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Self-Directed Brokerage Accounts Tend to Reduce Retirement Success and May Not Decrease Plan Sponsor Liability

BY GREGORY W. KASTEN

Plan participants often expect that self-directed brokerage accounts offer more choices and wealthier retirement prospects than do managed model portfolios; plan sponsors might expect less liability. But the substantial underperformance, restrictions, costs, and liabilities of such plans dictate that caution is in order.

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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 percent of all plans offer a brokerage account, but only about 6 percent of participants use it. The demand for self-directed brokerage accounts arose in the 1990s when the bull market was in full throttle and irrational exuberance about the stock market was at its peak. Plan participants pushed for more choice because of their overconfidence in their own trading skills.

Plan sponsors also welcomed self-directed brokerage accounts as a means of further reducing their liability as fiduciaries. After all, if a sponsor offers the participant the full range of the market as an investment opportunity, shouldn't the reduction of liability offered by ERISA Section 404(c) be available? Contrary to what many purveyors of brokerage services may tell plan sponsors, plan fiduciaries continue to retain significant fiduciary responsibility and liability by selecting the provider or 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.

In terms of successful retirement outcomes, the investment performance of self-directed accounts is generally inferior to managed 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 those of women's because of the extra trading activity. We have found that 72 percent of all self-directed brokerage account investment returns lag behind equally weighted managed model portfolios constructed from the core funds in the plan. When all accounts were combined, the average annual underperformance compared to the managed model portfolio was -4.70 percent.

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 20 or more, and sometimes access to company stock. 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.

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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 represents one of the first forms of employee direction in profit-sharing and money purchase plan accounts.

Typically included in retirement programs established for law firms or medical practices, these brokerage programs survived for many years primarily because of 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 ("DOL") issued an interpretive bulletin regarding investment education versus advice—the so-called dividing line between education and advice. The ruling did not specifically shed any light on brokerage accounts; but it did remind plan sponsors and providers that there was a level of fiduciary liability for restricting investment choices. The sales pitch from vendors was that more choice meant less liability. The idea was then heavily promoted to plan sponsors (fiduciaries) by brokerage houses (nonfiduciaries).

The shift in thinking was heightened by two other trends: By the mid-1990s the bull market was in full throttle, and irrational exuberance was at its peak. Plan participants felt ready, and eager, to move beyond the typical eight to ten mutual fund choices of their 401(k) plan.

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 thousands of mutual funds. 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, however, some ERISA limitations. Plan participants with self-directed brokerage accounts may not be able to invest in all of the investment vehicles available in retail brokerage accounts. They cannot hold investments prohibited under ERISA or utilize imprudent investment vehicles such as municipal bonds. They cannot generally buy options or futures, commodities, or derivatives, and they cannot margin or sell short. They cannot conduct investment strategies 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 that can offer this option has grown from virtually zero in 1993 to more than 90 percent today.

As with plan sponsors, many service providers remained unconvinced of the prudence or practicality of the option. Many service providers had "anecdotal" knowledge about a client or two with poor outcomes, but most could not cite a detailed study. We have examined all of our accounts in detail to understand what the likely results are for a plan participant who requested a self-directed brokerage account.

The true momentum for this change did not arise from plan sponsors, industry consultants, fiduciaries, or service providers; however, having found themselves eliminated from one search after another because they did not offer the option and losing out on business, most service providers now have reacted to the demand and figured out a way to permit their clients to offer self-directed brokerage accounts.

The driving force for this investment option was the plan participants 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 percent of plan sponsors offered brokerage accounts, compared with 7 percent 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 percent cited employee demand as the primary driver for the additional option.

The surge in interest revealed 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 continually to add 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.

Interestingly, only a handful of employees tend to use the service when it is offered. Only about 6 percent

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of participants actually use the feature in the plans that now offer brokerage options. In general, these employees tend to be more sophisticated and more highly paid employees. Under the ERISA and Code nondiscrimination rules, the option must, however, be made available to everyone in the plan.

The brokerage-house sales pitches claim a self-directed brokerage account can protect fiduciaries even more than a traditional 404(c) plan can, 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 evaluate and communicate retirement-plan investment options prudently.

Brokerage Accounts Do Not Eliminate Fiduciary Liability Concerns

Several ERISA fiduciary liability risks 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 by the broker that the individual investments do not need to be prudently selected and monitored.
2. If the myriad of ERISA Section 404(c) requirements are met, the fiduciaries are not responsible for the investment allocation decisions of the participants.

Compliance with ERISA Section 404(c) generally 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 select investment choices prudently, but also the obligation to evaluate the performance of these vehicles to determine whether they should remain available under the plan.

Offering self-directed brokerage accounts is more risky 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 reasonable interpretation of that general requirement is that plan fiduciaries must decide whether it is prudent to offer brokerage accounts to participants.

In DOL Interpretive Bulletin 96-1, DOL officials have opined that fiduciaries must consider the nature of the workforce in selecting 401(k) investments. 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 three or three hundred—those options are designated, and as a result, must be prudently selected, periodically monitored, and removed from the plan when they are no longer prudent or suitable for the participants.

The legislative history, statutory language, and DOL 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.

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

Having self-directed brokerage accounts creates MORE, not less, liability for the plan sponsor/fiduciaries than the limited-scope 404(c) plans have. The common-law concept of investment prudence, codified by ERISA, would appear to require fiduciaries—that is, trustees, plan sponsors, retirement committees, groups offering advice, or other decision-makers—to review the entire portfolio of each self-directed brokerage account.

The plan sponsor needs 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. Further, the investment policy statement should address expense issues such as brokerage fees, trading costs, directed brokerage arrangements, execution, mutual fund revenue sharing payments, and any soft-dollar arrangements to make sure all fees are reasonable in light of the services provided.

The plan sponsor should endure that the self-directed brokerage account service provider is contractually liable for the consequences of its failure to satisfy any agreed-upon limitation on permitted investment vehicles. Many plan sponsors would like to reserve self-directed

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accounts for participants who are sophisticated investors by establishing a minimum account balance; however, the use of such thresholds will typically discriminate in favor of highly compensated employees. Such discrimination would jeopardize the tax-qualification and tax exemption of the plan and trust.

Managing the educational issues presents significant challenges for plan fiduciaries. Studies show that most people have trouble managing a mutual fund portfolio. The problems are even greater for plan participants picking individual stocks. 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 18 to 65, more than a third of respondents indicated that they "did not know how to invest" or "did not know anything about the stock market." Another 9 percent indicated they would be better off using an investment professional. The survey also found that even the sophisticated participants most likely to take advantage of a self-directed brokerage account were reluctant to use this tool.

As a result, 401(k) brokerage accounts should be approached more with caution than many plan sponsors believe. In deciding whether to offer the option, plan fiduciaries should consider, among other issues, the investment sophistication of the participants, the breadth and effectiveness of the investment education programs, whether investment advice is available for the participants, and the communication needed to inform the participants of their various risks.

Section 404(c) Safe-Harbor Provisions

ERISA generally outlines significant fiduciary requirements for 401(k) plan sponsors 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 ability 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 procedure and substance 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 the safe harbor under Section 404(c) could be important in declining markets, especially if disgruntled plan participants search for scapegoats to reimburse them for self-induced losses.

Many plan fiduciaries do not understand their duties, or understand them but have no time to fulfill them and document their fiduciary process. 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.

We believe most plan sponsors have difficulty fulfilling the Section 404(c) requirements if the self-directed brokerage account offers unlimited investments. Notwithstanding the unlimited investment options problem, there are steps the fiduciary can follow to increase the potential that he/she can rely on 404(c).

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. The plan sponsor must provide the following information to plan participants:

1. A general description of the self-directed brokerage account, including the investment alternatives available;
2. An explanation of the circumstances under which participants may give investment instructions in the brokerage account;
3. A description of the transaction fees and expenses of the brokerage account;
4. The name, address, and phone number of the person responsible for providing disclosures, which must be provided upon request;

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5. Distribution of a prospectus to participants in connection with their initial investment in a mutual fund or other registered security;
6. A description of proxy voting materials, if proxy voting is passed through to participants for the investment;
7. 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, many plan sponsors 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 [Study of 401(k) Plan Fees and Expenses, April, 1998] and found that in some instances, the fees paid by a typical 401(k) plan compared unfavorably with retail investment fees. In some cases, the higher fees paid for additional services to the plans; in some cases, they did not. The study also 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 a major provider of participant-directed brokerage accounts [Charles Schwab] found that a surprisingly large number of participants, nearly half (43 percent), used their plan brokerage accounts to purchase stock mutual funds. Unfortunately, in many cases, the plan participants purchased 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. Under the DOL Frost Model, [DOL Op. Ltr. 97-15] various internal fees from the no-load funds, such as 12b(1) fees, shareholder servicing fees, finders fees, and sub Transfer Agency fees, are collected by the plan's trustee and returned to the plan as dollar-for-dollar fee offsets. 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. The Frost Model is the "gold standard" of fee disclosure and objectivity of the service provider.

In most self-directed brokerage accounts, the brokerage house retains the mutual-fund trail fees. Because the revenue is typically neither disclosed nor returned to the plan, any possibility of revenue-sharing from the self-directed brokerage assets is eliminated and the overall expense level of the plan may be higher than necessary.

Trading Overconfidence

One of the major contributions of academic behavioral finance is insight 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. This has been studied in detail by professors Terrance Odean and Brad Barber.

These researchers had difficulty matching the volume of trading observed in equity markets with the actual trading needs of rational investors. Rational investors make periodic additions and withdrawals from their investment portfolios and rebalance their portfolios. The high level of ongoing trading, averaging about 78 percent annual turnover, far exceeds such basic needs.

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

As shown in Exhibit 1, when compared with the portfolios they had in place at the beginning of the year, both men and women earned net monthly

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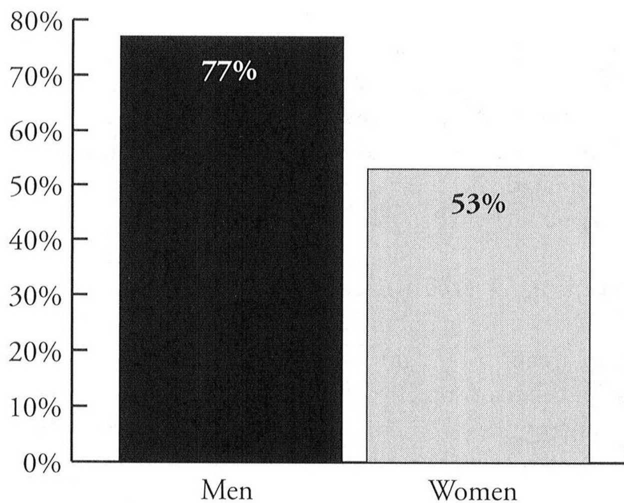
Exhibit 1: Comparison of Annual Trading Rates
Men Versus Women Annual Portfolio Turnover Rates



Data from Odean and Barber.

returns that were lower than those earned by the portfolio they held at the beginning of the year. Men earned lower returns than women did, and in direct proportion to their increased trading activity.

Other studies have shown the same trend. Professors Brad Barber and Terrance Odean studied the performances of 66,465 households with discount brokerage accounts. Households that traded actively earned 6.7 percent less on their investments each year than did 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 did 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 segment. Seventy-two percent of self-directed brokerage accounts underperformed a model portfolio, with the average account underperforming by 4.72 percent.

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 to 2003 period. Because this approach is generally discouraged, self-directed brokerage assets represent less than 2 percent of all assets of the trust company. The sample size was large enough to draw meaningful conclusions and did represent 100 percent of the Internet-driven participant-directed brokerage accounts that Unified Trust Company maintains for ERISA plans.

Account Demographics

1. Although the plan sponsors offered the self-directed brokerage account to all participants, virtually 100 percent of users were highly compensated and highly educated professionals.
2. Accounts ranged in size from $1,100 to $1,300,865.
3. The median account value was $75,952.
4. Most users were between the ages of 35 and 48.

Asset Allocation

1. Most participants managed their accounts either very aggressively or very conservatively.
2. Ninety-eight percent of assets consisted of equities (stocks or stocks funds) plus cash.
3. The overall asset allocation was 68-percent equities and 30-percent cash.
4. Fifty-five percent of accounts held at least 75 percent of the portfolio in equities.
5. Thirty-one percent of accounts held at least 90 percent of the portfolio in equities and 22 percent of accounts held at least 80 percent of the portfolio in cash.

Investment Performance

1. Seventy-six percent of account returns were below the S&P 500 return.
2. Sixty-three percent of account returns were below a blended return of 68-percent stocks, 30-percent cash, and 2-percent bonds—the overall asset allocation of the accounts.
3. Seventy-two percent of account returns were below the core fund model portfolio for their plan (equivalent asset allocation).
4. Larger portfolios tended to fare worse than smaller portfolios did.
5. Compared with model portfolios constructed from the plan's core funds, the overall

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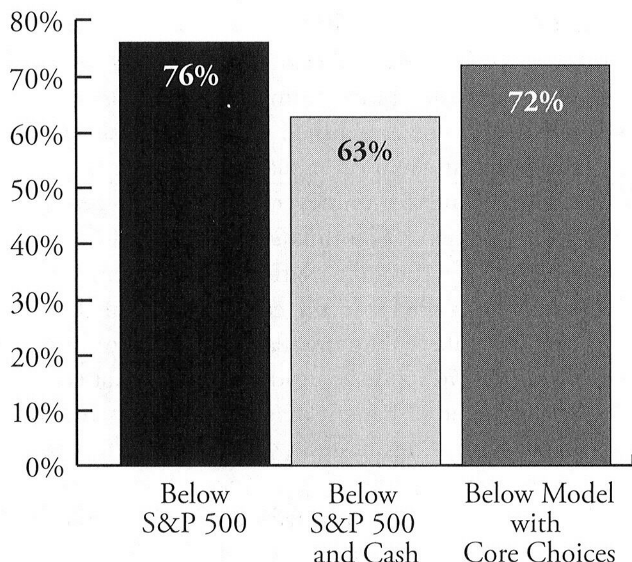
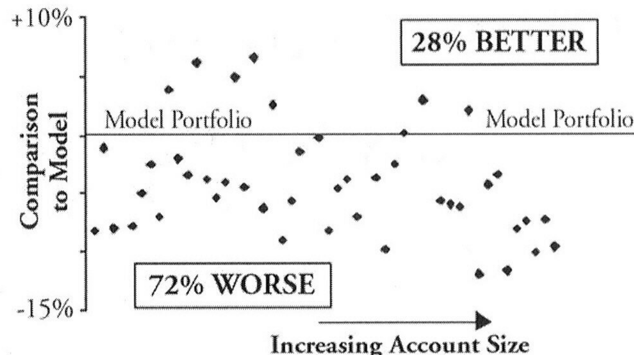
asset-weighted performance lag was 4.70 percent, and accounts greater than $250,000 lagged by 5.18 percent.

Exhibit 2: Number of Accounts Underperforming Benchmarks



Data from Unified Trust Company, NA

Exhibit 3: Performance Compared with Model Portfolios



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