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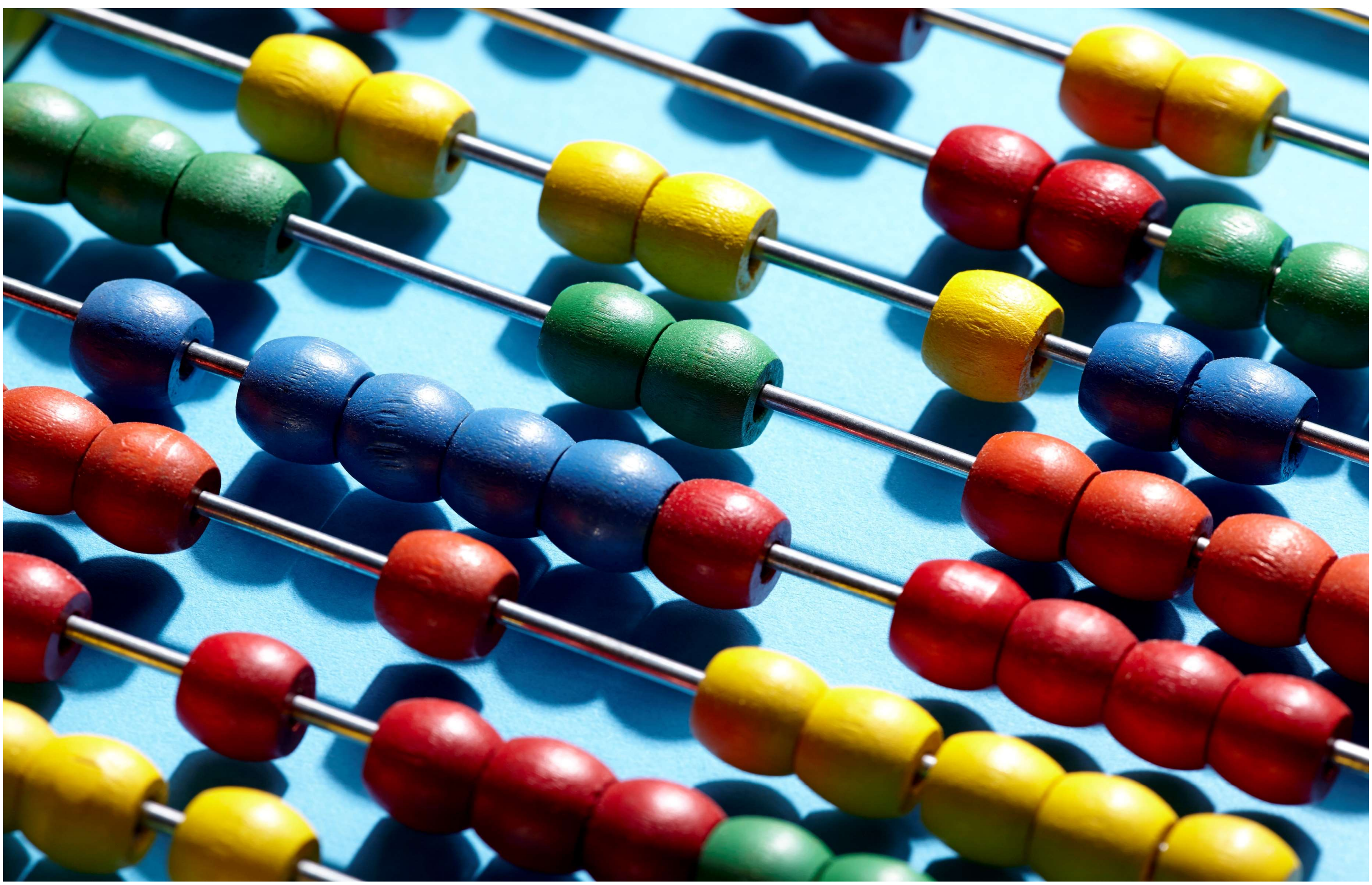
The Top Five

Hidden Fees

In 401k & 403b Retirement Plans



Top Five

Hidden Fees in Retirement Plans

Below is a list of the top five most common ways 401(k) and 403(b) recordkeepers "package" hidden and confusing fees into retirement plans. Those overseeing their company's retirement plan have a legal fiduciary responsibility to understand any fees their employees pay and determine if they are "fair and reasonable."

Step-one in determining if fees are “fair and reasonable,” is to identify all fees being charged to participant accounts. Often there is no invoice, so fees can go unnoticed for years or even decades. Fees would be found in a contract and in the ERISA required fee disclosures, 408(b)2 & 404(a)5.

Step-two is to compare those fees to what other providers are charging for a similar set of services. Cheapest isn’t always best, however when fees go unchecked employees often pay too much, and fiduciaries assume unnecessary liability.

Top Five Hidden & Confusing Fees in 401(k) and 403(b) Retirement Plans

1 Asset Management Charges (AMC)

Asset Management Charges (AMC), sometimes called Mortality & Expense (M&E) fees, are taken as a percentage of plan assets in addition to fund management fees. Some recordkeepers do a good job of disclosing these fees, however many do not. Since the recordkeeper already holds plan assets, these fees can be taken from employee accounts without a bill or invoice. These charges go largely unnoticed by employers and the employees who pay them.

AMC's can be 10X more than fund management expenses and can add up to $150,000+ over the career of an average employee[1].

Key Fiduciary Action: Plan fiduciaries should know if their plan has an AMC, M&E or other asset-based fee above and beyond the fund expense ratios for the investments in their plan. These fees, as with all participant-paid fees, need to be evaluated regularly (every 2-3 years) and determined if they are "fair and reasonable." Fee evaluations should be documented in the plan's fiduciary files.

2 Loaded Mutual Funds

Recordkeepers have worked with fund managers to package additional fees into the expense ratios of the funds offered within their products. One of the motivations for recordkeepers to use loaded mutual funds has been to offer products with low or no AMCs. Often the result is not a net fee reduction, just a shift in how they receive their fees. A plan with an AMC could have lower total fees than a plan with no AMC due to this expense loading of funds.

Many mutual fund companies have created multiple share classes of their funds, with the only difference between them being their expense ratios. For example, ABC Growth Fund might offer six share classes, R1, R2, R3, R4, R5 and R6. The only difference between the ABC Growth R1 and ABC Growth R6 might be an additional 1% in fees that are passed back to the recordkeeper. A 1% fee difference in a mid-sized 401(k) plan could add up to millions of dollars over a 10-to-20-year period.

It doesn't matter whether the fee is an AMC or M&E charged by the recordkeeper or an extra fund expense ratio levied by the fund company and passed back to the recordkeeper. All fees, regardless of their origin, should be accounted for and included in a total cost analysis.

Key Fiduciary Action: Know which share class of funds your retirement plan offers and how much revenue recordkeepers, TPA's and advisors are getting. This is an important (and required) step for employers in understanding total plan fees and determining whether they are "fair and reasonable."

3 Stable Value Subsidization

A growing trend of fee packaging is the use of a Stable Value or Guaranteed Investment Contract (GIC) to subsidize plan pricing. These investments are often included in a plan's fund line-up as the low-risk cash or money market option. If you have received a quote from a recordkeeper and the fee appears too good to be true, it's possibly because they are subsidizing their fees by adding extra revenue to the Stable Value or GIC investment option that they manage.

The issues with this practice are,

i. Stable Value/GIC subsidization is often not fully understood by the employer and almost never by the participants who pay these fees.

   and

ii. Employees with a higher allocation to the Stable Value/GIC account end up paying (subsidizing) a disproportionate amount of the recordkeeping fees for the entire plan. This isn't fair to those unknowing employees and creates a potential liability for fiduciaries.

Key Fiduciary Action: Understand the Stable Value or GIC option your plan uses and if it subsidizes plan administrative fees. Most recordkeepers offer a Stable Value option that does not disproportionately subsidize plan fees versus other plan investments, which would be considered a fiduciary "best practice." If participants are paying for administrative fees, they should be fairly allocated across all participants.

4 Proprietary Fund Requirements

Many recordkeepers also manage their own mutual funds. Profit margins for managing mutual funds is often significantly higher than for providing recordkeeping services, so there is a financial incentive to promote their use. Recordkeepers may offer a "free" 401k plan, but in exchange require the use of some or all their "proprietary" mutual funds. There is no “free” 401(k) or 403(b) plan.

Using funds for reasons other than their merits (i.e., performance, risk, management, expense, etc.) can increase liability for employers and those individuals overseeing the plan (fiduciaries.)

Additionally, when recordkeepers offer non-proprietary fund families on their platform, they sometimes offer more expensive (loaded) share classes than their own funds, creating an unlevel playing field for participants. Again, in this scenario, some employees would be subsidizing plan fees for others simply by the funds they chose, which is not fair to those unknowing employees and creates additional fiduciary liability.

Key Fiduciary Action: When choosing investment options for your plan, consider the funds based upon their merits and not whether their use will reduce administrative fees. When the lines are blurred on why funds are selected, fiduciaries can be exposing themselves to additional liability and employees to higher fees.

5 Managed Accounts

As recordkeepers look to generate additional fees, a common approach is to look for new ways to extract them directly from plan assets. This is because once these fees are in place, they go largely unnoticed by employers and the employees that pay them. No invoices are sent because the recordkeeper already has the assets and can simply deduct the fees from accounts.

Managed accounts are an emerging service that recordkeepers are promoting to clients to generate additional asset-based fees. They are commonly presented as an investment allocation service that creates and maintains a customized portfolio for employees. The service is often an algorithm (not a human “manager” or advisor) that considers the participant's age, income, assets, and risk tolerance (among other data points) to allocate the participant’s account across investment options within the plan.

While managed accounts can be a valuable service and an improvement over one-size-fits-all target date funds, their utilization comes into question when they subsidize overall plan administration fees. Managed account services often have fees that range from 0.30% to 0.70%, which may be 3X-5X the total administrative cost for the plan.

Once again, creating a plan that has some employees subsidizing recordkeeping fees for others is arguably not fair to those participants and exposes employers to increased fiduciary liability.

Key Fiduciary Action: Understand the fees within the managed accounts offered by your recordkeeper before adding them to your plan. Do they impact overall administrative and recordkeeping costs? If so, they may be subsidizing overall fees and you may want to reconsider their addition.

Author

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