How Retirement Advisors Really Add Value to 401(k) Plans

Most people believe that the value of the retirement advisor is the ability to enhance returns. But if that were true, there would be no asset allocation because that strategy deliberately reduces returns. The fact is that a well allocated portfolio offers asset preservation at the expense of enhanced returns. There is no conclusive evidence that retirement advisors increase investment returns.

The value of the retirement advisor is far greater than marginal investment returns.

Understanding the real value requires stepping away from the investment itself and focusing on the outcome if the retirement advisor was not in the picture. The answer lies in how different the 401(k) industry would look if there were no retirement advisors:

- There would be far fewer plans. Of the over 600,000 plans, 90% to 95% would not exist without the efforts of advisors.
- Participation rates would be lower. Instead of 87% participation, the no-advisor world would have fewer that 25% of eligible employees participating.
- Diversified investments would be the exception. Stable value and fixed income investments would dominate.

These estimates are not mere speculations but were the facts in the 401(k) marketplace before retirement advisors were active.

With an estimated 5 million businesses still without a retirement plan, it becomes obvious that advisors will continue to play a critical role in achieving a more secure retirement for more workers.

The Retirement Advisor's Challenge

Providing the value of a secure retirement may appear on the surface to be a simple task. Experienced professionals recognize that this is not the case. Enhancing retirement security requires uncompensated and labor-intensive work that is required before a plan is in effect for an employer and then for each employee.

A successful retirement advisor must overcome the resistance of the employer to increasing employment expenses by offering a retirement plan. The highly visible direct and indirect expense to the employer has to be justified by an altruistic and often illusive long term benefit that employees may or may not value.

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Before the typical retirement advisor receives compensation, he/she must also convince employees to participate in the 401(k) and then wait for years for contributions to accumulate to a meaningful level. The effort to convince the employee requires making the case to lower their current standard of living in the hope that this sacrifice will yield a more secure retirement that is often decades in the future.

It is only after overcoming both of these challenges that the retirement security is improved.

Several tools have been developed that streamline the role of the retirement advisor. These include regulatory waivers and exemptions that reduce the employers' burden as well as incentives and automatic features for employees. On the other hand, there have been regulations and proposals that make the retirement advisor's job even more difficult.

Risks

The retirement advisor faces business risks that are unique. Most serious is the risk of not recovering the cost in time to establish and operate the plan through its formative years. The retirement advisor who establishes the plan and builds participation and contributions is rewarded only as long as the employer remains a client. Unfortunately, such a profitable plan is an attractive target for other advisors, who can offer lower fees since there are no more start-up costs.

This risk pushes retirement advisors to pursue larger employers, where the time for start-up cost recovery is shorter.

The second unique risk is being held responsible for plan losses and failing to comply with regulatory requirements. These liabilities put an additional administrative burden on the retirement advisor that translates to higher operating costs.

This risk increases the fees that must be charged for the retirement advisor to operate profitably.

Compensation

The trigger for advisors became active in enhancing retirement security was the introduction of compensation programs to fund these activities. These compensation programs funded the activities necessary to start up, retain and improve the 401(k) plans.

Today's successful compensation programs evolved after other attempts at funding failed:

- Employer Funded: This is a non-starter because employers could not be convinced to pay an expert to convince them to start a 401(k) plan.
- Employee Funded: While this might appear to be logical, since the benefit is enjoyed by the employee, it is highly impractical and very costly.
- Government Funded: This possibility is still under consideration but is unlikely to materialize since Washington has little appetite for additional spending.

The successful funding approach has been to treat the advisor's compensation as an expense of the retirement plan. This has the added benefit of creating and incentive for the advisor to succeed.

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Having solved the funding, the issue of the standard of care now looms large. Market forces have produced an adequate level of care but a significant gap still exists between the best and worst practitioners. Few of the best practitioner take advantage of a superior standard of care and fewer of the worst suffer for being inferior.

The reason is the disparity in the standard of care is the lack of generally accepted quality measures combined with the use of investment returns as a measure of advisors' value.

The disparity can be resolved by the best advisors adopting a uniform standard of care and using this standard to win business from competitors who cannot operate at that level.

Conclusion

The critical role played by the retirement advisor has not been understood. This failure threatens the retirement security of the 68 million workers with no retirement plan who are primarily employed by small businesses. Instead of focusing on investment returns and lowering expenses, real benefits can be achieved on finding additional ways of funding retirement advisor activities.

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