FEATURE

Managing Managed Accounts

They see more 401(k) take-up, but also face hurdles

BY JUDY WARD

"WE MANAGE YOUR 401K FOR YOU. No more pie charts, line graphs or nausea."

That's not how 401(k) participants typically hear about the option to invest in a managed account. Blooom, Inc. — the nascent RIA firm with those words on the top of its website's home page — does not want to do things typically as an advisor managing the accounts of 401(k) and 403(b) participants. Its website doesn't use the phrase "managed account," for one thing.

"The communication our clients get is radically different than the typical financial experience that has turned so many people off," says Chris Costello, the co-founder and CEO of the Overland Park, Kan.-based company, who previously spent nearly 20 years as a wealth-management RIA. "A lot of 401(k) interfaces are intimidating, they're confusing," he says. Blooom utilizes robo-advisor-style technology in asking a 401(k) participant to fill out a brief questionnaire (and provide the plan record keeper's name and the participant's login and password information to the plan website), from which an algorithm does an analysis. Then the system makes its recommended changes to that person's 401(k) asset allocation, and subsequently monitors and rebalances each participant's allocation quarterly for the participant.

Blooom's approach to using managed accounts in the 401(k) space comes at a time when managed accounts have made some headway, but also face challenges to further adoption. Advisor Jason Dagley sees some growth potential for managed accounts, particularly for late-career employees.

A managed account "could be a great opportunity for assistance with people approaching retirement," says Dagley, president, retirement plan consulting at Alpha Squared, LLC in Alpharetta, Ga. "There is some opportunity, especially as we see a swell of the population getting closer to retirement and needing help figuring out what to do with their money."

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Personalization, at a Cost

Managed accounts have picked up some momentum among mega plan sponsors as a qualified default investment alternative (QDIA), researcher Cogent Reports finds. Plans with $500 or more in assets increased their use of managed accounts as a default from 5% in 2014 to 18% in 2015, Cogent found in its annual "DC Investment Manager Brandscape" report issued in May.

"It ties into the desire of these large employers to offer a more personalized investment for their employees," says Linda York, a vice president at Cambridge, Mass.-based Cogent. "Managed accounts aren't necessarily cheaper, but what they do provide is a much more personalized solution for each individual." She says she wouldn't be surprised to see more downmarket growth in the use of managed accounts as a QDIA among plans that have $100 million to $500 million in assets, or even $50 million in assets.

Managed accounts can serve as a powerful tool for participants if they incorporate participants' complete financial information and charge a reasonable fee, according to "Are Managed Accounts a Better QDIA? Yes, but at What Cost?", a paper released by consultant Towers Watson in June. "A participant can get an asset allocation more tailored to that individual participant's circumstances and not just based on that participant's age," says David O'Meara, a New York-based senior investment consultant at Towers Watson and one of the paper's authors. He says sponsors also like managed accounts' broader services for participants nearing retirement, such as personalized drawdown-strategy models and individualized suggestions on how to maximize Social Security benefits.

Managed accounts "are able to integrate the retirement-planning element with the investment strategy, which we think ought to be more 'joined at the hip,'" he says.

But as the paper's title makes clear, those advantages come at a cost. "Of course, you have to justify the fee," O'Meara says. Sponsors hesitate to use managed accounts as a default in part because they question whether all participants will benefit enough to justify the higher fee, he says. "If a managed account is a default for automatic enrollment, meaning that participants have not engaged with the plan to the extent that they want to choose their investments, then they're far less likely to engage with the managed account program and do the essential planning that's required," he says. "A managed account where a participant did not engage with the service is not any better than a target date fund."

And sponsors who take a closer look sometimes find that managed accounts aren't as closely managed as the name implies, says Matthew O'Brien, a research analyst at Media, Penn.-based investment advisor O'Brien Greene & Co. Inc. "Fund companies, banks and brokers are looking for ways to replace 12b-1 fees and revenue sharing in a way that doesn't raise fiduciary hackles, so sometimes they slap an algorithm on top of their funds and charge 50 basis points for it as a 'managed account,'" he says. "I've seen some managed accounts that aren't really 'managed' — it's just a fixed asset allocation. That is very different from a customized separate account, where you have real asset managers crafting a portfolio. That's an account that's really managed, not just an algorithm that puts you in a mutual fund."

With the encouragement of Bethesda, Md.-based advisory firm AFS 401(k) Retirement Services LLC, none of its plan clients currently have managed accounts on their investment menu, as a default or option. "We made that strategic decision a couple of years ago because we lost some confidence in managed account programs," explains Daniel Haverkos, principal and lead advisor-retirement plans. "With most of our sponsors we took a pretty hard stance in the sand and said, 'We don't like the additional cost for

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what we see as minimal services.' In a lot of ways, they're simply layering a cost onto a target date or risk-based portfolio."

Instead, AFS 401(k) put together risk-based model portfolios for these plans that cover a spectrum of five risk categories and that do not have any additional charge on top of the expense ratios of the underlying funds, Haverkos says. The firm couples that with education, including one-on-one sessions, to help participants with a wide range of issues that includes retirement-income planning.

Add to that the monitoring challenges these complex products pose for sponsors, and all these factors explain sponsors' hesitation about managed accounts. "At the moment we think of it as a good option to provide, and not necessarily as a default," O'Meara says. "To the degree that the pricing becomes adjusted going forward, we could see it as a default for all participants, or as a default for participants over a certain age threshold."

Enter the Robo-advisors?

The downward fee pressure could come if robo-advisors enter the 401(k) space, in the wake of their growth spurt in the retail market.

Financial researcher Corporate Insight, Inc. found that as of December 2014, the 11 low-cost investment-advice startups it polled advised $19 billion in assets: $5.1 billion under discretionary control and $13.9 billion classified as paid investment advice. That's a 65% increase from when Corporate Insight first collected the data in April 2014, says Sean McDermott, a New York-based analyst.

"In 2014, the robo firms had their big breakthrough," McDermott says. "They went from being written off as a fringe movement to being taken as a force to be reckoned with."

Robo-advisors remain a tiny part of the total asset-management market, says Michael Kitces, a partner and director of planning research at Columbia, Md.-based Pinnacle Advisory Group, Inc. and publisher of the financial planning industry blog Nerd's Eye View. "But the technology robos use is of interest to everybody," he says. "Many established companies are very jealous of the quality of technology robo-advisors have."

The investment philosophies and algorithms used to make investment recommendations aren't what make robo-advisors distinctive, Kitces says. "The asset-allocation solutions aren't new in any way: Their portfolios aren't materially different than what any balanced mutual fund has done for a long time," he says. "What's different is the interface and the user experience." Robo-advisors' technology allows for more and simpler functionality on a computer and a smartphone, he says, and the interfaces have a modern design that looks clean and efficient. Contrast that to the 401(k) space, he says, where many participants get statements that are essentially a PDF of a 20-year-old, paper-based design.

Dagley says the user-friendly technology may appeal to 401(k) participants. "We're seeing Millennials who feel very comfortable using these online systems, and that could move over to the 401(k) market if that comfort level causes people to say, 'I want to have that same experience in my 401(k),'" he says.

But robo-advisors would face some challenges entering the 401(k) market, says Kitces. Unlike longtime 401(k) providers, he says, robo-advisors generally all use the same Apex Clearing platform to build their infrastructure. By contrast, a robo-advisor coming into the 401(k) market would have to build more expensive technology that integrates with hundreds of legacy providers, he says. Also, the retail-oriented platforms of these newcomers are not built to handle all the extra layers of record keeping and compliance needs a 401(k) plan has, he says.

"Because the barriers to entry are higher in the 401(k) space, it is going to take longer for robo-advisors to enter it," Kitces says. "But sooner or later, somebody will do it."

Blooom is just beginning to try to utilize robo-advisor technology to make an impact in the 401(k) market. "We are now managing just over $100 million in assets for 401(k) and 403(b) participants," Costello said in late July, adding that the company started collecting assets in October 2014. "Our average client age is about 38, and the average account balance is about $115,000." He expects the average age and balance to decrease as it signs up more customers.

The company intends to utilize a distribution strategy that combines signing up DC plan participants directly, working with plan sponsors — including trying to become a QDIA as a managed account — and co-branding with advisors. Blooom will not be a competitor to these advisors, Costello says, since it will not take rollover IRAs or individual wealth-management accounts. "I don't believe that what we do is a threat to advisors," he says. "They will tell you, off the record, that they don't want to work with the smaller end of the market," referring to participants with small account balances. But the advisors definitely are interested in capturing the rollover assets, he says, which blooom enables them to do.

O'Meara foresees potential for advisors to utilize robo-advisors' more user-friendly technology in their practices. "An investment advisor would need to partner with a technology firm to make it work, and we see that as a model moving forward," he says.

The robo-advisor technology could help advisors solve the problem of how to profitably offer managed accounts to participants with smaller balances, York says. "Advisors can drown in smaller accounts," she says. "I see these automated solutions as more of a scalable solution in their practices, almost a benefit to advisors. If they can get people to understand the appeal of these solutions while they are Millennials and just starting out, by the time they get to their 50s and 60s and their financial situation is more complex, that is when an advisor can share his or her expertise."

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