Written Testimony of

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on

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A Brief History

The 401(k) phenomenon is an accident in legislative history that has changed the face of America's retirement system. Voluntary pre-tax contributions from employees have generated substantial financial resources that provide a comfortable retirement for many. Considering the average American employee, early projections indicated that these plans would generate roughly five times the asset value at retirement than would have been received from the continuation of what was then a combination of qualified profit sharing, money purchase and defined benefit plans. Current statistics for the average employee who has been a participant for at least twenty years (and who is in their early 60's) support this original projection. The $3 trillion now accumulated in 401(k) plans offers a testimonial to their success.

The fact that pension laws have evolved to provide what amount to "portable" pension plans is critical in a country where the average employee changes jobs every seven years. The Bureau of Labor Statistics recently determined that the average employee born between 1957 and 1964 has had 10.5 different jobs between ages 18 and 40. Twenty-one percent of this group have had 15 jobs. Only fifteen percent have had fewer than four jobs. Those with college degrees had no better statistics regarding job stability than those without degrees.

To the extent that the traditional retirement plan system (that which preceded the 401(k) era) failed to meet expectations, its failure was largely attributable to the practical reality of employee turnover. Traditional pension benefits were designed to create a form of "golden handcuffs" with vesting schedules that rewarded only those employees who remained with a company long enough to become vested in their retirement benefits. In the early '70's, this could have required as much as ten years of service. A direct quote from President Reagan at the time was that he wanted to create "portable pension programs." Over 70% of working Americans work for companies having less than 100 employees. A large percentage of these employees work for companies with less than 25 employees. In the past, small, relatively unstable companies rarely offered traditional retirement plans when employer contributions were the only source of funds. Today, many offer some variation of a 401(k) plan or the small-company equivalent in the form of SIMPLE 401(k)'s.

The complicated laws requiring 401(k) plans to pass non-discrimination tests has compelled company owners and highly-compensated managers to spend time and money promoting plans to all rank and file employees. Without substantial contribution percentages from these non-highly compensated people, the managers were limited to contribution amounts below the legal maximums. This has prompted management to do everything in their power to promote the plans. Matching contributions, company discretionary contributions, employee meetings, individual financial advice and careful selection of investments are all a part of this promotional effort leading to the success of these plans.

Cost to Participants in General

The costs to 401(k) participants struggling to save for retirement is a detriment that has marred what would otherwise have been the unqualified success of the 401(k) phenomenon. Excessive fees, just over the past twenty years, have reduced participant account balances by an average of 15%. On a projected basis, excessive fees charged to participants will have reduced retirement "nest-eggs" by 20% according to a wide variety of organizations conducting research on the subject.

Understanding the Fundamentals of 401(k) Costs

Fees taken from plan assets to pay for administration and/or money management are paid with funds that could otherwise be earning and compounding on a tax-deferred basis. The "Magic of Compound Interest" works against employees to dramatically magnify the loss of these missing dollars. The business term for this condition is "opportunity cost" --- the calculated cost in dollars of a lost opportunity.

Example:

The best illustration of the cost of excessive fees is to project a flow of 401(k) contributions over time at percentage returns that reflect the difference of 1% (a typical amount of an "excessive fee.") Choosing $10,000 as an employee contribution amount is reasonable considering that we are looking well into the future. The median income today is $71,000 and the average contribution amount is 6-7%. In many cases, both members of a married couple are contributing, so $10,000 per year is not unreasonable. The returns for the American stock market have averaged 10% per year over a long historical period.

The Opportunity Cost of a 1% Excess Cost - $10,000 Annual Contribution

Percentage Annual Return	Account Value 10 Years	Account Value 20 Years	Account Value 30 Years
10%	171,178	641,491	1,925,836
9%	162,568	566,549	1,570,441
Cost of 1% fee	8,610	74,942	355,395

For the 20-year period through the 1980's and 1990's, the stock market averaged a 16% rate of return. Looking at what might be higher underlying rates of return going forward, the opportunity cost of the missing 1% is much higher. By 2000, many employees in expensive plans who had been participating for twenty years effectively paid the following amounts in opportunity costs as a result of high fees during that 20-year period.

The Opportunity Cost of a 1% Excess Cost - $10,000 Annual Contribution

Percentage Annual	Account value	Account Value	Account Value

Return	10 Years	20 Years	30 Years
15%	232,057	1,279,641	6,008,782
14%	215,656	1,079,734	4,541,874
Cost of 1% fee	16,401	199,907	1,466,908

After twenty years, this illustrates the actual cost for what might have been a single employee contributing $10,000 a year (or two people contributing $5,000 each) in the twenty years ending in 2000. Multiply these single-participant detrimental effects times the $3 trillion now in 401(k) plans and we can understand why the fee issue is critical.

Stop and recall for a moment the "Rule of 72" which states that money earning 7.2% doubles every ten years, and money earning 10% doubles every 7.2 years. Today's $3 trillion can be reasonably expected to double twice to $12 trillion in the next 14 years, thanks to reasonable investment returns and annual contributions. Excessive, undisclosed fees scheduled to cost participants as much as $2 trillion dollars is the problem we are here to try to correct.

Where the Abuse Begins

The greatest abuses are seen in the small-company environment where the average company owner is not a mutual fund or retirement plan expert. Large companies, by comparison, have reasonably sophisticated decision-makers. Xerox, for example, operated its own mutual funds and charged participants just 3/100ths of one percent per year. Participants in many small-company plans can be paying as much as 3 full percentage points --- exactly 100 times more for the same level of services.

Technically, all fees charged to participants are disclosed today to plan sponsor decision-makers, but not all fees are disclosed to participants. In the insurance industry, for example, the practice of non-disclosure was justified by the rationale that "fees didn't matter --- net investment results were all that participants needed to see." This was an actual quote from the marketing Vice President of a major insurance company when interviewed by MONEY magazine in 1998.

Fees charged to participants may be stated in the investment materials, but they remain effectively hidden on an ongoing basis because participants never receive a bill and never see a separate line item outlining what their costs, in dollars, have been.

According to FORBES magazine, the mutual fund industry is the world's most profitable as it earns a consistent 30% pre-tax profit. Investors are not fee sensitive because they are focused on returns. Generally this means "chasing last year's best performing mutual funds."

In today's seamless electronic financial services arena, the hard-dollar cost of administering a mutual fund with at least $50,000 is 6/100ths of one percent per year ---

approximately $30. Virtually all 401(k) plans are administered in pooled accounts where the investor is the plan itself --- not the individual employee. As a result, virtually all 401(k) accounts, on a fund-by-fund basis, meet this $50,000 benchmark, meaning that the profit on the account is anything beyond the 6/100ths being charged. If the average mutual fund charge in a 401(k) investment is 1 full percentage point per year, the profit on those accounts might be as high as 94%.

In all discussions regarding fees, we have to take as a given that no single mutual fund or fund family can show that that they have consistently earned a higher rate of return (to justify higher fees) for any sustained length of time. The money management industry is a "zero sum game" in which all players revert to the norm at some point. Moreover, even when we can review past performance, there is no way to know prospectively whose performance might compensate for an excessive fee going forward. Over longer periods of time, a difference in performance among funds of the same type can be largely attributed to the difference in their costs to investors.

How 401(k) Plans are Structured

Most 401(k) money is maintained today in a "daily-valued" electronic environment managed by the mutual fund or insurance companies themselves or the transfer agent industry that services the mutual fund industry. Plan participants can dial up their account information on an 800 voice-response number, but by far the most popular access is through the Internet. The raw cost of providing this seamless, electronic recordkeeping function is approximately $50 per year per participant. This is referred to as the "recordkeeping fee." It is the cost of maintaining the accounting of the participant's account.

Apart from the money management, there is the cost of complying with the layers of retirement plan regulations dictated by ERISA. This work is concentrated immediately after the end of every year when the discrimination testing must be completed. Later in the year, the government reporting form (Form 5500) for the plan must be completed and submitted. It is essentially a balance sheet and income statement for the plan. The cost of this compliance testing and administration is typically about $35-$60 per participant with a base company fee of $1,000- $1,500.

An Illustration of Fees in a Typical Plan

We can use an example a plan with 50 participants and $3,000,000 in assets. This is typical of an engineering or professional firm that has had a plan for twenty years.
The record keeping and compliance cost for these 50 employees should be roughly $130 per employee. If the true cost of money management is only 6/100ths of a percent, the money management cost for $3,000,000 would be $1,800. The total cost of the plan would be $7,800. By comparison, a typical vendor in the industry today would be charging an average of $36,500 for this plan. Some have scheduled fees that would amount to as much as $60,000 or 2% of assets.

While a plan sponsor (the company) might be happy to pay for the administration cost, it will never pay total fees of this magnitude. Asset-based money management fees will

always be charged to participants where they will be largely ignored. After all, no participant ever receives a bill or writes a check for these costs. They are automatically deducted from what would have been earnings --- or from principal in years when earnings may be negative.

Techniques that Obscure the Magnitude of Fees.
Having established that hidden excessive costs are a guaranteed detriment to optimizing savings results over time, it is generally easy to identify them when we know where to look. Some of the more difficult hidden costs, however, are those that are buried in the process and that will never show up in any stated cost to participants.

Non-disclosure at Participant Level in "Bundled Plans"
In the 401(k) marketplace, participants are told the annual expense ratios of the mutual funds offered by the plan, but administrative fees charged to their accounts are typically disclosed only in an annuity contract signed by the plan sponsor. This percentage amount is referred to as the "wrap fee" and it is typically one or two percent in a small company environment. The insurance industry is not legislated by federal laws, so the normal disclosure requirements demanded of the fund industry do not apply to insurance companies legislated only by state governments. In the mutual fund industry, the cost of administration, if presented as being "free," is usually imbedded in the expense ratios of the funds. Comparable funds, if not priced to support administration, could generally be found that would be less expensive for participants.

These plans that combine investment products with administration all provided by one company are referred to as "bundled" plans, and the providers of such plans are suggesting that "bundled" plans be exempt from any disclosure requirement to come out of these hearings. With what I estimate to be 70% of all 401(k) plans provided in this "bundled" format, making them exempt would emasculate any new disclosure requirements.

Mutual Fund Industry --- Proprietary Fund Requirement
In the mutual fund industry, the fees to participants are disclosed because they are the normal annual expense ratios of the funds. They are spelled out in the prospectus of each fund and today are universally summarized in the employee promotional literature. The mutual fund industry does not add a wrap fee. Instead, a company such as Fidelity will insist that at least half of the funds selected for the plan include their own proprietary funds. Remembering that the profit from a 401(k) account can be as much as 94% to the fund family, the insistence that at least half of the funds come from the fund family's proprietary list ensures that the plan will be profitable. A refinement of this technique is to require that the so-called "core funds" will be proprietary. These are the large-company or balanced funds that traditionally attract as much as 70% of the money in the plan. So, while the fund requirement based on the number of funds may only be half of the offerings, the percentage of employee money in those funds can easily be 70% or more.

The balance of the funds offered in the plan may come from other fund companies as part of an effort to create a “veneer of objectivity” for marketing reasons. These other fund families will typically be limited to just those funds that charge enough to pay the primary fund family 25/100ths of one percent and possibly some additional funds to buy “shelf space” on the “platform” offered by the primary fund family selling and administering the plan.

What does this practice cost the participant? No single fund family offers superior funds across the entire spectrum of the industry. Common sense would tell us that selecting from a vast universe of choices will generate better fund selection than a limited universe from just a single fund family. Here, we are selecting funds for the convenience and pricing demands of the vendor --- not with the sole purpose of improving the outcome for the participant. Knowing that this is the case explains why major mutual fund companies in the 401(k) industry refuse to be construed as fiduciaries of the plan. Selling their own funds would be a prohibited transaction and would violate the requirement that fiduciaries make decisions based upon the “sole interests of participants.”

In the sample plan above, (50 employees and $3,000,000) most vendors today would offer to do the administration and record keeping at no cost to the plan sponsor. A quick review of the arithmetic would explain why. Those administrative costs would have been about $7,000 and the plan is charging participants $30,000.

Barring the Exit --- Back-end Charges for Plan Sponsors who Want to Leave

The most egregious examples of excessive fees today are found in plans that are using share classes or annuity products that pay commissions up front and then have high ongoing fees to participants to offset, over time, the commission that was paid up-front. If a plan sponsor chooses to leave one of these plans there will be a “contingent deferred sales charge” otherwise known as a “back-end load.” Eventually, the load grades down and disappears after five to seven years, but in the meantime, the plan sponsor can not leave without subjecting participants to an exit charge that can be as high as 5% of their assets. Moreover, the law specifically bars a plan sponsor from paying that cost as a company expense, because plan contributions can only be made as a percent of compensation --- never as a percent of assets. These are the plans that can be charging participants as much as 3% per year. Once introduced, they are locked in by exit charges for at least five years.

The insurance industry and the subset of the mutual fund industry selling through the NASD brokerage industry are selling these 401(k) packages with back-end loads. The pure no-load sub-set of the fund industry does not offer this format. The back-end-load phenomenon occurs only in an environment where a mutual fund sales person or insurance agent requires a sales commission that has to be charged to the plan.

Funds as a “Feeding Trough” for the Brokerage Industry

As yet another example of a hidden fee, FORBES magazine published an article entitled, “ What’s the Matter With Brokers’ Funds?” The fact that these funds generate relatively poor performance is well-established, and the reasons have to do with two facts. The

article stated that "…the whole psyche of a brokerage firm is built around selling, not buying…Analysts at wire houses get ahead by helping underwriters, not by being skeptical." This is essentially saying that the brokerage-sponsored funds are used as a resource for investing in the kind of companies that the firm was underwriting. High turnover of assets in the funds also generated trading fees for the brokerage firm. I was once told by a Prudential-Bache retirement plan representative offering a "free" plan to a plan sponsor that "once we have the assets, we don't have to worry about making money." The FORBES article went on to say, "Another problem is that broker-sponsored funds tend to have steep expense ratios."

How an Expensive Plan Can Be Marketed

Thanks to the benefit of hindsight, a classic marketing ploy involves a presentation of funds from a new vendor candidate that have substantially out-performed the incumbent selection of the existing vendor. The current vendor, of course, is saddled with a selection of funds that were chosen three years previously in most cases. There are the problems of logistics and inertia that stand in the way of making changes in plans unless performance has fallen off a cliff. Of course, in this environment, a new set of fund choices will always look substantially better. The average plan sponsor rarely thinks to ask for examples of what the proposed new vendor's investment selections might be for a plan that they have operated for three years. There would typically be no improvement shown by this comparison.

This is symptomatic of how the consultants and marketing personnel in the industry can appear to be offering improvement when, in fact, they are simply rearranging the deck chairs and adding to the level of hidden fees in many cases. Representations of superior performance are a major tool used to take the focus away from participant fees.

Misinformed Decision-making on the part of Plan Sponsors

Section 404(c) is a U.S. Department of Labor regulation establishing requirements for plan sponsors that reduces their liability for making poor decisions with regard to the plan. Employees must be able to change investments and receive statements at least quarterly. They must be offered three basic fund types including a money market or guaranteed fixed income option. Finally, the plan must have a written investment policy statement, and employees should be provided with investment education (the latter being undefined and unspecified.)

Ironically, Section 404(c) proved to be a solution looking for a problem which then created a far more serious disadvantage for the employee participant. Since 1980 or the earliest days of the 401(k) phenomenon, virtually all plans offered quarterly statements and investment changes and a selection of different investment types. Remember that senior executives were major beneficiaries of these plans and they were inclined to want investment quality and flexibility. Virtually all plans operated under what was essentially an investment policy statement because decision-makers wanted decent investment choices for themselves.

The financial services community seized on Section 404(c) as the reason for hiring them to monitor the plan and therefore reduce liability. In fact, there was no practical liability for reasons having to do with 404(c). At industry conferences, lawyers were quick to point out that there were no lawsuits anywhere in the country brought by employees or groups of employees offered a selection of name-brand mutual funds and a rudimentary investment education and plan promotional effort.

The law of unintended consequences quickly created a "create the need" opportunity for the financial services community. An army of qualified and experienced "advisors" fanned out across the 401(k) Plan Sponsor community and talked about the potential liability of not using professional help and advice with regard to operating the plan. What this universe of advisors did not point out was that a.) there was no practical legal problem stemming from the way plans were typically being operated, and b.) the cost of this advisory service was going to be, at a minimum, one half percent to one full percentage point charged to plan participants--- a cost that guaranteed a loss of up to 20% of retirement assets for each participant.

Meanwhile, there have been some lawsuits successfully filed against plan sponsors. The first that I am aware of was against First Union Bank settled for $25 million in behalf of the bank's employees. The bank was operating a collection of mutual funds, (Evergreen Funds which they owned at the time) and these funds were charging bank employees substantially more than 401(k) investments the bank was selling to its bank customers.

In the same vein, the recent class action suits against Fortune 500 companies such as Caterpillar, Boeing, Kraft and International Paper are all centered on fees --- not a lack of reporting, investment choice or investment education.

Avoiding Compliance Responsibility

While the financial services industry has seized upon Section 404 (c) and the scare tactics it can foster, they have deliberately avoided responsibility for most of the other IRS and Labor Department Regulations that they should be upholding when representing themselves as providing 401(k) administrative services. A typical service contract will have hold harmless language such as "the design and ongoing operation of your retirement plan needs to be reviewed by your tax and legal advisors." The "bundled provider" contract of one of the nation's largest mutual fund companies says the company will perform the 401(k) test and coverage test, but all other tests are the responsibility of the plan sponsor. In effect, the financial services industry is saying that they will do the work, but they are not offering a guarantee that it will be done correctly or completely. A plan failing an audit can cost the plan sponsor a substantial amount of money in legal fees and corrective measures. In an indirect way, this misrepresentation could be construed to be a hidden fee. The average plan sponsor assumes that the major financial institution handling their plan has taken responsibility for its compliance with all government regulations. In my experience, however, the immediate response when compliance problems arise is the voice on the phone saying, "read your contract."

The Search for a Solution
To identify a solution, a process would involve working back from a perfect, if admittedly impractical, model.

Ideally, the best 401(k) plan would be one that charged nothing to the plan. All fees, even those associated with managing the mutual fund, would be charged to the company and paid with tax-deductible corporate dollars. A typical employee would be better off electing to have his or her taxable salary reduced slightly to help defray all or a portion of these costs. This would be far better than having the same costs deducted from plan assets that could be compounding on a tax-deferred basis.

Here's an actual example of that positive arithmetic. Over 800 dentists use a money management firm to manage retirement assets at their respective practices. The firm charges 1% of assets and routinely levies this charge against plan assets. In one actual case, I pointed out to a dentist that the firm was free to bill his practice for what, in this case was $15,000 per year on $1.5 million of assets. The net cost to the dentist billed directly, considering his 50% marginal state and federal tax bracket was $7,500. Instead, the dentist was paying that year's $15,000 with money in his plan that in 7.2 years (at a 10% annual return) would have doubled to $30,000. In 14.4 years, it would have doubled again to $60,000 --- in 22 years, $120,000 etc. Obviously, the dentist asked to be billed directly and then started wondering if 1% might be little high for mediocre investment management that failed to beat basic benchmarks. The financial services industry will always opt to bill the plan directly because they do not want fees to become an issue. The arrangement outlined above had persisted for over twenty years. The billing format had a projected cost for the dentist and his employees of well over one million dollars of opportunity cost--- a cost that was reduced to a fraction of that amount in future years with the stroke of a pen.

Xerox charged just 3/100ths of one percent to its employees. Vanguard, on large amounts of money, can charge as little as 6/100ths of a percent and still make a profit. DFA is yet another mutual fund company renowned for its Vanguard-equivalent low fees. These organizations offer mute testimony to the fact that it doesn't have to cost what most of the industry charges to invest pools of money. An oligopolistic situation exists thanks to buyers who are unaware of the impact of fees. With few exceptions, nobody in the financial services industry wants to see this condition change.

The Solution
A simple but impractical solution would be to bar any organization that manages money from actually selling and administering 401(k) plans. The industry selling plans would be barred from receiving any revenue-sharing from the money management (mutual fund) industry. This would end the hidden fee elements seen in the brokerage industry and mutual fund industry where the sale of 401(k) plans is an engine for selling proprietary funds and generating trading commissions. There are 3,500 third party administrators across the country today who are independent of major financial institutions and that perform recordkeeping services and compliance work for retirement plans. Some of these companies, such as Hewitt Associates and Milliman and Roberts,

are substantial and equipped to handle the nation's largest plans. Without this separation between product producers and 401(k) administration and sales, it is difficult to see how some of the more subtle examples of hidden costs can be avoided. Considering the foothold that mutual fund companies have in the industry, however, it is difficult to envision this as a practical solution. The horse is out of the barn.

The next option would be to have a national standard fee disclosure form required of any 401(k) presentation and require that it be renewed to reflect any change in investment mix. This standard would require that the cost in dollars and compound earnings over ten and twenty year time periods would be based upon the average fee charged to participants, assuming an even mix of investments across the entire spectrum of fund offerings. This would be stated on the front page of the 401(k) presentation and as part of the Summary Plan Description. In other words, a 401(k) vendor would have to show what the average opportunity cost would amount to over ten and twenty years based upon the average fee charged to a $10,000 per year contribution. It would be reasonable to assume a 10% rate of return as the starting point or gross return on investments assuming no fee. Fees would then be subtracted from this percentage amount, and the compound results would be illustrated. Using an average contribution of $10,000 per year would be simple (and inspirational.)

This comparison would illustrate the dramatic difference in costs over time between different vendors. It would offer a reality check for the average decision-maker who might otherwise have chosen a hidden-cost but expensive plan for his or her company. It is critical to require that the comparison use an example in dollars as I have suggested. To just require a stated percentage cost is too abstract. Even investment professionals have a hard time grasping the magnitude of opportunity cost presented by just a fraction of a percent in excess costs.

The Outcome and Benefit to Those Saving for Retirement
Saving fees increases retirement benefits, in the aggregate, by as much as 15%-20%. How can this not be important enough to enact disclosure standards demanded of every company in the industry? Decision-makers may still purchase expensive plans for their employees, but not without hearing from the "self-styled mutual fund experts" that manage to find a voice in every company. An army of retirement savers have now deposited $3 trillion in their 401(k) plans. They are rapidly becoming a nation of reasonably sophisticated investors. For the most part, they know how to diversify investments, and they have lived through the volatility of stock market performance. This is a clear case where the glass is half full. The financial services industry can be commended for getting us this far. Going forward, however, we can improve results by insisting on an educational tool (comprehensive cost disclosure) that the industry acting on its own is inclined to avoid.

Stephen J. Butler is the founder and President of Pension Dynamics Corporation, a third party administration firm designing, installing, administering and advising 401(k) plans since 1980. He has written two books, "The Decision-maker's Guide to 401(k) Plans"

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