

Cruise Control for 401(k) Plan Participants

Running on auto pilot is okay, as long as plan administrators keep their hands on the wheel.

By Larry Heller



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Although much has been written about the controls put in place by 401(k) plan sponsors to protect “day traders” from themselves, participants at the opposite end of the spectrum are often overlooked. Let’s call them the “auto pilots”—the participants who aren’t paying much attention to their 401(k) plan. Today’s technology and typical plan design have made it very easy for the hands-off participant to remain that way, even in a generous, well-advertised retirement program.

Without necessarily understanding the plan or tax rules in any detail, the auto pilots know it is a good thing to contribute some of their pay. So they joined the plan, perhaps with contribution amounts and investments dictated by automatic enrollment. They have been contributing via automatic payroll deduction. Perhaps this plan also offers automatic contribution increases, whereby contribution percentages (of pay) automatically increase upon pay increase, and automatic rebalancing, which saves the participant the effort of reacting to an account that, for example, has skewed far from the investment split that the participant (or the automatic enrollment) originally intended.

In this hypothetical (but very possible) scenario, the participant who once chose or defaulted into a healthy contribution level might now be a mere spectator while the plan applies the IRS’s annual contribution limits—stopping their pre-tax contributions at this year’s \$14,000 limit, perhaps with an automatic restart of contributions in the first pay period of 2006.

On a more sophisticated level, perhaps the participant chose managed accounts, where the participant delegates responsibility to a financial entity authorized by the plan sponsor to make all of that account’s ongoing investment decisions. If so, that step of allowing their account to be managed for them might be one of the only active steps they ever take during their participation in their plan. Perhaps the plan also offers an employee stock ownership feature, offering automatic dividend reinvestment or cashout, with a likely default to reinvestment.

It’s all automatic, and it’s all under control by the plan’s recordkeeper. But the auto pilots need several defense mechanisms to be in place on their behalf. At the very least, the plan’s overseers are obligated to communicate the

plan’s default rules and their implications, and carry the fiduciary responsibility to monitor investment performance. Yet plan sponsors usually delegate to plan administrators much of the responsibility for helping those who have chosen not to help themselves.

Let’s look at these lines of defense:

Communications—By law, all plan participants are notified if their plan employs any of the “automatics” mentioned above and, if so, its default contribution rate and investment approach. Printed account statements confirm the status of the account, and Summary Plan Descriptions lay out the participant’s alternatives, deadlines for changes, and implications of inaction. But is the plan administrator monitoring the level of default elections taking effect, or how or how often participants override them? Are their communications personalized and targeted enough to catch the eye of the auto pilots who just let their 401(k) ride until their retirement, despite what it might be costing them?

Investment Selection—During the past decade, life-cycle and lifestyle funds—presetting an investment mix appropriate to the assumed age or investment time horizon of the investor—have solidified their place in the offerings of 401(k) plans. These funds help investors follow proven long-term investment strategies and diversification without requiring them to make ongoing, explicit reallocation decisions. Again, are all of these default options made clear to a generally unsophisticated and often uninvolved audience?

Fiduciary Responsibility—The recent growing trend towards offering the “managed accounts” described above expands the plan’s fiduciary exposure. All along, the retirement or pension committee overseeing the plan has had the responsibility of offering its participants a “prudent” array of investment options. The fate of the auto pilot is especially in their hands.

Ironically, for the recently terminated employee who never contributed much to the plan, their final action could be just as automatic—an involuntary rollover of their vested account balance (if it has not exceeded \$1,000) to an IRA preselected by the company they just left.

Defaulters should beware. It is always a good idea to remind them to drive with their eyes open. **HRO**