## Ready to Roll?

# What to Weigh Before Leaving a 401(k)

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Investors who are changing jobs or preparing to retire often find themselves faced with an important decision: What, if anything, should they do with the savings in their 401(k) plans after they leave their employer?

Coming up with the answer hasn't always been easy. "For better or worse, there haven't been frameworks for advisors to use to determine what really is best for investors," said David Blanchett, head of retirement research for Morningstar Investment Management. "The financial advising industry has been based upon 'Does this kind of make sense for you?', not necessarily, 'Is this rollover in your best interest?'"

"The industry is moving in this direction regardless," Blanchett said. "This is an evolution toward putting clients first in a meaningful way."

The U.S. Department of Labor's conflict of interest rule, or fiduciary rule, has put pressure on advisors to act in their clients' best interests when providing guidance about retirement accounts. If the rule is applied as originally intended, advisors will be subject to more stringent requirements in demonstrating whether an IRA rollover meets a "best interest" standard.

Although the fiduciary rule remains in flux, the business trends driving it are not. "The industry is moving in this direction regardless," Blanchett said. "This is an evolution toward putting clients first in a meaningful way."

Blanchett has worked with Paul Kaplan, director of research for Morningstar Canada, to create a framework that advisors can follow as they explore whether a rollover is the appropriate recommendation. The potential benefits and costs associated with transferring money out of a defined-contribution plan are highly personalized and unique to each person's circumstances and preferences. But Blanchett and Kaplan found that advisors should evaluate certain factors that include client fit, investment quality, and service value.

We asked Blanchett about how this approach can help advisors act in their clients' best interests when making a rollover recommendation. Here's what he had to say:

**What options do investors have for their retirement funds when they leave a job?**
When leaving a job, you can choose to keep your balance in the company's 401(k) plan or take it with you. If you're going to work for a new company, you can probably roll it into that plan. You also can roll it into an IRA. There are clearly a lot of choices, but what isn't always as clear is what is the best choice for the investor. Our approach helps advisors and investors figure this out.

**Is there a deadline or timeframe in which investors need to make a choice about what to do with their retirement savings?**
Not really. If you're moving to a new company, you can roll money into that plan whenever you want. Or you can choose to leave the money in your existing plan for as long as you'd like. Some plans have rules that may limit things though, so it's important to check out the exact rules within each plan.

**So why have this methodology?**
There has been an incentive, and there still is today, for advisors to focus on selling investors products versus offering them advice. Many advisors today are paid based on commissions, and so they often have an incentive to make recommendations that may not be what's best for a client. With the Department of Labor's conflict of interest rule, there's a specific focus on advice for IRAs. This approach helps answer the question, "Is this actually in the person's best interest?"

**Using your framework, what are some questions advisors should be asking to determine whether a rollover is in their client's best interest?**
Well, first off, "Does this portfolio make sense for the client?" Clients have a given risk-aversion level, goals, assets, and liabilities. So, is this the right portfolio for the individual?

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**What are the additional questions on the advisor's list?**
Are the investments high quality? You could have a suitable portfolio that's appropriate for the investor given his or her risk targets, but if the funds stink, that isn't necessarily a good outcome for an investor. Another important consideration is all the different fees for things like investments, fees for the funds, and so on. And then I think more broadly, what are the services that are being provided for those costs? Clients often focus on costs that can be more explicit, like advisor fees, but not the value of the services.

**How should an advisor think about the value of those services, such as financial planning?**
There's been a huge gap in how we quantify the value of advice. Most research around financial planning is focused on the portfolio. While decisions around the portfolio are obviously very important, there are a lot of other aspects associated with accomplishing a client's goals. Therefore, it's important for an advisor to be able to describe the services they're providing for a client.

**Are there other considerations advisors should take into account before making a rollover recommendation?**
Yes. For example, if a client holds appreciated employer securities in a defined-contribution plan, he or she can take advantage of what's called net unrealized appreciation. And 401(k) plans generally offer greater levels of creditor protections than IRAs. State laws vary. So if your client has a large balance in their plan, that's something to note. Along those same lines, what's the financial strength of the client's employer? If the company is going to file for bankruptcy, that could tie up the funds and there are costs to wind down the plan. These are things that you should be aware of that you may not ask yourself unless there's a checklist or something in front of you.

**And rolling over a 401(k) is a permanent choice, right?**
Right. There is the notion of irrevocability here. If you roll the monies out of the 401(k), you can't undo the decision. That's a difficult variable to add to the equation. Therefore, you want to be relatively certain that rolling out of the plan is the right decision.

**How does this methodology account for the finality of a rollover?**
With our approach, we want them to be extra sure. There's a cushion where the rollover has to appear to benefit the investor by some extra amount. If the benefit is very small, our framework says rolling over isn't the best option. The benefit has to be meaningful to make a move, since you can't get back in the plan once you're out. It really must appear to be in the investor's best interest.

**Are there any other risks advisors or investors should be aware of as they're considering these factors?**
These are all things that can change, so this is a point-in-time decision. It could be that an advisor says, "Sure, this looks great. Roll out." And then the client doesn't do what he or she said, and the portfolio isn't as good. This is obviously a very important decision. And there is the math part, but it also needs to feel right. We can't quantify everything.

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**What other considerations are hard to quantify?**
How important is it for the client to remain with his or her employer? Some people like getting information about the company and want to stay connected through their 401(k) plans. Other folks may want to leave their employers' plans regardless, and they don't care that it's not in their best interest. There are emotional parts of this that we can't incorporate into our model, and that's where advisors can ask questions and add value. This is the softer aspect of rolling out beyond quantifying the fees and the portfolio.

**How can an advisor put this framework to use in an effective way?**
I think this framework gives advisors a documented process to go through to demonstrate value. It's more than just saying, "Hey, trust me" or "I've looked at this." It's advisors using the resources and tools offered by Morningstar, a well-known independent source of investment information, and providing documentation that the recommendation is in the best interest of the client.

**Does the framework benefit the investor, too?**
Yes. It's effectively a win-win, because it also gives the client additional assurance that an independent, third party is helping frame how his or her advisor arrives at a decision.

**What role does this approach have if the fiduciary rule is further delayed or scrapped?**
I think the investment advice industry is going to move in the fiduciary direction regardless of what happens. If the rule continues to be delayed or is scrapped, it might slow things down. But I think there is a clear demand for this by investors, and it will definitely help the industry. What we've come up with is a comprehensive framework to help advisors make sure that their recommendation is valid—that it really is in someone's best interest.

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