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Planning to Retire



Conflicts of Interest in Your 401(k) Plan

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Employer-sponsored 401(k) plans are riddled with conflicts of interest, according to a Government Accountability Office report released this week. The analysis found a variety of 401(k) service providers are recommending investments that may not be in the best interests of retirement savers and deliberately structuring their relationships with 401(k) plans to avoid being held responsible for poor performance. Here are seven conflicts of interest that could hinder your retirement savings efforts.

Biased advice. Plan sponsors and participants sometimes rely on service providers for assistance in making investment decisions. While some service providers operate as independent, fee-only advisers who are compensated solely by their clients, a service provider with a conflict of interest may steer 401(k) plan sponsors toward investment funds that increase the service provider’s compensation. “The structure of advisers’ compensation and their other business arrangements could create competing interests that may bias their investment recommendations to plan sponsors or participants,” according to the GAO report. “If left unchecked, conflicts of interest could lead plan sponsors or participants to select investment options with higher fees or mediocre performance, which, while beneficial to the service provider, could amount to a significant reduction in retirement savings over a worker’s career.”

Miseducation. Investment advice is required by law to be in the participant’s best interest and prohibits the adviser from having a financial interest in the investment options recommended. But investment education is not subject to these standards. Service providers who provide education materials and brochures to 401(k) participants may have financial interests in the investment options available. “Participants may believe that providers are giving investment advice that is in

participants' best interests, even in situations where this may not be the case," GAO found. Companies can highlight their own funds as examples of investment options under each asset class through investor education, even when they have a financial stake in the outcome of participants' investment decisions.

Bundled funds. A service provider that offers its own investment funds or has an affiliated brokerage arm has an incentive to steer 401(k) plan sponsors to select these proprietary funds, even if other funds from different providers better suit the needs of the plan. Sometimes service providers require plan sponsors to include their proprietary funds as investment options in the plan or even designate one of their funds as the default investment for employees automatically enrolled in the 401(k) plan. "In order to make prudent investment decisions, plan sponsors and participants need to understand when a service provider is acting in the role of a salesperson rather than a fiduciary adviser, required by law to act in the best interests of the plan and its participants," according to the report. "It is especially important for plan sponsors and participants to know if a service provider stands to gain from the selection of particular investment options."

Don't call me a fiduciary. The Employee Benefits Security Administration can recover losses related to conflicts of interest when the service provider functions as a fiduciary. Fiduciaries are prohibited from benefiting from the investment of plan assets and required to act solely in the interest of the plan's participants and beneficiaries. Fiduciaries who breach their plan duties are also personally liable for making up losses to the plan and restoring any profits made through the use of plan assets. However, many service providers structure their contracts with 401(k) plans to attempt to avoid meeting one or more of the five parts of the current definition of a fiduciary. Also, sometimes 401(k) plan sponsors rely on consultants and other service providers to assist them in asset management, who may or may not be fiduciaries and required to act in a retirement saver's best interests.

Revenue sharing. Revenue sharing creates an incentive for the service provider to suggest funds with higher revenue-sharing payments, even if those funds have poorer performance or higher costs for participants. GAO found that revenue-sharing payments from various investment funds ranged from 5 to 125 basis points. Using revenue sharing to reimburse for record-keeping expenses can also create conflicts of interest if these payments are not clearly disclosed to the plan.

Brokerage repayments. An investment adviser can direct a broker-dealer to use commission revenues to pay the fees of other service providers or to purchase services of value to investors. But payments may not terminate when fees due to the service provider have been paid in full, resulting in the plan overpaying for services. These arrangements can also create an incentive for the service provider to recommend a more active trading strategy to increase the number of transactions and, consequently, the amount of commissions.

Recruiting rollovers. Conflicts of interest also arise when 401(k) service providers sell nonplan products and services, such as IRA rollovers, to participants outside their 401(k) plan. "The service provider may advise a participant to roll his or her account funds into an IRA, even if such a transaction may not be in a participant's best interest," GAO found. Service providers are not required to provide fee disclosures that specifically alert participants to the difference in fees between comparable funds available in and outside their 401(k) plan. GAO found that some 401(k) service providers are marketing IRA rollover accounts with much higher fees than the 401(k) account to 401(k) participants. Some plan sponsors require service providers to sign nonsolicitation agreements to prevent service providers from marketing nonplan products and services to 401(k) participants.