Time for a Change

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Dr. James McMahon, DMD paid little attention to the 401(k) plan he offered to his dental office staff.

In the back of his mind, however, he had an inkling that the plan was lacking. It had been in place for over a decade and neither he nor his employees were adequately educated about the various investment options. He also suspected that the plan was too costly and that fact alone put him at some risk as the plan sponsor. He asked Twelve Points Wealth Management to review the existing plan and suggest improvements. Here's what we found after focusing on the three quantitative aspects of the plan that most directly affect participants:

- Expenses
- Portfolio Diversification
- Performance

Expenses

The investment options in the existing plan were heavily weighted towards "load" funds that include a "12b-1" fee that is paid to the broker of record. These management fees are passed directly to the participants and affect performance (see next section). The average weighted fee charged by the plan's funds is 0.86%, and total fund expenses of the existing plan equaled $25,166 per year. For comparison, the average weighted fee for the funds recommended by Twelve Points equaled 0.18% or $5226 per year.

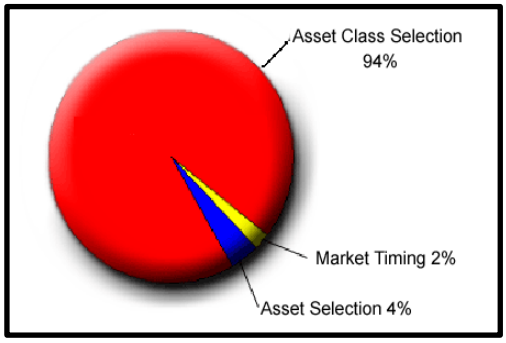
The following example compares the expenses of two similar US Large-Cap stock funds. The American Funds Growth Fund is an existing option and has an annual expense of 1.46% -- including a 1.0% 12b-1 fee that is paid to the broker. The Vanguard Total Stock Market fund has an expense of 0.05% and no 12b-1 fee.

Investment Name(Ticker)	Expense Ratios % Prospectus Net	Prospectus Gross	Audited Net	$ Annual Cost*
Large-Cap Equity				
American Funds Growth Fund of Amer C (GFACX)	1.46	1.46	1.46	1,146.52
Vanguard Total Stock Mkt Idx Adm (VTSAX)	0.05	0.05	0.05	31.60

Portfolio Diversification

The investment options in the existing plan did not appear to be well thought-out. Indeed, it was our opinion that the array of funds would likely confuse most participants. For example, the current plan offered five different US Mid-Cap funds. One could argue that the four Mid-Cap funds were differentiated by their strategies – one was "Blend," three were "Growth," and one was "Value." In reality, less than 10% of plan participants would be able to explain the differences between those three strategies. Our recommendation was to take a simpler approach and offer a single fund within each asset class – which could potentially be increased to two if special circumstances warranted it.

The investment menu was weak from a diversification perspective. Numerous studies have demonstrated that the most important factor in portfolio performance is the asset mix (aka diversification).



We believed the current plan lacked exposure to some key diversifying asset classes and recommended adding these asset classes:

- TIPS (Treasury Inflation Protected Securities)
- U.S. High Yield Bonds
- International Bonds (both developed and emerging markets)
- Commodities and natural resources
- International Real Estate

Because many participants prefer an all-in-one investment option, the current plan included a wide range of target date funds. **We recommended retaining those choices but moving from high-cost funds to low-cost options.**

A unique aspect of Twelve Points' approach to the retirement plan market is our belief in the value of diversifying beyond the traditional asset classes. Towards that end we recommended the inclusion of five model portfolios -- from conservative to aggressive risk profiles -- that include investment options like Managed Futures that are not appropriate as standalone funds for most participants. However, as a diversifying position in a well-designed strategy, they can help reduce risk and increase long-term performance.

INVESTMENT PERFORMANCE

Comparing performance is always difficult. Unless the two funds are index-based (differing only in expenses) it's hard to truly compare apples to apples. Two funds might have similar names but employ widely different strategies (e.g., number of holdings, trading frequency, etc.). In addition, the fund name does not always accurately reflect the fund's strategy and the benchmark used in similar funds may differ. Nonetheless, **we were able to recommend an appropriate -- and less expensive -- replacement for each of the current plans**. In most cases, the replacement fund outperformed the existing fund.

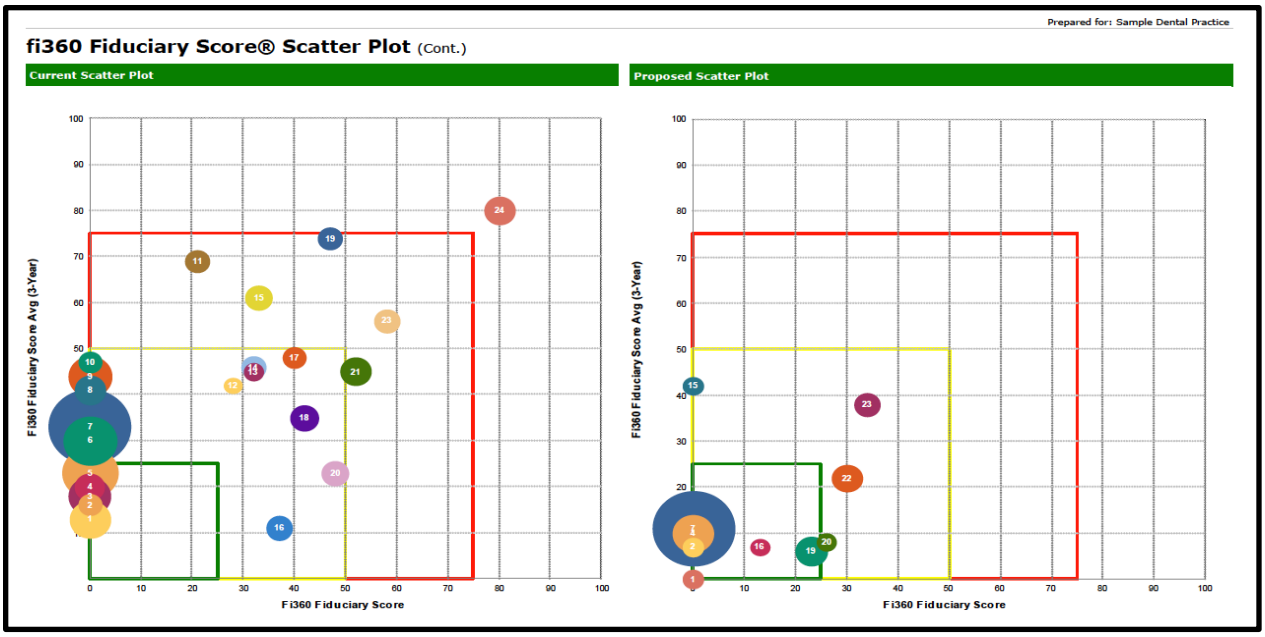
The example below compares the two funds discussed previously: the American Funds Growth Fund and the Vanguard Total Stock Market fund.

			Total Return % (% rank in peer group)					
Investment Name (Ticker)	Peer Group	Type	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Large-Cap Equity								
A American Funds Growth Fund of Amer C (GFACX)	Large Growth	MF	-0.05	4.12	3.49 (10)	7.48 (48)	12.95 (33)	6.01 (78)
B Vanguard Total Stock Mkt Idx Adm (VTSAX)	Large Blend	MF	-1.79	5.82	4.24 (25)	8.09 (27)	13.31 (20)	6.91 (16)

While the American Funds fund outperforms in the short-term, the Vanguard fund outperforms over the 1-year, 3-year, 5-year, and 10-year periods. Much of this is due to the 1.41% decrease in annual expenses as well as the passive nature of an index fund such as Vanguard's and a resulting decrease in trading expenses.

The Impact on the Plan Sponsor's Fiduciary Liability

Due to the media and recent Federal regulations, employees are becoming increasingly aware of the expenses they're being charged by 401(k) plans and the long-term impact on the size of their retirement account. Understanding that, Twelve Points also compared the current and proposed plans using the fi360 Fiduciary Score program:



This chart plots each scored investment using the fi360 Fiduciary Score Average (3-Year) on the vertical axis and the fi360 Fiduciary Score on the horizontal axis. Green, yellow, and red lines are drawn to highlight the different fi360 Fiduciary Score quartiles. Investments in the bottom left corner of the chart have a better Score. Bubble sizes are based on the dollar amount invested. Bubble numbers refer to the various investment options analyzed.

End Result

Dr. McMahon decided to move his office's 401(k) plan to the model recommended by Twelve Points. Because of that decision, based on the $500,000 value of his own 401(k) account, Dr. McMahon will earn $3,000-$4,000 more per year. And his employees will experience similar gains in account value.

Please keep in mind that every dental office has different needs and priorities. Understanding those needs and priorities is what we do -- and we invite you to contact Dave for a customized analysis.

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