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"We felt like we had been scammed"

403(b) plans are failing public school teachers.

Lisa McEvoy, a middle school teacher in Long Island, New York

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Photo: Boris Zaretsky

Teachers Are Getting Schooled on Retirement

403(B) PLANS ARE FAILING TEACHERS. A HANDFUL OF ADVISORS AND TECHNOLOGY COMPANIES WANT TO UNDO THE DAMAGE AND BRING LOW-COST FIDUCIARY PLANS TO K-12 EDUCATORS. **BY DIANA BRITTON**

Lisa McEvoy, a teacher in the Shoreham-Wading River School District on Long Island, N.Y., was 24 years old when she walked into the teachers' lunchroom and saw a gentleman sitting at a table with a stack of papers. He was a representative from AXA Equitable (recently rebranded Equitable), a life insurance company. He said he had an easy way for her to save for her retirement beyond her pension.

She opened up a 403(b) account that very day, with an annuity as the underlying investment; she doesn't recall having any discussion about fees, although she did notice a $30 administrative charge on her statements.

"My impression was that that's what I was being charged," McEvoy says. "There was not any indication or transparency at all about all the other fees in there. I was just proud of myself that at 24, I was putting more money away. I felt like that was a good thing."

Years later, she would learn that AXA was charging her 2.5% annually for the annuity that came with a long lockup period. She was married to a school guidance counselor, who had also opened up a 403(b) with AXA, and they had both ramped up their contributions. By 2019, they had saved about $75,000 in the two accounts; they contributed about $4,400 that year—and paid close to $2,000 in fees to AXA.

"AXA was costing us almost half of what we were contributing to do business, and we had no idea," she says.

"We felt like we had been scammed. We felt like we had been taken advantage of because we're not in the financial industry. We are in the education field, and we just kind of trusted that we wouldn't have been getting as screwed over. It wasn't that they were in particularly bad investments, but whatever we were putting in, it was just going right out to the AXA advisor's pocket."

To be sure, the fractured nature of the market, where contracts are sold to individuals and the invested sums are often relatively modest, makes it an expensive one to service. A spokesperson for Equitable said their goal was to provide teachers with choices that match their circumstances. "We believe in choice, providing individualized advice and a wide range of investment options so clients can make the right decisions for themselves and their families. For many, the guaranteed income, downside protection and death benefit that an annuity can provide is the best path to meet their goals."

McEvoy's story is a common one among educators. The K-12 403(b) plan system is broken, dominated by high-fee products pushed by high-commission sales agents, primarily from insurance companies. These brokers may appeal to well-meaning administrators to get themselves invited into teachers' lounges, lunchrooms or even classrooms to pitch the investment products.

But it's the way these plans escape regulatory scrutiny that makes nefarious sales practices possible. Private schools, not-for-profit hospitals and not-for-profit universities 403(b)s are covered under the Employee Retirement Income Security Act of 1974 (ERISA), so they enjoy the same investor protections that regulate 401(k) plans.

Public K-12 school retirement plans fall outside the ERISA spotlight. There are some minimum requirements to keep the plans in compliance. But observers say too often a district turns the plan over to a third-party administrator that makes pay-to-play arrangements with financial firms to put their investments on the list of options—many of them annuities from insurance firms.

"The rules are set up that the school districts, if they don't have to take on the responsibility of vetting or protecting their employees, then a lot of times they don't," said Steve Holman, principal at Vanguard and head of Vanguard Retirement Plan Access. "The vast majority of those options that are available are filled with annuities, and they're high cost plans."

Teachers are notoriously underpaid, the money they can put into a retirement plan does not necessarily create the scale that can drive down costs and few school districts would claim to have the resources to act as a financial fiduciary plan sponsor. But Holman says that compounds the problem; the tragedy is the people open to exploitation are those we hold responsible for educating our children.

"We're kind of lambs to the slaughter," McEvoy says. "Most people go into education not because they have a huge extensive background in financial literacy, but more because we want to give back and work with

> **"We're lambs to the slaughter. This stuff does not go on in the 401(k) world."**

“The gravy train has been going on for far too long.”

children. This does not go on in the 401(k) world.”

Teachers need access to quality financial advice, and observers say the market is starting to open up for fee-based, fiduciary advisors. Some record-keepers are building platforms that allow advisors to more easily manage 403(b) assets and bring in better investment options. Some financial planners, such as Ritholtz Wealth Management’s Tony Isola, are already carving out a niche serving teachers. Perhaps most worrisome for entrenched providers is that low-cost fund giant Vanguard is starting to push into the space.

The Land That Time Forgot

Isola, an advisor who heads the 403(b) division at Ritholtz Wealth Management in Stony Brook, N.Y., was a teacher for 20 years before starting his own RIA. In all that time the 403(b) system hasn’t evolved much at all, he says.

“Think of how the world has changed in just 20 years, and then think of this,” he says. “It’s the land that time forgot.”

The plans are still dominated by annuities with high fees and long-term contracts. According to Isola, some 70% of non-ERISA 403(b) assets are in annuities, with an average fee of around 2%.

When Pittsburgh-based teacher Adam Holy signed up with AXA in 2006, he got locked into a 12-year variable annuity contract with a 5% surrender charge without, he says, knowledge of the fees or the lockup period. It also had fees of about 3%, which were buried deep in a 172-page prospectus.

“Trying to break it down individually was like trying to crack Da Vinci’s code,” Holy says.

“The ‘financial advisors’ from these 403(b) vendors, that are mostly insurance companies, are preying on teachers’ innocence in terms of coming into our lunchrooms or our classrooms on our prep periods to take advantage of teachers’ retirements, and they’re tapping into your nest egg by these high fees and high commissions,” Holy said.

He brought up the high fees to his teachers union, and asked if they could get some low-cost options, like Vanguard, Fidelity, T. Rowe Price or TIAA, and at first, the union was hesitant to help. But after recruiting other members to help push back, the union has started to listen.

“They have finally brought in some experts to evaluate our current options,” Holy said.

Scott Dauenhauer, a fee-only advisor with Meridian Wealth Management in Murrieta, Calif., decided to focus his practice on public school employees after being “appalled” by the tactics an annuity salesman used on his wife, a teacher in Newport Beach, Calif.

Dauenhauer said the broker claimed to represent the California State Teachers’ Retirement System (CalSTRS), the state pension system. That was just a way to get in front of her, he says. Every single vendor on her list of investment choices was an insurance company.

Shortly after, his wife’s colleague asked him to review her 403(b). She had been sold an equity indexed annuity, with an 18-year surrender period and 20% surrender charge. She was promised 10%-12% returns on her investment, he says, which immediately set off alarm bells for the advisor.

“She was not going to get a good return in this policy,” he says. “It was toxic, and this policy should never be sold to anybody.”

Dauenhauer soon learned that the practice was commonplace and decided it was an area where he could make a real difference.

“I said, ‘I’m going to be a fiduciary planner for teachers, and I’m going to work to get better investment options for them and help them get into those better investment options.’”

When a teacher approaches Dauenhauer with their 403(b) plan, the first thing he does is review every product they have. Surprisingly, a lot of these teachers have multiple accounts. One couple he works with, for instance, had 16 accounts between the two of them. He got them out of five or six variable annuity accounts with fees in excess of 3%.

For most of the accounts he comes across, if they’re in California, he’ll put them into CalSTRS’ 403(b), a low-cost option, or move the money to a Vanguard or Fidelity fund.

Dauenhauer does not dismiss all annuities. Some have redeeming qualities, in particular the decade-old ones that have attractive minimum income benefit features, and for retirement savers with moderate income, they can make a lot of sense. But he found those were far more the exception than the rule in teachers’ portfolios.

Ripe for Disruption

The 401(k) space under ERISA is tightly regulated with a complex web of laws that keeps many business conflicts and abuses out of the system. And the government just recently enacted the SECURE Act, a bipartisan reform of the retirement system and defined contributions plans. But little in the legislation addressed the 403(b) space.

To be sure, some regulators have recently begun to look at the issues. The Securities and Exchange Commission has launched campaigns to educate teachers on their options, and they are investigating the sales and disclosure practices at companies that administer and sell retirement plans to teachers, including AIG unit Valic, according to published reports.

The New York State Department of Financial Services has also reportedly sent letters to major insurers asking about their annuity sales practices in the 403(b) market.

A handful of states are stepping up with alternatives for their teachers, including California, North Carolina and Arizona.

California’s state-sponsored 403(b) product, called Pension2, launched in 1994, has no commissions, no front- and back-end load fees, no surrender charges and no liquidity restrictions on benefit withdrawals. It does include annuities along with other investment options, but Dauenhauer said the programs are an attempt to bring ERISA-like retirement plans to the teachers.

But in the few states with similar programs, schools aren’t required to use them, and when they do, it’s usually one of several options on the menu for participants.

Competition may change the market faster than the regulators. Low-cost fund giant Vanguard is making a strategic effort to focus on the 403(b) space through a partnership with Newport Group, a plan record-keeper. Vanguard’s 403(b) business now has $11.3 billion in assets under management, with 11,000 plans and about 130,000 participants. Vanguard’s Holman has plans to grow that further.

“This is a segment that is just ripe for disruption; the gravy train has been going on for far too long,” he says.

Vanguard also plans to work with 403(b) advocacy groups, such as *403bwise.org*, and financial advisors, like Dauenhauer and a handful of others, who recognize that the K-12 segment has been exploited for years.

“Reform has to come from both a regulatory standpoint and a competitive standpoint,” says Holman. “In the near term, my team, my group is focused on how do we really build awareness and get the word out that there are options, there are low cost options available to the vast majority of the public school employees and have people start voting with their fees. I think that will trigger a competitive response.”

One thing the entrenched players have going for them is elaborate distribution systems needed to get to individual teachers one at a time, one of the reasons for the plan’s high fees, Holman adds. That’s not Vanguard’s strategy.

Instead, it will identify the top third-party administrators that work with school districts and broach a partnership with them.

“The new Vanguard-Newport offer has capabilities and services that is a nice complement to the financial guidance that they can get from these advisors,” Holman says. “That could be a scalable way for us to get out there, to have that broad reach, if we can find enough advisors we’re aligned with.”

Many advisors are initially turned off because they see a complex space, a “riddle wrapped in an enigma,” Dauenhauer says.

His mission is to correct those assumptions and demystify the space. He is guiding other fiduciary advisors on how to work

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with teachers, putting out a lot of content around the topic and helping others see the opportunities.

A Mission to Modernize the 403(b) Market

Another factor holding advisors back is that the fee-based model doesn't work with most of the current vendors selling products to teachers. The advisor can guide a teacher toward a Vanguard or Fidelity option, but they won't be able to service the account.

A handful of technology platforms and record-keepers see that as an opportunity.

Aspire launched a 403(b) vendor option in 2007-2008 and now is in over 6,000 school districts across the country. The company has built an open-architecture platform that can be white-labeled by advisors, who can layer on their compensation as they negotiate with the client.

But distribution is a challenge because, unlike annuity providers, Aspire is not sending salesmen into school lunchrooms. They're slowly building up a presence through word of mouth and partnering with administrators, said Matt Drummond, national sales director of individual accounts.

FPS Group in Centennial, Colo., has built the Investment Provider XChange (IPX), a modernized record-keeping and trust and custody platform that allows fee-based and fee-only advisors to build their own portfolios within these school plans. Managing Director James Olson likens it to an Envestnet for 403(b)s, because there are third-party strategists available and a fund portal, as well as the ability for advisors to create their own investment program—participants can even self-direct their own account.

"I've been on a mission to modernize the 403(b) market for at least a decade, if not longer," Olson said. "I think the narrative is changing in the space for the better."

IPX is currently in more than 3,000 plans around the country and has $32 billion in assets under administration, Olson says.

The goal is to create a structure using technology to get access into the plans for RIAs and product manufacturers, Olson said. "[IPX is] very customizable using an open architecture background … it brings your brand, your fees, and your construct of your product into the platform that you use with your participants."

As for McEvoy, her district now uses Aspire, so she has access to Vanguard funds for 60 basis points through the platform; she's also paying her advisor, Dina Isola (Tony's wife), a fee to manage the account and provide financial advice. But, "it's all transparent, and now I'm able to see exactly what's coming out," McEvoy says. ■

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