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THE STRUCTURE OF 401(k) FEES

BY RICHARD W. KOPCKE, FRANCIS VITAGLIANO, AND DAN MULDOON*

Introduction

Increasingly, people are depending on 401(k) and similar defined contribution plans sponsored by their employers for their retirement income. As a result, participants in these plans also are paying more of their plans' costs, ranging from administration and sales expenses to the cost of managing investments. These costs can take a substantial toll on retirement savings. Over a 30-year career, for example, paying an annual fee of 50 basis points can reduce the purchasing power of savings at the time of retirement by one-eighth.

Employers who sponsor 401(k) plans have a fiduciary responsibility to ensure their plans' fees are reasonable and communicated to participants.¹ Recently, the Government Accountability Office reported that participants need more information and sponsors need to disclose this information more effectively to fulfill this responsibility.² The Department of Labor is revising regulations to require sponsors to report the fees of their plans more clearly to their employees.³ Congress also has been holding hearings, inquiring if greater disclosure would help reduce costs within 401(k) plans.⁴

This *brief* reviews the structure of 401(k) plans, describing the services they provide and the cost of these services. It also reviews the typical schedules of fees that providers of financial services charge plan sponsors and participants. It finds that 401(k) fees are so complex, confusing, or obscure that many sponsors and participants report that they do not understand either their magnitude or their consequences. The structure of fees does not correspond closely to that of costs. Fees for some services often are set high enough to subsidize the provision of other services within the plan. In some circumstances, when the funds of a 401(k) plan are pooled with the funds of other investors, the plan's participants might be paying a share of the trading costs incurred by investors who do not belong to the plan.

This *brief* concludes that clearer, more complete disclosures of the fees charged by 401(k) plans would help sponsors and participants make more economical choices. These disclosures would be most effective if the structure of fees were remodeled to match more clearly the specific costs of providing the various services within 401(k) plans.

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The Costs of 401(k) Plans

Employers who sponsor 401(k) pension plans for their employees engage financial service and administrative providers to maintain and operate their plans. These providers supply a range of services to their sponsors and participants, generating expenses that fall into three general categories: marketing, administrative, and asset management costs (see Figure 1).

Marketing costs include the expense of informing participants about the plan and its investment options. This expense arises from the provision of promotional material to sponsors and participants and from the efforts of service providers' sales forces. Administrative costs include the expense of keeping records, providing statements, processing transactions, ensuring the plan complies with applicable regulations, answering participants' questions, and providing customer service. Administrative costs also cover the expenses of processing participants' special needs, such as making loans or processing divorce orders.

Asset management costs cover the expense of managing and maintaining plans' assets. These costs typically include payments to portfolio managers, the expense of investment research, the payments to custodians who hold the plans' assets, and trading costs. Trading costs comprise commissions on securities transactions, the expense of paying bid-ask spreads

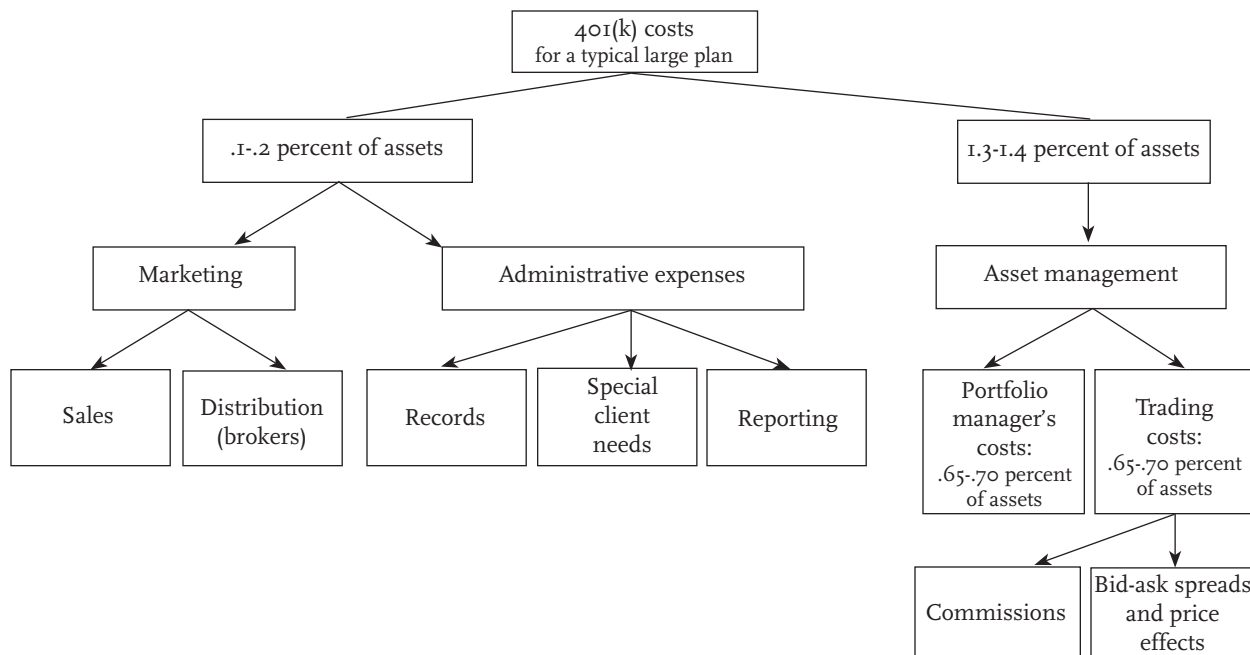
when buying or selling securities, and the expense of accepting prices away from prevailing averages when buying or selling large volumes of securities. The costs arising from bid-ask spreading and trading large volumes, which are not easily measured, are implicit costs that are deducted from the values of securities as trades occur. These trading costs are about as large as management costs for the actively managed mutual funds that commonly appear in 401(k) plans.⁵ For large plans, management and trading costs can account for 85 to 99 percent of the plan's total costs.⁶

401(k) Plans' Fees

Companies that provide financial services to 401(k) plans cover their costs by collecting fees from their plans' participants and sponsors. Within a typical plan, a predominant fee is the expense ratio, which is explicitly paid by employees through an assessment on the value of their balances in the plan (see Figure 2 on the next page). Participants also implicitly pay fees in the form of trading costs, which can be as large as the fees resulting from expense ratios.

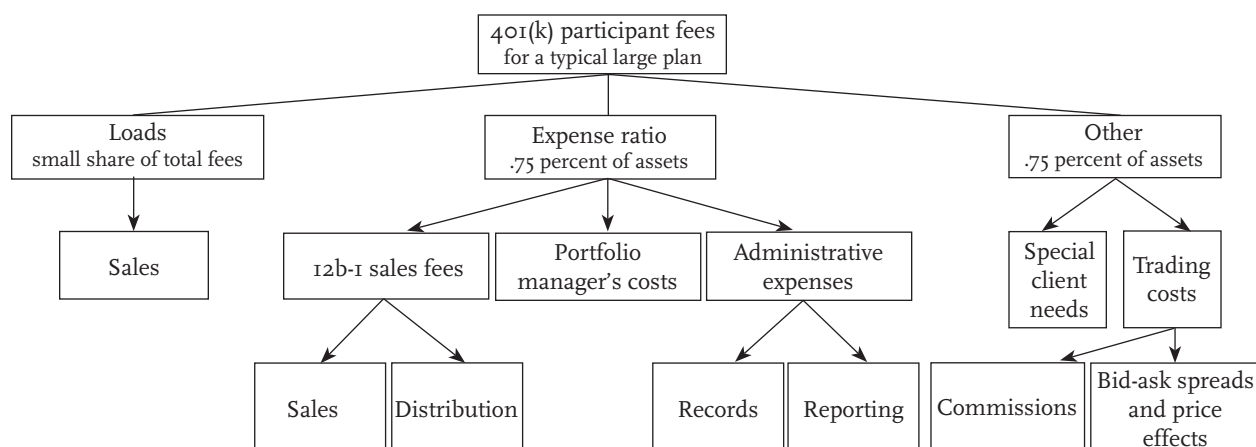
Expense ratios for the mutual funds and trusts in 401(k) plans cover portfolio managers' costs, a portion of sales costs, and administrative expenses. The administrative expenses include the costs of processing participants' transactions, maintaining custody of

FIGURE 1. 401(k) PLAN COSTS



Source: Authors' illustration.

FIGURE 2. 401(k) PARTICIPANT FEES



Source: Authors' illustration.

the funds' assets, and tracking the assets' values. The 12b-1 fees, which are charged as a percentage of assets, pay for the marketing and selling of the funds as well as communications with participants.

The expense ratios of mutual funds offered in a 401(k) plan often range from 10 basis points to more than 150 basis points with 50-100 basis points being the most common range for actively managed funds.⁷ Many plans also offer their participants the opportunity to invest in private investment pools, often organized as trusts, instead of mutual funds. The fees of these trusts can be significantly lower than those of similar mutual funds, with expense ratios ranging from 2 to 50 basis points.

The "other" fees of plans include trading costs, which cover brokerage commissions and the unfavorable prices that result from trading larger blocks of securities. These fees, which are not explicitly charged to participants, are charged directly against the value of assets as trades occur.

In some instances, participants also might pay a fee assessed on the amount of their contributions into their plans or their withdrawals from their plans. These assessments are known as "loads." At the end of 2006, only about 25 percent of 401(k) plans' assets were held in mutual funds with some type of load. However, these loads often are waived for participants in retirement plans.⁸

A small fraction of the total fees in 401(k) plans are constant dollar assessments levied on each ac-

count or each participant. These fees, which do not vary with the size of the account, usually cover the cost of keeping records and issuing statements to participants.

Although participants pay the majority of the fees in most 401(k) plans, most employers pay at least a small fraction of their plans' maintenance costs. Most often the employers pay the fees of vendors who provide recordkeeping and related services for their plans. But even when the employers take the responsibility of paying for these services, the fees paid by employers frequently do not cover the full cost of these services. In common "revenue sharing" arrangements, the fees assessed against participants' accounts are shared with the vendors providing recordkeeping and related services. These shared fees range, in general, from 10 basis points of assets up to 35 basis points. These sharing arrangements, which are proprietary and kept out of the public domain, reduce the net fees that employers need to pay.

Disclosing Fees

Currently, most 401(k) plans do not report their fees in a convenient manner. Fees typically are not mentioned in participants' monthly account statements or in quarterly reports. Plans typically do not encourage participants to review fees when they reallocate their balances or their contributions. Expense ratios

often are provided only in handbooks or technical supplements that are available upon special request or after searching beyond each plan's primary website. Participants who obtain these fees must then multiply the expense ratios for each of their investments by the average balances they have held in each investment in order to calculate their total fees in dollars.

The Department of Labor is developing two sets of regulations, to be adopted in 2009, for improving the disclosure of fees. The first will provide more guidance for sponsors in choosing the best vendors for their 401(k) plans. This set of regulations will establish standards of disclosure to assist sponsors in assessing whether contracts with vendors are reasonable and suitable for their plans. The second will establish new standards for disclosing fees to participants. These regulations will encourage vendors and sponsors to provide more information about fees, expressed in a clear and useful format.

With these reforms, participants in a 401(k) plan could receive, once a year, a report of the fees they paid, expressed in dollars as well as expense ratios. They also might receive a more convenient disclosure of fees as they make their investment decisions. Although reforms like this can improve disclosure considerably, they would not reveal the implicit fees that result from trading costs. Trading costs depend on the frequency, volume, and timing of trades conducted by mutual funds' portfolio managers. These costs are significantly higher for actively managed funds than for more passively managed index funds. These costs also are higher for funds that attract investors who actively trade their mutual funds' shares. Accordingly, potential reforms might ensure that sponsors and participants understand the additional costs they incur from holding actively managed mutual funds and mutual funds whose assets under management are more volatile than average. Lacking full information, sponsors and participants might select costly actively managed funds that might not be the most reasonable or suitable investments within their 401(k) plans.

Design Issues

Even with better disclosure, the current structure of fees would still raise at least three issues for 401(k) plans. First, as discussed above, most 401(k) plans

simply charge participants a fee that is expressed as a percent of their assets. Although this expense ratio often varies by type of asset, reflecting differences in the cost of managing the funds, it is otherwise constant. This bundled fee is itself very simple, but it does not allow a plan's participants to weigh the benefits against the costs of their plan's services as they manage their assets.

Second, the familiar constant expense ratio also transfers retirement wealth from accounts with higher balances to those with lower balances. Other things equal, the fees collected from participants tend to be a constant proportion of the balances they hold in the plan. Yet, some of the costs covered by these fees – many administrative and sales costs – are relatively constant for all participants, regardless of the size of their balances. Moreover, participants with twice the balances of others are not likely to entail twice the management cost, although they pay twice the management fee. Thus, a constant expense ratio

is a deceptively simple method of pricing, which, by decoupling fees from costs, reduces the return credited to higher bal-

ance accounts while boosting that on lower balance accounts. This transfer of wealth tends to be larger within plans with greater ranges of account balances and within plans that achieve greater economies of scale by controlling their costs more effectively.

Consider the following example. Suppose the various costs for a plan amount to 0.8 percent of its assets. These costs include marketing and administrative costs of \$100 per year for each participant. These costs also include investment management expenses, which range from \$200 a year for a participant with a balance of \$20,000 to \$400 a year for a participant with a balance of \$80,000. Suppose, further, the plan charges its participants a fee equal to 0.8 percent of balances to cover all of its costs. The participant with a balance of \$80,000 would pay a fee of \$640, but this participant would account for only \$500 of the plan's costs. The participant with a balance of \$20,000 would pay a fee of \$160 while accounting for \$300 of the plan's costs. This discrepancy between the fees each participant pays and the cost of services that each uses can increase as plans achieve greater economies of scale in managing their assets, so that management costs vary relatively little by size of account.

Beyond disclosure, 401(k) fees raise design issues.

This subsidization of accounts with lower balances, in principle, can be desirable from the viewpoint of public policy. But, obscuring the specific costs that are bundled within the simple expense ratio serves neither public policy nor participants in 401(k) plans. The amount of the subsidy can vary significantly for participants with low balances, depending on the amount or type of assets held by others in their plans. Simple expense ratios, therefore, obscure policy-makers' ability to assess and compare the subsidies received by participants across different 401(k) plans. This lack of information hinders policymakers from assessing the equity, adequacy, or propriety of subsidies. Are participants with relatively large 401(k) balances otherwise sufficiently wealthy to subsidize other participants? Does the bundling of expenses hinder sponsors and participants from making more economical choices, which consequently reduces retirement wealth for all participants? Might the importance of saving for retirement warrant funding the subsidies in another way? Might inequities in the treatment of participants in 401(k) plans discourage participants with higher balances from accumulating or holding assets within their plans? Within the intent of The Employment Retirement Income Security Act of 1974, should fees be reasonable for each and every participant?

Third, the investment of 401(k) funds in pools of assets that include other investors also can decouple fees and costs in a way that needlessly reduces the rate of return on these 401(k) funds. All investors in a pool share proportionately the trading costs incurred in managing the pools' assets. Most of these costs are not reported or measured, implicit only in transaction prices as the pool buys or sells assets, and therefore charged directly against the value of the pools' assets as trades occur. If all investors traded their shares in the pool equally frequently and in amounts of nearly the same proportion to their balances, then this sharing of the pool's own trading costs would be equitable. But, when some of the pool's investors trade more aggressively than others, the aggressive investors pay trading costs only in proportion to their average balances, not in proportion to their larger trading activity. Accordingly, when 401(k) plans offer their participants the opportunity to invest their money in funds or trusts that also include other investors who trade more actively, the plans' participants sacrifice returns on their retirement saving by subsidizing the trading costs of these other investors.

To illustrate this cost, consider the case of a 401(k) plan that offers its participants a popular index fund.⁹ Suppose this fund also attracts other investors who

trade more aggressively. The investment by the plan accounts for 1/10 of the total investment in the index fund, and the plan's participants, on average, conduct one transaction a month, buying or selling 0.1 percent of their balances. The outside investors conduct transactions twice a month, buying or selling 0.2 percent of their balances. In these circumstances, the plan's participants account for only 2.7 percent of the fund's trading costs, but pay for 10 percent of these costs, a fee that is 3.7 times the cost of their services.¹⁰ If annual trading costs amount to 6.4 basis points per dollar of balances, the return on the 401(k) participants' balances would be reduced by 6.4 basis points rather than the 1.7 basis points that represent their share of trading costs.¹¹ This toll can be much greater for investments in actively managed mutual funds, for which estimates of trading costs are as much as 7 times that of index funds.¹² This toll also is greater for investments in funds that pay larger brokerage commissions to cover the cost of other services they obtain from their brokers, a practice commonly called "soft-dollar" arrangements.¹³

Conclusion

A clear and complete disclosure of fees and costs will help employers fulfill their fiduciary responsibility to ensure that the defined contribution plans they sponsor do not impose unreasonable costs for their employees. This disclosure, in turn, also can help employees avoid expenses that unnecessarily diminish the value of their retirement savings. But better disclosure alone is not sufficient. The structure of fees commonly used in 401(k) plans tends to transfer wealth among participants and can reduce the returns that participants earn on their wealth.

These findings imply that employers would benefit from more guidance, in law and regulation, in satisfying their fiduciary responsibilities for selecting both service providers and investments as well as making sure their plans' fees are reasonable given the quality of their services. This guidance could encourage service providers to disclose the structure of their fees in more detail and to charge fees that correspond to the cost of services their participants use. It also could encourage plans to provide investments that do not expose participants to excessive trading costs and to the risk of subsidizing other investors who do not belong to the plans. These investments can include separate accounts, exchange-traded funds, trusts, collective investment funds, and mutual funds that restrict transactions.

Endnotes

- 1 U.S. Department of Labor (1998).
- 2 U.S. Government Accountability Office (2006 and 2007).
- 3 For proposed regulations for ERISA Sections 404(a) and 408(b)(2), see U.S. Department of Labor (2007 and 2008).
- 4 U.S. House of Representatives, Committee on Education and Labor (2007a and 2007b); U.S. House of Representatives, Committee on Ways and Means (2007); U.S. Senate, Special Committee on Aging (2007); and U.S. Senate, Committee on Health, Education, Labor, and Pensions (2008).
- 5 Karceski, Livingston, and O'Neal (2004) and Edelen, Evans, and Kadlec (2007).
- 6 HR Investment Consultants (2007).
- 7 Investment Company Institute (2007).
- 8 Investment Company Institute (2007).
- 9 The plan's participants can be offered a class of shares in the index fund that charges them appropriately lower sales, administrative, and management fees than the classes of shares offered to other retail investors. This example emphasizes the implicit "fees" for trading costs, which are not covered by these other fees.
- 10 Suppose the total assets of the fund are \$100 million, with the plan's participants holding \$10 million. The monthly trading volume for the participants would be $.001 \times 1 \times \$10$ million, or \$10,000. The volume for other investors would be $.002 \times 2 \times \$90$ million, or \$360,000. The participants' share of total trading costs is $10 / (360 + 10)$, or 2.7 percent. Trading costs reduce the net values of the fund's assets, so all investors pay a share of these costs that is proportional to their share of the fund's assets. Participants, therefore, are charged 10 percent of the trading costs, $10 / 2.7 = 3.7$.
- 11 For 6.4 basis points, see Karceski, Livingston, and O'Neal (2004).
- 12 On larger trading costs, see Karceski, Livingston, and O'Neal (2004), and Edelen, Evans, and Kadlec (2007).
- 13 On soft dollars, see Lemke and Lins (2008).

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- U.S. House of Representatives, Committee on Education and Labor. 2007a. "Are Hidden 401(k) Fees Undermining Retirement Security?" Committee Hearing. Washington, DC (March 6).
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