GUNFIGHT at the 4O1 K CORRAL

by

Brooks Hamilton

A Little History

The original "Gunfight at the O.K. Corral" was a gunfight of legendary proportion and has been portrayed in numerous Western films. Its importance is that it has come to symbolize the struggle between the rule of law and open banditry in the Old West, where effective law enforcement was too often lacking.

That last statement bears repeating: **its importance is that it has come to symbolize the struggle between the rule of law and open banditry in the Old West where effective law enforcement was too often lacking**.

This actual event occurred on Wednesday afternoon, October 26, 1881, in a vacant lot known as lot 2, in block 17, behind the corral in Tombstone, Arizona Territory, United States. Some thirty shots were fired in just thirty seconds.

Although only three people were killed, it probably has become history's most famous gunfight: Wyatt Earp, Morgan Earp, Virgil Earp, and Doc Holliday fought against Frank and Tom McLaury, Billy and Ike Clanton, and Billy Claiborne. Both McLaury brothers and Billy Clanton were killed, while Holliday, and both Virgil and Morgan Earp, were wounded.

Is Another "Legendary" Gunfight Possible (or has it already begun)?

Has the time come for another historic showdown between the rule of law and what some are boldly characterizing as open banditry in the 401(k) marketplace?

Many will recall one of the most successful advertisements of all time: i.e., the Fram Oil Filter ad with the punch line: "You can pay a little now, or you can pay a lot more later!" The customer had a choice.

We the People have a similar choice. That is, we can pay a little now by confronting the flaws in the country's retirement income system, or our children (and future generations) can pay a lot more later, after tens of millions have retired into despair and run out of money. And unless this “retirement” preparedness issue is quickly addressed, we will all be seeing the following type advertisements (which we have long predicted):

Wall Street Journal, New York Times, et cetera

“Friends, are you forced to make investment decisions regarding your retirement nest-egg by your employer when he knows full well that you don’t know a stock from a bond? And further, that you really don’t care to go back to school to learn how to become your own investment manager and expert (anymore than to become your own doctor!)?

And is this being done to you in a conniving attempt by your employer to avoid his responsibility to you and your family under the pension laws of America? Are you now growing old, and ever poorer as well, destined to be a financial burden to your children and an embarrassment to yourself?

Finally, even though you have sacrificed and saved enough to have assured your well being in your Golden Years, will you only be reaping fool’s gold because of your employer’s treachery and deliberate indifference to the despair that he and his investment industry buddies have selfishly inflicted upon you?

Well, relax my friends. Just call the following 800 phone number and you and your family can fully recover the retirement funds that have always rightfully belonged to you in the first place.”

ERISA (signed by President Ford on Labor Day of 1974) federalized state trust law, which in turn had descended from the English common law. Intended by Congress or not, ERISA has (a) imposed on businessmen a strict fiduciary duty and responsibility which is far too subtle and yet simultaneously incredibly complex, and (b) placed businessmen in what a growing number of industry gurus view as an incurable conflict of interest.

ERISA fiduciaries should not, must not really, knowingly facilitate and then willingly tolerate a retirement plan system (like 401(k) plans) which ensnares ordinary financial novice employees in a byzantine trap where they are overwhelmed by "decisions" and thus doomed to retire in despair, an embarrassment to themselves and a burden to their children.

For if such fiduciaries do, whether actively or passively, they may be shocked, shocked, when they are found legally (and personally) liable pursuant to the emergence of a new body of ERISA laws. How so, you ask? Well, the essence of their legal problem may be that after voluntarily accepting the highest fiduciary honor, duty, and responsibility yet defined by Western Civilization, such fiduciaries then became ***deliberately indifferent*** as to the financial predicament into which their [easily proven] ignorance and apathy will have placed the beneficiaries they were obliged to faithfully safeguard!

The Good News is that such ERISA fiduciaries have a unique opportunity seldom offered by history. Paraphrasing Winston Churchill, ERISA fiduciaries now have the opportunity to do so much for so many. And in the spirit of Adam Smith's less famous book, “The Theory of

Moral Sentiments" (penned as a young man well before his "The Wealth of Nations"), now is the time for good men and women who have made a personal commitment to live a morally virtuous life to demonstrate both fiduciary honor and duty, as well as noble leadership. It is indispensable that our country's social contract enable employees to retire in dignity, and thereby continue to actively participate in our consumer driven economic system, thus contributing to a sustainable economy which is a keystone to producing the wealth of nations.

Most problems are actually opportunities in disguise. Whether or not *We the People* are up to the challenge that morally virtuous and honorably bound fiduciary retirement planning demands will likely determine whether history will record a 2nd gunfight, but if it does, this time it will become known as the . . . . .

GUNFIGHT at the 4O1 K CORRAL

and will pit the new sheriff in town (i.e., the best of the plaintiff's bar) against major corporations, with a "key argument" in such a flurry of class actions lawsuits being whether ERISA fiduciaries were *deliberately indifferent* to a 401(k) Plan's excessive fees and expenses. We will now consider and illustrate the probable context of this key argument.

While there are many ways to measure the adequacy of future retirement income benefits, one simple yet elegant proposition holds that just five elements determine every person's future financial retirement income security and well-being; namely

Current age;

How much has already been saved;

How much is saved annually from now on;

How much such savings earn; and

How long one works, and then lives after retiring.

As nobody can change the first two items, all of the heavy lifting necessary to enhance one's future financial well-being has to be accomplished by the last three components. A comprehensive treatment of each of these integrated parameters is beyond the scope of this brief synopsis. However we will focus on the fourth item; namely how much our savings earn, and the huge difference that just this one item can make regarding a typical employee.

In April, 2004, I wrote a brief paper entitled "Connecting the ERISA Fiduciary Dots" and would hope that today's reader might re-visit that paper to obtain a broader context of the core issues in play. Quoting from that paper:

To illustrate the concept, we will take the case of two twin brothers, Joe and Charlie Doe. Joe is now age 35 and earns $35,000 annually, has $3,500 in his 401k plan account, contributes 3.5% of pay to the plan, directs that his account be conservatively invested (the annual investment return target is 5%), and plans to retire at 65. Charlie is also 35 and earns $35,000 annually, but has $35,000 in his plan account, contributes 8.5% of pay to the plan, directs that his account be invested in a market index fund (the annual investment return target is 9%), and plans to retire at 68. XYZ matches 50¢ on the dollar up to 6% of pay. For those who may wish to duplicate the following numbers, there are three additional assumptions to consider: future annual pay increases will average 4.5%; total annual plan fees and expenses are 200 basis points; and future inflation will be 3.5%

For simplicity's sake we will focus just on Charlie. That is, we will take a look at the impact that various investment returns, and Plan fees, would have on Charlie's future benefit. While there are infinite scenarios that we could run, we will just run three: (1) a sad case, (2) a typical case, and (3) a happy case.

In the sad case, Charlie's 401(k) funds only earn an average of 5%, with Plan fees and expenses averaging 4%. Regarding Plan fees and expenses, one-half are deemed to be both knowable and visible while the other one-half are legally hidden (and cover things such as trading costs, et cetera). The Table to the right sums up the sad case.

Career Pay	2,546,469
Employee Saves	216,450
Employer Match	76,394
Current Savings	35,000
Investment Income	406,787
Expenses	-325,431
Benefits Paid	409,200

In the average case, Charlie's 401(k) funds earn an average of 7% annually, with Plan fees and expenses averaging 2.5%. Again, one-half are deemed to be both knowable and visible while the other one-half are legally hidden (covering things such as trading costs, et cetera). The Table to the left sums up the typical case.

Career Pay	2,546,469
Employee Saves	216,450
Employer Match	76,394
Current Savings	35,000
Investment Income	1,008,519
Expenses	-360,185
Benefits Paid	976,178

In the happy case, Charlie's 401(k) funds earn an average of 8.75% while Plan fees and expenses average 1.00%. As before, we assume that one-half are known and visible while the other one-half are legally hidden (and cover things such as trading costs, et cetera). The Table to the right sums up the happy case.

Career Pay	2,546,469
Employee Saves	216,450
Employer Match	76,394
Current Savings	35,000
Investment Income	2,509,289
Expenses	-286,777
Benefits Paid	2,550,356

Some may wonder why the highest rate of annual investment return is paired with the lowest fees and expenses, and visa versa. While one reason has been that the writer's professional experience has witnessed just such pairings, the main reason was to illustrate the potential magnitude of the problem. That is, in all three of these illustrations, Charlie's annual pay at retirement was $143,150. How did total plan funds at retirement compare?

Well, the participant who experienced the sad case had total Plan funds at retirement equal to 2.7 times his annual pay at retirement. Generally speaking, Plan funds totaling 10 to 12 times final pay at retirement is often considered a good target for the average employee.

The participant who was typical had total Plan funds at retirement equal to 4.9 times his annual pay at retirement. Finally, the participant who experienced the happy case had total Plan funds at retirement equal to 9.6 times his annual pay at retirement. Many readers have raced ahead and thus have already calculated that the happy case person will retire with Plan funds at retirement which are $987,735 more than the Plan funds in the account of the sad person (that is, [9.6 - 2.7] * 143150).

Now, if achieving near-market returns, combined with modest Plan fees and expenses, produce an additional benefit of about One Million Dollars per participant, as compared to say lousy returns combined with excessive Plan fees and expenses, do you think that maybe the plaintiff's bar will notice the tragic consequences triggered by a fiduciary's *willful indifference*?

Final Observations

Some defending the current industry paradigm contend that Plan fees and expenses are actually quite reasonable considering the total "service package" being delivered. In short, that if a particular service for which a provider charges $1.00 costs such provider $0.95 to deliver, then the nickle profit per dollar is what capitalism is all really about! In fact, a dime profit would be OK too!

If total Plan fees and expenses were either (1) excessive or (2) fair, then such an argument might very well hold water. But the logical universe is not limited to "excessive or fair" . . . in addition it includes the possibility that total Plan fees and expenses may be both excessive and fair!

To illustrate, we will simply take the sad case above, and assume that the bundled provider charging 400 basis points for "**everything**" has a real cost of 360 basis points, and thus makes what all would deem to be a fair 10% profit. But "**everything**" includes just that; every Plan "bell and whistle" that one could imagine. If Plan fees and expenses consume over half of an employee's career investment returns, as some [like John Bogle] contend, it really does not matter whether a Plan laden with an EXCESSIVELY priced plethora of "bells and whistles" in the aggregate is fairly priced or not! Why?

If Charlie hired the Sly Fox Pool Company to build an affordable pool in the backyard of his $105,000 modest worker's home, they should not slyly build a pool costing $175,000 even if their profit was but 10% and thus deemed fair and reasonable. Think about it: such an arrangement is akin to a "cost plus" deal where the provider charges his cost, plus 10% for a fair profit, which many would deem to be fair and reasonable.

It is only when the pool company unilaterally runs the cost from say $15,000 for a modest pool in the backyard of a modest home to one costing $175,000, as it is now an Olympic sized pool with a two story double diving board; plus a pool house with a fireplace, wet-bar and heated spa; plus a tennis court on the side to boot; et cetera; et cetera; that one starts to see that the cost plus 10% paradigm has morphed into a financial cancer that *We the People* cannot afford.

In short, if Sly Fox can make a dime for every dollar of cost, and can unilaterally run the cost sky-high via "bells and whistles," isn't it commonsensical that he will attempt do so, especially if the "fiduciary" oversight of his activities is, shall we say, *willfully indifferent*?

C O N C L U S I O N

Plan fees and expenses are NOT either excessive **or** fair. In fact, many view them to often be both excessive **and** fair.

If they are excessive they doom Plan participants to a sorry fate: retiring into despair and running our of money. We need not inquire whether such excessive Plan fees and expenses are redeemed by being fair, and perhaps even in sync with community standards (which is the same as saying: "It must be OK since everybody is doing it").

Well, many passionate patriots feel that it is not OK, and thus *We the People* may witness one hell of a Gunfight!