

# INTERLAKE

CAPITAL MANAGEMENT, LLC



## MEDIA RELEASE

### Price and Hutcheson to Discuss Key Concerns in the Rapidly Changing 401(k) Marketplace

**FOR IMMEDIATE RELEASE—February 19<sup>th</sup>, 2008**

MADISON, WI –Interlake Capital Management, LLC, invites the general public to listen in on a conversation between the firm’s Chief Investment Officer, Kevin S. Price, and Matthew D. Hutcheson, one of the country’s best-known and most influential independent fiduciaries.

**The conversation will begin at 2:00 pm EST (11:00 am PST) on Thursday, February 21<sup>st</sup>.**

Hutcheson, whose commitment to participants and beneficiaries is unmatched anywhere in the industry, will join Price for a philosophical discussion about the general state of the retirement industry, the shortcomings of many established 401(k) plans, legislative and regulatory developments, and Interlake’s pension-caliber approach to defined-contribution plans.

“Interlake Capital Management has developed a program that fully reflects ERISA’s fiduciary principles,” Hutcheson said. “I look forward to this interesting and important discussion and I think all interested parties will benefit from listening in,” he added.

“We reached out to Matt a few months ago because his philosophy so closely matched our own,” said Price. “We saw big problems in the 401(k) marketplace and drew tremendous inspiration from Matt’s tireless efforts on behalf of plan participants. We think Thursday’s conversation will help sponsors, participants, journalists, and our industry colleagues better understand the 401(k) landscape.”

To listen in, dial 712-775-7000 and enter code 771081#. You will be asked to announce yourself, but that is unnecessary. The call will be recorded and made available as a podcast.

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#### **About Interlake Capital Management, LLC**

Interlake Capital Management, LLC, is a fully independent registered investment advisor located in Madison, Wisconsin. The firm, which provides money management services to private clients and retirement plans, can be reached at 608-204-9709 or [info@interlakecapital.com](mailto:info@interlakecapital.com). Additional information is available at the firm’s website ([InterlakeCapital.com](http://InterlakeCapital.com)) and blog ([TheFloat.typepad.com](http://TheFloat.typepad.com)).

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For more on current trends, opinion, news, legislative action, investments, marketing, sales, consulting, and legal issues concerning 401(k) plans, please visit <http://www.401khelpcenter.com/401k/topics.html>.

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## INTERLAKE – MDH DISCUSSION

February 21, 2008

*(Note: The media release on the prior page refers to a recorded discussion between Interlake and Hutcheson about fiduciary responsibility and the state of the 401(k) industry in general. That specific discussion can be downloaded from [www.TheFloat.typepad.com](http://www.TheFloat.typepad.com). The following dialog is not a transcript from that discussion, but is a previous, separate dialog being made available in text form only).*

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**Preface:** Here at Interlake, we've paid very close attention to various discussions—within the industry, in Congress, at the Department of Labor, and in the media—of the ongoing efforts to reduce plan expenses, make those expenses more transparent, and, most importantly, improve long-term outcomes for participants.

In November, once we had assembled what we thought was a truly exceptional 401(k) program, we contacted Mr. Matthew D. Hutcheson to let him know that there is some creative, participant-friendly work being done in the financial services industry.

Matthew Hutcheson is one of the most interesting and influential figures in the 401(k) and retirement plan space. Some of you may just be learning about Matt and his great work in developing participant-friendly policies in Washington D.C. Within the 401(k) industry, he is recognized as a leading defender of fiduciary principles and practices. Matt has been fighting this very good, very important fight for well over decade, so he's seen the good, the bad, and the ugly in the retirement plan marketplace.

As we learned more about Matt's work and he learned more about our own, we realized that what we were saying to one another just *had* to be shared with a wider audience. Again, we're very glad to have all of you joining us this afternoon.

Whether you're a plan sponsor, an ERISA attorney, an accountant, a reporter or columnist; we think you'll find this discussion intellectually stimulating and practically useful.

**Interlake:** Matt, it's great to talk to you again.

**Hutcheson:** Yes, definitely. I always enjoy our conversations. How is Interlake doing with your special 401(k) program?

**Interlake:** We're doing very well. We're especially pleased with our recordkeeping partnership with 401kASP. They provide every imaginable tool and service...all in a very attractive per capita pricing structure that's vastly superior to the typical arrangement.

**Hutcheson:** Yes, they are incredible; top notch. You guys make a great team. As you know, I have been advocating a traditional, prudent approach to retirement plan investing. And I

think your ability to deliver pension-caliber investment discipline in a defined-contribution framework gives your program several important advantages over typical plans.

**Interlake:** Naturally we agree. But before we get into any of the details of our approach, I'd like to provide everyone with a little background on how and why we built the Interlake 401(k) Solution the way we did.

First, in our business, we tend to work with unusually affluent clients. And we do everything we can to help preserve and build their wealth. But we grew up in middle class households, and we're deeply committed to putting our skills and expertise to work for rank-and-file workers in this country who—how should I put this—well, let's just say they haven't had especially strong allies in our industry.

So we started thinking about what our alternative to the typical off-the-shelf 401(k) plan would look like. And we started from the first principles of ERISA itself. We wanted to assemble a program that lives up to ERISA's fiduciary principles.

**Hutcheson:** So what did that mean in practical terms?

**Interlake:** Matt, it's very simple: We wanted to reduce plan expenses, make all remaining costs fully transparent, and give participants the best long-term investment outcomes they can have.

**Hutcheson:** Let's talk about expenses first. Then I'd like to spend a couple minutes on the topic of investment discipline.

**Interlake:** Expenses. Well, the bottom line is that most plans cost too much and deliver too little. They ask sponsors and participants to pay for things they *don't* need and don't deliver what they *do* need. And the problems of excessive costs and poor disclosure are two sides of the same coin.

The explicit costs of a typical plan will be reflected in the expense ratios of the plan's mutual funds. There may be additional costs as well—for participant education, redemption fees, legal and auditing work, recordkeeping, administration, and so on.

But there are two other important types of costs in the typical plan. The first one is the *implicit* cost of mutual fund ownership. Here I'm referring to the funds' internal trading costs (the commissions paid by fund shareholders when the fund manager makes trades); the cost of bid-ask spreads in the secondary market; and the market impact, or price-changing effects, created by big mutual funds when they buy and sell positions.

The leading academic research on this topic estimates that implicit fund costs range from *50 to 150% of funds' stated expense ratios*. No investor ever sees these expenses, but all investors pay them just the same.

The second category of costs that plague the typical plan takes us to the question of investment discipline: The *opportunity* costs of participant decision-making, fund underperformance, and limited asset class exposure.

**Hutcheson:** I think you're on to something very, very important here. Opportunity costs are badly underappreciated—and a very big deal for plan participants.

**Interlake:** Let me say a few words about decision-making. The causes of poor decision-making are relatively well-known: Ignorance, inertia, loss-aversion and risk-avoidance (*fear*), and overconfidence and performance-chasing (*greed*).

According to last year's DALBAR study, from 1987 through 2006, the broad U.S. equity market compounded at just under 12% per year. The average equity mutual fund investor? 4.3% per year. Why the huge gap? Poor decision-making, pure and simple.

The other components of the typical plan's opportunity costs—poor fund performance and limited asset class exposure—are absolutely unnecessary. There's just no reason to settle for either one, but the vast majority of 401(k) participants suffer from both.

**Hutcheson:** Say a little more about asset class exposure.

**Interlake:** Investors should participate in the full range of global asset classes. Plans that have denied them that opportunity impose long-term costs on participants.

**Hutcheson:** So when you put all this together, what characteristics define retirement plans that reflect ERISA's fiduciary standard of care?

**Interlake:** Matt, that's the big question. In the broadest sense, fiduciary plans improve expected outcomes for participants. They do that by ensuring that participants' assets are invested as close to the "efficient frontier" as possible, that minimize the risk of extremely expensive behavioral errors, that impose the lowest possible fees consistent with the true value of services provided, that make those expenses fully transparent so market forces produce lower expenses across the marketplace, that emphasize pension-style asset allocation and favor index-based vehicles in all available asset classes, that have high rates of participation and salary deferral, and that take advantage of automatic enrollment, high-quality default investments, and regular deferral increases.

That may sound like a lot. But *every one* of those things is comfortably within the reach of *all* plan sponsors. And there's no reason sponsor and participants should settle for any less.

Now, one of the key principles you emphasize in your work is *prudence*. The premise is that sponsors should be—by law they have to be—prudent, but most plans don't quite live up to that standard. Is that right?

**Hutcheson:** That's exactly what I believe. When held to a true fiduciary standard, most plans just don't pass the prudence test. They may be operating according to generally accepted practices, but many generally accepted practices *aren't prudent*, and that's exactly the problem. .

**Interlake:** You realize you're striking at the root of a very large, very deeply entrenched system that many people—if they think about it at all—think is a valuable employee benefit.

**Hutcheson:** It *is* valuable. Very much so. It just isn't as valuable as it could and should be. "Striking at the root" implies that I'm trying to topple the tree. Nothing could be further from the truth. The 401(k) in its basic form is one of the great success stories of America's employee benefit system. That's why we have to protect it from inappropriate practices that undermine it, including some practices that have become generally accepted. I've been an independent fiduciary for several years now, and after seeing plans of every size and shape, I've concluded that the typical 401(k) plan is fundamentally imprudent.

**Interlake:** Will you share a specific example?

**Hutcheson:** Yes, of course. I have a friend who was a Captain in the Air force. He flew jets, both B-52s and T-38s. He was telling me one day that the F4 Phantom is proof that if you put wings on a train locomotive engine, and strapped a large enough turbine to the back, you could get it to fly.

**Interlake:** I sense a metaphor at work here...

**Hutcheson:** You got it: The current 401(k) system is a fighter jet made from a locomotive. The locomotive wasn't made for the purpose of chasing down enemy MIGs. However, if you place enough "oomph" behind it, you can get it to do many things it was never designed to do. It's clumsy, heavy, and costs way more than necessary to deliver efficient retirement benefits in the future.

**Interlake:** What kind of "oomph" are you referring to?

**Hutcheson:** Specifically, if you can extract enough fees (more than the market will bear), the financial services industry can get the 401(k), in its currently state, to fly. They've proven that. However, it doesn't do very well; it's heavy, very inefficient.

**Interlake:** Inefficient sounds like exactly the right word. It isn't that it can't fly at all; it's that it takes too much fuel, and doesn't have a very good safety record. Tell us about some of the inefficiencies you have discovered in the system?

**Hutcheson:** One of the more obvious inefficiencies is the same one you guys right away. It's participant control over trust assets. I acknowledge that a small percentage of participants are quite qualified to make the right decisions for their future, but I'd say over ninety percent are not. That is why I think Interlake's ability to deliver pension-caliber investment discipline in a defined-contribution framework is so important in today's environment. It what you

mentioned a couple minutes ago: Minimizing the risk of big, expensive mistakes. That you understand the importance of this element of the system tells me you've figured it out.

**Interlake:** Back to prudence. What's your definition of that key term?

**Hutcheson:** I admit it's difficult to define. It's kind of like a big blob of Jell-O on the floor. You can see it, you can touch it, but if you try to pick it up and get a handle on it, it may slip through your fingers. Prudence is a noun – a “thing” – but it can be difficult to grasp. It's one of those things that has to be discerned by people who want to make good decisions.

**Interlake:** Matt, my question, and I assume many others might share it, is if it's so difficult to understand, how can sponsors and advisors know they're operating prudently?

**Hutcheson:** That's another big question. There have been some efforts to construct processes that help fiduciaries, committees, and other decision-makers behave in prudent ways. Kind of like putting them on a straight road and if they don't deviate by a fraction of a degree three miles down the road, they can keep driving. But if they do deviate, even just a little, they may find themselves in the ditch a few miles down the road. That is where advanced decision-making skills – the fiduciary discernment and judgment kicks in. So a prudent process—and keep in mind we're talking about the *process* more than specific outcomes—is a system of making decisions, with the necessary information and appropriate motives, that serve the best interests of plan participants. When a prudent process is deployed in an environment and attitude of protecting participants and beneficiaries; i.e. truly acting for their greater good, that's Prudence.

**Interlake:** Say a little more about information and motives.

**Hutcheson:** On information, my point is simply that sponsors have to spend some time gathering information about how the industry operates, about where the hidden costs are, about what's really worth paying for, and about the available options in the marketplace.

On motives, the bottom line is that sponsors have to have—and *demonstrate*—undiluted loyalty to participants. When fiduciaries *embrace* their duty of loyalty, they make better decisions. It's that simple. The second component of Prudence is a set of core fiduciary principles. The third component, which is inextricably connected to the five core principles are five core actions – in other words – proactive decisions that must be made on a regular basis. When those three components simultaneously exist, again with the correct attitude, Prudence exists also. In fact, a person can *prove* they are prudent, and thus be protected from what they fear the most – fiduciary liability.

**Interlake:** Are you saying plan sponsors can *know* that they're protected from liability?

**Hutcheson:** That's exactly what I'm saying. And it all comes down to doing the right things in the right way.

**Interlake:** That's a very powerful idea, Matt. But from where we sit we see so many people in the financial service industry beating the "you're at risk" drum, presumably to frighten plan sponsors and get them to buy that particular provider's products or services. They say that a plan sponsor cannot avoid liability.

**Hutcheson:** I hear that all the time, Kevin. And I think plan sponsors *are* at serious risk due to the current 401(k) business model—the "locomotive" connected to a pair of wings. But sponsors aren't at risk because of the 401(k) per se. They're at risk because the industry has integrated imprudent aspects into their business models that give plan sponsors the false belief that they have less responsibility than they actually do. The most important point I can make is that a plan sponsor cannot avoid responsibility – but they *can* avoid liability—as long as they act prudently. Like truth being the absolute defense against libel or slander, Prudence is the absolute protection against fiduciary liability.

**Interlake:** That's what we've worked to do with our pension-style approach. The point is to build prudence into the program, to help sponsors and participants make good choices that serve their own short- and long-term interests.

**Hutcheson:** Exactly, that is exactly what I am talking about. What you have constructed may not be what the marketing machine tells people to want. Your program is prudent, because it gives participants the best possible chance to enjoy long-term investment success—and therefore a decent standard of living in retirement, which is what this is all about. Remember, 401(k) plans are not subject to a "rational" standard, or the "suitability" standard. They are subject to the "*fiduciary*" standard. That is the highest standard anyone can meet. All sponsors of 401(k) plans are obligated to understand that standard, and to live up to it.

**Interlake:** Matt, I have to admit, we sense that very few plan sponsors understand the fiduciary standard.

**Hutcheson:** That's been my experience as well. That is why the very first thing I do when I am retained by a client is provide instruction and education about what the fiduciary standard actually is, how to meet that standard, and how to operate a plan prudently. By taking that approach, I guarantee my clients are protected from liability, and I stand behind them, 100%. If something goes wrong, I stand with them and accept responsibility like a fiduciary should. I don't run for the hills trying to avoid that responsibility. Trying to avoid responsibility is prima-facie evidence of disloyalty to participants. That is why I appreciate what Interlake is doing. You understand prudence, loyalty, and fiduciary responsibility. And your program is exactly what the industry needs.

**Interlake:** How do you see the industry changing over in the coming months and years?

**Hutcheson:** Good question. I can't say for sure, of course. But I can tell you what I'd like to see.

**Interlake:** Please do.

**Hutcheson:** I'd like to see fiduciaries empowered to demand full transparency within their plans so they can determine which elements of their plan are truly valuable, and which elements are not. Then, remove those non-beneficial, non-valuable elements and ensure that the plan isn't charged for them.

**Interlake:** What else?

**Hutcheson:** I'd like to see employers take more responsibility to understand how investments really function. The Capital Markets truly work, and there is science behind it. I'd like to see employers and fiduciaries learn something about that science, and rely less on investment salespeople who by definition are conflicted in their services.

**Interlake:** Do you believe that understanding the value of each service rendered is a requirement to prove Prudence?

**Hutcheson:** Absolutely. Of course. And it takes us back to the importance of sponsors working with good, complete information.

**Interlake:** We agree; that's exactly our view as well. What are the five principles and five actions of Prudence?

**Hutcheson:** There's not enough time to discuss them all here. Suffice it to say that identification of value is one of the principles. Think of it, if an employer had to offer a plan, and had to pay for each component of a plan separately, out of their own personal checking account, we'd find out very quickly what he or she deemed valuable, and what they didn't. That reaction and discernment about placing value on something must then be projected out to decisions sponsors make for participants. Thus, if the employer won't pay for it, and since they are the fiduciary in most cases, which defines the threshold for what a reasonable cost is for participants to pay.

**Interlake:** Very interesting. We've run out of time, but we'd like to do this again sometime and learn more about the five principles and five actions of Prudence.

**Hutcheson:** I strongly believe in what you are doing. Hope you enjoy great success in 2008.

**Interlake.** Thank you. Some of Hutcheson's papers and strategies can be downloaded off our website at [www.interlake.com](http://www.interlake.com).