# Retirement Success

## A Complete Instruction Guide for Plan Sponsors and Their Advisors

## Chapter 14: Self-Directed Brokerage Accounts Reduce Success

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## Summary

Many employer-sponsored retirement plans now offer participants the option of self-directed brokerage accounts in addition to a core menu of mutual funds. Today, approximately 20% of all plans offer a brokerage account, but only about 6% of participants use it. The demand arose almost solely because participants pushed for more choice and because of their overconfidence in their own trading skills. In the 1990s, the bull market was in full throttle, and irrational exuberance was at its peak.

Contrary to what brokerage houses may tell plan sponsors, plan fiduciaries continue to retain significant fiduciary responsibility and liability, restricting the range of investments that may be offered in a self-directed brokerage account. The plan sponsor has a fiduciary duty of prudence in the selection and retention of investment choices, including those in self-directed brokerage accounts.

More pragmatically, the investment performance of self-directed accounts is generally inferior to model portfolios. The low performance translates into a low real rate of return and increases the probability for retirement failure. Men trade more than women because of their overconfidence, and their returns lag women’s because of the extra trading activity. We have found that 72% of all self-directed brokerage accounts lag equally weighted model portfolios constructed from the core funds in the plan. The average annual underperformance was 4.70%.

## Employees Want Different and More "Sexy" Investment Choices

Traditionally, employer-sponsored retirement plans offered participants a varied but limited menu of mutual funds, ranging from a handful to twenty or more, and sometimes access to company stock. But, especially with the explosion of online trading and the long bull market of the 1990s, some participants began pushing for more choices, so more employers began offering the option of self-directed brokerage accounts.

Under this arrangement, participants open an account with a brokerage firm of their choosing or through a single brokerage-firm plan window coordinated with the plan's trustee or record keeper. The notion of a self-directed brokerage account is not new or revolutionary. It represented one of the first forms of employee direction in profit-sharing and money purchase plan accounts.

Long a staple of programs established for law firms or medical practices, these brokerage programs survived for many years primarily due to the hard work of bank trust departments—and the insistence of the law partners and doctors who picked the providers. Eventually, more powerful computer technology began to tear down some of the barriers that initially restricted such offerings.

In the mid-1990s, another event pushed the idea to the forefront. In 1996, the Department of Labor issued its proposed regulations on ERISA's Section 404(c)—the so-called dividing line between education and advice. The ruling did not specifically shed any light on brokerage accounts; however, it did remind plan sponsors and providers that there was a level of fiduciary liability for restricting investment choices. More choice meant less liability, or so the thinking went. The idea was then heavily promoted to plan sponsors (fiduciaries) by brokerage houses (nonfiduciaries).

The shift in thinking coincided nicely with two other factors: By 1996, the bull market was in full throttle, and irrational exuberance was at its peak. If ever there was a time when participants felt ready—and eager—to transcend the dozen or so mutual fund choices of their 401(k) plan, this was it.

For most 401(k) plans, a brokerage account is the medium for offering the widest range of investments to plan participants. These self-directed brokerage accounts offer a broad range of investments, including listed and over-the-counter stocks, fixed-income instruments, money market funds, and many mutual funds. In this way, in theory, plan participants can customize their retirement portfolios, and plan sponsors can satisfy their employees' desire for more investment alternatives.

There are some ERISA limitations, however. Plan participants with self-directed brokerage accounts may not be able to invest in all of the investment vehicles that are available in retail brokerage accounts. They cannot hold investments that are prohibited under ERISA or invest in municipal bonds. They cannot generally buy options or futures, commodities, or derivatives, and they cannot margin or sell short. They cannot conduct investment maneuvers that might cause them to lose more than their total account value.

Over the past ten years, more 401(k) plan service providers have permitted plan sponsors to augment their plans with self-directed brokerage accounts. In a predictable response to the customer demand, the percentage of 401(k) service providers who can offer this option has grown from virtually zero in 1993 to more than 90% today.

As with plan sponsors, many service providers remained unconvinced of the prudence or practicality of the option. However, having found themselves eliminated from one search after another because they did not offer the option, most now have figured out a way to say yes.

The impetus for this change did not arise from plan sponsors, industry consultants, fiduciaries, or service providers. The driving force was the employees themselves. Plan sponsors contemplated implementing self-directed options because of employee pressure. For example, a 2001 survey of large-plan sponsors by Hewitt Associates found that some 12% of plan sponsors offered brokerage accounts, compared with 7% in 1999. In 2003, Hewitt's research found that more than half the employers surveyed either had a brokerage option in place or were considering adding a self-directed brokerage account within the next eighteen months. Of this group, 75% cited employee demand as the primary driver for the additional option.

The surge in interest shows that employers are responding to employee demand for ultimate investment choice and control. The plan sponsor hopes that the brokerage option will take pressure off the employer to continually be adding the next "hot fund" or investment category. In theory, a self-directed brokerage window allows employers to focus a plan's core investments around the needs of a broad participant base while meeting the fund requests of other employees.

Only a handful of employees use the service when it is offered. Of the plans that now offer brokerage options, only about 6% of participants use the feature. In general, these employees tend to be more sophisticated and more highly paid employees. However, under the ERISA rules, the option must be made available to everyone in the plan.

The brokerage-house sales pitches claim that a self-directed brokerage account can protect fiduciaries even more than a traditional 404(c) plan, because it removes almost all restrictions on investment options. Some employers have been told that the more investment options or strategies that are offered, the less fiduciary liability. This is a myth. The fact is that more investment options create greater fiduciary responsibilities to educate, communicate, and evaluate retirement-plan investment options.

## Brokerage Accounts Do Not Eliminate Fiduciary Liability Concerns

We discussed ERISA fiduciary liability risk in detail in chapter 12. However, several points are worth reviewing, because they are particularly applicable to self-directed brokerage accounts. At first blush, self-directed brokerage accounts are attractive, because they appear to offer two advantages: (1) the plan sponsor has been told that the individual investments do not need to be prudently selected and monitored, and (2) if the twenty-plus DOL 404(c) requirements are met, the fiduciaries are not responsible for the investment allocation decisions of the participants.

Compliance with ERISA section 404(c) protects plan fiduciaries only from losses that result from plan participants' exercise of control over the assets in their accounts. An employer's designation or limitation of investment options is a fiduciary function. Plan fiduciaries have not only the obligation to prudently select investment choices, but also the residual obligation to evaluate the performance of these vehicles to determine whether they should remain available under the plan.

Thus, there is more risk to self-directed brokerage accounts than meets the eye. ERISA imposes an overriding responsibility on plan fiduciaries to act prudently and for the exclusive purpose of providing benefits for participants. A plausible interpretation of that general requirement is that plan fiduciaries must decide whether it is prudent to offer brokerage accounts to participants.

DOL officials have opined that fiduciaries must consider the nature of the workforce in selecting 401(k) investments. That is, they must decide whether the participants have the education, experience, and ability to make intelligent buy-and-sell decisions about individual stocks. If they do not, offering brokerage accounts in a 401(k) plan could be a breach of fiduciary duty. Keep in mind that when fiduciaries limit investment options to a specific number—whether it be five or fifty—those options are designated, and as a result, they must be prudently selected, periodically monitored, and removed from the plan when they are no longer prudent and suitable for the participants.

The legislative history, statutory construction, and labor regulations make it clear that plan fiduciaries continue to retain significant fiduciary responsibility and liability, restricting the range of investments that may be offered in self-directed brokerage accounts. The plan sponsor has a fiduciary duty of prudence in the selection and retention of investment choices, including those in self-directed brokerage accounts.

The preamble to the DOL regulations makes it clear that the plan sponsor needs to review the investments that are purchased in the self-directed brokerage account. It would appear that prudent fund selection and retention duties continue to apply, even if the plan sponsor places no limits on the investment universe of the account.

The common-law concept of investment prudence, codified by ERISA, would appear to require fiduciaries—that is, trustees, plan sponsors, retirement committees, or other decision-makers—to review the entire portfolio of each self-directed brokerage account.

The plan sponsor needs to have a procedure to conduct periodic reviews to ensure that inappropriate investment options are eliminated in a self-directed brokerage account. The plan sponsor's investment policy should establish criteria for the selection and ongoing due diligence of the investment vehicles under such accounts.

The plan sponsor should make certain that the self-directed brokerage account provider is liable for the consequences of its failure to satisfy any agreed-upon limitation on permitted investment vehicles. Although some plan sponsors would like to reserve self-directed accounts for participants who are sophisticated investors by establishing a minimum account balance, the use of such thresholds may discriminate in favor of highly compensated employees. Such discrimination would jeopardize the tax qualification and tax exemption of the plan and trust.

The educational challenges alone are significant. Studies show that most people have trouble managing a mutual fund portfolio. The problems that plan participants have with picking individual stocks are even greater. For example, a recent national survey of 401(k) plan participants commissioned by Northern Trust Retirement Consulting suggests that even sophisticated investors with access to self-directed brokerage accounts need more targeted education to take full advantage of this flexible benefit.

In Northern Trust's survey of more than 450 randomly selected, prequalified 401(k) plan participants ranging in age from eighteen to sixty-five, more than a third of respondents indicated that they do not know how to invest or do not know anything about the stock market. Another 9% indicated that they would be better off trusting investment professionals. The survey also found that even participants most likely to take advantage of a self-directed brokerage account—those who tend to be more aggressive and confident in their retirement plan management—are reluctant to use this tool.

As a result, 401(k) brokerage accounts should be approached with caution. In deciding whether to offer the option, plan fiduciaries should consider, among other issues, the investment sophistication of the workforce, the scope and effectiveness of the investment education programs, whether investment advice is made available to the participants, and the communication needed to inform the participants of the risks.

## Section 404(c) Safe-Harbor Provisions

ERISA mandates significant fiduciary requirements for 401(k) plan sponsors in order to protect employees who depend on these plans for their retirement. However, ERISA Section 404(c) offers plan sponsors a “safe harbor” from their fiduciary responsibilities in cases where participants have decision-making power over their account investments. Section 404(c) relieves plan sponsors from liability for any loss that is a “direct and necessary” result of a participant’s exercise of control.

In order for Section 404(c)’s safe-harbor provision to take effect, plans must meet certain procedural and substantive requirements. Procedurally, the plan must make certain disclosures to participants. Substantively, the plan must offer a range of investment options. Generally, a plan must offer a minimum of three investment options, each of which must be diversified and each of which must have materially different risk and return characteristics.

Though most plan core offerings address the investment needs of most participants, a brokerage window ensures that all participants will be able to create portfolios that are appropriate for all levels of risk and return. Ensuring that a plan qualifies for safe harbor under Section 404(c) could be important in declining markets, especially if disgruntled investors search for scapegoats.

Most fiduciaries do not understand their duties, or they understand them but don’t have time to fulfill them. Self-directed brokerage accounts add another layer of complexity and exposure to plan sponsors. Most plan sponsors should know that an essential aspect of Section 404(c) compliance is fulfilling its disclosure requirements. The primary disclosure requirements relate to providing participants with the information needed to make informed decisions in exercising control over their accounts.

Section 404(c) imposes a series of disclosure requirements on both designated and non-designated investment alternatives. A brokerage account offering mutual funds or other securities would be categorized as a non-designated investment alternative under a 401(k) plan and would have to provide the following information to plan participants:

- A general description of the brokerage account, including the investment alternatives available

- An explanation of the circumstances under which participants may give investment instructions in the brokerage account

- A description of the transaction fees and expenses of the brokerage account

- The name, address and phone number of the person responsible for providing disclosures, which are required to be provided upon request

- The distribution of a prospectus to participants in connection with their initial investment in a mutual fund or other registered security

- A description of proxy voting materials, if proxy voting is passed through to participants for the investment

- Prospectuses, financial statements, reports, and other materials relating to mutual funds offered under the brokerage account, provided upon request

As an added measure of protection, plan sponsors may also require participants who want to invest through brokerage accounts to read and sign documents indicating that they understand the risks of this approach and assume responsibility for their decisions.

## Administrative Fees and Cost Issues

As part of its fiduciary duties, the plan sponsor should determine whether the self-directed brokerage arrangement would increase its record-keeping and plan-audit fees. The DOL recently conducted a study of 401(k) plan fees and found that in some instances, the fees paid by a typical 401(k) plan compared unfavorably with retail investments. In some cases, the higher fees paid could be explained—additional services were provided to the plans—and in some cases, they could not. The study further concluded that participants are likely to pay most or all fees charged for investment management and increasingly likely to pay administrative fees as well.

A quarterly report from Charles Schwab Corporate Services found that a surprisingly large number of participants—nearly half (43%)—use brokerage accounts to purchase stock mutual funds. Unfortunately, in many cases, the plan participants were purchasing funds of lower fiduciary quality than the core choices in their plan in the same category.

Another problem is that purchasing no-load mutual funds through a self-directed brokerage window can increase the overall costs to the plan. Following the Frost Model DOL opinion letter, one of the key concepts today in retirement-plan cost control is mutual-fund revenue-sharing. Not all provider groups do this, but some trustees will fully disclose, collect, and then rebate certain fees to the plan sponsor.

Various internal fees from the no-load funds, such as 12b(1) fees, shareholder servicing fees, finders fees, and sub T/A fees, are collected by the plan's trustee and returned to the plan as dollar-for-dollar fee offsets. In most self-directed brokerage accounts, the mutual-fund-trail fees are retained by the brokerage house and not returned to the plan sponsor, eliminating any revenue share possibility from the self-directed brokerage assets and typically raising the overall fee level of the plan.

## Overconfidence

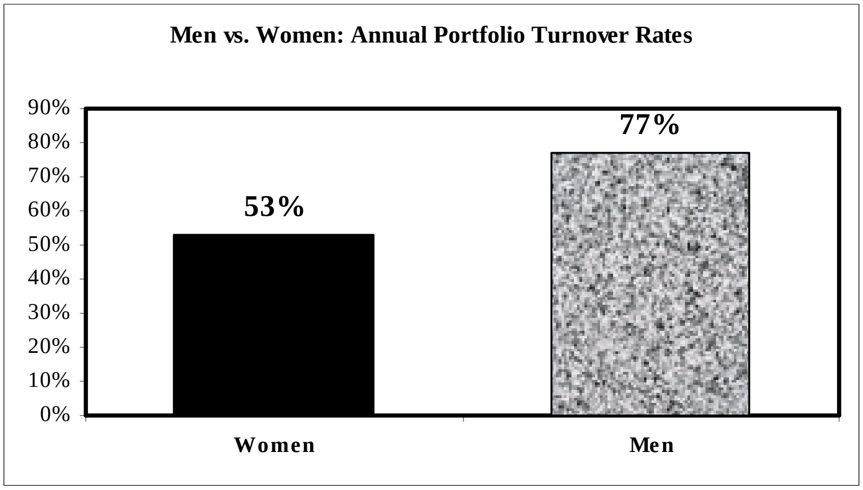
One of the major contributions of academic behavioral finance is that it provides insights into investor behavior where such behavior sometimes appears to be irrational and counterproductive. Probably the most prevalent behavioral trait of investors using self-directed brokerage accounts is overconfidence.

It is difficult to reconcile the volume of trading observed in equity markets with the trading needs of rational investors. Rational investors make periodic contributions and withdrawals from their investment portfolios and rebalance their portfolios. The high level of ongoing trading—about 78% annual turnover on average—far exceeds these basic needs.

Overconfidence is the most simple and powerful explanation for high levels of trading on financial markets. Human beings are overconfident about their abilities, their knowledge, and their future prospects. Studies have shown that overconfident investors trade more than rational investors and that doing so lowers their expected returns. Greater overconfidence leads to greater trading and to lower expected returns.

A direct test of whether overconfidence contributes to excessive market trading is to separate investors into those more and those less prone to overconfidence. Psychologists find that in areas such as finance, men are more overconfident than women. This difference in overconfidence yields two predictable outcomes: (1) men will trade more than women, and (2) the performance of men will be hurt more by excessive trading than the performance of women.

**Chart 15-1: Comparison of Annual Trading Rates**




When compared with the portfolios they had in place at the beginning of the year, both men and women earned net monthly returns that were lower than those earned by the portfolio they held at the beginning of the year. Men earned returns lower than women and in direct proportion to their increased trading activity.

Other studies have shown the same trend. Two finance professors, Brad Barber and Terrance Odean, studied the performances of 66,465 households with discount brokerage accounts. Households that traded actively earned 6.7% less on their investments each year than the households that seldom traded.

Odean also found that investors had a strong tendency to chase past performance. On average, the stocks they bought had higher returns over the previous two years than the stocks they sold. Investors also were more likely to sell stocks with positive two-year track records than to sell stocks with negative returns. Investors tended to buy stocks with above-average volatility. Yet returns were below market average. So the average investor underperformed the market by an even larger margin on a risk-adjusted basis.

## The Unified Trust Company Study of 401(k) Self-Directed Brokerage Accounts

Unified Trust sought to determine whether the generally poor outcome of self-directed brokerage accounts is also applicable to the ERISA market subsegment. We found that 72% of self-directed brokerage accounts underperformed a model portfolio. The average account underperformed by 4.72%.

The primary goal of this study was to identify whether participants using self-directed brokerage account options in qualified retirement plans were exceeding or lagging the performance of the core options in their plans. A secondary goal was to determine the extent of asset class diversification achieved by each participant. Sixty-one brokerage accounts were examined with a collective market value of $12.5 million during the 2002–2003 period. Because we have generally discouraged this approach, self-directed brokerage assets represent less than 2% of all assets of the trust company. But the sample size is large enough to draw meaningful conclusions and does represent 100% of the Internet-driven participant-directed brokerage accounts that Unified Trust Company maintains for ERISA plans.

### Account Demographics

- Although the plan sponsors offered the self-directed brokerage account to all participants, virtually 100% of users were highly compensated and highly educated professionals.

- Accounts ranged in size from $1,100 to $1,300,865.

- The median account value was $75,952.

- Most users were between the ages of thirty-five and forty-eight.

## Asset Allocation

- Most participants managed their accounts either very aggressively or very conservatively.

- Ninety-eight percent of assets consisted of equities (stocks or stocks funds) plus cash.

- The overall asset allocation was 68% equities and 30% cash.

- Fifty-five percent of accounts held at least 75% of the portfolio in equities.

- Thirty-one percent of accounts held at least 90% of the portfolio in equities and 22% of accounts held at least 80% of the portfolio in cash.

## Investment Performance

- Seventy-six percent of account returns were below the S&P 500 return.

- Sixty-three percent of account returns were below a blended return of 68% stocks, 30% cash, and 2% bonds—the overall asset allocation of the accounts.

- Seventy-two percent of account returns were below the core fund model portfolio for their plan (equivalent asset allocation).

- Larger portfolios tended to fare worse than smaller portfolios.

- Compared with model portfolios constructed from the plan’s core funds, the overall asset-weighted performance lag was 4.70%, and accounts greater than $250,000 lagged by 5.18%.

**Chart 14-2: Number of Accounts Underperforming Benchmarks**

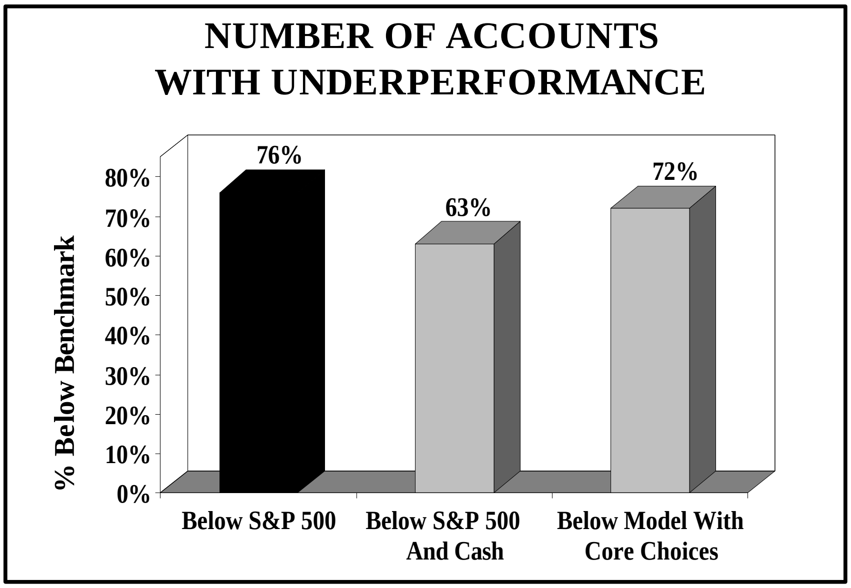
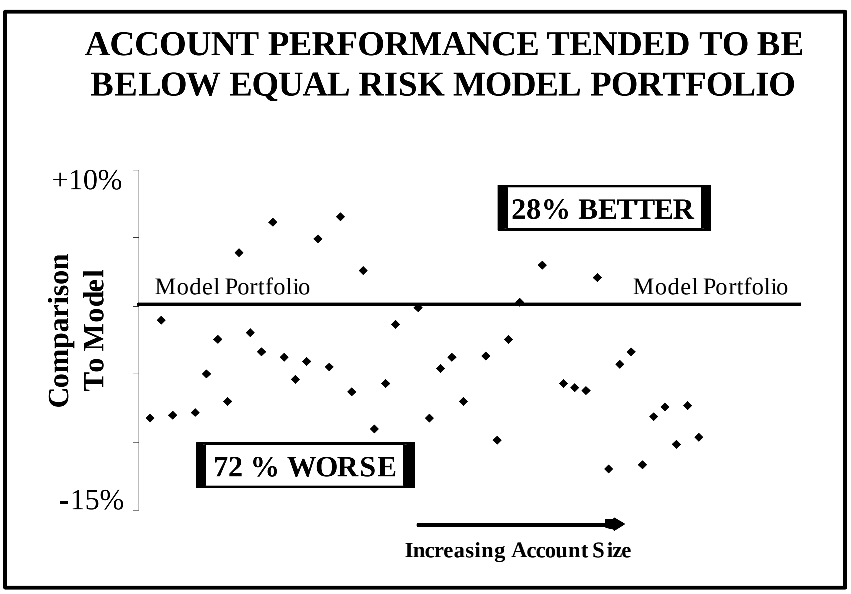



**Chart 14-3: Performance Compared with Model Portfolios**



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