to plan sponsors:

* *Maintenance or service charges* (annual charges in the form of flat fees, per-participant fees, or both). These are quite common, and can differ greatly from company to company.

* *Startup or plan document fees* (one-time flat fees for establishing a new plan). These can go as high as several thousand dollars.

* *Termination fees* (one-time charges for terminating a relationship with a fund manager). Happily, these fees are becoming less and less common.

Fees charged to participants:

* *Wrap fees* (annual charges added to plan management fees, calculated as a percentage of the assets in each participant's account). These fees are often invisible because they are wrapped into the overall fund fee--that is, the fund fee is simply increased, typically by 50 basis points to 1.5%. The fee may be added to cover some additional benefit for plan participants--a wider variety of fund options, employee education meetings, etc.--or it may simply be a way to shift costs from the sponsor to participants.

* *12b(1) fees* (annual charges added to plan management fees, calculated as a percentage of the assets in each participant's account). These are virtually identical to wrap fees, and often just as invisible. These tend to run 25-50 basis points.

* *Sales charges* (one-time charges for buying or selling a financial product used to fund the plan; calculated as a

percentage of the assets in each participant's account). These normally range from 1.0-5.75%, and may be either front-end or back-end loaded. They are most commonly used with equity accounts

These fees can easily go unchallenged or unnoticed. But until you know exactly what all the fees are--and who is paying them--you don't know the real costs of managing a 401(k) plan.

Many benefit services firms clearly disclose all charges in their prospectuses and statements; others, however, may bury the real costs in the fine print, or disclose them in language that can easily be misunderstood (or not understood at all).

As an added twist, some plan management firms proudly proclaim that they charge no wrap fees--but, though they don't talk about it, they **do** charge 12b(1) fees. Other firms trumpet that they charge no 12b(1) fees, but build in wrap fees. Variations on this "freebie in front of you, fee behind you" theme abound. (I'm reminded of the pizza shop that advertised free delivery, but charged a dollar for the box the pizza came in.)

All of this can have a very significant impact on your company's employees--and on the assets in your own 401(k). As an example, my company was recently called in to analyze a corporation's 401(k) plan, and we discovered that the sponsor and its 135 participating employees were spending over \$190,000 a year for plan administration. It wasn't hard to locate three very similar (and in some ways superior) plan management options that ranged in cost from \$73,000-\$88,000 a year. This was roughly a 55-60% cost savings. What should

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you do about all this for your own company? First, determine the most satisfactory balance between costs to participants and costs to the corporation. While on the one hand it makes sense to keep the company's costs down, this shouldn't be your only (or even your primary) consideration. After all, how much sense does it make to use a firm that saves the organization \$10,000 a year but charges participants an extra \$80,000? (Remember that you, your colleagues, and your superiors are all plan participants as well. How much of their--and your--personal assets are you willing to sacrifice for the ostensible good of the company?)

Next, if you're in the process of selecting a benefit services company, comparison shop. Read each prospectus with great care, and dig into the numbers and fine print. Most important of all, ask each field representative the following questions:

- What specific charges will my company be billed for? How often?
- Are there any startup charges? What are they?
- Are there any plan termination charges? What are they?
- Are there any front- or back-end sales loads? What are they?
- What are the underlying fund management fees?
- What are the 12b-1 fees, if any?
- What specific services will you provide to participants?
- What specific services will you provide to my company?

Sometimes you do get what you pay for. One plan management company might charge more, but give you more services in return. There's nothing wrong with making a high-end purchase in exchange for added value. Just make sure

you understand clearly exactly what everyone is paying, and exactly what they're getting in return.

If you've already got a plan in place, call the fund manager's field representative and ask for specific answers to these same questions. Then add up all the charges. If they seem excessive, seriously consider switching benefit management firms.

Another option is to arrange for an analysis of your current 401(k) plan by an independent financial services firm--one which markets the plan management services of a variety of different companies. (This audit is normally done at no charge, in the hope of getting your business.) Such an independent firm has little incentive to sell you on a particular company--and every incentive to carefully analyze your needs, then find you a plan manager that gives you everything you need, most cost-effectively. Better yet, ask the firm to come up with three or four different plan management companies and scenarios, so that you can compare and make your own final decision.

Problem #2:

Your corporation has had a popular 401(k) qualified plan in place for some years. For the past two decades it has also sponsored a non-qualified 401(k) plan to help reward and retain its most highly-compensated executives. But the non-qualified plan doesn't dovetail well with the company's qualified plan, and a different employee benefits firm handles the administration, record-keeping, and reporting for each. For your company, this means high administrative costs and some fairly convoluted

coordination of benefits. For you and other executives enrolled in both plans, it means unnecessary complexity, occasional confusion and frustration, and poor coordination of benefits. Statements for the two plans are organized very differently, and are generated at different times and intervals. Furthermore, because the funding options and arrangements are different for each plan, you and other key people must deal with an extra layer of complexity in your financial planning.

The Solution: Look Into Mirror Plans

Recently the financial services industry has begun offering a strategy known as **mirroring**, in which a 401(k) qualified plan and a very similar non-qualified plan are designed and administered together by a single employee benefits firm. The non-qualified plans employed in such a strategy are usually called **mirror plans**--or, less frequently, look-alike plans, extension plans, tandem 401(k)'s, or phantom plans. Top hat employees enrolled in both plans receive a single regular statement of benefits which reports, in parallel fashion, earnings and contributions in each plan. To participants, the two plans look and function alike, though their behind-the-scenes administration is somewhat different.

Essentially, mirroring is a financial solution and an administrative solution bundled together. Its whole purpose is to simplify things, solve problems, and save money for both HR and accounting. Mirror plans can be especially useful for midsize companies seeking to expand benefits for their highest-paid

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executives, but who wish to

reduce both the cost and the complexity of administering those benefits.

Employers may choose to make contributions to the non-qualified plan, or to simply provide the plan as a vehicle to help their top people accumulate cash for retirement through income

deferrals. Participants in the non-qualified plan can normally choose to have all contributions grow at the same rate as their investments in the company's qualified 401(k) plan. And, of course, employees are not taxed on their contributions to either plan.

Consider this typical mirroring scenario: your company employs 115 people and offers them a qualified 401(k) plan. Each employee may defer up to 12 percent of their annual salary and bonus, and each may choose from any of five different investment vehicles. In addition, the six people in your company who make more than \$90,000 a year are eligible to participate in a non-qualified plan. Your company makes an annual contribution of 10% of the key employee's annual compensation (salary plus bonus) to this plan; participants may defer up to 20% of their annual compensation as well.

Each participant may elect to have all contributions to this plan grow at a rate identical to that paid by any fund offered

by the qualified plan. Each also receives a single benefits statement each quarter. In addition, executives enrolled in both plans can obtain answers and information about both plans from a single web site, phone number, and customer service team. The typical result is greater simplicity, less confusion, and a modest (and sometimes more-than-modest) cost savings.

The ideal time for implementing a mirroring strategy is when your company is first setting up a 401(k) qualified plan. In these cases, both the qualified and non-qualified plans can be designed to fit together harmoniously, and to be as advantageous as possible. Much more commonly, however, a non-qualified plan is retrofitted to an existing qualified plan. In these cases, the non-qualified plans tend to have the same advantages and drawbacks as their twin 401(k)s.

Sometimes, however, when a company begins looking into non-qualified plans, it will have an employee benefits firm analyze its current qualified 401(k) program with an eye toward potential redesign. (This is typically when my own company gets involved.) This redesign may be warranted when a company has significantly changed in size, mission, or direction. The redesign of a qualified plan creates an ideal opportunity for designing and adding a non-qualified mirror

plan.

Mirror plans are not magic wands, of course. They must be carefully and appropriately designed in order to be as beneficial and cost-effective as possible. And, as with all other financial products and services, they are only as good as the expertise and integrity of the people who design them.

Thus far, mirroring strategies have been marketed almost exclusively by life insurance carriers and mutual fund houses. Theoretically, of course, almost any investment vehicle can be used to fund a non-qualified 401(k) plan. But thus far mirroring has become primarily a life insurance phenomenon, largely because of the tax advantages of corporate owned life insurance. (The growth of the cash value in a life insurance policy is not a taxable event for the employer.)

Nevertheless, as the mirroring concept becomes better known, and as more financial services firms begin marketing mirror plans, we can expect the number of options for funding such plans to grow exponentially. Indeed, because mirror plans tend to save companies money--and everyone time and trouble--we may see tremendous growth in their popularity in the years to come. A decade from now they even may become the standard for non-qualified plans.



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