THE SCARBOROUGH GROUP, INC.

401(K) MANAGEMENT & INVESTMENT PLANNING

Written Statement for the
House Ways and Means Committee – Subcommittee on Oversight

Hearing on *Employee and Employer Views on Retirement Security*

By J. Michael Scarborough
President & CEO
The Scarborough Group, Inc.
441 Defense Highway, Suite E
Annapolis, MD 21401
800-835-401K (Phone)
www.401kadvice.com

Overview of The Scarborough Group, Inc.

The Scarborough Group Inc. is an independent investment advisory firm specializing in helping people prudently manage their 401(k) assets. Presently, the company manages nearly $1.5 billion in retirement assets for 8,700 clients across the country.

When Mike Scarborough began advising his clients about the assets they were holding within their savings plans he realized quickly that his clients, with proper allocation advice and management, could potentially boost and help protect their retirement savings. Mike established The Scarborough Group in 1989 to offer education, advice and allocation management to corporate employees.

Our signature Savings Plan Management℠ service gives people the peace of mind that their retirement savings are being prudently managed, with little effort on their part. We provide ongoing management of the 401(k) savings plan along with personal guidance and support from a professional Retirement Advisor. The dedicated Advisor becomes a personal financial trainer, answering questions about the savings plan, proactively updating clients about their account, and helping them plan for retirement fitness.

The company maintains an 'independent advisor' status, enabling us to avoid any potential conflict of interest with 401(k) plan providers, such as mutual fund companies and banks. The Scarborough Group is a registered investment adviser with the Securities and Exchange Commission (SEC). All Retirement Advisors are Investment Adviser Representatives with The Scarborough Group. The principal and advisors of The Scarborough Group are also separately registered representatives of, and offer securities through, Royal Alliance Associates, Inc., an independent registered broker-dealer, member NASD/SIPC.

History of 401(k) Education and Advice

There basically are three levels of help available to 401(k) participants. The basic level of help is termed 'education.' Companies have a fiduciary responsibility to educate their employees about investing in the 401(k) plan. For most companies, this consists of a Summary Plan Description and prospectuses for the options available within the plan. Unfortunately, "communicating" does not necessarily mean "educating."

The next level is 'advice.' Although perfectly legal under certain conditions, companies, especially large ones, avoid giving specific investment recommendations to employees for fear of lawsuits if the investment were to lose money. In this 'advice' category, some companies are implementing Internet-based advisory services.

However, its efficacy is still in question.

The final level is being termed 'managed accounts,' although we have called it Savings Plan Management[SM] for almost thirteen years. A managed account provides an employee with professional management for their 401(k); similar to the professional management an employee would get with a pension (defined benefit) plan. This level of service can help employees prudently allocate their 401(k) investments with little knowledge and effort on their part. The Department of Labor recently issued an advisory opinion favorably reviewing 'managed accounts' as an option for 401(k) participants.

The Problems

The Scarborough Group has always warned plan participants about the dangers of overweighing your retirement account in a single stock issue. When lawsuits were brought against Lucent Technologies, we were hopeful that the issue was finally going to be addressed. Unfortunately for thousands of Enron participants, this warning went unnoticed.

The problems in defined contribution plans today can be linked to participant behavior and plan design.

Participant Behavior – In the wake of Enron it is easy for everyone to simply lay blame at the feet of the human resource and benefits personnel at the company for not addressing the issue of stock in their plan. However, participant behavior does play a major role also.

Look back on the rapid growth of the economy during the mid- to late-nineties; it is evident that participants were smitten by the idea of making huge returns in their plans through investment in technology and company stock. In order to capitalize on the opportunity, they seriously overweighed their plan in single stock issues or investments that did not fit their investor profile and risk tolerance. When the market slipped into the recession, participants failed to divest out of the stock or did not rebalance their accounts. Huge losses were inevitable.

To better explain the mistakes participants make within their retirement plan, The Scarborough Group has identified the *Seven Sins of Participant Behavior*. They are:

- *Greed* – The desire for wealth, quickly and recklessly. Often causes participants to overweight the hot sector of the day. Company stock is often misused.

- *Panic* – Reacting without thought in an untimely fashion. Participants fall into the trap of either timing the market or locking in their losses when they react poorly to short-term events.

- *Conformity* – Following along with others. Participants will invest as they hear others investing, without regard for their personal situation.

- *Naiveté* – Not knowing, usually from lack of experience or education, the benefits and methods of properly investing in the savings plan options.

- *Apathy* – Lack of interest, indifference that causes employees to avoid education programs and/or not participate in the savings plan.

- *Arrogance* – Participants believe they know more than they actually do. They avoid education because they 'already know it all.'

- *Passivity* – Not active. Participants tend to rarely change their allocations from their first day of participation in the savings plan even though their personal situations have changed.

While seemingly beyond a plan sponsor's control, participants who exhibit these behaviors may not only fall short of their savings goals, but also could potentially represent a future liability.

A recent Watson Wyatt analysis of Defined Benefit and 401(k) Performance concluded that if employee-investors fall significantly behind, employers could expect that employees may eventually complain that either the funds or the education offered were inappropriate or insufficient.

Plan Design – Plan design can also be a culprit.

UCLA Accounting Professor Shlomo Benartzi has found that participants will place an inordinate amount of discretionary dollars into company stock when their non-discretionary company match is in stock.

Benartzi found that in plans that match with stock, 48% of all plan assets were in stock. Conversely, for companies that match contributions in cash, only 25% of the assets were in stock. Benartzi stated in the January 2001 issue of *IOMA's DC Plan Investing*, "…that employees interpret stock matches as an endorsement or as implicit investment advice."

The Solutions

How to resolve some of the issues affecting 401(k) plans, participants, and plan sponsors is currently being debated in the halls of congress, in our courtrooms, in the media, and in company lunchrooms.

Legislation – Since the collapse of Enron, and the subsequent collapse of 401(k) accounts, congressional and senate leaders have been introducing

legislation at a break-neck pace. A number of the proposed initiatives only skirt the problems while other measures don't address the important issues at all.

As congressional leaders deliberate proposed legislation, it would be wise to simply eliminate all measures that place limits on how much company stock you can hold in your 401(k) account. We believe it is not the role of our government to determine where an investor can and cannot invest the discretionary dollars in their retirement plan. By prohibiting how much stock an investor may hold, our government could potentially set the stage for other problems.

Other measures the government should avoid considering, include any that lead to conflicted or biased advice; policies that force participants to hold stock for long periods of time; and proposals that allow companies to dictate how a participant's discretionary contributions are made.

We have a vision for what our government leaders can do to help prevent similar situations in the future. We recommend a 90-day holding limit on stock received through a company match; the encouragement of plan sponsors and plan providers to work with independent advice providers; and the passage of legislation which will permit participants to hire an independent retirement planner on a pre-tax basis.

The DOL Advisory Opinion – The idea of "managed accounts" as a service for 401(k) participants has resonated throughout the Defined Contribution industry.

In response to an application by SunAmerica for a Prohibitive Transaction Exemption (PTE) in 2001, the Department of Labor responded with a landmark Advisory Opinion (2001-90A ERISA Sec. 406(b)), which affirms the validity of using licensed, independent advisers to provide advice and active management to individuals participating in 401(k) accounts.

Conclusion

America's future retirees are crying out for help. The suffering of plan participants at Enron and Lucent Technologies, is being felt by participants across the country. More than ever, people are asking themselves, "Will today be the day when my retirement disappears because of poor decision making by me or my employer?" The more it is discussed in congress, in the media, and in the lunchrooms, the more concerned participants become.

A major concern we have at The Scarborough Group is that legislators seem to be more concerned about how their decisions will impact the plan sponsors and plan providers and not the participants who seem to be distressed. Our government leaders and those in the media should be talking with those whose voice is not being heard in this debate – the voice of the participants.