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10 Things Your 401(k) Provider Won't Tell You

By Nicole Bullock
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1. "We're making a mint on your 401(k) — even if you're not."
The number of 401(k) investors has soared in the past decade, to nearly 50 million from 28 million, according to Cerulli Associates. That torrid growth has created impressive efficiencies for the folks who run your plan. But it doesn't mean those savings show up in your account; in fact, they could be coming straight out of it. In a practice known as revenue sharing, providers get a cut of the expense ratio on the funds in your 401(k) to cover day-to-day "administrative costs." Since the fee is charged as a percentage of assets, that revenue increases as your 401(k) grows, even though those costs stay virtually the same.

But the gravy train may be coming to an end, as these and other fee arrangements in 401(k)s are suddenly drawing attention. Companies, who have the legal responsibility to ensure reasonable fees, are facing lawsuits onthe issue; the Labor Department is mulling new disclosure rules; and New York Attorney General Eliot Spitzer is sniffing around 401(k)s. "Plan costs will become more transparent," says Matt Gnabasik of retirement-plan consultancy Blue Prairie Group. "Any time you have more transparency, it tends to lower fees."

2. "You're buying wholesale, but we're charging you retail."
With $2.4 trillion sloshing around in 401(k) plans, you shouldn't be paying the same fees for a fund that you would if, say, you bought it on your own. But in reality, you might be. Here's how it works: Asset managers sell mutual funds in different share classes, each of which has a different fee structure. From the most expensive to the cheapest class of funds, the range can be as much as a full percentage point, says Yannis Koumantaros, chief pension consultant at Spectrum Pension Consultants. That works out to an extra $1,200 a month in retirement for a 30-year-old with $50,000 in his plan and contributions of $3,000 annually. "You're talking about a difference in your quality of life at retirement," Koumantaros says.

What plans have the highest fees? Usually, those with the fewest investors. Small plans are expensive to run, so they often have to accept costlier fund classes. But your employer can renegotiate for cheaper options as the plan expands: Those holding between $10 million and $30 million per asset class should lobby for institutional funds, which are cheaper on average than traditional mutual funds.

3. "No one in his right mind would buy these funds — given a choice."
Confused about why your 401(k) doesn't offer the top funds? That's because your asset manager may not have them in each category — it might offer stellar large-cap stock funds but mediocre small-cap picks. And providers may charge extra for better alternatives from other sources. "If you see some lousy funds from the company that's providing the plan, that's probably why," says Russel Kinnel, research director at Morningstar. Another issue: Funds need to be big enough that they don't get swamped by the influx of 401(k) money, but for mutual funds, size is often a handicap. Take Fidelity's Magellan, the poster child for asset bloat. The fund is a mainstay of 401(k)s, but has underperformed the S&P 500 for years. It closed to new retail investors in 1997 but continuesto accept new 401(k) money. The current manager has revamped the strategy, but only time will tell if Magellan can return to its former glory.

As a 401(k) investor, it's also wise to find out whose job it is to do the fund picking. Often, it's a hired hand in HR likely more schooled in recruitment than in investing.

4. "Our 'target-date funds' may miss the target."
In the wake of the Pension Protection Act passed this year, many 401(k)s will have "target date," or "life cycle," funds as their default option. These funds devise an asset allocation based on when you think you'll retire and become more conservative as that date nears. Target-date funds address one of the worst mistakes 401(k) investors make: keeping all their savings in low-return investments like money markets or stable-value funds that won't produce enough for retirement.

But research shows some target-date funds may come up short. The problem, says Tom Fontaine, a senior portfolio manager at AllianceBernstein, is that even these funds may become too conservative too early. "You need more equity than conventional wisdom suggests," he says. Stocks may be volatile in the short term, but without them, you risk running out of money in retirement. By his estimates, even a 50-year-old needs the majority of his portfolio in stock, as well as more diversification — think REITs, international investments and inflation-protected securities. Target-date funds are still helpful, but they're not the panacea your provider might suggest they are...yet.

5. "We offer tons of investment options. Too many, in fact..."
When it comes to picking funds for your 401(k), the more choices the better, right? Wrong. The latest survey from the Profit

Sharing/401(k) Council of America shows that, on average, 401(k) investors have 19 fund options, but with more than 10 to 12, "the average participant goes into paralysis," says Rick Meigs at 401khelpcenter.com. Indeed, academic research draws a direct link between "choice overload" and poor investment decisions: For every 10 funds added to a plan, the probability participants will invest nothing in stock funds goes up significantly. The result: cash- or bond-heavy portfolios unlikely to yield enough for retirement.

According to Emir Kamenica, assistant professor of economics at the University of Chicago Graduate School of Business and coauthor of the study, there is no magic number. Instead, he suggests that plans offer a handful of core funds including a money market, bond index, domestic equity index and international equity index, with extra choices for those who want them. "Nobody will be worse off by allowing investors who are more sophisticated to select from a wider range of options," Kamenica says.

6. "...but you still aren't diversified."
The two most popular holdings in 401(k)s are stable-value funds and company stock, says Pam Hess, senior retirement consultant at Hewitt Associates. And "neither is appropriate." Stable-value funds protect your savings but, by design, don't take enough risk to create as much return as bond or stock funds. Young workers in particular should not have big chunks of their 401(k)s in them. As for company stock, many planners will tell you not to put any of your retirement money there.Your company pays your salary and provides health benefits, so you already have enough exposure. What's more, you never want the bulk of your portfolio in one stock. But despite watching companies like Enron crumble, employees with 401(k) plans still put 22% of their holdings in company stock, on average, and one in five participants holds more than half of his balance there.

If part of your 401(k) match is in company stock, sell it; it should never compose more than 10% of your portfolio. A target-date fund or mix of large- and small-cap equity, international investments and fixed income is a wiser way to go, Hess says.

7. "If you quit your job, you'll have to pay to keep your 401(k) here."
A Hewitt study shows that 32% of people who quit their job wind up leaving their 401(k) with their old company. Maybe that seems easier than hassling HR for the paperwork involved in transferring a 401(k) to an IRA. But chances are, you're paying for it another way. Some employers foot an upfront fee for costs associated with running your plan while you work for them, but an increasing number are pulling the plug once you're off the payroll, says Cook Street Consulting's Sean Waters. This may or may not be clear to employees. "It's not like you get an invoice saying, 'Hey, you owe me $40 a year now,'" Waters says. It makes a case for consolidating your various 401(k)s, because that cost will only increase for those who have multiple plans. "It doesn't make sense to have 401(k)s all over the planet," Waters says.

Often, the simplest solution isto roll them over into your current plan. What if you love your new job, but hate the shoddy funds offered for your 401(k)? Consider an IRA rollover, which means a separate account with an extra set of fees, but also the flexibility to pick the investments you want.

8. "You'd be better off in a Roth 401(k) — too bad your plan doesn't offer it."
In a traditional 401(k), taxes on your investments are deferred until you begin withdrawing your money in retirement. With the increasingly popular Roth 401(k), however, you pay the taxes up front, then make withdrawals tax-free. Granted, the Roth isn't for everyone (see "Ask SmartMoney[1]"). But if it's the right choice for you, you'll likely be disappointed to discover that your company doesn't offer it — only 5% of plans do.

Since Roth 401(k)s first appeared on Jan. 1, 2006, the primary obstacle to their rollout has been the fact that they were supposed to disappear after 2010. Now, thanks to this year's Pension Protection Act, they're permanent — but retirement plans have yet to catch up to the legislation. Companies cite other reasons, like administrative complexity, for not offering Roth 401(k)s out of the gate, according to a Hewitt study conducted before the new ruling.

Remember that a 401(k) plan is about having the most money possible in your pocket during retirement. If your plan doesn't include the Roth and you think it's the best option for attaining your goal, ask your benefits department why and what steps employees like you can take to get one. The logistics are their problem.

9. "You want to see some outrageous fees? Try a variable annuity 401(k)."
Insurance companies that run 401(k) plans often package them as annuities. It's the common format for small plans and 403(b)s, which are geared to teachers, professors and employees of nonprofit organizations. It's also an expensive one. The insurance company slaps a fee on top of the expense ratio you pay for the mutual funds in the annuity. In return, plan participants can get some type of insurance benefit, like principal protection or the opportunity to annuitize their income stream at retirement, says Michael DeGeorge, the general counsel for the National Association for Variable Annuities.

To be fair, insurance companies have the clout to haggle successfully with asset managers for lower expense ratios on the underlying funds. That said, the combined total of the expense ratio and the insurance fee will still be higher than the cost of other plans. All fees should be explained in the prospectus, but critics of the annuity structure complain they're not often

broken out in quarterly statements. Instead, the provider quietly deducts its fee from the total return on your fund. Unless you study the prospectus, you may never notice.

10. "Your nest egg could be a whole lot bigger."
In truth, 401(k) plans are getting better. As lawmakers and regulators are scrutinizing fees, some providers are offering participants access to a more attractive suite of investments and refunding money to plans when expenses exceed costs and a set profit. That said, it's still hard for 401(k) investors to grasp how a small difference in expenses can make a big difference for their retirement. Consider this: Brent Glading of the Glading Group, who used to sell 401(k) plans for Merrill Lynch and Dreyfus but now negotiates better plans for company clients, typically can shave 0.20% to 0.40% off a plan's expenses. That doesn't sound like much, but it can translate to $100,000 per employee over 20 to 30 years.

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