

Determining Whether 401(k) Plan Fees are Reasonable: Are Disclosure Requirements Adequate?¹

Excessive fees levied on 401(k) plans can drastically reduce the size of a retirement nest egg. Plan participants are typically poorly informed about fees. A reform of the current regulatory framework is needed to provide them with the transparent and clear information necessary to understand the costs of different investment options.

Introduction

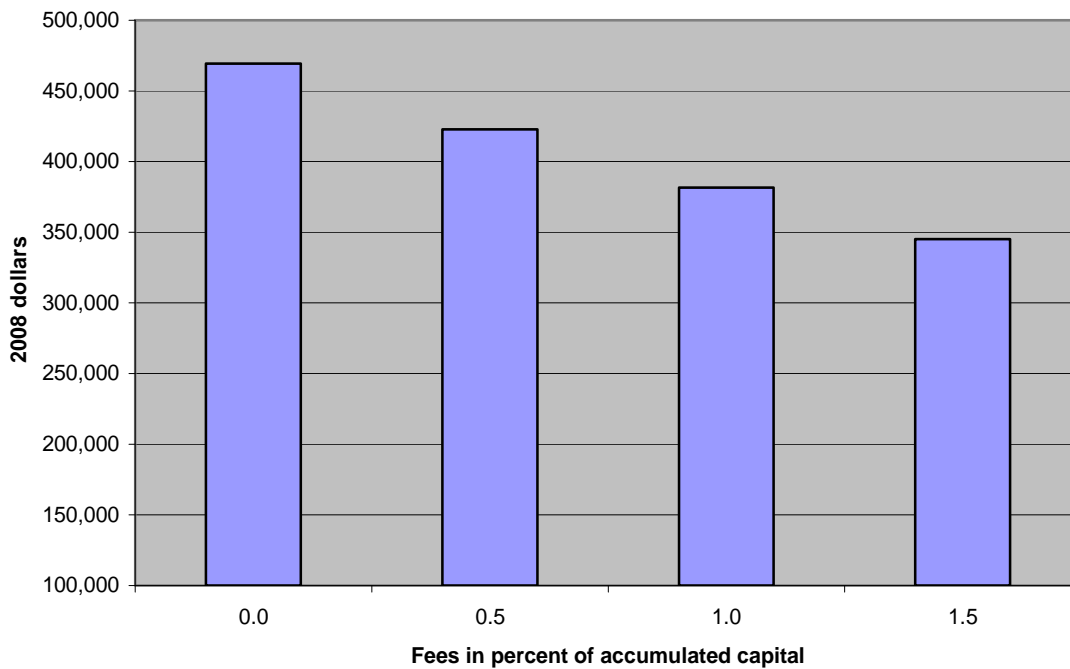
Whether the fees that 401(k) plans charge are fair or reasonable is a vital issue for working Americans and their families. The role of 401(k) plans in financing retirement eclipsed some years ago the role that traditional defined benefit (DB) pension plans used to play, and that role continues to grow. As a publication from AARP's Public Policy Institute illustrates, 401(k) plans are estimated to cover some 69 percent of the workforce that participates in an employer-provided plan, while the coverage of DB plans has shrunk to 31 percent (Mackenzie and Wu, 2008).²

For the sake of their retirement security, participants in 401(k) plans, in addition to making regular and sizeable contributions to their plans, must also earn a respectable rate of return on their investments. Excessively high fees can eat into the accumulating balance of a plan participant, and cause the income that the balance can sustain in retirement to be much lower than it should be (see figure). Excessive fees are also a concern for plan sponsors, who have a fiduciary duty to avoid choosing service providers (investment advisors and brokers, legal advisors, record-keepers, etc.) whose fees are unreasonably high.

Excessive fees can jeopardize retirement security even when financial market performance is satisfactory. In the example shown, a worker invests \$5,000 (in constant 2008 dollars) annually over a 35-year period, earning a constant annual return of 7 percent. After taking into account an annual inflation rate assumed to be 2 percent, the real annual return is 4.9 percent.³ With no fees—not a realistic scenario, but a useful benchmark—the worker accumulates about \$469,000 (2008 dollars) over 35 years. With an annual fee of 0.5 percent of the account balance, total accumulation declines to about \$423,000. With a fee of 1.5 percent, however, the total accumulation shrinks to \$345,000 after 35 years (see figure).

Making a sound judgment about the reasonableness of 401(k) fees may not be easy in any circumstances, but a necessary condition for such a judgment is clear and accurate information on the amount and composition of those fees. In fact, as this report will describe, information on 401(k) fees tends to be fragmentary and confusing. Even informed observers have difficulty tallying the total amount and composition of fees and, as discussed later, the results of a recent survey of 401(k) plan participants and a mountain

Effect of Fees on Accumulated Capital over a 35-Year Period



of anecdotal evidence demonstrate that most plan participants are poorly informed.⁴

This report has two main objectives. The first is to summarize what plan regulators and plan participants know—or do not know—about the fees that 401(k) plans charge in light of the current requirements for fee disclosure. The second objective is to review and comment on recent legislative and regulatory proposals that would require greater disclosure by both service providers (to plan sponsors) and plan sponsors (to participants).

The reporting demands that regulators now make of 401(k) plans fall considerably short of what participants need, both to understand the effect of fees on their rates of return and to make informed choices among different funds. Under the circumstances, it is not surprising that surveys find that plan participants are ignorant of the fees they

pay. More complete dissemination of 401(k) plan fees by plan sponsors might not dispel this ignorance, but it is a necessary condition for that to occur. The report explains why participants' lack of knowledge is undesirable, both from the point of view of their retirement security and even the efficiency of financial markets.

The report supports the kind of disclosure that several legislative proposals now before Congress call for. At a minimum, 401(k) plan sponsors should be required to inform plan participants at least once a year of the sum total in dollars of the various fees and charges that enrollees can expect to pay, excluding transactions costs. Transactions (trading) costs and charges for certain other activities or services cannot be estimated in the same way because they cannot be predicted accurately. However, realized trading costs should be tallied at least once a year and included in a retrospective

statement of the costs of each 401(k) plan account. Complying with this requirement should not prove onerous. If the plans wish to include further information (such as the fees paid to mutual funds and other service providers) they would be free to do so. Adequate and clear disclosure would put both plan sponsors and plan participants in a much better position to make informed decisions in their respective roles as fiduciaries and investors.

The Basics of Fees

The terminology and variety of 401(k) plan fees can be very confusing. The U.S. Department of Labor has identified no less than 17 separate charges. The high number is partly explained by the broad range of assets in which 401(k) plans may be invested. Nonetheless, fees can be grouped in four broad categories: administrative fees, investment fees, transactions fees, and other fees (mainly those for specific services).⁵ Fees may be expressed as a fixed percentage of a plan participant's assets, on a per capita basis, or in dollars per transaction. The most consequential of them (like investment fees) are usually expressed in percentage terms.

Investment fees include sales charges, investment advisory fees, so-called 12b-1 fees (sales fees for mutual funds) and surrender and transfer charges (for variable annuities). Some classification schemes include transactions fees with investment fees, because trading is closely linked to other investment activities. However, the role of trading costs in the total fees charged to a plan participant can vary substantially from plan to plan and even from participant to participant within the same plan, making a separate categorization desirable. The trading costs of actively managed funds (see note 4 for an explanation of this term) are higher than those of passively managed funds, because the portfolios of

actively managed funds turn over much more rapidly than those of passively managed funds.

A study of 401(k) fees by the Government Accountability Office (GAO) found that investment fees alone (in this case including trading costs) account for nearly all the fees that large 401(k) plans—those with 5,000 or more members—charge, and close to 85 percent for even small funds (U.S. GAO, 2006). Administrative fees shrink to a small fraction of share value when plans are large, a telling sign of the importance of economies of scale with these functions.

Under current arrangements, neither plan sponsors nor plan participants can be assured of receiving complete or comprehensible information on the fees that they pay. As a result, it is impossible to be specific about either the composition of 401(k) plan fees, their average value, or their variability across plans. The situation varies somewhat depending on the asset class in which plans invest, but in no case is it fully satisfactory. In the case of mutual funds, direct investors (this includes 401(k) plan sponsors, but not plan participants) get reasonably comprehensive information with their prospectuses or over the internet because the Securities and Exchange Commission (SEC), which regulates mutual funds, requires the funds to provide it. The information they report is sufficiently accurate to allow the fees that different funds charge to be compared.

Nonetheless, even with mutual funds, plan sponsors will not typically obtain information on trading costs—although other costs will be combined and presented as an expense ratio or a percentage of total assets. Plan participants, for their part—in addition to not receiving information on trading costs—will not necessarily know what

fees, if any, the plan sponsors themselves charge for any services they provide. Further, because the plan sponsor is not obliged to share the information with them, investors may not receive information on expense ratios. Putting together a complete picture of costs for a particular 401(k) plan is even more difficult when the plan includes investment options other than mutual funds. There is no such thing as a comprehensive study of the costs of 401(k) plans or particular classes of plan.

A 2007 study of expense ratios—which subsume investment fees, 12b-1 fees, and record-keeping and administrative fees (although not trading costs)—of mutual funds held in 401(k) plans finds that they are somewhat lower than the expense ratios for mutual funds as a whole (Investment Company Institute, 2007).⁶ The same study finds that expense ratios have declined over time, as have turnover rates for stock mutual funds in 401(k) plans (see table).⁷ This information may be indirect evidence for the reasonableness of fees, but it tells us nothing about the fees charged with other investment vehicles.

Statutory Reporting Requirements and Disclosure Practices

The unsatisfactory state of disclosure of 401(k) plan fees results in part from the fragmented regulation of both 401(k) plans and of the financial institutions that market and manage the asset classes in which participants invest. The regulatory oversight of 401(k) plans is shared among the IRS/Department of the Treasury, the Department of Labor, and the Pension Benefit Guaranty Corporation. The Department of Labor has responsibility for ensuring that the sponsors of 401(k) plans observe their fiduciary duties and act in the best interest of plan participants. Specifically, the Labor Department seeks to ensure that the fees paid to a plan’s service providers are reasonable and necessary; that the plans maintain diversified investments with a broad range of investment options for plan participants; and that they report certain information on arrangements with service providers.

The Department of Labor is not responsible for the supervision of the financial institutions that supply the assets of 401(k) plans. There are three

Asset-Weight Average Mutual Fund Expense Ratios, 1996 and 2006				
	1996		2006	
	401(k)	Industry	401(k)	Industry
Stock funds	0.84	1.02	0.74	0.88
Domestic	0.82	0.97	0.70	0.84
Foreign	1.14	1.32	0.97	1.05
Hybrid	0.79	0.95	0.64	0.8
Bond funds	0.71	0.93	0.56	0.68
High yield and international	1.07	1.17	0.86	0.95
Other	0.64	0.82	0.53	0.62
Money market funds	0.44	0.52	0.43	0.41

Source: Investment Company Institute, 2007.

groups of supervisory agencies involved in the oversight of these institutions: the SEC regulates mutual funds and brokerages; the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation (FDIC) have responsibility for collective investment funds; and state insurance regulators oversee guaranteed investment contracts (GICs) and other insurance products.⁸ The amount and type of information that these agencies require their regulatory charges to provide to investors differ. The SEC's standards are the most demanding, and the increase in the share of mutual funds in the assets of 401(k) plans that has been taking place since the inception of these plans may have been a force for increasing the information on the fees that plans disclose.

However easy it would be for 401(k) plan sponsors to disclose relevant data, the Department of Labor's current regulations do not give plan sponsors the power to require that service providers furnish comprehensive information on the fees they charge, nor do the regulations require plan sponsors to provide the Labor Department with a comprehensive reporting on the fees charged to plan participants and/or the fees paid by the plans themselves. Proposed new regulations, made public for comment on July 23, 2008, would establish more comprehensive requirements regarding the disclosure of plan information, including plan fees, by sponsor to participants. (Federal Register, 2008).⁹ Currently, however, the department's regulations require the transmittal only of partial information on fees to participants, and do not require a complete accounting of fees from plan sponsors for the department's own purposes (U.S. GAO, 2006).¹⁰

The limited information that 401(k) plan sponsors are required to provide to plan participants is in marked contrast to the

information that the SEC requires mutual funds to disclose to their investors. Participants of 404(c) plans (named after §404(c) of the Employee Retirement and Income Security Act (ERISA) but a type of 401(k) plan), which enjoy immunity from lawsuits by plan participants seeking redress after a poor financial performance, fare somewhat better than participants of other 401(k) plans do. The sponsors of these plans, in return for their immunity, must provide information on transactions fees, and on request, the expense ratio for each investment option. To meet certain requirements under §404(c), qualifying plans distribute prospectuses for each investment option. Because the prospectuses do not cover the entire plan, they cannot furnish plan participants with an aggregate expense ratio. Some plan participants might be able to derive an aggregate figure on their own, but those investors who are not financially literate might have difficulty with the calculation. Approximately 54 percent of 401(k) plans are classified as 404(c) plans, so that the participants in close to half of the total number of 401(k) plans will not have the right to even the partial information on fees that participants in 404(c) plans have.¹¹ Some of the 401(k) plans that hold mutual funds may pass on this information on fees even if they are not required to do so, but apparently many plans do not.

The transparency of fees is further compromised by the practice, said to be common, of one provider of services to a 401(k) plan furnishing free services to another provider in return for the right to provide services to the plan. For example, a broker (trader) may offer free information technology services to a mutual fund in exchange for a particular 401(k) plan account.¹² The plan sponsor should know what the plan is paying for a bundle of services—IT services, brokerage, and investment advice and

management—but may not know about the arrangement between the broker and the mutual fund. The lack of transparency of this arrangement entails the risk that brokerage will be more costly than it would be with an open, competitive arrangement.

Knowledge of Fees by Participants

In light of the limitations on the Department of Labor’s mandate for information from 401(k) plans, it would be surprising if plan participants had a good idea of the fees they pay. The AARP survey *401(k) Participants’ Awareness and Understanding of Fees* (2007) found that a lack of knowledge of fees among 401(k) plan participants was widespread. Notably, an estimated 65 percent of enrollees believed that they were not paying any fees. When told that fees were commonly charged in 401(k) plans, an estimated 83 percent of participants acknowledged that they did not know how much they were paying.

The survey also revealed that there was considerable ignorance about the structure of those fees, and about the effect of fees on the level of retirement savings. For example, about one in five participants thought that a difference in annual fees of one percentage point between otherwise identical funds would not have a big effect on their total long-term retirement savings. Two in five survey respondents confessed to not having a good understanding of how fees would affect how much they could accumulate for retirement.

Why Plan Participants Need to Understand Fees Better

Several arguments have been advanced that if the participants’ ignorance of 401(k) fees is not bliss, its harmful effects on financial security in retirement have been overstated. The first is that

plan sponsors are generally conscientious and carry out due diligence in selecting the range of investment options among which their plan members may choose. The second is that competition among financial providers has been driving down fees, at least the fees that mutual funds charge.¹³ A third argument comes from the investment community. It is argued that fees can only be understood “...within the context of the services [that participants] are receiving” and that overly detailed information could be confusing (American Benefits Council, 2007). For example, plan participants may pick their investment options solely or largely on the basis of the fees charged, without taking into account the extra services that above-average fees might purchase, the extra costs associated with investing in certain markets (e.g., emerging markets), or the additional investing acumen that higher fees might buy.

The argument from fiduciary duty overlooks the fact that even plan sponsors may lack full information on the costs of a plan, especially when they do not know of the existence of the arrangements between service providers. Moreover, the lack of awareness of plan participants of the fees they are paying must blunt the incentive of plan sponsors to carry out the due diligence that is part of fiduciary responsibility. Additional information in the hands of plan participants could and should make plan sponsors more responsive, and would increase competitive pressures. The fact that the money invested in 401(k) plans is mostly the participants’ may also weaken the plan sponsors’ fiduciary incentives. In any event, even the most conscientious sponsor has no direct control over a participant’s asset allocation, which can only increase the importance of full and clear disclosure to plan investors.

Some plan participants might fixate on costs, but this is not a problem that is unique to the financial industry. As one writer pointed out, pasting a nutrition facts label on processed food does not seem to have made the average American's dietary choices worse than they were already. In other markets, consumers seem to understand that although costlier is not necessarily better, "you tend to get what you pay for." The risk of such a misinterpretation of comprehensive and accurate expense ratios could be reduced by a requirement that the plans present information on the cost of competing plans of a similar asset composition, and by improved programs of financial education.

Arguably, if there is a marked difference between the fees charged by two U.S. mid-cap stock funds (i.e., funds that are invested primarily in the stocks of mid-sized companies) or between any two portfolios with a similar risk-return profile, that difference is a sign that the more expensive fund or portfolio is being inefficiently managed. Also, there would be nothing to stop a 401(k) plan with relatively high fees from including a detailed listing of the services it provides. Buyers of computers choose between more or less expensive versions of the same machine on the basis of lists of their features (and perhaps some additional research and word of mouth). Comparing like with like in this fashion would at least address the objection that comparing high and low expense ratio funds is similar to comparing apples to oranges.

Finally, adequate information on 401(k) fees need not imply drowning participants in a sea of details. Full disclosure of fees need not require a complicated statement. Many fees are a very small percentage of account balances. It is not necessary to have a complete accounting of every single fee that a plan participant pays to have an adequate overall picture of the

administrative costs of a 401(k) plan. Clarity is of the essence, as a recent letter from the House Committee on Education and Labor to the Employee Benefits Security Administration advised in commenting on a proposed set of regulations governing fee disclosure by service providers to plan sponsors: "The proposed rule must ensure that service providers provide all fee and expense information in understandable and prominently disclosed language" (U.S. Congress House Committee on Education and Labor 2008). The same dictum should apply to disclosure by plan sponsors to investors.

Recent Legislative and Regulatory Proposals

Several legislative proposals that address the disclosure issue have been introduced in the 110th Congress.¹⁴ All the bills require service providers to provide comprehensive information to plan sponsors, and require plan sponsors to provide comprehensive information to plan participants. The various proposals differ mainly in the extent of detail in the information they require of plan sponsors. The Department of Labor, as noted, is issuing regulations for plan sponsors, and has revised Form 5500, the reporting form for 401(k) plans to require more information from service providers.

All of the legislative proposals require plan sponsors to provide information on fees in some, but not exhaustive detail. The most basic information that plan participants need is a measure of what the plan costs them overall—the difference between the gross rate of return on the assets they hold and the net rate of return that, along with their additional investments in the plan, determines the rate of growth of their account balances. The difference between the gross and net rates of return to a plan's portfolio measures the cost of financial

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intermediation and the cost of the services that the plan provides. Investors deserve the information with a reasonable amount of detail on its composition. The additional information on fees that the proposals would require should be enough to give plan members an adequate breakdown of the fees they pay.

Compliance with these proposals would increase a plan's costs. However, once the reporting system was established, the periodic reporting costs would surely not be great. All of the information needed is available somewhere—the issue is putting it all together. The cost of assembling and processing the information, which would ultimately be borne by plan participants, would undoubtedly be outweighed by the resulting enhancement of their welfare.

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² See Mackenzie and Wu (2008) for more information. The share of participants with defined benefit plans includes participants with both types of plan, who account for 12 of the 31 percentage points of the share of DB plans. If the group with both types of pensions were included in the group with only a 401(k) plan, its share would be even higher.

³ The real rate of return equals $\{(1.07)/(1.02) - 1\} * 100$ percent = 4.9 percent. Taxation, which is deferred in the case of eligible contributions to 401(k) plans, is not taken into account.

⁴ The problems entailed by ignorance of the facts are compounded by differing interpretations of the significance of fee differentials across plans. For example, observers who believe that actively managed funds cannot outperform indexed funds—that an investor, no matter how savvy, cannot consistently beat the market—contend that *all* of the difference between the fees of an actively managed fund and the fees of a passively managed index fund of the same risk class are excessive. These observers believe that there is no point in investing in actively managed funds, because even if the extra fees reflect only the extra

costs of such funds, they buy no extra performance. An *actively managed mutual fund* is one where the managers select stocks for the fund's portfolio according to a strategy that they have devised to outperform the market average. The strategy might be to pick stocks that are undervalued according to fundamental analyses of the stock's worth, or it might be to make a choice by employing technical analysis (which tries to find predictable patterns in stock price movements without relying on a theoretical model of stock price determination). A *passively managed or index fund* selects stocks according to their weight in an index—the share of the stock's value in the total value of the stocks represented in the index.

⁵ U.S. Department of Labor (2004) discusses the different fees that 401(k) plans levy in some detail.

⁶ The expense ratios are lower not only for stock funds overall, but also for domestic stock, hybrid, and foreign stock funds.

⁷ Expense ratios are calculated as weighted averages of the expense ratios of the relevant group of funds, where the weights are the share of the assets of each fund in the total. In the case of 401(k) plans, the shares are shares in the total assets of the funds in the plans. Turnover rates are calculated by dividing the value of the shares sold in a specified period (usually a year) by the total value of the portfolio.

⁸ Collective investment funds are bank-administered trusts that hold commingled assets. The bank holds legal title to the assets, and participants are beneficial owners with an undivided interest in the whole of the assets (U.S. Comptroller of the Currency, 2005).

⁹ A revised reporting framework that will take effect next year will require fuller disclosure of information by service providers to plan sponsors.

¹⁰ Department of Labor regulations do not require plan sponsors to provide information on the investment fees charged by mutual funds. Plan sponsors have an incentive to demand this information from service providers, however, because a failure by the sponsor to review such information is a breach of fiduciary duty.

¹¹ Hutcheson (2007) contends, based on his experience as a plan auditor, that compliance with the disclosure requirements of 404(c) leaves something to be desired.

¹² See Forman (2007).

¹³ The ICI study previously referenced argues that the responsible behavior of plan fiduciaries and the competition among mutual funds has reduced the cost of mutual funds in general and those that end up in the portfolios of 401(k) plan members.

¹⁴ These proposals are H.R. 3185, sponsored by Rep. Miller, H.R. 3765, sponsored by Rep. Neal, and S. 2473, sponsored by Sen. Kohl.

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