

# PLAN COSTS



Nowhere is there more confusion about 401(k) plans than in the area of costs and fees. Unfortunately, ignorance about this subject can be dangerous to your participants' (and your) retirement. Since participants pay for most of the costs in the form of asset-based fees,<sup>1</sup> they are heavily penalized when an employer chooses a "high cost" plan. The majority of the costs come straight out of participants' investment returns and can seriously erode retirement balances. Sponsor ignorance coupled with lack of adequate vendor disclosure continues to contribute to this serious problem.

This chapter is designed to provide a quick yet thorough overview of this important topic so that you can make an informed buying decision. The chapter will describe the importance of fees, illustrate the different ways vendors charge fees, show you how to quickly analyze a service provider's cost structure, define "high," "low," and "moderate" plan costs, and, finally, offer rules of thumb proven to keep plan costs low.

## THE IMPORTANCE OF UNDERSTANDING PLAN COSTS

When average account balances were small, sponsors could more easily ignore the issue of plan costs. That's no longer the case today as account

balances have mushroomed, and participants pay for the majority of a plan's costs in the form of asset-based fees. Sadly, sponsor understanding of this important issue has not kept pace with the growth of account balances, especially in the small-plan marketplace.<sup>2</sup> And many participants don't even know that they are paying fees at all.

What kind of impact are we talking about? Suppose you have thirty-five years until retirement, and a current 401(k) account balance of \$25,000. Let's assume your average return is 7 percent, you don't contribute another dime to the account, and the annual fees are 0.5 percent. In thirty-five years, your account balance should grow to \$227,000. If the fees were just one percentage point higher—1.5 percent—your account balance would be \$163,000 at the end of thirty-five years. That's \$64,000, or a 28 percent difference.<sup>3</sup>

There are a number of reasons for lack of sponsor understanding. First, when account balances were small, high fees had little impact because the effects were negligible. Second, they never directly affect the company's bottom line since participants bear the majority of plan costs anyway. Third, during the great bull market of the 1990s, there was little concern over fees when investments were routinely returning 20 percent a year. Finally, the way in which service providers price and package their products, especially at the small end of the marketplace, can be confusing to the uninformed buyer. Few vendors go out of their way to talk about how they price, and for some of the high-cost providers, it is in their best interest to remain quiet. If plan sponsors truly understood their responsibility to keep plan costs in check, and if participants understood the impact of excessive fees over time, there would be much more of an outcry.<sup>4</sup>

## THE DOL STEPS IN

In chapter 3, we saw that one of the main duties of a fiduciary is to ensure that the fees paid to service providers are "reasonable." This is more than an academic exercise. As 401(k) plans play an expanding role in the U.S. retirement landscape, the careful design, operation, and

administration of these plans has become a public policy issue and has caught the eye of the federal government. Olena Berg-Lacy, in her role as former Assistant Secretary of the U.S. Department of Labor, left no doubt about the DOL's stance when she said, "We want to make sure that plan sponsors pay attention to fee issues"<sup>5</sup> and "It is an employer's fiduciary duty to make sure the fees 401(k) participants pay are reasonable."<sup>6</sup> In an effort to clarify the situation and to give plan sponsors comparative cost information, the DOL held hearings on the issue of plan fees and costs in November 1997 and prepared a booklet the following year dedicated exclusively to the topic of 401(k) pricing<sup>7</sup>—the clearest sign yet of the topic's importance.

## PARTICIPANTS AS ACTIVISTS

Increasingly, it is activist plan-participants that are leading the charge for lower costs. Spurred on by articles from popular financial magazines with headlines like "How to Protect Yourself Against the Great Retirement Rip-off"<sup>8</sup> or "How Funds Get Rich at Your Expense,"<sup>9</sup> participants are beginning to ask questions and demand answers. Don't be surprised if someone walks into your office and insists on knowing why the plan you selected costs so much. This is even more likely in the current bear-market environment as participants are increasingly focused on costs. As a buyer, you want to know what you're paying, what you're getting, and how it stacks up with the competition, so you can get the best deal and protect yourself against possible litigation.<sup>10</sup> And once you know, you'll want to fully disclose all fees to participants on a regular basis.

## UNDERSTANDING PLAN COSTS

Determining the reasonableness of fees requires three separate steps. First, you have to know what the total costs are. Second, you have to compare these costs against some objective benchmark. And finally, you have to judge whether the costs you are paying are reasonable in light

of the services received. The remainder of this chapter is devoted to giving you the tools necessary to understand any vendor's pricing formulas so you can make an informed buying decision.

## VENDOR PRICING

In order to understand the fees and charges you and your participants pay, you have to first understand how vendors price their services. As a general rule, total plan assets and, in particular, average account balances, drive vendor pricing. The more money there is in a plan, and the higher the account balances, the lower the administrative fees and the greater the opportunity of using nonproprietary and lower-priced "institutional" investments. Other variables that affect vendor pricing include annual net cash flow, the number of company locations and payrolls, plan design complexity, potential merger and acquisition activity, and strategic fit.<sup>11</sup>

The next step is to determine whether the sponsor or the participant pays for each fee. Participants almost always pay the asset-based fees as they are netted out of the investment returns, and there is a growing trend toward shifting even the administrative fees to the participants as well. Finally, your plan fees have to be put into some kind of overall context of "high," "average," or "low." For example, a \$1 million plan that pays 1.75 percent of plan assets in total fees (i.e., \$17,500), may be "average," whereas for a \$25 million plan, 1.75 percent would be considered "high" (i.e., \$375,000). Determining the total cost of a plan is a relatively simple affair once you understand the types of fees and where they are hidden. (See the appendix for a useful chart to help in breaking down plan costs.)

## BILLED (EXPLICIT) EXPENSES

There are two sources of revenue for 401(k) service providers: explicit and implicit charges. Let's start with the easier of the two—explicit fees. Explicit fees are charges that are billed directly either to the plan sponsor or to plan participants. These charges are easy to determine

since they should be clearly stated in your service provider's administrative services agreement. Below, I've listed some of the more common explicit fees:

- ◆ One-time start up and conversion costs
- ◆ Annual administrative, recordkeeping, and compliance-testing charges
- ◆ Transaction-based charges like loans, hardships, and benefit distributions
- ◆ Per diem fees for employee-education meetings
- ◆ One-time termination charges
- ◆ Investment transfer fees

Many service providers have gone out of their way to reduce or even eliminate explicit fees as a way to advertise “low-cost” or “no-cost” 401(k) plans. Recordkeeping fees often serve as a “loss leader” with the service providers hoping to make it up in more-lucrative asset-based fees. Whenever possible, the company should pay for these fees since these costs are tax deductible as a business expense. When participants pay, dollars are diverted from tax-advantaged investment growth, which represents a lost opportunity for dividends, interest, and gains. Unfortunately, more and more companies are shifting the burden of the explicit fees to participants.<sup>12</sup>

### ASSET-BASED (IMPLICIT) FEES

Most service providers derive the majority of their revenue from asset-based fees. Unlike explicit fees, which are usually flat dollar charges, asset-based revenues are derived as a function of the plan assets. That's why, generally speaking, the more money inside your plan and the higher your plan's average account balance, the more attractive it is to the marketplace. Asset-based fees now account for nearly 90 percent of the revenue generated by 401(k) service providers.<sup>13</sup> As assets increase, that percentage will continue to grow, making the sponsor's understanding

of these fees absolutely necessary. As we saw earlier, a relatively small fee of say, 0.5 to 1.5 percent over a period of time, can seriously erode a participant's retirement-account balance.

The implicit costs, or the costs associated with the investments, come in several different forms:

- ◆ Front-end and back-end loads
- ◆ Investment management fees
- ◆ 12b-1 and Sub Transfer Agent fees
- ◆ Asset-based “wrap” fees
- ◆ Spreads, market-value adjustments, and contract-termination fees

## LOAD FUNDS

Front- or back-end loads, transaction costs charged when a participant buys shares of a fund either going into the plan (front-end) or exiting a fund (back-end), can be found in broker-dealer 401(k) products with less than \$1 million of total assets. Although not a true asset-based fee per se, these charges occur every time a participant buys or sells a fund in which the loads pay for the broker's fees. When plan assets reach a certain critical mass, usually \$1 million, the broker-dealer products generally purchase shares at Net Asset Value (NAV) with the front-end load waived.

## TOTAL EXPENSE RATIO

Fund companies derive significant revenue from the internal operating expenses of their funds, and it should come as no surprise that many of the leading 401(k) service providers are also top investment firms. The cost of administering and recordkeeping tens of thousands of participants is the price they pay to efficiently gather assets. If you recall from chapter 1, gathering and managing assets is an extremely lucrative business and the 401(k) marketplace represents a way in which service

providers can gain hundreds and thousands of individual shareholders overnight along with tens of millions of assets. And because of the long-term horizon of the average retirement investor, the money tends to stay put and continue to roll in despite the swings in the marketplace.

The expense ratio is the percentage of plan assets paid for fund operation, distribution, and management fees. Fund expenses are reflected in the daily share price, the Net Asset Value (NAV), after all of the expenses have been netted out of the returns. To a buyer, the total expense ratio, or the sum of all the individual components (e.g., investment management fee, custodial fee, 12b-1 fee if applicable, etc.), is far more important than the detail of the individual components. What the specific pieces tell us, however, is the story of how the funds are marketed.

## 12B-1 AND SUB-TRANSFER AGENCY (SUBTA) FEES

The second way vendors make money is by distributing other companies' products (funds). In chapter 7, we looked at the growth of fund "supermarkets" and "alliances" as the paradigm of choice for many 401(k) service providers. In brief, if an investment company is not large enough to distribute its own products, it must find others to distribute for them.<sup>14</sup> In a manner similar to how a grocery store operates,<sup>15</sup> service providers with "alliance" platforms collect revenue from the company whose funds they distribute in addition to the revenue their own investments generate. The distributors typically earn between 25 to 50 basis points, or \$.25 to \$.50 for every \$100 of assets they sell, depending on the fund. And the most common way in which distributors get paid is through 12b-1 fees.<sup>16</sup> This common industry practice is known as "revenue sharing."

### 12b-1 Fees

Many funds have 12b-1 fees built into them as part of their operating expense. 12b-1 fees are used to pay for marketing and distribution costs

and usually range from .25 to 1 percent, or 25 to 100 basis points.<sup>17</sup> A 401(k) service provider can usually expect to receive between .25 and .50 percent from the funds they distribute. That may not seem like a lot of money—.35 percent means you earn \$3,500 for every million of assets—but with nearly \$2 trillion of 401(k) money sloshing around, and nearly \$6 trillion of assets held in mutual funds, the old saying remains true—a small percentage of a lot of money is a lot of money.

### Sub-TA Fees

When you're putting together a typical investment alliance platform, revenue sharing is one of the main reasons (along with brand-name recognition, performance, cost, and manager tenure) for inclusion. Reimbursement for distribution usually comes in the form of 12b-1 fees but they may also include what are known as Sub-Transfer Agent (Sub TA) fees. These are fees between the service provider and the investment firm "that specify a payment from the investment management firm to the service provider in exchange for specified services."<sup>18</sup> Both the 12b-1 and Sub TA fees are spelled out in each fund's prospectus. At the close of each market day, the Net Asset Value (NAV) is calculated after netting out all of the internal operating expenses of the fund including the 12b-1 and Sub TA fees. Let's look in more detail at how an alliance works.

### EXAMPLE: FIDELITY ADVISOR, FIDELITY DIRECT, AND VANGUARD FUNDS

Many alliance products will go out of their way to claim they offer Fidelity funds as part of their investment lineup. Upon closer inspection, however, most of these Fidelity funds are part of Fidelity's "Advisor" series. Fidelity has several kinds of funds grouped primarily by their distribution channel (e.g., "direct," "third-party," "institutional," etc.) Fidelity's "Advisor Funds," for example, are distributed by intermediaries, e.g., stockbrokers or commission-based financial planners, as well as third-party institutions such as banks and insurance companies.

Because of the need to pay for distribution, these funds have built into them 12b-1 fees between 50 and 75 basis points. The service provider usually collects 50 basis points for distributing one of these Fidelity funds. In addition, the vendor who offers Fidelity Funds can gain a marketing advantage by piggybacking off of Fidelity's well-known brand name.

In contrast, let's consider the Vanguard family of funds. Vanguard markets the majority of its funds directly to the public on a no-load basis.<sup>19</sup> The company aggressively markets itself as the industry's low-cost provider shunning both loads and 12b-1 fees. With no 12b-1s built into their funds, they lack the mechanism with which to compensate fund supermarkets and alliances for distribution. The upshot: despite Vanguard's low-cost expense structure and solid investment record, you usually won't find service providers distributing their funds. The explanation for this is just plain economics. Why would a service provider distribute Vanguard funds for free when they could distribute another company's comparable high-quality fund and get paid? If you do run across a Vanguard fund in the small plan marketplace, there is usually an additional asset-based fee layered over the fund's internal operating known as a "wrap" fee—which we will discuss next.

### ASSET-BASED "WRAP" FEES

"Wrap" fees are common expense-recovery mechanisms in the start-up and small-plan marketplace (roughly defined as under \$10 million of total assets) and are usually associated with insurance companies. With this type of fee, the insurance company establishes separate investment accounts using retail mutual funds as the underlying investment vehicle. The separate account then "wraps" an additional fee over and above the cost of the underlying investment. For example, if the fund's expense ratio were normally 1.25 percent, then the insurance company's asset-based wrap fee of 1 percent would raise the total cost of the investment to 2.25 percent.

The primary justification of a wrap fee is to (1) offset the upfront

costs incurred in setting up a plan with little or no assets, and (2) pay a third-party broker or agent a commission for distributing the product and servicing the client. Wrap fees vary by vendor but they are usually based on the following criteria: total plan assets, explicit billed expenses, the amount and type of broker commissions, and the existence of a contract-termination charge. The amount of the wrap fee is determined by the amount of total plan assets. It should come as no surprise then that start-ups and small-plans with the least amount of assets have the highest wrap fees. As the plans grow in size, the wrap fee usually declines and, depending on the vendor, may even expire. During the course of the wrap fee's life however, the wrap fee lowers participants' net returns.

Insurance companies who use wrap fees denominate their investment's daily price in unit values as opposed to Net Asset Values (NAV) common to the mutual fund world. Although the two numbers track together (if the NAV of the underlying mutual fund goes up, the insurance company's unit value will also go up), they are not the same. This means that participants in wrap-fee programs cannot track their investments in the local paper since newspapers only show NAV data and not unit values.

### OTHER CHARGES: "SPREADS," MARKET-VALUE ADJUSTMENTS, AND CONTRACT-TERMINATION CHARGES

Vendors have other, more subtle ways in which to earn revenue, and we briefly review them here. If you already have a plan, be sure to check your contract to see if any of these charges apply. If you haven't yet set up a plan, ask the prospective vendors if these charges pertain to your situation.

Some vendors require that the buyer use one of their "guaranteed" or stable value accounts. These accounts are like a CD paying a guaranteed rate of interest. The vendors make money on the spread between the interest rate they earn in the marketplace and the interest rate they pay. For example, if the insurance company earns 6.5 percent investing the

assets, it credits only 5.5 percent to the investor, earning a spread of 1 percent, or 100 basis points.

When the GIC contract terminates, there is a reconciliation, or a market-value adjustment (MVA), between the contract's "book" and "market" values.<sup>20</sup> Depending on interest rates at the time of contract termination, there can be either a gain or loss. The MVA is the price paid for a stable-value contract where the principal is insured and there is no fluctuation in the price. In addition to the pure market-value adjustment, there may be an additional expense factor, depending on the contract.

Finally, some group annuity contracts will charge a "surrender fee" or "contract termination charge" if the plan terminates its contract within a specified period of time. This surrender charge is usually determined as a percentage of total assets and eventually expires. For example, a vendor may charge 7 percent if the contract terminates in year 1, 6 percent in year 2, 5 percent in year 3, and so on, until it expires in year 7.

## WHERE TO FIND THE INFORMATION

Mutual funds are by definition "registered," meaning that they must disclose investment fees in a prospectus and are governed by the Securities Exchange Commission (SEC). Third-party investment databases—such as Morningstar, and Lipper—conveniently compile the investment information generally found in a prospectus. (Please see the appendix for a summary of average mutual fund expense ratios.) Banks and insurance company service providers, in addition to mutual funds, may also use nonregistered products such as collective trusts and group variable annuity products, which are not required to issue a prospectus. However, most vendors will gladly disclose their pricing formulas. It's up to you, the plan sponsor, to ask for a full explanation of all the fees and costs.

At this point, we are noting the various ways in which service providers charge fees in order to make money. The purpose is to help you understand pricing schemes. There is no right or wrong way. In the end, the cost of the plan has to be measured against what you can get

in the marketplace for a plan your size, and the value the service providers bring to your plan.

### “HIGH,” “AVERAGE,” AND “LOW” COSTS

Once you’ve determined what your costs are, the next step is to place the costs into some kind of context of “high,” “average,” or “low.” Since asset-based fees account for 90 percent of total plan costs, it makes sense to first calculate the average expense ratio of your fund lineup and compare it to industry averages.<sup>21</sup> Be sure to add any asset-based wrap fee to the average portfolio cost if you use a product that imposes one. (See the appendix for a detailed breakout of average investment costs by fund style and market capitalization.)

The next step is to compare your total plan costs against national normative data. The table below lists some essential plan cost information taken from the “401(k) Averages Book.”

	<b>25 participants; \$1,000,000 in assets</b>	<b>50 participants; \$2,000,000 in assets</b>	<b>100 participants; \$4,000,000 in assets</b>	<b>200 participants; \$8,000,000 in assets</b>
<b>Average plan cost per participant</b>	\$637.60	\$583.14	\$560.59	\$525.63
<b>Average plan cost as a percentage of assets</b>	Investment: 1.30% Record-keeping/ Administration: .24% Trustee: .05% Total Bundled: 1.59%	Investment: 1.26% Record-keeping/ Administration: .17% Trustee: .03% Total Bundled: 1.46%	Investment: 1.26% Record-keeping/ Administration: .13% Trustee: .01% Total Bundled: 1.40%	Investment: 1.20% Record-keeping/ Administration: .10% Trustee: .01% Total Bundled: 1.31%
<b>Range of total plan costs</b>	Low: \$10,151 Average: \$15,757 High: \$23,781	Low: \$16,900 Average: \$29,053 High: \$46,461	Low: \$30,061 Average: \$55,796 High: \$90,621	Low: \$47,330 Average: \$104,772 High: \$178,940

As you can see from the data, smaller plans usually pay more than larger plans, all things being equal. Also, fees can vary widely even among plans of similar asset sizes.

As a plan sponsor and fiduciary, fees are an important issue but there are two caveats to keep in mind. First, fees must be considered in the context of the scope and quality of the services received. Second, since most of the fees are netted out of the investment returns, total plan costs generally and investment fees in particular, can only be properly understood within a larger context of risk-adjusted investment returns. To focus solely on plan costs without considering the investment piece of the equation is to perform analysis that is too simple by half.

### PRICING RULES OF THUMB

Although each vendor has its own pricing model, generally they use total liquid assets, average participant-account balances, net annual cash flow, and ratio of proprietary to nonproprietary investments in order to determine what, if any, explicit fees to charge. After looking at hundreds of plans of all different asset sizes, one can make certain generalizations about pricing.

- ◆ Plan costs become a major issue as 401(k) assets and average account-balances increase. Plan sponsors can no longer afford to be uneducated about costs, as it is clearly their fiduciary duty to understand and control them.
- ◆ The best way to look at total plan costs (explicit plus implicit fees) is as a percentage of plan assets over time. To look only at explicit costs is to miss where the majority of fees are found.
- ◆ Explicit fees are tax deductible as a company business expense, while asset-based fees are not. If possible, it makes more sense to use tax-deductible dollars to pay for plan expenses than to use plan assets to pay for them. Dollars that are diverted from a tax-advantaged retirement account represent a lost opportunity for dividends, interest, and investment gains.

- ◆ The larger your plan's asset base and average account balance, the greater your ability to lower or negotiate away costs like start up, conversion fees, employee education, and annual record-keeping fees. More money also gives you a greater chance of reducing or eliminating asset-based "wrap" fees, adding "outside" funds to your lineup, and, if your provider offers them, access to lower-cost "institutional" shares.
- ◆ Be careful of simplistic generalizations and absolute statements about pricing. Is a plan that costs 1 percent of total plan assets better than a plan that costs 1.25 percent? Is a fund with a 50 basis point 12b-1 fee and an expense ratio of 110 basis points worse than a similarly-priced fund with no 12b-1 fee? Absolutely not. Asset-based fees are a function of the underlying investments, and the investments, in turn, must be evaluated in the context of risk-adjusted returns and relative peer group performance. In short, fees can only be understood within the context of a total value equation.
- ◆ Generally speaking, NAV pricing is less expensive than "wrap" fee pricing. However, this doesn't necessarily mean that you should always select a NAV product. A lot depends on fund selection, investment performance, and the overall number and quality of services provided. A plan may be better served with a modest wrap-fee product where employees are being actively counseled to join the plan, increase their savings percentage, and allocate their investments more appropriately. Also, what you gain in cost savings you may lose in fund selection, since the NAV provider may require your plan to use only their proprietary investments.
- ◆ Start up and small plans have the highest fees as measured by percentage of assets. This should not be surprising, since many providers use wrap fees to offset the up-front costs incurred in setting up a start-up plan and to pay a third-party broker or

agent a commission for distributing the product and servicing the client.

- ◆ Plan decision-makers can have a significant impact on the cost of the plan. You can lower the plan's overall expense structure by shopping around, being an informed buyer, and favoring high-quality, lower-cost investment vehicles. Over time, this could mean tremendous savings to the plan participants.
- ◆ Some vendors are consistently more expensive than others. There is variance not only between different kinds of vendors (insurance and mutual fund companies, for example) but also within categories. Some insurance and mutual fund companies are consistently more expensive (or less expensive) than their peers.
- ◆ If your plan is large enough, you may be able to qualify for lower-cost institutional fund pricing.<sup>22</sup> If you run a large plan (i.e., \$250 million or more), you may consider collective trust funds, or even setting up your own proprietary funds.
- ◆ Voluntary full disclosure of all fees to participants should be your mantra. Not only do they have a right to know, but they will be demanding this information from you anyway.

Cost is an important consideration, yet it is not the only criteria in designing a plan. Breadth and quality of service, as well as overall investment performance, are also important considerations. The trick is to look at costs relative to services and to benchmark these against other comparable plans. We will discuss how to factor these various pieces into a buying equation in chapter 12, "A Good Plan (Benchmarking)" and chapter 13, "Putting It All Together—Vendor Selection."



## Notes

1. PSCA Annual Survey.

According to Spectrem Group's projections, the aggregate 401(k) marketplace generates \$13.204 billion of total fees, of which 89.5 percent (\$11.817 billion) is derived from asset fees, while the remaining 10.5 percent (\$1.387 billion) comes from service fees. "Plan Sponsors Need Better Fix on 401(k) Fees," *Employee Benefit Plan Review*, September 2001, p. 22.

2. "Seventy-five percent of all plan sponsors are unaware of or unfamiliar with 'hidden' costs and fees embedded in their plan, despite ERISA requirements that they ensure such fees are reasonable, a new study by Investmart found." "Managing 401(k) Plans," Institute of Management & Administration (IOMA), December 1, 2001.

"The Department of Labor's 1998 'Study of 401(k) Plan Fees and Expenses' revealed that nearly 80% of plan sponsors didn't know how much their plans cost." "Confusion Reigns When It Comes to 401k Plan Fees," Roxanne Fleszar, 401kWire, July 26, 1999  
<http://www.financial-management.com/planfees.html>

3. "A Look at 401(k) Plan Fees," U.S. Department of Labor Pension and Welfare Benefits Administration, 1998, p. 2.

4. Whose Board?

If directors of mutual fund companies redefined their role, shareholders would benefit

—John C. Bogle is the chairman of the Vanguard Group.

Managers' profits have grown even faster. Despite their pervasive failure to outperform the market, many fund managers are now booking pretax profit margins of 35 to 40 percent. And margins of probably 50 to 60 percent exist before factoring in marketing costs—costs that benefit fund managers by increasing assets and fees but that are borne by the fund shareholders.

[http://www.bloomberg.com/personal/archives/vcs\\_A9712\\_bog.html](http://www.bloomberg.com/personal/archives/vcs_A9712_bog.html)

5. "That 401(k) May Cost More Than You Think," Jeffrey Laderman, *Business Week*, November 10, 1997, p. 130.

6. "Protect Yourself Against Retirement Rip-Off," *Money*, April 1997, p. 98
7. "A Look at 401(k) Plan Fees," U.S. Department of Labor Pension and Welfare Benefits Administration, 1998, p. 2.
8. "How to Protect Yourself Against the Great Retirement Rip-off," by Penelope Wang, *Money*, April '97  
<http://www.timyounkin.com/periodicals.html>  
 According to Spectrem Group's projections, the aggregate 401(k) marketplace generates \$13.204 billion of total fees, of which 89.5 percent (\$11.817 billion) is derived from asset fees, while the remaining 10.5 percent (\$1.387 billion) comes from service fees. "Plan Sponsors Need Better Fix on 401(k) Fees," *Employee Benefit Plan Review*, September 2001, p. 22.
9. "How Funds Get Rich at your Expense", *Money Magazine*, February 1995.
10. ". . . today's employees are a litigious bunch. If they ever bear the brunt of a long and painful bear market for stocks, you may find yourself in court trying to explain why you, as a fiduciary, ignored the damage done to employee's retirement security by sky-high plan costs." "Facing Up to Total Plan Costs," *CFO*, April 1996, p. 1.
11. "Economics of Defined Contribution Plans," speech given by Kevin Weise, American Express Retirement Services, March 24, 1998.
12. Administrative fees are often paid by the plan sponsor. Increasingly, however, employers are passing part or all of this cost to participants.

### What You Pay for 401(k)s

By Jane Bryant Quinn

Thursday, January 8, 1998

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<http://retireplan.about.com/gildynamic/offsite.htm?site=http%3A%2F%2Fwww.washingtonpost.com%2Fwp-srv%2Fbusiness%2Flongterm%2Fquinn%2Fcolumns%2F010898.htm>

Sponsors must be careful as to which expenses can be properly transferred to plan participants. In Advisory Opinion 2001-01A, issued in January 2001, “the DOL . . . stated that the key element in deciding if costs can be paid from plan assets is identifying an expense as a ‘settlor’ expense (related to establishing, designing, or terminating a plan) or a ‘fiduciary’ one, such as those resulting from the operation and administration of the plan. . . . Settlor expenses such as choosing what type of qualified plan to offer employees, preparing the plan documents, plan amendments to add new features, etc. may not be paid for by the plan. . . . Fiduciary expenses such as amendments to comply with tax law changes, calculations of benefits for participants, routine nondiscrimination testing, preparation of Form 5500, administering the loan program and communicating plan information to participants and beneficiaries may be eligible for payment from plan assets.” “Plan Expenses: Can They Be Paid from Plan Assets?” *Plan Sponsor Outlook*, 2nd quarter 2001, The Guardian Life Insurance Company.

13. According to Spectrem Group’s projections, the aggregate 401(k) marketplace generates \$13.204 billion of total fees, of which 89.5 percent (\$11.817 billion) is derived from asset fees, while the remaining 10.5 percent (\$1.387 billion) comes from service fees. “Plan Sponsors Need Better Fix on 401(k) Fees,” *Employee Benefit Plan Review*, September 2001, p. 22.
14. After a while of looking at various leading bundled provider’s product, you begin to see the same “outside” funds over and over again (e.g., AIM, Dodge & Cox, Janus, Pimco, etc.). There is a simple reason for this, and, in a word, it’s distribution. These are fund families who have made the strategic business decision to sell their product as “investment only” (as opposed to creating a fully bundled product as a means to distribute product). They make sure their product is part of the investment platform of the large bundled providers, who, in turn, collect a fee for distribution.

According to Cerulli Associates, investment-only 401(k) assets will exceed 401(k) proprietary assets by 2006.

**Source:** Speech made by a Consultant from Cerulli Associates, Inc. at the Scudder Investments Consultant Symposium held on February 1, 2002 in Key Biscayne, FL—Slide 26

15. The alliance platform is the “store,” which provides “shelf space” to various investment companies’ “products.” In exchange for the “shelf space,” the product providers pay for this service when their product is bought.
16. “401(k)’s Dirty Little Secret,” *Bloomberg Personal*, September 1997, p. 4.
17. “12-1 fees, charged by some funds, are deducted from the plan assets to pay marketing and advertising expenses or, more commonly, to compensate sales professionals. By law, 12b-1 fees cannot exceed 0.75 percent of the fund’s average net assets per year. The fund may also charge a service fee of up to .25 percent of average net assets per year to compensate sales professionals.”  
*The Mutual Fund Business*, Robert C. Pozen, The MIT Press, 1998, p. 20.  
  
“From a relative handful of funds adopting the charges in the mid-1980s, some 70 percent of funds today have 12b-1 fees in place, according to data from Morningstar. . . . The impact of 12b-1 fees has helped drive up the overall annual fees charged by mutual funds. Between 1979 and 1999, the average expense ratio charged by mutual funds increased to 1.36 percent, from 1.14 percent, according to a report on mutual fund fees released last year by the SEC. While front-end sales loads decreased, the 12b-1 fee was listed as one of the main reasons annual fund expenses had risen.”  
“Fund Fees Get SEC Scrutiny,” Aaron Lucchetti, *Wall Street Journal*, p. C1, May 28, 2002
18. “Revenue Sharing Aspects of Qualified Retirement Plan Management,” Daniel Clark, *Solutions*, September 1998, p. 36.
19. Front- and back-end loads, as well as 12b-1 fees, are used to pay intermediaries to distribute product. Since Vanguard does not use brokers to distribute its product, there are no loads and no 12b-1 fees.
20. A guaranteed investment contract or guaranteed income contract, is a contract between an insurance company and a corporate profit-sharing or pension plan (i.e. 401(k) plan), whereby the plan invests a sum of money with the insurance company for a specified period of time, and the insurance company, in turn, pays interest

on the loan at a fixed rate over the life of the contract. The borrowed funds are then invested by the insurance company in a portfolio of securities, including bonds, mortgages, and are usually structured to mature around the time that the GIC is scheduled to expire.

21. To determine an average expense ratio, sum the expense ratios (and any additional asset-based fee if applicable) of all the investment options and divide by the number found in the portfolio. For example, the sum of .75, 1.0 and 1.25 is 3 percent. The average expense ratio is therefore 100 basis points or, 1 percent. For greater accuracy, you can create an asset-weighted expense ratio by multiplying the expense ratio of each fund by the proportion of the assets of a particular fund to the plan's total assets and sum the number. For example, assume fund 1 has 10 percent of total plan assets and costs .75 percent, fund 2 has 50 percent of total plan assets and costs 1 percent and fund 3 has 40 percent of total plan assets and costs 1.25 percent. The asset-weighted expense ratio would be 108 basis points or, 1.08 percent  $[(.10 \times .75) + (.50 \times 1) + (.40 \times 1.25)]$
  
22. Many of the large mutual fund companies have created retirement share classes which are lower priced alternatives to the higher cost retail version of their funds. Typically these share classes are for mid and large size plans (at least \$50 million of plan assets) although if institutional share classes are available, you should ask for them.