The Changing Face Of 401(k) Plans
By Jeff Schlegel

The 401(k) plan has become a bedrock of the American retirement account, but its foundation is becoming increasingly fluid with evolving rules, products and attitude shifts that add choices—and complexities—for plan participants and their sponsors.

The landscape is bound to change after the U.S. Department of Labor in October issued its final rule on default options for 401 (k) enrollment in company-sponsored defined contribution plans, and employers are now cleared to automatically enroll workers in life cycle funds, professionally managed accounts or balanced funds as default options. Stable value funds no longer qualify as default investments in 401(k) plans. Such funds—generally offered by insurance companies in the form of fixed-income products or guaranteed insurance contracts—are allowable options in professionally managed accounts overseen by financial advisors.

These changes stem from the Pension Protection Act of 2006, and the Labor Department hopes they will boost retirement savings in 401(k) plans to between $70 billion and $134 billion by 2034. It's scheduled to go into effect on December 24.

It's estimated that roughly one-third of eligible workers don't participate in their employer-sponsored defined contribution plans. In response, employers are structuring their 401(k) plans to boost both the quantity of participants and the quality of their offerings.

According to Hewitt Associates, the human resources outsourcing and consulting firm, 34% of companies automatically enrolled their employees in 401(k) plans in 2007, up from 19% in 2005. And one of the big beneficiaries of this trend are life cycle funds (also known as target-date funds). These portfolios have a predetermined asset allocation based on your desired risk tolerance or expected retirement date, and it automatically adjusts itself to become more conservative as it approaches the specified target date. More than half of company plans already use these funds as a default option, and that will probably increase going forward.

Including life cycle funds in 401(k) plans gives many people the investing discipline and all-around portfolio structure they often lack when they call their own shots, and these funds also simplify the investing process for the rank and file, says Malcolm Greenhill, who as CFP and president of Sterling Futures in San Francisco helps advise employees in company defined contribution plans. "Most people are not hardwired for prudent investment planning, and they often don't give their portfolios the attention they deserve, nor do they have the knowledge."

Pamela Hess, Hewitt's director of retirement research, says that life cycle funds represent 13% of assets in the average company defined contribution plan, up from 10% in 2005. "Some argue that's not very successful given there aren't as many assets in them as in other vehicles," she says. "But I argue that they are successful because these are used most often by lower-income people with lower balances. You can't measure success simply by the amount of assets."

The Roth Option

The Pension Protection Act made Roth 401(k)'s permanent by removing sunset provisions that would have caused them to expire in 2011. That might grease the skids for more rapid adoption among 401(k) plans; earlier this year, only 11% of companies offered these products to their employers, according to Hewitt.

Unlike regular 401(k)'s, which don't tax up-front contributions but only withdrawals, the Roth version taxes contributions but allows for tax-free distributions. For many investors, figuring out whether to use a Roth is an exercise in financial gymnastics that requires blind assumptions about what their tax brackets will be like 20 to 30 years down the road.

"It hasn't been a popular feature," says Michael Scarborough, president of The Scarborough Group in Annapolis, Md., which actively manages company 401(k) plans. "I don't think people have figured out how to use them, including us. Part of the problem is that you can take a 35% haircut to get in [a Roth 401(k)] and grow the money tax-free, but there's a good chance you'll be in a lower tax bracket when you're eligible to take it out tax-free, which can mute the intended benefit.

"When I give away one-third of my money up front," adds Scarborough, "you have to show me I'll get at least a one-third benefit on the back side, and I don't know if you'll see that with the Roth."

But Roth 401(k)'s might be a good bet for certain investors. "The Roth has the most potential with younger, lower-income employees," says Phyllis Klein, managing director of professional services at Captrust Financial Advisors in Raleigh, N.C., which provides fiduciary services to retirement plan sponsors. "They have a larger accumulation period and are in a lower tax bracket than they'll likely be in later, so it makes sense to pay tax now and let it accumulate."

Pamela Hess says that companies offering Roth 401(k)'s to their employees typically see a 5% adoption rate within a year. "What employers are asking is whether 5% is enough to justify doing this," she says. Nonetheless, Hess forecasts that 25% of all companies will offer Roth 401(k)'s by the early part of 2008.

Annuities In The Mix

At least among some aging baby boomers, the traditional role of the 401(k) as a means for wealth accumulation leading up to retirement is gradually giving way to the realization that 401(k)'s can be a source for retirement income that will hopefully last a lifetime. In response, insurance companies are rolling out a raft of new annuity-based products—both fixed and variable—designed to provide investors with a steady income stream in retirement.

Unlike many typical annuities whose benefits end when the policyholder dies, some of these newer products seek to generate income while protecting some portion of the lump sum for beneficiaries. One of the purported advantages of placing annuities in a 401(k) is that group pricing makes them cheaper than buying them individually.

But the guaranteed income options aren't cheap, and the products lack portability when people switch employers. "I can't justify the costs of using fixed annuities in 401(k)'s," says Scarborough. "The typical expense ratio is 1.5% to 1.7% on something that might return 5% to 6% or less. I can't in good conscience justify that when the intent of this money is to last over a lifetime for people who might live another 20 to 30 years."

According to Hewitt Associates, only about 15% of employers offer annuities to their workers as part of their 401(k) plan. "They're really misunderstood by employers," says Hess. "You have to educate them in how to use them appropriately."

But as more annuity-type products try to penetrate the 401(k) market, the need for education will only increase. "Annuity riders are getting more complex by the day," says Elliot Shifman, president of Outer Banks Financial, a financial product development firm in Raleigh, N.C. that creates annuities and other vehicles. "And financial advisors and consultants will play the biggest role in deciphering the different offerings."

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