Reconsidering the 401(k) Rollover

Confusion over distribution options and providers' conflicted business models may be putting employees and employers at risk

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Financial Engines®

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Executive Summary

The notion that people will remain with the same employer throughout their careers has changed over the last several decades. Workers of all ages are changing jobs with greater frequency, for a variety of reasons – be it voluntary or involuntary. This trend creates retirement planning challenges, especially when they must decide what to do with money they have invested in a former employer's 401(k) plan.

A recent survey by Financial Engines, the workplace division of Edelman Financial Engines, found that 52% of workers between the age of 35 and 65 have left a job where they had money in the employer's 401(k) plan. Although it's common for people to assume that they should take the money with them when they leave, leaving the money in the plan actually makes more financial sense in the majority of cases.

Leaving one's 401(k) account with the employer allows the worker to take advantage of the institutional buying power and high-quality plan design that many leading employers have made available. Furthermore, rolling money out of the plan can result in higher, often hidden costs, including taxes, IRS penalties and other costs.

Although survey respondents revealed their confusion about retirement planning, the overwhelming majority acknowledged they could benefit from professional help from a trusted source. Nearly 80% of respondents said it was extremely or somewhat important that financial advisors act as fiduciaries, which means they not only act in the individual's best interests, but that they are legally held to the highest standard of care. Unfortunately, some financial advisors engage in aggressive rollover practices veiled in putting the individual's "best interests" first – but who are not actually holding themselves to an appropriate legal standard of care. And as recent litigation shows, such practices – which often involve cross-selling of proprietary investment products or excessive fees – are harmful to individuals and expose employers to additional risk.

This paper discusses in more detail the survey findings and proposes a solution to overcome distribution conflicts of interest and reduce risks. With Financial Engines' new Fiduciary Distribution Review experience, individuals with distribution decisions can get personalized, fiduciary-quality advice on whether remaining in the plan makes sense for them – free of any business model conflicts of interest.

Key Findings

- More than four in 10 individuals (42%) between ages 35 and 65 who left a job where they had money in a 401(k) plan were unaware that it might have been possible to keep their money in the plan.
- More than one in four (28%) didn't know that some retirement distribution choices trigger tax liabilities and penalties.
- Nearly half of respondents (47%) were not sure that they knew all of the fees in their current retirement accounts.
- Among all respondents, most (69%) have not consulted a financial advisor about their distribution options.
- Among those who withdrew money from a 401(k) before their retirement, a quarter (26%) got no information or help from any resource.
- Yet, nearly 80% of those who did consult a financial advisor said they felt more confident about their distribution strategy.
- Nearly 80% of respondents felt it is important that the distribution advice is delivered by a financial professional who is a fiduciary acting in their best interest.
- Nearly one in three individuals had negative feelings about their chances of reaching their financial retirement goals.

Introduction

Most people dream of a successful and rewarding career followed by a comfortable retirement – spending time with family, traveling the world or simply being free to do what they want, when they want.

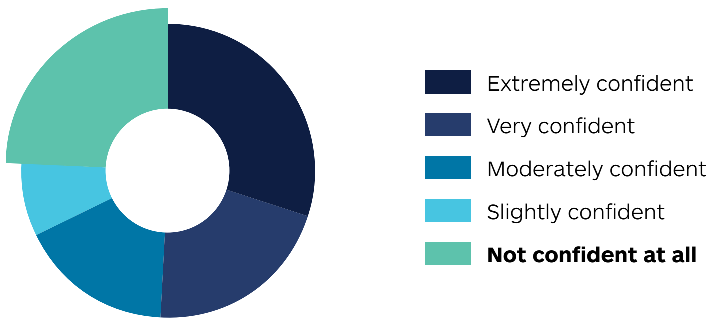
It's been widely reported that the ways Americans save for their futures have changed dramatically over the past few decades. Pension plans that provide retired employees a fixed income for life are quickly becoming a relic of a bygone era. Social Security benefits aren't likely to sustain future generations throughout their retirements. Defined contribution plans, such as 401(k)s, have shifted the burden onto individuals, giving them full responsibility to save, invest appropriately, turn their savings into retirement income, and ensure they do not outlive their money.

At the same time, a strong economy, low unemployment and new opportunities are resulting in people changing jobs more often. The consulting firm Mercer[1] estimated that voluntary turnover in 2018, excluding retirements, was 15.5%, up from 14% in 2017. And estimates from Mercer and Gallup[2] suggest that between 21% and 51% of millennials have changed jobs within the past year.

All this workforce churn raises important questions that can have long-term implications. How well do people understand their current retirement savings strategies and their options should they decide to leave their job? And what should employees do with the money they've accumulated in their former employer's 401(k) plan?

Retirement Savings Knowledge Gaps Abound

A recent Financial Engines survey found that Americans don't understand their own retirement savings. For instance, a shocking 25% of respondents were not at all confident that they knew the current balance of their retirement accounts. The finding was even more pronounced for women – 30% felt this way, compared to 17% of men.



It also found that people don't know how much they pay in fees for their retirement accounts. Nearly half of the respondents (47%) said they were very or somewhat uncertain they know and understand all the fees they pay in their current retirement accounts. Furthermore, a 2018 TD Ameritrade survey found that over one-third (37%) of investors[3] believe they don't pay any 401(k) fees.

Without a baseline understanding of their retirement portfolios, it can be difficult for people to make savvy decisions about what to do with the money accumulated in their 401(k) when they change jobs.

A simple question with several possible answers

The Financial Engines survey found that 52% of workers between 35 and 65 years old have left a job where they had money in the employers' 401(k) plan. It's common for people to assume that when they leave a job, the money must leave with them. In fact, that common misperception is often perpetuated by financial providers who are incented to drive rollovers to higher cost IRAs, incorrectly characterizing such rollovers as being in the individual's "best interest". But that advice isn't always the best advice for the worker, because:

- Individual Retirement Accounts often feature proprietary investment options from the same provider that is managing the account, introducing a conflict of interest through “double dipping”;

- IRA investment options and the associated management fees are often more expensive than the in-plan 401(k) plan options[4]; and
- Rolling out of an employer-sponsored plan causes investors to lose existing fiduciary and creditor protections.

In fact, a Callan 2019 survey found that 70% of plan sponsors seek to retain assets in the plan, up from 49% in 2016[5], as they recognize that many of these plans provide a structure that is more cost effective than what is available if assets are moved out of the plan.

To help protect individuals from making costly mistakes, it’s important to provide them with access to a trusted, independent source who legally acts as their fiduciary, serving their best interest. To understand why this is so important and the stakes of the decision, let’s consider the various options a departing employee has.

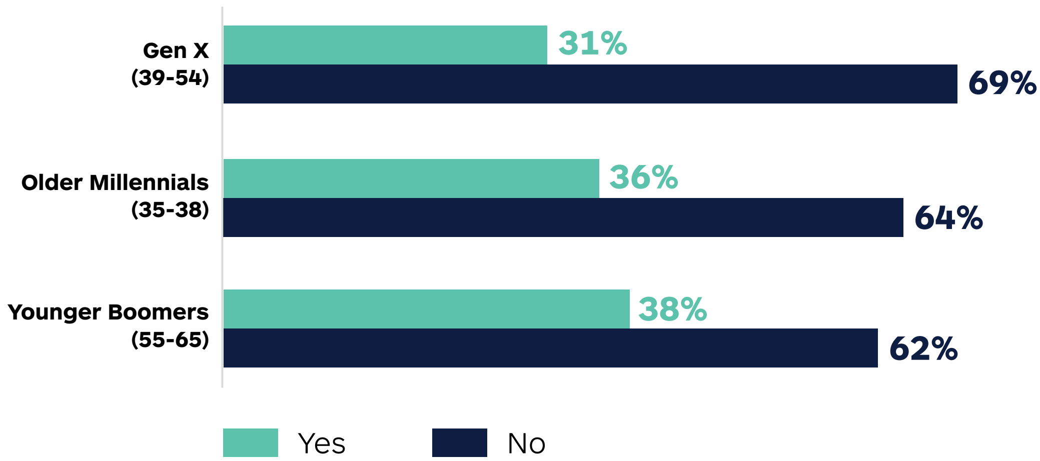
Withdraw cash

One option is to liquidate the 401(k) and withdraw the money as cash. Except in rare cases, that’s not the best strategy since the employee will incur federal and state tax liabilities and, if the worker is under age 59½, a 10 percent IRS penalty. **Financial Engines found that more than 28% of retirement investors were not aware that they could incur such tax costs and penalties.**

More than one-third of survey respondents (34%) said they had withdrawn money from their 401(k) prior to retirement. Younger Baby Boomers (38%) were most likely to have done so, compared to 31% of Gen X (ages 39-54) and 36% of Older Millennials (ages 35-38).

Even worse than the unexpected taxes and penalties, money withdrawn from the 401(k) plan is known as “leakage” – meaning that the money is typically spent, eliminating its use as a resource in retirement. Leakage makes it very difficult for a worker to accumulate enough retirement assets, and they miss out on the upside potential of the time value of money by removing assets from the retirement system.

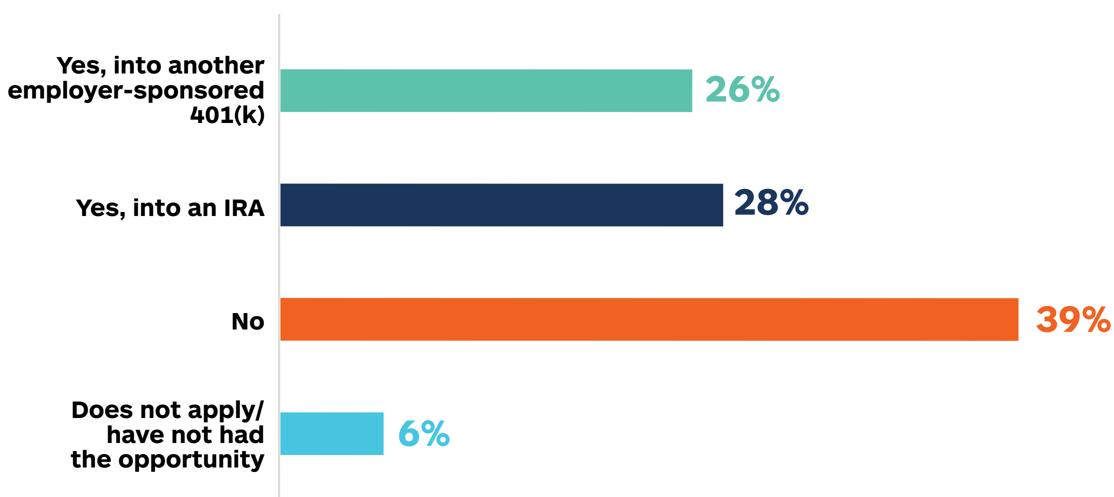
Have you withdrawn money out of your 401(k) account prior to your retirement?



Roll over into a new plan

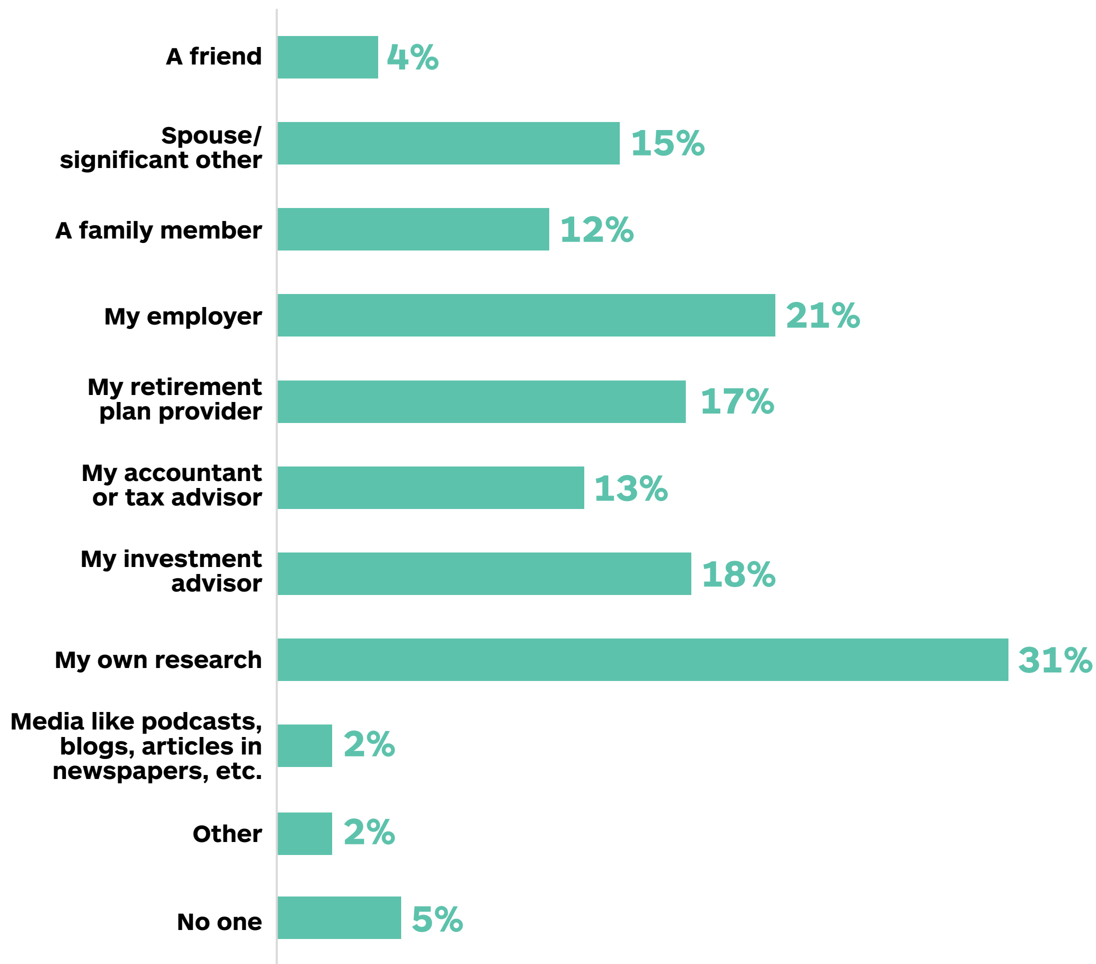
Instead of withdrawing money from the old employer's 401(k) plan, some workers roll the money into a new investment vehicle such as a Deductible IRA, Roth IRA, or their new employer's 401(k) plan. More than half (54%) of the respondents in the Financial Engines survey said they have done this, and those between the ages of 30 and 44 were most likely to consider this option (68%).

Have you ever rolled money from an old 401(k) acccount into another retirement account when switching jobs? Select all that apply.



Nearly a third (31%) said they relied on their own research when they rolled money from a 401(k) into another retirement account. Only one in five people (21%) sought guidance or advice from their employer before acting.

Which of the following, if any, helped you decide when and how to roll money from your 401(k) account into another retirement account? Select all that apply.



Many well-known financial advisory firms encourage this option. But there can be downsides to the strategy.

Many prominent retail advisors promote a rollover – sometimes with high-pressure sales tactics –in order to collect commissions and/or ongoing fees. Unencumbered by the Employee Retirement Income Security Act, these firms operate outside the protection of the workplace and are thus free to make recommendations that steer clients into their managed retail accounts. Their conflicts of interest allow them to earn commissions and fees that are great for the advisors and their firms but are not necessarily in the best interest of the investor.

Worse, many workers don't fully understand the nature of the transaction, and consequently may end up with investments or accounts that are not in their best interest. Nearly 38% of the respondents in the Financial Engines survey didn't know the difference between a Deductible IRA and a Roth IRA.

It is also easier for workers to invade IRAs, increasing the risk of leakage that reduces a worker's retirement savings and threatens their retirement security.

Leave it in-plan

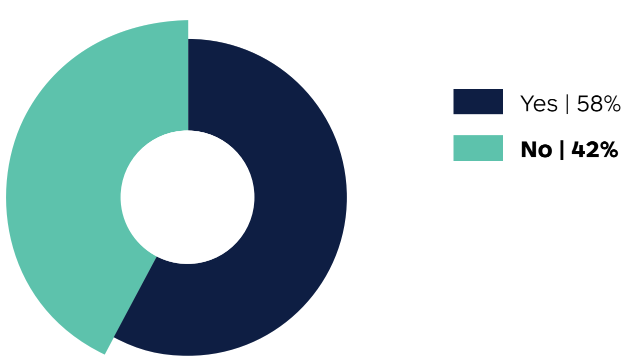
The last option is one that many workers don't know is often available to them. In fact, 42% of the survey respondents admitted they didn't know it was even possible. That option? Leave the money exactly where it is: in their former employer's 401(k) plan.

Not every 401(k) plan provides this option to departing employees, but most larger employers' plans do.

The greatest benefit of remaining in a former employer's plan is having access to the institutional buying power and high-quality plan design that many leading employers have made available. The result: potentially lower fees, and more varied and higher quality investment options.

Big companies that employ hundreds or thousands of workers have better bargaining power to negotiate the lowest management and fund fees possible. That means more money stays in their employees' accounts and compounds over time. Larger plan sponsors also typically offer more customized funds that are more closely monitored than individuals can access on their own through an IRA. These benefits give employees greater flexibility to develop an investment portfolio that meets their needs and helps them achieve their financial goals.

To the best of your knowledge, is it generally possible to keep your money in the 401(k) of a former employer?



Of course, there are potential downsides to remaining in a former employer's 401(k) plan. People who change jobs frequently and do not have time to accumulate sizeable balances could find themselves with an investment portfolio that is not optimized and difficult to manage. Such employees might also eventually forget where some of their smaller or older accounts are.

So, this strategy may work better for people who work for big companies that have greater leverage to negotiate lower management fees. Until recently, mid-size companies and small businesses lacked that same bargaining power. That's why it's important for individuals to have access to an independent professional who can help them select the right option for them.

A Side-by-Side Comparison of Distribution Options

Financial Engines research revealed that plan participants in employer plans that have adopted Financial Engines services, on average, have access to funds with fees that are below the industry average[6].

Comparing in-plan fees versus the industry averages, participants who keep their 401(k) savings in the workplace retirement plan, rather than rolling out to retail products, can potentially increase their retirement savings by 4.7% after 10 years on a $100,000 initial balance. This represents additional savings of more than $4,600 for the employee to potentially live on in retirement[7].

Unbiased Advice Can Help Employees Make the Right Decisions

With such a range of distribution options available, how can investors know which is the best to choose? And how can plan sponsors help their employees make the right decisions?

Because each worker's situation is different, the best approach is to provide workers with professional guidance from an advisor whose sole interest is helping the employee achieve their financial goals. And, most importantly, the advisor must be a fiduciary in providing this personalized guidance.

Nearly 80% of respondents to the Financial Engines survey believed it is important to get financial advice from an advisor who is a fiduciary. However, 69% also said they had never consulted a financial professional about their retirement distribution strategies. That's a significant missed opportunity. Demonstrating the value of obtaining advice from a financial planner, nearly 80% of those who did consult a financial advisor said they felt more confident about their distribution strategy.

Introducing Fiduciary Distribution Review

Financial Engines is once again leading the industry by providing strategic advice to employees when it comes to weighing their distribution options, with its Fiduciary Distribution Review.

This service helps investors ask the right questions about their retirement account distribution and helps them understand the conflicts of interest that might exist when dealing with other financial advisors.

The service provides guidance and advice on key financial decisions when employees leave their employers, whether through retirement, corporate actions or job changes. As a plan fiduciary, Financial Engines always acts in the best interest of employees when providing investment and distribution advice.

As a primary focus, Financial Engines helps retirement workers evaluate their distribution options from their 401(k) plan, as well as other retirement benefits available to them. While in most cases that includes advising the individual to leave the assets with the 401(k) plan and take advantage of the high-quality plan design, our approach is flexible enough to consider the benefits of rollovers to an IRA or new employer's 401(k), and/or encourage consolidation and roll-ins into their current 401(k). This in-depth analysis is based on the individual's personal situation, goals, and preferences. Special consideration of retirement-plan distribution rules and limitations, investment and management fees, available investment options, protections from creditors, and income goals are some of the factors examined when advising employees.

Additionally, Financial Engines can support benefit plan optimization, encouraging employees to take advantage of all employee benefits available to them upon separation. Financial Engines can work proactively with the employer to support corporate workforce management and early retirement events. Finally, we can also discuss what employees should do with old 401(k) plans they have left behind when starting a new job with an employer offering Financial Engines' services. While upholding a strict legal standard of care, we will review what is in the individual's best interest: taking the money in cash, rolling it into the new employer's 401(k), rolling it to an IRA, or keeping it with the former employer.

We deliver this experience through private, one-on-one access with one of our experienced financial advisors, each of whom has deep knowledge of the employer's plan rules and options. Together, the advisor and the worker review the individual's unique situation, weigh the options available and design a strategy aligned to the individual's personal goals. By working with an advisor who's acting in their best interest, employees can greatly reduce the risk of making a costly mistake.

Most importantly, employees can be confident they're in the best possible position to achieve their financial goals.

About Financial Engines

Our story began with one of the brightest minds in modern finance: William F. Sharpe.

Dr. Sharpe is a Nobel Laureate in Economics, professor of finance at Stanford University and the godfather of Modern Portfolio Theory and the Capital Asset Pricing Model. He pioneered taking best practices from the academic world and applying them to institutional financial problems. He worked for decades with large pension plans and other companies, helping them invest their money to create the highest expected return for a given risk level.

In the 1980s, Dr. Sharpe recognized that a financial crisis loomed on the horizon as Baby Boomers approached retirement age. Millions of workers would be entrusted with the responsibility of deciding how to invest and save for retirement. They would have to make decisions about what risk level to select, how to invest, how much to save and how to make it last throughout retirement. But the vast majority would not be able to handle those financial responsibilities on their own because they lacked the financial knowledge they needed, or the interest in obtaining it. People thus needed help from an objective, expert source who could help them navigate the tough questions without exploiting their lack of knowledge by trying to sell them unneeded or unwanted products and services.

Sharpe co-founded Financial Engines to provide advisory services with a different philosophy, primarily through the workplace. It distributed advisory services not by opening branch offices and advertising, but by going directly to large employers and offering services as a fiduciary – providing objective, personalized investment advice and professional management for employees regardless of their account balances.

The company initially offered two services: Online Advice and Managed Accounts. Online Advice provides nondiscretionary asset advice so participants can create a retirement plan and get recommendations about how to invest their 401(k)s. These recommendations get updated as markets change, but the onus is on the participant to implement changes. Participants have full control over their accounts, but the company gives them all the information they need to make sound financial choices.

Managed Accounts offer professional management services. Participants delegate the responsibility of managing their 401(k) to the company, which charges a modest asset-based fee. Every month, the company examines their portfolios and decides whether changes must be made. It helps the participant understand how much they'll need to save to achieve their retirement goals. As the client ages, the company gradually becomes more conservative in its recommendations.

In 2015, the company added a third service. Recognizing that many workers wanted help beyond the workplace retirement account, Financial Engines acquired The Mutual Fund Store to provide comprehensive financial planning and the option to meet face-to-face with a dedicated financial advisor at more than 140 locations.

In 2018, Financial Engines merged with Edelman Financial Services to form Edelman Financial Engines. Founded more than 30 years ago by Ric and Jean Edelman to help overlooked investors – the ones most in need of clear, easy-to-understand financial advice and education – Edelman Financial Services became the nation's dominant financial planning and advice provider. Ric and Jean created their firm when, as newlyweds, a financial advisor they'd hired told them to lie on their mortgage application! This angered them so much, they decided to teach themselves how personal finance works so they could share what they'd learned with others. That cornerstone – putting the needs of the client first – remains the foundation of Edelman Financial Engines to this day.

Edelman Financial Engines is now the #1 independent financial planning and investment advisor in the United States, with more than 330 advisors serving more than 1.1 million clients from more than 180 offices throughout the country. The firm is the largest independent RIA in the country in terms of both the number of clients it serves and assets under management, which now surpasses more than $200 billion on a discretionary basis[i].

In 2018, Barron's ranked Edelman the #1 Independent Financial Advisors[ii]. Edelman Financial Engines has partnerships with 12 top recordkeepers, giving it access to 80% of 401(k) participants in the United States. The average account balance across its book of business is about $173,000, with a median of about $66,000, demonstrating that high-quality financial help is not just for those who have million-dollar accounts.

Edelman Financial Engines has always been independent, and always acting as a fiduciary for its clients. Its pioneering technology delivers personalized financial planning, account management services and customized advice at scale.

Every person's situation and goals are unique, and the powerful fusion of high-tech and high-touch allows Edelman Financial Engines to deliver the personal plan and financial confidence that everyone deserves.

For more information, visit www.EdelmanFinancialEngines.com and www.FinancialEngines.com.

Survey Methodology

Edelman Financial Engines surveyed 1,071 individuals between the age of 35 and 65, located in the US. The survey was fielded in February and March 2019 using the Qualtrics Insight Platform with a panel sourced from the Lucid Marketplace.

Footnotes

[1] Global HR consulting firm Mercer surveyed 163 large employers in 2018 and found that voluntary turnover the year before, not including retirements, accounted for 15.5 percent, up from 14 percent the previous year.

[2] Gallup Survey, How Millennials Want to Work and Live.

[3] TD Ameritrade survey of 1,000 investors, press release January 29, 2018, https://www.businesswire.com/news/home/20180129005124/en/Three-Quarters-Americans-Dark-401-Fees.

[4] According to a study from the Center for Retirement Research, the average annual return in an IRA account from 2000 to 2012 was 2.2%. The average return in a 401(k) plan for the same period was 3.1%, ~50% greater than the IRA. Much of the difference is attributable to fees. Cited in Robert C. Lawton, "Bad Idea: Rolling a 401(k) into an IRA, Part III", Lawton Retirement Plan Consultants, Jan 16, 2016. https://go.financialengines.com/e/464532/sponsor-insight-401k-rollover-/61bdg/88631543?h=ePTifuyg4t-Z-JFmMXVel1dAQ8sUHgUESqrBKahrSv8

[5] Callan, LLC, 2019 Defined Contribution Trends.

[6] ICI Research Perspective, Trends in the Expenses and Fees of Funds, March 2019

[7] Savings on $100,000 with a 5% compound growth rate over 10 years; analyzed fees for 60/40 equity/bond portfolios and found a 0.31% differential in underlying fund fees when comparing in-plan fees at plan sponsors offering Financial Engines' services vs industry averages; based upon Edelman Financial Engines data as of 5/31/19 and ICI 2018 industry average.

[i] InvestmentNews ranking and status for 2018. For independence methodology and ranking, see InvestmentNews Center (http://data.investmentnews.com/ria).

[ii] The Top Independent Advisory Firm Ranking issued by Barron's is qualitative and quantitative, including assets managed, the size and experience of teams, and the regulatory records of the advisers and firms. Firms elect to participate, but do not pay to be included in the ranking. Investor returns/experience are not considered. 2018 ranking refers to Edelman Financial Services (EFS), which combined its advisory business in its entirety with Financial Engines Advisors L.L.C. (FEA) in November 2018. For the same survey, FEA received a precombination ranking of twelfth. (http://webreprints.djreprints.com/55686.pdf)

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