
MANAGING YOUR 401(k) PLAN FEES

DEVELOPMENT OF THE 401(k) MARKET

Over the past two decades, an obscure sub-section added to the Internal Revenue Code in 1978 has come to represent the primary retirement savings vehicle for most Americans. Section 401(k) plans have grown to the point that they now hold approximately \$1 trillion in assets. Access Research, Inc. estimates that 401(k) assets will grow at a 20-22% annual rate over the next five years. In response to the emergence of this massive accumulation of assets, hundreds of financial service organizations have developed an entire new industry dedicated to supporting the needs of 401(k) plan sponsors and plan participants. If we very roughly estimate the average annual cost of supporting 401(k) plan operations at 1% of assets, 401(k) expenditures total approximately \$10 billion annually. Given the size of the 401(k) pie, it's not surprising that banks, insurance companies, brokerage firms, money managers and mutual fund companies are competing vigorously to secure increased market share. Yet, despite this competition, numerous surveys indicate that 401(k) service fees are high and rising. To address why fees are increasing, and what plan sponsors can do to control costs, we'll:

- Analyze the forces driving costs in the 401(k) market;
- Review regulatory developments that seek to provide better fee disclosure and control the rate of fee increases; and
- Investigate techniques that plan sponsors can adopt to ensure that fees charged to their plans are not excessive.

Contrasting 401(k) and Pension Plans

Although employees fund most 401(k) contributions, while employers fund most pension contributions, numerous surveys have demonstrated that 401(k) plans are significantly more popular with employees than pension plans. Some of the popularity is attributable to the positive investment results experienced over the past several years. Employees watch their 401(k) account balances soar as the stock market hits new highs, while the promised monthly benefit under most companies' pension plan remains unchanged.

However, the principal factor driving the popularity of 401(k) plans is that the benefit provided is simple to communicate, and the value to the employee is obvious. 401(k) plans reduce your taxes today. The value of a 401(k) plan balance

can be determined today. Conversely, the value of a pension benefit depends on a complex formula factoring in future earnings, years of employment, Social Security benefits, age at retirement, and other elements. Most employees find it impossible to estimate the value of their pension benefit unless they are within a few years of retirement. And a benefit that is determinable today is generally perceived as preferable to a benefit with a value that can't be determined for many years.

Why Mutual Funds are Popular

In the early to mid-eighties, most 401(k) money was invested with the same institutional fund managers that companies used for their pension plan investments. Investment management fees were low, reflecting economies of scale attributable to the large pool of funds being invested in the company's retirement plans. Employees received quarterly statements reporting the value of their accounts, generally 45 to 60 days following the close of the quarter. Any inquiries regarding the plan or investment options were directed through the company's Human Resource department.

Around 1986, some of the large no-load mutual fund companies recognized that funds flowing into 401(k) plans represented a significant opportunity to capture new investment assets. Tax reform had significantly restricted dollars flowing into Individual Retirement Accounts (IRAs), and the fund companies needed a new revenue source. Their telephone call centers were ideally situated to address 401(k) participant inquiries, and their marketing materials were easily convertible into 401(k) investment education pieces. Their shareholder service systems functioned as reasonable plan recordkeeping platforms. Furthermore, the determination of daily mutual fund Net Asset Values (NAVs) meant that the valuation of participant accounts could be expedited from quarterly to daily. With companies like Fidelity investing heavily in 401(k) service capabilities, many plan sponsors found the mutual fund delivery channel to be the perfect vehicle for outsourcing administrative functions while providing participants with more rapid, more frequent access to information about their accounts.

Do Mutual Fund Fees Matter?

The principal downside to the new mutual fund delivery channel was that investment management fees increased dramatically. Instead of paying institutional money manager rates, plans were now paying much higher retail mutual fund rates. But no one really worried much about these higher fees. Participants (who paid the fees anyway) were happy. They could track their funds based on reports in the newspa-

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per, or using the fund company's telephone service center. Plan sponsors were happy. Most time consuming administrative functions and participant interactions were outsourced to the fund company. Many plan sponsors weren't even aware of the fees that were being charged, since they weren't invoiced. In a report to the Department of Labor's Pension and Welfare Benefits Administration, Economic Systems reports, "It is clear from evidence in the literature that not all investment products disclose the fees and expenses charged to a 401(k) plan, nor are all of the fees and expenses charged by service providers disclosed." And since, in the late eighties, 401(k) account balances were relatively small, the higher percentage based investment management charge generally didn't translate into a large cost in total dollar terms.

The Pending Shake-out

After more than a decade of phenomenal growth in 401(k) assets, the competitive landscape is beginning to change for mutual fund company service providers. Some smaller fund companies have determined that they don't have sufficient capital to make the investment in infrastructure and service capabilities necessary to capture significant market share, and consequently have exited the market. For example, in early 1998, Van Kampen American Capital announced that they would not be taking on any new 401(k) customers, and would resign from existing accounts at the end of 1998. In 1999, MFS resigned from all full service plans with total assets less than \$2 million. Concurrently, plan sponsors are demanding greater flexibility in investment choice from their 401(k) plan service vendors. Many plan sponsors refuse to accept an all Fidelity fund menu just because Fidelity administers the 401(k) plan. Depending on the size of the plan and fund company in question, most fund companies will now permit plan sponsors to offer "outside" funds for half, or more, of the investment menu.

Demands for Additional Services

Additionally, as fund companies scramble to build 401(k) market share and develop economies of scale necessary to support the ever more complex service structure that plan sponsors demand, the competitive focus shifts from fund performance and fund cost, to administrative service capabilities. The service package

that defined the mutual fund companies' initial successful forays into the 401(k) market—daily valuation of participant accounts, a 24 hour automated voice response system, a live operator participant service center, and outsourcing of basic administrative functions such as loan administration—is now the minimum standard for offering a 401(k) product. The fund companies are now struggling to differentiate their services by introducing new capabilities, such as Internet access for account balance information and transactions, more fund choices, brokerage account windows, and sophisticated investment communication and education programs. Of course, additional service increases costs. Fund companies struggling to remain competitive seem to have little alternative but to add the same service package that their competitor just introduced. Interestingly, 85% of 1000 respondents to an Internet survey reported that they would prefer greater investment returns to more plan services.

Solving the Revenue Sharing Puzzle

Another emerging trend is the increased emphasis on revenue sharing arrangements between mutual fund companies, and between fund companies and other 401(k) service providers, such as banks, insurance companies and third party administrators. For years, many fund companies have paid a fee to compensate broker/dealers for marketing and distributing their funds. This payment, known as a 12b-1 charge (referencing the section of the Securities Code that permits payment of the fee) typically ranges from 0.10% to 1.00% of fund assets. Funds assessing a 12b-1 fee of 0.25% or less may be marketed as "no-load" funds. Over the past decade, 401(k) service providers have begun using 12b-1 fees to offset administrative expenses that would otherwise be invoiced to the plan sponsor. Other true no-load (no 12b-1) mutual fund companies realized that, without any ability to share revenue, their funds were at a competitive disadvantage in the multi-fund family 401(k) market. Consequently, many no-load fund companies, such as Janus, Scudder and American Century began offering revenue sharing directly from their funds' management fees. Some companies pay the revenue share directly, reducing the fund's profitability, others introduce a new, higher cost class of fund shares, and then funnel revenue back to the 401(k) provider. Other companies adopt all

three approaches. For example, Neuberger & Berman offers their regular no-load fund shares, a higher priced "Trust" class of shares that generally offers 0.25% of revenue sharing to 401(k) providers, and an even higher priced "Asset" class of shares that includes both revenue sharing and 12b-1 payments. Additionally, Neuberger is planning a new institutionally priced share class for larger plans that choose to avoid revenue sharing arrangements. Although these revenue sharing arrangements are perfectly legal (when administered correctly), they can make it extremely difficult for plan sponsors to compare costs assessed by different providers.

MANAGING COSTS

Department of Labor Initiatives

Over the past few years, we've seen a nascent trend towards greater focus on 401(k) costs. The Department of Labor's Pension and Welfare Benefits Administration (PWBA) has overall responsibility for ensuring that plan sponsors manage 401(k) costs passed through to plan participants. In a recently developed booklet intended to inform participants about 401(k) fees, the PWBA writes, "You should be aware that your employer also has a specific obligation to consider the fees and expenses paid by your plan...Among other things, this means that employers must:

- Establish a prudent process for selecting investment alternatives and service providers;
- Ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of the services provided;
- Select investment alternatives that are prudent and adequately diversified; and
- Monitor investment alternatives and service providers once selected to see that they continue to be appropriate choices."

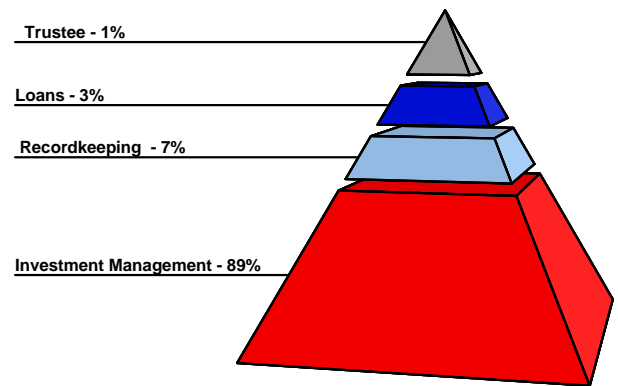
Scare Stories in the Popular Press

Much of the PWBA's recent focus on the topic of 401(k) fees is attributable to press reports of abuses in the system. According to a Dow Jones New Service report, the PWBA be-

lieves that recent stock market performance has deflected attention from 401(k) plan fees, but that a return to more normal (or worse than normal) performance is likely to refocus attention on fees.

Additionally, numerous industry studies have demonstrated the dramatic increase in 401(k) fees over the last several years. Although much of the increase is attributable to the larger size of most 401(k) accounts, there appears to be a general sense that the investment management component of 401(k) fees is growing out of control. For many plan sponsors, investment management fees are a "forgotten" cost, since they are paid by participants. The PWBA reports, "By far the largest component of 401(k) plan fees and expenses is associated with managing plan investments...You should pay attention to these fees. You pay for them in the form of an indirect charge because they are deducted directly from your investment returns." A study by the Institute of Management and Administration (IOMA) quantifies the PWBA's assertion, finding that investment management fees represent over 85% of the total operating costs for a typical 500 participant 401(k) plan.

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Managing Fees Through Suasion

Consequently, the Department of Labor (DOL) has recently attempted to temper the increase in investment management costs. Although the DOL indicates that they don't intend to regulate how 401(k) fees are charged, they have attempted to raise the level of dialog on the topic through initiatives such as public hearings held on November 12, 1997, and release of the participant booklet

As a plan sponsor, you may be wondering how to go about controlling costs for your company's 401(k) plan. The first step is to be sure that you know what you are paying now. This sounds simple enough, but may not be, as one study determined that there are at least 80 different ways that 401(k) service providers charge fees, and there are no all inclusive standard forms or worksheet templates for making fee comparisons.

and industry survey, as previously referenced. The DOL believes that much of the problem stems from the fact that many plan sponsors are unaware of the fees that they are paying. A 1992 Dalbar study found that 78% of plan sponsors do not know how much their costs are. According to Olena Berg, former assistant secretary of the PWBA, steps need to be taken "to ensure that plan sponsors and participants understand what fees are being charged and that they are reasonable."

Corporate Cost Control Initiatives

Partly in response to the DOL's nudging, and partly to ensure that their benefit programs operate as effectively as possible, numerous corporate 401(k) plan sponsors have taken steps to control their plans' investment costs. These sponsors understand that by paying lower investment management fees, their participants should earn a greater net rate of return on their 401(k) accounts, making the 401(k) plan a more attractive and more valuable benefit. Numerous studies have concluded that paying higher investment management fees doesn't buy you a better investment manager; it just costs more money. For example, a study conducted for U.S. News by mutual fund consulting firm Kanon Bloch Carre compared stock mutual fund performance for the 5% of funds with the lowest expense ratio to performance for the 5% of funds with the highest expense ratio. For growth and income funds, over a three-year period, the cheap funds returned an average of 59.7%; the expensive funds returned an average of 25.8%. The consultants noted similar patterns for long-term growth, aggressive growth, global and international equity funds and bond funds.

By 1996, the average 401(k) account was estimated to be \$32,000, with 1.9 million individual accounts of \$100,000 or more. By reducing investment management fees by 1%, an individual with a \$32,000 balance would retain \$320 per year more in his account, all else being equal. An individual with a \$100,000 balance would retain \$1,000 more. Is a 1% fee reduction a reasonable goal?

According to the 401(k) Provider Directory, total fees for a 401(k) plan with 2,000 participants and \$60 million in assets would average about 110 basis points (1.1%) per year. But the range of investment expenses for these plans trended between 36 and 191 basis points.

Larger plans have even greater opportunities for cost savings. In IBM's \$14 billion 401(k) plan, total costs average just 12 basis points (0.12%), down from the average 1.4% that IBM paid just for fund management in the eighties. US West's average cost for the eight funds in its \$5 billion 401(k) plan is just 20 basis points.

TECHNIQUES FOR MANAGING YOUR COMPANY'S FEE STRUCTURE

Evaluating Your Current Fee Structure

As a plan sponsor, you may be wondering how to go about controlling costs for your company's 401(k) plan. The first step is to be sure that you know what you are paying now. This sounds simple enough, but may not be, as one study determined that there are at least 80 different ways that 401(k) service providers charge fees, and there are no all inclusive standard forms or worksheet templates for making fee comparisons. (Note: HR Investment Consultants' 401(k) Provider Directory includes a two-page model fee analysis form permitting reasonable comparisons between most providers). The Economic Systems report to the PWBA summarized the issue as follows:

"Systematic and reliable measurements of the fees and expenses incurred by 401(k) plans and their participants are difficult to establish. Within the 401(k) plan universe, the mechanisms through which record-keeping and administration services are delivered, the manner in which expenses are charged for the services, and the expenses associated with the management of plan investments all vary widely. Additionally, there are difficulties in measuring the differences between the total expenses involved in administering plans and the expenses actually paid by the participants."

These issues notwithstanding, most fees fit into the following general categories:

Recordkeeping and Administration Fees

- Base Plan charges
- Per participant or per eligible participant charges
- Other minimum charges
- Discrimination testing charges
- Tax form (Form 5500) preparation

Based on the complexity of the process, it may make sense to have a consultant assist with the benchmarking. Although evaluating each service component and pricing structure is relatively straightforward, there are a number of issues that may require interpretation or diligent review. A consultant's industry experience and vendor knowledge may be invaluable.

- Distribution processing charges
- Loan processing charges (set-up and maintenance)
- Surcharge for additional payrolls
- Surcharge for employer securities

Trustee Fees

- Base Plan charges
- Asset based charges
- Transaction processing charges
- Surcharge for large number of funds

Investment Expenses

- Investment management fees
- Marketing and distribution (12b-1) fees
- Other fund administrative expenses
- Sales loads and charges (front-end and back-end)
- Wrap fees
- Indirect fees

Benchmarking Your Provider

Once you have an idea of what you are currently paying, the next step is to benchmark your fees against industry standards. The 401 (k) Provider Directory can be useful in establishing a reasonable benchmark, as the directory reports on average, high and low expenses for numerous prototypical plan configurations. However, this benchmark may not be truly applicable to your plan. Although the Provider Directory does an adequate job of classifying costs, it provides no indication as to the quality of service that you receive for these costs. Further, the unique dynamics of your company's plan may render the prototypical plan configurations inapplicable for a pricing comparison. Consequently, you may need to solicit other proposals from several vendors to build a customized benchmark that is appropriate for your plan. This is generally accomplished through a formal Request for Proposal (RFP) process, where a cross section of service providers are asked to respond to a set of questions in a standardized format. This permits the plan sponsor to rate the vendors in a reasonably consistent manner. Note that most organizations sending out RFPs don't restrict the pool to providers offering the same administrative and

investment structures. Often, RFP responses will provide additional ideas or information that change the sponsor's initial concept of the preferred service configuration.

In structuring your RFP, you should ask questions that will permit you to gauge vendor's capabilities in each of the following areas:

- Administrative Capabilities;
- Fiduciary Liability Management;
- Investment Capabilities; and
- Communications and Participant Services

Evaluating The Responses

A successful RFP process rates vendors separately in three primary areas:

- Service capabilities and responsiveness;
- Administrative fees, expenses and pricing structure; and
- Investment offerings, performance, diversification and fee structure.

Based on the complexity of the process, it may make sense to have a consultant assist with the benchmarking. Although evaluating each service component and pricing structure is relatively straightforward, there are many issues that require interpretation or diligent review. A consultant's industry experience and vendor knowledge may be invaluable.

Finally, although there appears to be a market trend towards bundled or alliance service providers, it makes sense to include one or more unbundled providers in your benchmarking process. Unbundled providers generally will quote services assuming no revenue sharing from the plan's investment management costs. Consequently, the unbundled proposal will provide reasonable insight into the true (unsubsidized) cost of administering your plan. Even if you elect to engage a bundled provider whose investment management fees are higher than other potential providers, it's helpful to know where the "break-even" lies (i.e., the point at which the additional incremental investment management cost outweighs the implicit administrative service cost subsidy). At a recent benefits conference in San Francisco, a DOL spokesman responded to a question

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Finally, sponsors should remember that minimizing fees isn't the primary objective. Neither ERISA nor the DOL expects sponsors to necessarily engage the low cost provider. Rather, ERISA and the DOL intend that the services that the plan and its participants receive should be reasonable and appropriate, given the fees that the plan pays.

regarding the relative merits of bundling and unbundling by indicating that the DOL informally prefers unbundled arrangements, because it is easier to determine whether the costs and benefits of each component of the service package was appropriately evaluated and engaged.

Reviewing Your Plan's Investments

Finally, you should evaluate your investment funds, relative to other funds available through your provider, and relative to other funds available in the market. Questions that should be asked include:

- 1) If you have selected retail mutual funds, are the same funds available in a less expensive class of shares? If so, does the revenue sharing subsidy that the plan receives more than compensate for the funds' higher expense ratios?
- 2) Does the plan's investment policy statement explicitly document the rationale for selecting the higher cost fund? How do the expense ratios for the selected funds compare to an appropriate peer group?
- 3) Does the plan qualify to purchase institutional class mutual funds? If so, does the revenue sharing subsidy that the plan receives more than compensate for the cost differential between retail and institutional class mutual funds?
- 4) Are mutual funds the appropriate vehicle for the plan's investment options; would the plan be better served by using commingled funds or separate accounts?

CONCLUSIONS

Plan sponsors have numerous reasons for ensuring that their 401(k) plan's cost structure is reasonable. In controlling costs, the plan sponsor enhances the stature of the plan, and the value of the 401(k) benefit, by ensuring that the bulk of investment returns are used to increase the value of participant accounts, not to pay investment management fees. By benchmarking the plan's cost structure, the plan sponsor knows that it is adequately prepared to respond to potential DOL inquiries regarding the plan, and to participant questions about

who bears what costs. As the DOL continues to focus on the fiduciary responsibility to control plan costs, it behooves the plan sponsor to know that plan costs are indeed reasonable.

Retail mutual funds have played an important role in the 401(k) explosion, to the point that 401(k) assets now total approximately \$1 trillion. For many plans, retail mutual funds continue to be appropriate investment vehicles. Much of the retail fund's higher management fee cost is explicitly or implicitly rebated to the plan sponsor in the form of reduced administrative costs. More expensive delivery vehicles, such as insurance company sponsored variable annuities and separate accounts may also be appropriate for smaller plans. But the sponsor is responsible for scrutinizing the plan's cost structure to ensure that the plan pays reasonable compensation for necessary services. Many sponsors will determine that the service provider's fee structure is entirely appropriate for their plan's needs. Other sponsors may find that their plans are eligible for significant cost reductions that haven't yet been adequately pursued. These sponsors should follow the lead of corporations like IBM and US West that have taken advantage of economies of scale to dramatically reduce the cost of their benefit programs.

Finally, sponsors should remember that minimizing fees isn't the primary objective. Neither ERISA nor the DOL expects sponsors to necessarily engage the low cost provider. Rather, ERISA and the DOL intend that the services that the plan and its participants receive should be reasonable and appropriate, given the fees that the plan pays. To meet these standards, the prudent plan sponsor should establish benchmarks for fees and services, and should periodically survey the market to ensure that selected vendors continue to be appropriate given changing needs and market dynamics.

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