Mutual Fund Update

The 401(k) Fee Fiasco

Peter C. Beller and Amina Khan 09.03.09, 6:00 PM ET

As mutual funds go, the Growth Fund of America wins high marks, both from rating firm Morningstar (which accords it four out of five stars) and from the market, where it has beaten the S&P 500 over the last 10 years. Many Growth Fund shareholders invest through company retirement plans, which enables them to avoid the sales charge the fund levies on the general public of as much as 5.75%.

A good deal? Maybe for owners of R6 shares, one of seven types of GFA shares in retirement plans (out of the fund's 14 total share classes). They pay a fraction of what workers at other companies must cough up in annual fund expenses.

Unfortunately for the millions of Americans who are counting on such accounts to fund their retirements, 401(k) plan fees are often absurdly high and next to impossible to uncover. Buried in plan literature are kickback schemes (in which fund firms pass on a portion of fees collected to the plan administrator in exchange for shelf space), custodial, advisory and record-keeping fees, transaction costs and innumerable other charges that few participants have any clue they're shouldering--or, in many cases, any ability to uncover.

Often, human resources executives are as ignorant about the true costs of 401(k) plans as rank-and-file workers. High, poorly disclosed fees are an especially big problem among smaller companies.

Now, for better or worse, Congress is getting in on the act with several bills purporting to reform the 401(k) market. All focus on improving fee disclosure. The most prominent legislation is sponsored by Rep. George Miller, D-Calif., and aims to force 401(k) plans to break down fees based on what they go toward, and to show participants how much they're paying, either in absolute dollar terms or as a percentage of their invested assets. Miller is also seeking to require that employees be offered at least one index fund that invests in stocks, bonds or a combination of the two.

"It will give Americans a fighting chance to strengthen their retirement," says Miller, who chairs the House Committee on Education and Labor.

To critics, improved disclosure of retirement plan costs appears long overdue. Under the Employee Retirement Income Security Act of 1974 (ERISA), employers have fiduciary responsibilities to oversee the plans and must provide workers with 401(k) plan summaries. Some list fees; others don't.

ERISA also requires plan sponsors to provide each participant with account statements, which typically include gross costs but little or no disclosure of where they end up. Employees are also supposed to receive annual reports listing plan expenses for their entire company; employers are not required to break down the cost of their retirement plans to individual employees, however.

The Government Accountability Office, the research arm of Congress, found that in order to get a clear picture of fees employees must request special documents, perform complicated calculations and even then would face a major challenge in coming up with numbers they can compare with those for alternative investments.

"You cannot, as a practical manner, easily determine the fees you pay in your 401(k) plan," says Mercer Bullard, a professor of securities law at the University of Mississippi and founder of Fund Democracy, a mutual-fund watchdog organization.

Rather than helping employees understand what they're paying, mutual fund companies and plan administrators have come up with some ingenious ways to skim off savings while obscuring which investments are expensive or perform poorly. Some plans do so by subtracting individual fees--such as for making short-term trades or borrowing against your own account--from ending balances without any indication you've been charged at all.

That means the only way an employee can come up with what he's paying is to work out the numbers--first by figuring the rate of return for his entire account and by calculating the difference between that and his ending balance.

Performance disclosure bears scrutiny too. Some mutual funds list historical performance without subtracting expenses, which can drastically overstate how much investors actually earned. Company-wide fees for record-keeping and custodial services are often not disclosed at all but instead bundled into aggregate fund expense ratios.

Supporters of this kind of disclosure argue that it shouldn't matter to employees where their fees are going but only how much they're paying in total. Critics counter that the lack of detailed disclosure provides plan administrators with a dangerous amount of latitude to operate plans in their own interests by, say, including only the funds that earn them the most profit, rather than a menu that best serves participants.

After fighting against added 401(k) disclosure for years, the mutual fund industry has come around, at least in part. Cynics might claim that's because it has seen the political writing on the wall and concluded that it will get off relatively easily, anyway, given that insurers, its main rivals in the 401(k) market, have so much more to hide.

Under the pending proposals from the House and the Labor Department, new hires would receive a list of 401(k) investment options, their objectives, expenses and past returns. Account statements would separately list the different charges. The largest cost for employees, what funds charge to manage their money, would probably still appear as a percentage of assets invested (Growth Fund of America's R6 shares, for example, charge 0.33%). However, plans would also be required to show in dollar terms how much that expense ratio would amount to for an employee with a hypothetical balance of $10,000 or some other figure.

The fund industry hasn't caved in altogether. It is continuing to fight Miller's proposal that it be required to offer all plan participants index funds, which tend to have lower fees, and thus lower profit margins, than actively managed alternatives. The industry is couching its opposition in the claim that 70% of 401(k) plans already include an S&P 500 index fund, which Miller's bill doesn't count as a broad enough stock market index.

Congress itself is unlikely to move on 401(k) reform until after plowing through the health care quagmire. Even then, some observers fear the result will be less than fully illuminating for mom-and-pop investors.

"A participant in the plan isn't going to understand the fees anyway," says Richard Kopcke, a visiting scholar with Boston College's Center for Retirement Research. To Kopcke and other experts, Americans are just too financially illiterate for anything but a basic line of index funds.

Finding out what you're paying right now is tough, but you can get a rough idea and learn how well your employer is looking after your interests. Start by adding up all fees listed in your account's quarterly statements. Get the annual prospectus from your employer (not from the fund's Web sites) for each fund in which you're invested and hunt down the expense ratios. Estimate your average balance in each fund by adding the starting and ending balances for the year and dividing the total by two.

Now comes the tricky part. Company-wide administrative expenses appear in the plan's annual report. You can ask your employer how that charge is divvied up among your employer and fellow workers. There's a good chance your human resources department won't be able to tell you and will instead refer you to your plan's outside administrator, who will probably defer to the annual report.

If the answer isn't forthcoming, you're best bet is probably to divide the total plan cost by the number of plan participants to estimate your personal contribution. If you are told there is no administrative fee charged to employees, it means your provider is including those charges in the funds' expense ratios.

If your plan's fees are too high, an appealing option is a self-directed brokerage account, which some employers allow for inside their 401(k) plans. The beauty of such programs is that they enable workers to opt out of the standard 401(k) fund menu and instead select from among thousands of other low-cost funds, or to own stocks and bonds directly. You'll still have to pick up some administrative costs, but it could save help you shave off most of the fees you're being charged.

Another alternative: Opt out of your 401(k) plan entirely. That's an increasingly sensible alternative, especially in companies that no longer match their employees' contributions.

See Also: