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## Hidden 401(k) Fees Are Stealing Your Nest Egg

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There's an old poker truism: If you look around the table and can't tell who the sucker is, it's you. Sadly, this truism may be apt when it comes to some investors' 401(k) plans.

Americans have more than \$1.75 trillion invested in 401(k) plans, yet most people spend more time fretting over \$1.50 withdrawal fees at the ATM than the expenses that can easily cut their nest egg in half in three decades. While the tax-deferred virtues of 401(k) and other defined-contribution plans have led some to perceive these plans as "free," the reality is quite different.

Increasingly, the employer that sponsors the plan opts out on footing the bill -- effectively passing the expense on to you. Meanwhile, outside consultants collect substantial fees for their advisory role with the plan, while fund firms levy costly fees to manage your holdings -- not to mention paying brokers who execute their trades at nearly three times more than it would cost to make a trade in a **Schwab** (SCH:NYSE) individual account. Many times these fees won't show up on your 401(k) statements -- and if they do, they won't be clearly presented.

"The entire system is based upon picking your pocket," said Gary Gensler, former Undersecretary of the Treasury and co-author of The Great Mutual Fund Trap. "It is a round robin of money collecting where the individual gets left out."

Costs and conflicts of interest have increasingly become an issue for investors -- as highlighted by New York Attorney General Eliot Spitzer's \$40 million settlement this week with a New Jersey hedge fund over allegations that it engaged in illegal trading in mutual funds.

As investors finally consider it safe to track the market again, it's high time to examine how much they are paying in their 401(k) plans. They might be in for an unpleasant surprise.

"Frankly, when you were making 25% annual returns a few years ago, you had money to spend," said Wayne Wagner, founder of cost consultant Plexus Consulting Group in Los Angeles. "Now, when you're talking rates of return in the single digits and even negative single digits, the costs that you could tolerate in the 1990s become absolutely intolerable."

For newly cost-conscious 401(k) participants, one small problem remains: With the exception of low-cost service providers, no one is giving a straight answer about how much you are paying. It costs too much in time and money to personalize the cost structure of each plan, firms say -- even though the General Accounting Office found it would cost about \$1.35 per fund account to personalize the cost structure. However, there is another reason why sponsors, consultants and fund firms may make it hard for you to know what you pay: Individuals would storm the barricades if they knew everything they paid for.

If your 401(k) plan has more than \$150,000, would you mind picking up the fees for the 20-something or the job-hopper whose \$5,000 balance doesn't pay for itself? Your employer may have already decided that you don't mind. Would you be willing to pay, say, 1% to 2% to a consulting firm that helps you pick your funds -- even though the consultant may be making much more money in its relationships with the funds it's selling to you? You might be. Would you be willing to have your money pay for a fund firm's computers, executive-education programs, telephone bills and dues at an exclusive Chicago club? You might be.

"People have a right to understand what they're paying for," said Gerard Mullvane, director of institutional sales at Vanguard, one of the lowest-cost and best-disclosed 401(k) plan providers available. "Sadly, many investors don't know."

It's important to realize that these various players aren't by definition interlopers -- they all serve a legitimate role, but some compensate themselves excessively out of your pocket. Let's take a closer look at the players at the table in the 401(k) game, see if the deck is stacked against you -- and examine how participants can turn the tables.

### The Sponsor



[The Seven Deadly Sins of 401\(k\) Plans](#)

In most uses of the word, a sponsor is someone who assumes financial responsibility for another, but that isn't always the case with employers who sponsor 401(k) plans.

Traditionally, the costs of administering defined-contribution plans such as 401(k)s were handled "in house" -- employers would cut a check to handle record-keeping, statements and the like. Increasingly, employers who sponsor these plans farm out the administration responsibilities of the plans to service providers, who range from independent administrators and insurance companies to brokers and fund firms. Of course, these consultants don't pay for the plans -- they add it to the participant's bill. Studies have shown that between 24% and 38% of employers now bill participants for administrative costs, up from 7% in 1995.

"Bigger companies have clearly moved more of their fees into the system than smaller companies," said David Wray, president of the 401(k)/Profit Sharing Council of America, a trade association of corporate-plan sponsors. "The reason is partially the economies of scale at work there. Small companies are reluctant to put fees in the plan," in part because owners typically have sizable stakes in the plan.



Administrative costs don't eat up an enormous chunk of the cost of 401(k) plans -- investment fees on average constitute 90% of total expenses in plans with 100 participants and 94% of plans with 2,000 participants, according to the 401(k) Provider Directory Averages. Of course, 401(k) critics would say the tiny administrative fees are actually turning up in the high investment fees, especially if an investment firm handles the administration. Part of the problem is that many sponsors simply don't know where the money goes.

Individuals should ask sponsors if they are footing the bill for their retirement plan, how much it is costing them and who actually collects the dough. Since increasingly you are the one paying for the service, make sure you are getting what you paid for.

Another cost matter regarding how sponsors handle your money: In 401(k)s as in life, good deeds often get punished. If you are a more tenured employee with substantial assets in the plan, chances are you are subsidizing service costs of lower-balance peers. "The funding disparities among participants mean the excess the sponsor or service provider collects from you can pay for people with lighter balances," said Ward Harris of McHenry Consulting Group in Berkeley, Calif.

Here's how it works: Let's say the administration fees per plan participant are 30 basis points, or 0.3%. If your 20 years of investing has swelled your 401(k) nest egg to \$500,000, your 0.3% tab is \$1,500. As it turns out, \$200 is probably enough to handle your fees. What happened to the other \$1,300? Well, the less-tenured folks who have \$10,000 in the plan only bring in \$30 in 0.3% administration fees. That's \$170 short. See where this is going? Your \$1,300 comes in handy.

Now, many participants may be content with this fee arrangement. If not, ask the folks in human resources -- or whoever handles the 401(k) sponsorship matters at your employer -- exactly who is paying for the administration of your plan. If the answer isn't to your liking, remember: It's your plan, you have the right to demand a change.

"If employers can get a better deal, it is their fiduciary responsibility to do so," said Steve Lansing, founder of Orlando-based Sentinel Fiduciary Services, which consults companies on retirement plans. "Unfortunately, there is massive apathy and ignorance in the plan-sponsor arena."

Of course, many employers have done an outstanding job stewarding their 401(k) plans. Most genuinely aim to minimize the cost of these plans because it's in their best interest, too. Oftentimes, the problems stem from the same thing that bedevils participants: ignorance to how the fee structures work.

"We have asked audiences of sponsors if they know how much they pay in administration fees, and 80% to 90% will say they don't know," said Joe Valletta, a principal with HR Investment Consultants, the Baltimore-based consultant that publishes the 401(k) Provider Directory Averages book.

[How it Works](#)  
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Also, sponsors don't just take money out of your plan -- they also put a substantial amount back in via "employer matches" and profit-sharing plans. The average sponsor contribution in 401(k) plans is 2.5%, according to the Profit Sharing/401(k) Council of America. Sadly, however, that percentage is on the decline. What's worse, many workers opt to not enroll in their 401(k) plans, at a cost: An Access Research study estimated employees lose \$5 billion annually in employer-matching contributions due to nonparticipation.

## The Consultant

Here's a business rule of thumb: The more profitable an industry is, the more middlemen there are. Most 401(k) participants know there are two middlemen between them and their investments -- the employer/sponsor and the mutual fund firm. But guess what? In about half of all 401(k) plans, there's a middleman between those two middlemen: the consultant, according to Greenwich Associates. Oh, and you pay the consultant for being in the middle.

The consultants serve an important function, one the other two middlemen are afraid to do because of legal implications: They advise the sponsor and/or the participant about how to invest. Of course, many of these consultants also get paid to advise the other middleman, which raises conflicts of interests.

"It's fair that consultants get paid for providing their services," said William Wechsler, vice president of Greenwich Associates. "The big question is: How does this advisor get paid?" The bad answer, Wechsler says, is that consultants get paid depending on what products go into the 401(k) plan -- i.e., funds with hefty fees that give them a cut. (A forthcoming article will discuss conflicts of interest in the 401(k) industry.)

Aside from conflicts of interest that may jack up your 401(k) fees, the biggest problem with consultants is the great divergence in fees paid by sponsors. According to HR Investment Consultants, for companies with 500 employees in a 401(k) plan, annual fees per employee ranged from \$204 to \$888 annually, depending on the account size. Considering the average 401(k) balance is \$43,215, this suggests a fee range from 0.47% to 2.1%.

Further, the study found larger companies get charged as little as 5 cents per \$100 invested in a 401(k) plan, compared with \$2 per \$100 invested for smaller plans. There are more than 432,000 401(k) plans, and most of them cater to smaller companies. The divergence in costs has a great deal to do with the size of the plan and the average account balance -- smaller plans will pay more, in general. Meanwhile, expenses for 401(k) plans of all sizes are on the rise.

The key to the costs paid to a consultant is: Are you getting what you paid for? The consultant is there to provide advisory services. "If I'm paying 1% rather than 60 basis points with the consultant, I should be getting more for my money," said Valletta.

Ted Siedel, whose Benchmark Companies probes money management abuses for pension clients, said the problem is that there is no "accepted methodology for assessing the reasonableness of fees." His research into consulting fees in defined-benefit plans -- which differ from defined-contribution plans such as 401(k)s because the employer primarily funds them -- unearthed substantial problems in the consulting industry. Consultants negotiating fee payments on behalf of pensions relied on little more than "gut feeling," which resulted in a huge differential in fees. "Some pensions were paying as much as four times the fees as others for the same services and same size accounts," said Siedel, who noted a 12% rise in active management fees over the past 10 years. Siedel said similar cost issues arise in the 401(k) industry, which often involve the same participants. "Whenever you have a gatekeeper with a potential conflict of interest, there's a potential for abuse with fees," Siedel said.

Steven Winks, co-founder of the Society of Senior Consultants, an industry trade group, acknowledged that conflicts of interest exist and that sponsors must ensure they are getting truly objective counsel. "There needs to be an itemization of the services that are rendered" to make sure it's clear where the money goes, Winks said.

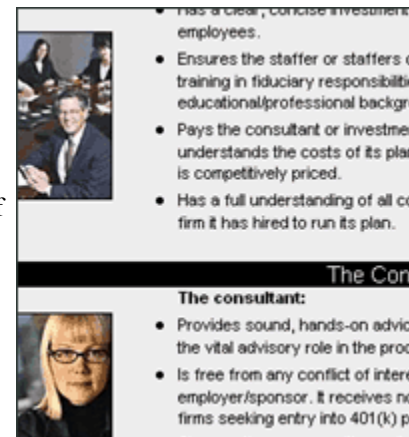
### **The Money Manager, and the Broker**

Here's the big enchilada of 401(k) fees.

Since investment fees constitute as much as 95% of your 401(k) expenses, this is clearly the area that matters most. Unfortunately, there is a broad range of behavior among the firms that actually manage plan money -- fees, disclosed and undisclosed, vary greatly. "Expenses can run as low as 10 or 12 basis points to as high as 300 basis points," said Ted Benna, who designed the first 401(k) plan.

While there is tremendous competition among asset-management firms to win 401(k) business, "they usually don't compete directly on the basis of their fees," said Richard Hillman, director of the financial markets and community investment team at the General Accounting Office.

The mutual fund industry charges investors \$70 billion a year in fees, according to *The Great Mutual Fund Trap*. Of that amount, \$50 billion goes to fund firms in management fees and sales loads, and the rest, largely trading costs, goes to brokerage industry. Here's the



- Has a clear, concise investment strategy for employees.
- Ensures the staffer or staffers conducting the plan has the necessary training in fiduciary responsibility, investment education/professional background.
- Pays the consultant or investor a fee that is competitively priced.
- Has a full understanding of all costs the firm has hired to run its plan.

**The Consultant:**

- Provides sound, hands-on advice on the vital advisory role in the plan.
- Is free from any conflict of interest with the employer/sponsor. It receives no compensation from firms seeking entry into 401(k) plans.

problem: It is estimated that 85% of retirement industry revenue is asset based and not billed explicitly, making it especially hard for investors to see where their money goes.

**Soft Dollars:** The majority of mutual funds pay the sizable costs that go to brokers via revenue-sharing agreements known as "soft-dollar" payments. "Soft dollars are the way things get paid for," said McHenry's Harris. "They aren't inherently bad, but they do allow room for questionable practices."

Soft-dollar commissions to brokers came into effect in 1975, replacing the fixed trading commissions that were a "50 cents a share bonanza" for brokers, according to Plexus' Wagner. Briefly, here's how soft dollars work: Some money generated from commissions to the brokerage firms that execute your trades gets shared with mutual fund firms, who can use the soft dollars to pay for services such as research that ostensibly help funds better serve you.

Some firms, such as Vanguard, American Century and Bridgeway Funds, don't use soft-dollar transactions, but many of those who do have taken a very liberal approach to what can be paid for via soft dollars. The spread between trading commissions is stark: American Century founder Harold Bradley says his firm's average trade commission is 0.85 cents a share; the fund industry's average commission rate is 5.1 to 5.5 cents a share. Those excess costs in between go to soft-dollar deals. In his testimony to the House Financial Services Committee this spring, Bradley provided a stunning list of more than 1,200 "services" that get paid for under soft-dollar deals. Included on the list on items you paid for was research, of course, but also: **Dell** (DELL:Nasdaq) computer, executive education programs at Wharton and membership fees to the "Standard Club of Chicago."

Soft-dollar deals may be executed in a variety of ways. In commission recapture programs, for instance, a penny of every 5 cents spent to execute a trade gets returned to investment managers in a check from brokers. The arrangements are poorly regulated, and go largely unreported and unnoticed by 401(k) plan sponsors and participants.

Fund firms and brokers deserve fair compensation for their services, "but not more so," said Don Trone, director of the Center for Fiduciary Studies, a nonprofit group that offers training for retirement plan sponsors and providers.

Meantime, soft dollars are in the rise. In 2001, the decline in assets under management reduced fee income by 27%; soft-dollar amounts increased by 17%, according to Greenwich Associates.

Soft dollars are supposed to reduce costs because it helps pay for research, "but studies found that funds with higher expense ratios also had higher brokerage commission costs," said GAO's Hillman.

**Trading and 'Nontrading' Costs:** While a commission of about 6 cents a share may seem unacceptable given the "soft-dollar" deals, it's just the tip of the iceberg when it comes to execution costs, according to Plexus' Wagner.

According to Wagner, the average cost to buy a \$30 stock exceeds 45 cents, or 1.5% of the equity. The same thing happens on the selling end, bringing the round-trip tally to 3%. Since most funds turn over 100% of their holdings every 15 months or so, those costs add up enormously -- and you pay them.

Here's how Wagner gets the 45 cent tally: First, 6 cents goes to commission. Second, 9 cents goes to the effect of the trading on the market -- in other words, as big institutions buy the stock, they can't do it in one fell swoop. The process pushes up the price by 9 cents a share on average. Third, a stunning 21 cents a share goes to delays in trading. "Less than half of what institutions seek to trade gets traded in the first day because their brokers can't get the right terms," Wagner said. Fourth, another 9 cents a share goes to "missed opportunities," the amount of a trade that doesn't get executed because of price appreciation or some other event that causes the manager to cancel the remainder of the order.

"Based on what we've seen, transaction costs are the heaviest burden shouldered by investors over time," Wagner said.

**Pricey Share Classes:** Soft dollars aren't the only onerous explanation for high investment fees. Among the bevy of mutual fund share classes, "retail funds" often carry hefty expense ratios, loads or sales charges that average about 4%, plus 12b-1 fees and the like.

"Investors need to know the share classes they're getting in their plans," said Sentinel's Lansing. "You might be paying unnecessarily high fees in certain retail share classes."

One of the better developments in 401(k) plans over the past few years has been the increasing use of institutional class fund shares, the dirt-cheap versions of funds offered to institutional clients. According to Cerulli Associates, about 30% of all 401(k) assets are in

institutional funds, up from 23% in 1996.

These are the same funds, except fiduciaries make more money from them.

### **The Fix**

According to the 401(k) Provider Directory Averages data, total plan expenses average between 1.07% and 1.4% for plans with 100 to 2,000 participants. Some run as high as 3%, some are less than 0.2%.

There are two pressing issues regarding costs: Whether the costs translate into better performance, and whether the costs are being fully and fairly disclosed.

Regarding the first, the evidence is fairly clear. "High cost fund managers do not outperform low-cost managers," Wagner said. The evidence overwhelmingly supports the case for low-cost index funds and lower cost actively managed funds, yet a number of 401(k) plans don't provide a diverse group of low-cost funds.

The second issue is trickier. John Collins, a spokesman for the fund industry trade group Investment Company Institute, acknowledges that "participants should have a way to know everything they are paying for, or what they're employer is paying for."

While regulators and legislators debate the need for greater disclosure of fees, the issue is greater simplicity in fee disclosure. The best solution for participants: A personalized explanation of how much their 401(k) plan costs.

GAO's Hillman says the fund industry's claim that the costs of preparing such a personalized explanation are too onerous "doesn't ring true. We've calculated that it would cost \$1.35 per account, and much of those costs are nonrecurring -- we think individuals would gladly foot the bill for that information."

Benna, the founder of the 401(k) plan, believes better-quality disclosure is essential -- and the 401(k) participants should demand it. "On the participant statement, it should be specifically disclosed in dollar terms what gets paid and to whom," he said.

At the very least, a reasonable solution, many 401(k) experts say, would be a simple, prominently displayed comparison of the average dollar cost of a \$10,000 investment, compared with similar service providers' plans. It speaks volumes that one of the lowest-cost providers of 401(k) investment services, Vanguard, doesn't have much difficulty with this level of cost disclosure.

"It is impossible to argue that uninformed investors are better investors," said Wagner.

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*Steven Schurr writes regularly for TheStreet.com. In keeping with TSC's editorial policy, he doesn't own or short individual stocks. He also doesn't invest in hedge funds or other private investment partnerships.*

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