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DEFINED CONTRIBUTION

Self-directed accounts still have staying power

Plan sponsors avoid dropping underutilized and largely ineffective brokerage options

By [Jenna Gottlieb](#)

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Defined contribution plan executives are reluctant to pull the plug on self-directed brokerage accounts, even though they are underutilized and often ineffective.

“It’s within the power of the plan sponsor to terminate the account and require those participants to map over or redirect their funds, but it’s something we rarely see,” said Mike Francis, president and consultant at Francis Investment Counsel LLC, Hartland, Wis.

The option allows participants to open an account with a brokerage firm through their 401(k) plans, giving them access to a much wider universe of investment selections than their plans offer, usually including mutual funds and sometimes including individual stocks and bonds.

Most plans want to maintain the flexibility a brokerage account offers, even if a small number of investors use it, Mr. Francis said.

Julian Regan, executive director at the New York State Deferred Compensation Board, Albany, said the fund’s brokerage account, which offers strictly mutual funds, holds only 0.1% of the plan’s \$7.3 billion in assets. “There has been modest interest in the option,” said Mr. Regan. “It is not considered to be part of the plan’s core options and therefore is designed for those that are expert investors.”

Lori Lucas, consultant at Hewitt Associates, Lincolnshire, Ill., said 16% of 401(k) plans offer a brokerage account now, up just four percentage points from 2001. Participants are simply not requesting the feature, she said.

Kept to appease

Despite the limited use and the fact that some plan sponsors fear employees will sue if they lose money through the brokerage option, most plan officials want to retain the option to appease sophisticated investors.

To protect the plan from liability, New York State’s plan requires participants in the brokerage option to agree to allocate no more than 50% of their assets to the account and to sign disclosure forms acknowledging the risk

involved. They also must agree to receive education about responsible investing.

Some participants “think they are master investors and can conquer the retirement industry on their own,” Mr. Francis said. “There was one Wisconsin plan (that is a client) where one of the doctors self-directed his seven-figure retirement account away.” The participant sued the plan sponsor and ultimately settled.

One client, with 4,000 employees, allowed participants to invest “in any Fidelity fund,” including sector funds, he said. Because officials were concerned about liability, Mr. Francis said his firm helped create a menu of 20 investment options, and the mutual fund window was terminated.

Making the switch

If participants did not allocate their holdings out of the mutual fund window, those assets were mapped into a like fund or placed in a general account where they were forced to reallocate, he said.

Jeff N. Maggioncalda, president and chief executive officer of Financial Engines Inc., Palo Alto, Calif., said although many companies added brokerage accounts in the late 1990s, the options have been ineffective because of participant inertia. “With brokerage windows, you can’t teach someone to be something they’re not. You can’t teach 15 million people about modern portfolio theory,” Mr. Maggioncalda said.

Charles Schwab Corporate Services, San Francisco, has close to \$10 billion in self-directed brokerage account assets, with more than 112,000 accounts. Sales peaked in 1999 and 2000, said Robert Jesch, product director at Schwab. The area experiencing growth now is deferred compensation plans, he said, although not at the feverish pace of five years ago.

Mr. Jesch said some plan executives face opposition from participants if they eliminate the brokerage option. “Once they implement the feature, there is a loyal group within the plan that would have a lot to say if they got rid of it.” Sometimes plans change record keepers and participants are forced into other options, but it is very rare to see a brokerage account terminated by a plan sponsor, he said.

Adding a window

Aspirus Inc., Wausau, Wis., is one plan that is adding a self-directed brokerage window. The hospital network has participants interested in the option, although the majority probably won’t be, said Kerry Brunner, manager of compensation and benefits for the \$100 million 401(k) plan. Company officials are working with the plan’s consultant, Milliman USA, Wayne, Pa., to launch the option later this year. The Aspirus plan has 16 core options, and Mr. Brunner said the brokerage window will give the plan more flexibility.

“An option like this requires a lot more hand-holding. Our goal to try to ensure that folks have a good program available” and are properly educated about it, Mr. Brunner said.

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