Doing Your Homework:

Understanding 401(k) Fees and Making Every Basis Point Count

by Pamela Hess and Valerie M. Kupferschmidt

Even though most plan sponsors realize they need to do more to manage 401(k) plan fees because such costs directly impact participants' retirement wealth accumulation, fiduciaries face challenges obtaining full and complete plan fee information, interpreting the results, and understanding what options are available and which to select. This article dissects the various types of fees within 401(k) plans and outlines specific steps plan sponsors can take to make sure their own plan's fees are competitive and their fiduciary risks are minimized. Disclosing fees in a way that not only satisfies existing legal requirements, but also is simple and meaningful, will go a long way toward giving employees comfort about the value of their plan. By following these steps, employers will gain knowledge, control and confidence to identify and manage fees now and over time.

The evolution of defined contribution plans as the primary retirement savings vehicle for many Americans has deepened the partnership between plan participants and plan sponsors in ensuring workers' retirement security.

Participants are responsible for utilizing a 401(k) plan appropriately, while sponsors are responsible for designing and managing the plan in a way that helps maximize retirement savings. Of all the factors within plan sponsors' control, managing fees—particularly fund expenses—is one of the most critical and often the most misunderstood. Small changes in 401(k) fees can have a large impact on employees' nest eggs over time. For example, saving just 0.5%, or 50 basis points, on a plan balance of $75,000 over 30 years would increase a worker's wealth at retirement by 15%, or $93,000.

Given the impact on participants' retirement balances and, historically, the lack of clarity regarding required disclosures, 401(k) plan fees have become subject to heightened scrutiny by legislators, regulators and litigators. The number of class action lawsuits on the issue continues to climb, with many participants alleging their investment options have excessive fees and lack transparency. Additionally, the U.S. Department of Labor (DOL) recently released new plan disclosure requirements that will provide both plan sponsors and plan participants greater transparency around 401(k) plan fees, and Congress continues to consider whether further action is needed.

This issue is increasingly on the minds of plan sponsors. Today, nearly 70% of employers report being concerned about 401(k) plan fees, up almost 10% from 2007 (Figure 1). But identifying and understanding all of the associated costs—known as *total plan cost (TPC)*—and then knowing what to do with this information can be a very complex process for plan sponsors.

WHAT IS TOTAL PLAN COST?

Put simply, *TPC* is the combination of explicit and implicit expenses that employers and employees pay

FIGURE 1

EMPLOYER CONCERN

401(k) plan fees are an increasing concern for plan sponsors. Nearly 70% of sponsors report being concerned about fees amid recent scrutiny, up nearly 10% from 2007.

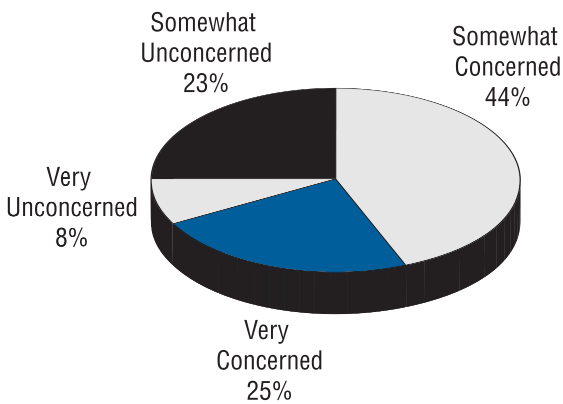
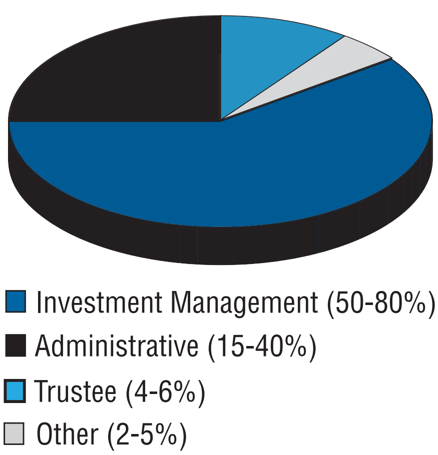


FIGURE 2

TOTAL PLAN COST COMPONENTS



for their defined contribution plan. Investment management, administrative and trustee fees are the three primary expenses (Figure 2). In most cases, plan participants bear most, if not all, of these costs.

Investment management fees—or fund expenses—are costs associated with managing the plan's assets. By far they're the largest component of TPC, generally making up between 50% and 80% of TPC, and are virtually always paid by the plan participant. Investment management expenses can be less visible than other fee components, since costs are netted out of assets. They also can vary significantly based on fund type, asset class, investment style and manager. For example, retail mutual funds tend to be more expensive than institutional vehicles, while indexed fund options are less expensive than actively managed funds. Furthermore, stock funds are typically more expensive than bond funds.

Other fees making up TPC are primarily operational in nature. Administrative fees include recordkeeping and participant servicing, and often range from 15% to 40% of TPC. Trustee and custodian fees include costs to maintain plan assets and are generally between 4% and 6% of TPC. In many instances, administrative fees are combined with investment management fees into a single cost and cannot be easily separated. A significant number of plans (83%) charge participants some or all of the costs associated with administration and trustee fees.

The table illustrates these fee components in more detail, and also highlights the drivers that may cause fee differences by plan.

EFFECTIVELY MANAGING 401(k) FEES

Plan sponsors are responsible, under the Employee Retirement Income Security Act (ERISA), for actively negotiating and monitoring "reasonable" defined contribution fees. Over the past few years, plan sponsors have increasingly focused on calculating and evaluating fees within their 401(k) plans. Today, 84% of plan sponsors report that they have reviewed and calculated their TPC, up from just 34% in 2003. However, plan sponsors report difficulty obtaining and understanding fee information, as well as confusion as to what to do with it.

While new disclosure requirements (e.g., Form 5500 Schedule C, recent DOL rules) will increase access to certain plan cost information, it is still difficult for employers to interpret and dissect these expenses. Here are some ways employers can better understand TPC, determine their options for controlling these expenses, and identify how they can help educate participants about the fees in their plans.

Step 1: Asking the Right Questions

The first step in understanding fees is determining how much they are and what they cover. This sounds a bit easier than it is in practice. To gather adequate data, employers typically need to do some detective work and ask the right questions.

What are your fees by component? Identify all major fee components, including investment management, administrative, trustee and any relevant trans-

TABLE

MAIN FEE COMPONENTS IN 401(k) PLANS

Component	Description	How They Are Assessed	Factors That Impact Cost	Portion of Fees
Investment Management Fees	Costs paid from fund expense ratio to manage fund assets	• Percentage of assets • Level varies by fund • Netted out of fund performance	• Mutual fund vs. institutional fund • Asset class • Active vs. passive • Share class • Bundled vs. unbundled administration	• Typically 50-80% of total fees • Within bundled plans, fees often equal 100% of TPC, and subsidize other fee components
Administrative Fees	Cost of recordkeeping services, Internet, call center	• Costs incurred based on number of participants • In bundled arrangements, fees are generally charged in %/basis points	• Services used • Plan complexity • Bundled vs. unbundled services • Number of participants serviced	• Typically 15-40% of total fees • May be subsidized by fund fees
Trustee Fees	Cost to maintain plan assets—securities transactions and records processing	• Flat rate • Variable or asset based	• Unitization of funds • Usage of company stock • Services used	• Generally, 4-6% of total fees • May be subsidized by fund fees
Other Fees	Compliance, legal, communication, investment consulting, investment advice, transaction based (e.g., loans)	Varies	Varies	• In total, ranges from 2–5% of total fees • May be subsidizing other components

action-based fees. Quantify costs for the previous 12 months in addition to expectations for the coming year. Remember—nothing is free. Request disclosures in dollars as well as a percentage of assets to ensure costs are not being masked.

What are your fees in total? Once you've identified all the components, you should calculate the total plan fees, which is the sum of all direct and indirect fees associated with the plan. As noted above, be sure to quantify costs for the previous year and estimate for the upcoming period. Calculate costs as a percentage of assets as well as per participant.

Is revenue sharing embedded with any of the funds, or are wraps assessed? *Revenue sharing* is typically a portion of fund expenses used to pay for, or offset, administrative fees. *Wrap fees*, or add-ons, can be used to assess additional fees over plan assets. If revenue sharing or wraps are involved, make note of each arrangement by fund. Find out what your service provider received in revenue sharing or wrap fees last year and determine what, if any, impact it had on your administrative and/or trustee fees.

What other revenue sources may impact your plan? Ask your service provider to disclose all revenue that is earned based on relationships with the plan. You should request both *direct revenue*—such as revenue sharing mentioned above and revenue from advice/managed account providers—*and indirect revenue*, which could include using the provider's proprietary funds in the plan and encouraging the rollover of assets from terminated workers into its own individual retirement account or annuity products (Sidebar 1). This will not only provide more complete fee information, but may uncover conflicts of interest among pro-

WHAT OTHER SOURCES OF REVENUE MAY BENEFIT MY SERVICE PROVIDER?

401(k) plans often offer a myriad of services that may generate revenue for the provider beyond administrative and trustee services. To fully understand your provider's fees and incentives, complete disclosure and review is important. This may include:

Use of proprietary funds. Service providers may provide favorable pricing or revenue sharing if *proprietary* fund options are offered (fund options managed by the administrator/service provider). Be sure to ask how this works and what would happen to the fee structure if fund changes were made; otherwise, you may limit your ability to select the best funds for your plan. If the service provider is assisting with fund selection, it may have conflicting objectives.

Rollovers from terminated workers. Many service providers encourage or mandate rollovers of terminated workers into an individual retirement account (IRA). This may directly benefit the service provider but negatively impact the plan participant, given that fees for IRAs are generally much higher than in the large and midsized 401(k) marketplace (Sidebar 4). Also, be sure to understand the marketing practices in place to encourage this behavior.

Advice/managed account services. Many plans that offer advice or managed accounts utilize independent, third-party investment advisory services. The costs of these services may be paid to the advice provider or the administrator, and revenue sharing between the two organizations is common. However it's structured, sponsors should understand the sharing of costs/revenues and how it impacts their plan.

Self-directed brokerage window. One in four plans (26%) now offers participants the ability to invest in a self-directed brokerage window and open an individual account within the 401(k) plan. The brokerage platform may generate returns for fund revenue sharing, as well as transaction and trading costs. Sponsors should recognize their options and the costs/revenues associated with this service, as well as any associated cross-selling or marketing of products within the brokerage window.

Some of the items noted above will be disclosed in the updated Schedule C requirements within Form 5500. However, the practice is not consistent as bundled and unbundled providers may not be required to share information in the same way. That said, information is available if requested, regardless of what is disclosed on Schedule C—so make sure to ask the question.

viders that may not support the plan sponsor's goals or the best interest of plan participants.

What might your fees look like in the future? Plan ahead and use projections, assessing criteria that may impact the 401(k) plan and its fees in the future. For example, review changes in demographics, services received, asset growth and participant growth, as well as the market environment. Don't forget to incorporate future projections into your analysis; we suggest estimating out at least five years. Asset-based fees can grow substantially faster than per-participant costs. Therefore, if your administrative fees are bundled and tied into plan assets, they have the ability to grow dramatically in a short time. Understand what costs are tied to assets—directly and indirectly.

It's important to note that these questions should be the same, regardless of whether the fee structure is bundled, unbundled or partially bundled. While many plans are *bundled (Sidebar 2),* whereby fund fees are subsidizing administration and trustee fees, plan sponsors still need to demand unbundled transparency to allow them to effectively deploy their fiduciary responsibilities. Plan fiduciaries cannot understand and manage fees properly unless administrative and trustee fees are disclosed separately from investment management fees.

Keep in mind that the only way plan sponsors can guarantee that they'll get the answers they need is by asking the questions. Make sure the answers you receive are complete and understandable. If an answer is unclear, ask again. It is your right as a plan sponsor—and your responsibility as a plan fiduciary—to have comprehensible and quantifiable answers.

Step 2: Next Steps and Understanding Your Options

Now that you've calculated your 401(k) fees—what's next? As you're evaluating costs, it's important to understand your options for managing those fees. The industry is constantly changing, and as assets grow, the leverage a plan sponsor has grows as well. Make this an ongoing process; you should review available options at least annually.

Benchmark costs. Now that you have a review of fees by fund, administrative costs per participant and other information, it's important to evaluate whether these costs are reasonable for the services received. Periodically, it's a good idea to perform a request for information/request for proposal to receive independent quotes for 401(k) services. Unless sufficient internal resources and knowledge are available, this process should be managed by a third-party evaluator that has significant experience within your market (large plans require different skill sets than small plans). To make an apples-to-apples comparison of provider fees, ask for a quote on a zero-revenue-sharing lineup comprised entirely of nonproprietary fund options. By requiring service providers to give a per-head administrative fee quote that assumes no proprietary funds, you can uncover the true administrative costs by leveling the playing field and lessening the opportunity for cross-subsidization. Finally, do not forget to consider all the fees outlined in Step 1, including transaction-based or other fees that may not be included in the flat rate provided.

Review how administrative fees are assessed to the plan itself. Most service providers will now agree to an unbundled relationship and will assess fees on a flat, per-head basis rather than as a percentage of plan assets. This type of relationship is more directly aligned to how the service provider accrues cost, and it also increases transparency and flexibility for the plan. At a minimum, you should determine whether the fees within your bundled structure can be reduced as assets grow.

Review how fees are assessed to participants. Just because you may be calculating or evaluating fees on a per-participant basis doesn't mean administrative fees are charged to participants in that way. Sponsors currently use an array of methodologies (e.g., per capita, pro rata, per capita with a cap) that are selected based on what's reasonable, fair and appropriate for their plans and their participant populations. There are a number of unique factors in each plan that can impact the decision on how to allocate fees to participants (e.g., revenue sharing, employer funding, transaction fees). Pro rata, across assets, remains the most common methodology while per capita is slowly gaining momentum (approximately one in ten plans charge fees this way).

Review how revenue sharing is used. Many plans currently pay administrative fees, either directly or indirectly, from revenue sharing—meaning part of the fund expense ratio offsets the cost of the administration. However, for many plans there is often little consistency on the amount of revenue sharing that is received by the fund. Some funds may be generating significant revenue sharing (e.g., 0.25% to 0.35%), while others may generate very little (e.g., 0% to 0.05%). Equitable sharing of costs is increasingly a focus among sponsors, and there are often alternatives available if requested. Many sponsors are moving toward funds with zero revenue sharing and accruing an identical amount across all assets to cover expenses. For example, 0.15% on all funds in the plan, rather than 0.35% for equities and 0% for fixed income funds.

Assess the availability of lower cost funds. Lower cost institutional funds (Sidebar 3) are becoming an

UNBUNDLED TRANSPARENCY

In many plans, administrative and trustee fees are often bundled with fund management fees, making it difficult for plan sponsors to understand costs. These *bundled arrangements* can negatively impact participants if not monitored properly, as the administrative expenses are determined based on a percentage of assets in the plan versus the actual services provided.

The following example illustrates this point.

XYZ Company's plan has $300 million in assets with 10,000 participants. It is a bundled plan with total fees of 0.75%, including 0.50% for fund management and 0.25% for administration. The 0.25% initially equates to $75 per participant. Over the next three years, assets double to $600 million. Given that administrative fees are 0.25% of assets, these expenses also double to $150 per participant—even though no additional work or services have been provided.

Breaking down each fee component enables plan sponsors to ensure that these expenses are appropriate for the services received.

INSTITUTIONAL FUND OPTIONS

Institutional fund vehicles are non-mutual fund products built for the institutional marketplace for large to midsized companies. Often they may be run by the same fund manager (a clone of a mutual fund), but in a different format. The two main types of institutional funds include:

Separate accounts. This strategy is run exclusively for the benefit of a single plan. These accounts typically have a higher asset requirement of $50 million+ per fund. These attain the lowest costs and highest savings.

Collective investment trusts (a.k.a. commingled funds or collective trust funds). These strategies are managed for ERISA-qualified investors with common investment objectives. The account is pooled and more similar to a mutual fund—akin to a private mutual fund for institutions.

The primary benefit of using institutional funds is lower costs—typically 30% to 50% lower than mutual fund products. Furthermore, fees are usually on a sliding scale so the higher the level of assets managed, the lower the expense ratio. This benefit accrues directly to participants in the form of higher returns.

increasingly attractive option among plan sponsors. Switching to these types of vehicles can substantially benefit participants—their fees are often 30% to 50% lower than a comparable mutual fund (and may be managed by the same money manager using the same investment philosophy). These types of investments have become more available in the marketplace, and administrators now typically provide more flexibility in allowing plans to offer them (especially within an unbundled relationship). Hewitt's research shows that these funds are currently the primary investment vehicle employed by one-third of large and midsized 401(k) plans, up from 22% in 2007. Among plans with more than $1 billion in assets, this number climbs to nearly 60%. Adoption of institutional vehicles is expected to continue to grow in coming years given increasing acceptance, availability and focus on costs.

Step 3: Starting a Dialogue With Participants

By following the steps above, you can structure a superior, cost-effective investment lineup and fairly assess fees to participants. Next, you'll need to make sure that the right information is being shared with plan participants in the appropriate manner. Disclosing fees in a way that not only satisfies existing legal requirements, but also is simple and meaningful, will go a long way toward giving employees comfort about the value of their plan.

Under pending fee disclosure regulations, sponsors of 401(k) and most other participant-directed plans will need to provide all participants with new plan and investment-related disclosures. Specific fee disclosures are expected to include:

- Annual disclosure of the fees and expenses that are charged for plan administration, individual plan and investment-related transactions (e.g., loan fees, redemption fees) and through each of the plan's investment options (e.g., in the form of an expense ratio).
- Quarterly disclosure of the fees and expenses actually charged to participant accounts for plan administration and individual transactions.

At the time this article was written, DOL had submitted its final rule on improved participant fee disclosure to the Office of Management and Budget for review. It's too early to tell whether these new disclosures will influence participant behavior and help increase retirement savings. In the meantime, employers need to develop a strategy for disclosing plan fees. Be careful of information overload when communicating with employees. Provide summary information in an easy-to-read format so employees can better identify and understand the fees they're paying or that may be charged to them. Beyond the required elements, complete fee information should always be available to plan participants, but these details are better shared upon request.

Fees are merely one factor of many that participants need to consider when making plan-related decisions. Relying on fees alone, or giving them too much weight, can have a detrimental impact on a participant's retirement savings behavior. In other words, 401(k) participants should not be shopping by fund fees—it would lead to poor decision making. Most plans include a smaller set of funds, typically just one or two funds per asset class. In this case, a participant focusing heavily on investment costs may end up overly invested in the plan's lowest cost investments, which are often stable value funds and employer stock funds. A 100% investment in either

KEEPING ASSETS IN THE 401(k) PLAN—401(k) PLAN FEES MORE COMPELLING THAN IRA FEES

As plan sponsors, our goal is to encourage workers to keep their retirement assets within the retirement system—and minimize cashouts. However, the retirement vehicle workers select upon terminating from their employer can have a large impact on their future wealth accumulation. Industry messaging strongly encourages workers to roll their assets over into an individual retirement account (IRA). What many participants fail to realize is that maintaining assets within a 401(k) account may be the best place for them. Large to midsized 401(k) plans typically provide lower cost and higher value investment options. IRAs, in comparison, have higher ongoing fees and are subject to front-end loads/sales charges and maintenance fees—all of which negatively impact wealth accumulation over time.

Benefit for employees. Using conservative assumptions and typical account balances, our calculations show that a 35-year-old average saver who moves her $33,000 balance from a company plan to a retail IRA could lose $37,681, or 9% (or more), relative to what she would have otherwise when distributions are required at the age of 70 had she remained invested in the 401(k) plan.

Benefit for the 401(k) plan. In addition to helping terminated workers, maintaining a larger asset pool in a defined contribution plan also helps active workers. As more plans use lower cost institutional fund options, greater assets within the plan translate into lower fund expenses for all plan participants.

of these funds is likely to be too conservative or too aggressive, respectively, for most plan participants.

Disclosing fee information to participants is a necessary step; however, it's not the only step. Participants need to understand how to interpret and apply this information. Guidelines include:

- Treat your disclosures as you would an educational piece by including examples and high-level explanations of how fees impact the plan and participant accounts.
- Remember to include not only percentage examples, but also the impact in dollars. Research shows that people are more receptive to numbers that are meaningful to them, and often percentages are not easy for the average employee to comprehend.
- Fee information should be provided with all of the other important considerations participants should take into account when making participation and investment decisions. For example, when discussing the costs associated with an investment option, it's important to highlight that fees should be considered in conjunction with other factors such as asset class, risk level, investment objectives and historical performance.
- In addition to helping participants understand how fees work in their plan, let them know how those fees compare with the outside world (Sidebar 4). As participants become savvier about the plan and its costs, they'll be better positioned to understand secondary costs impacting their retirement savings that may be incurred by cashing out of or rolling over from the plan.

Step 4: Creating a Paper Trail and Documenting Decisions

As you're performing due diligence in selecting your plan's service providers and investment options, create a paper trail and document your research, analysis, output and alternatives. ERISA requires that plan fiduciaries make prudent decisions that are solely in the best interests of plan participants and beneficiaries—including making sure that the plan pays only reasonable fees. In hindsight, a decision could always have been "better"; fortunately, that's not the standard that applies when it comes to meeting fiduciary responsibilities. What's important is that you took the right steps at the time the decision was made—in which case, a clearly defined process and good documentation may be your best defense if your decisions are challenged.

Here are a few quick steps you can take to be sure you're appropriately documenting and staying on top of 401(k) fees:

- Add a plan fee status review as an agenda item for your employee benefits committee meetings that includes an annual TPC review.
- Update your investment policy statement to address fees. Incorporate fund expense considerations into the statement and explicitly state that seeking low-cost, high-performing funds is a guiding principle.

- If you have a standard request for information/request for proposal that you use for plan service providers, enhance the cost-related sections to include the items addressed in Step 2 above.
- If the plan is paying asset-based fees, be sure to identify certain breakpoints up-front where your basis point fees will be reduced after reaching a certain asset level, or provide for a fee review to make sure fees that were initially reasonable haven't become excessive due to asset growth.

Remember, fee analysis and documentation is not a one-time project. Fees need to be revisited on a regular basis, preferably at least annually.

CONCLUSION

With the recent attention given to plan fees by regulators, litigators, participants and the media, it's no surprise that most plan sponsors have gotten the message: 401(k) fees directly impact participants' retirement wealth accumulation, and plan sponsors need to do more to manage those fees. The concept of fees seems simpler in theory than in practice. Fiduciaries face challenges obtaining full and complete information, interpreting the results, and understanding what options are available and which to select.

To tackle this topic, plan sponsors need to ask the right questions, understand what options are available, leverage the opportunities they have as plan fiduciaries, start a dialogue with participants around fee communication, and create a paper trail that documents processes and decisions. By following these steps, employers will gain ability, knowledge and confidence to identify and manage fees now and over time. ◀

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