Retirement Plan Expenses Uncovered

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The increased focus on mutual funds has caused an increased scrutiny on expenses in the entire financial industry. This increased focus has caused many plan sponsors and participants to take a closer look at their retirement plans and determine if areas exist for better services or cost savings. In an industry where the largest fees are hidden, determining actual costs can be a difficult task. According to a study by McHenry Consulting Group, it is estimated that each year there is $1.5 billion in transfer payments from mutual funds to retirement plan service providers and that 85% of the retirement industry revenues are not billed explicitly. Since many of the costs are asset based, as plans grow in assets, the revenue to plan vendors and investment managers can increase dramatically.

This paper will discuss:

> The types of costs that retirement plan sponsors generally or could potentially incur, allowing them the opportunity to go back to their vendors and review their own plan's costs.
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> The duty of plan sponsors to uncover plan expenses, identify reasonableness of the fees, and determine areas of potential cost savings.
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> The difficulty of determining these plan expenses, as fees can be challenging to discern.

The Attorney General of New York, Elliot Spitzer, first uncovered that many mutual fund companies were not acting in the best interests of their investors, allowing the market timing of their funds. The Securities and Exchange Commission (SEC) followed Mr. Spitzer and uncovered other questionable activities, such as late day trading and ethics violations. Retirement plans and their vendors also received additional scrutiny from the SEC and the Department of Labor (DOL). In late 2003, the SEC sent out questionnaires to the largest retirement plan vendors asking how mutual funds make their way onto the retirement plan vendor's platform and whether those funds that are paying the vendor are more likely to be made available on the vendor's platform.

Investment Costs

Mutual funds include built in fees and expenses. Expenses include management fees, legal/audit/professional, custody, postage, shareholder reports, insurance, directors fees, transfer/sub transfer agent fees, 12(b)1 fees and trading costs.. The mutual fund's net return is the gross return minus these expenses.

The expenses of different types of mutual funds can vary greatly. Institutional products have lower expense ratios than most retail funds, but retail funds are not all created

equally. Some “load funds” can be inexpensive if the load is waived, but other load products can be extremely expensive. That also holds true in the “no-load” arena. Some no-load fund products have very high expenses while others are low cost.

In addition, a fund’s expenses should be evaluated relative to others in its asset class. Generally, stocks are more expensive to manage than bonds, small stocks are more expensive than large stocks, and international funds are more expensive than domestic funds. Median mutual fund costs as calculated by Callan Associates are listed below (as of 12/31/2004):

Callan Median Expense Ratios

S&P 500 Index	Core Bond Style	Large Cap Value Style	Large Cap Growth Style	Small Cap Value Style	Mid Cap Value Style	Mid Cap Growth Style	Intl Equity Style	Small Cap Growth Style
0.50	0.63	0.94	1.01	1.12	1.13	1.22	1.27	1.39

In determining reasonableness of plan expenses, it is worthwhile for plan sponsors to review how their plan’s mutual funds’ expenses match up to these median expenses. If most of the funds are above median, this may be an area for further review.

Revenue Sharing

It is important to note that the amount of revenue sharing given by mutual funds to retirement plan vendors may be directly related to the size of the investment expense. That is, high cost funds typically pay more revenue sharing back to the retirement plan provider. The expense evaluation must be a “net” calculation after revenue sharing. Plan sponsors will need to determine whether a higher cost fund is actually cost-effective because the revenue sharing offsets administration costs, or whether it is better to use a lower cost fund and pay for administration separately.

When revenue sharing occurs, the retirement plan provider has a direct conflict of interest in recommending funds and developing the option array. The profitability of the plan to the provider can be enhanced greatly if the array is full of high cost, high revenue sharing products. Since revenue sharing is part of the retirement plan vendor’s compensation, it is important to look at whether the total compensation a vendor is receiving is reasonable, not just the out of pocket fees participants may be paying. Revenue sharing is negotiated independently between each mutual fund company and each retirement plan vendor, and it varies depending on the size and clout of the vendor. Plan sponsors would be advised to request from their retirement plan vendor a report to the plan about how much they are earning from both explicit fees and in revenue from each mutual fund on the plan’s investment menu.

Administration Costs

One of the costs associated with the ongoing operation of the plan is the recordkeeping/administration cost. Typical administration activities include: the plan level responsibilities of cashiering deposits and withdrawals; maintaining custody of the assets; participant recordkeeping and administration, participant communication/education/advice, and compliance testing. Frequently, these costs are covered through mutual fund revenue sharing or through proprietary product management fees, but may be paid directly by the participant. Paying these fees directly may be a less expensive choice than through revenue sharing. Plan sponsors should quantify and evaluate which method makes more sense for their specific situation. A retirement plan provider's approach to pricing generally includes average plan participant balances, design, operational complexities, and issues related to employee communication.

Plan administration charges can either be a fixed amount per participant (e.g. $10 – 50 person) or can be a percentage based on the assets in the plan (e.g., 0.05% - 0.55% of each dollar). Depending on overall plan size, characteristics and mutual fund revenue sharing amounts, this charge is highly negotiable.

Average account balances are the most important factor when providers are developing their pricing models. A small plan with few participants but relatively large average account balances can be very profitable to a provider, and may allow for service upgrades or fee reductions. Conversely, a large plan with many participants and a relatively small average account balance can be unprofitable to the provider. A plan that has more participants has many more investment changes, deaths, terminations, and divorces, which result in higher costs to the provider. Further, the more participants, the more the call center operators are utilized; the more communication meetings take place; and the more opportunities for error. The more the parts move, the less profitable the plan is to the provider.

Review and comparison in the area of administrative fees is vitally important. It is common to find situations where account balances have grown significantly (especially in the public sector where there is typically low employee turnover) and the profitability to the provider has increased as the amount of revenue sharing has increased with these larger account balances. Plan sponsors have the responsibility to monitor not only the fees of their plans but also the compensation of their vendors to make sure that they are reasonable. Many vendors are placing a limit on their fees and returning excess revenue above a “fair” amount to the plan to pay other plan expenses or share back with participants.

Contingent Deferred Sales Charges (CDSC)

A CDSC is a sales charge that participants pay when liquidating an investment before a contractual time period has expired. Historically, these charges were put into place as an incentive for investors to keep their money in a fund. Typically, there is a graduated scale and the sales charge is reduced over time (i.e., 5% charge for the first year, 4%

charge for the first through the second year, etc.). In some cases these charges apply to additional purchases of investments (i.e., additional payroll contributions) so that even if an initial investment has been in place for quite some time, CDSCs can be a factor if participants are purchasing additional shares through payroll contributions. CDSCs are often found in older contracts with insurance companies and typically not present in newer contracts.

Guaranteed Insurance Contracts

Guaranteed Insurance Contracts (GICs) may be the most profitable area to the plan provider. It may also be an area that is the most foreign to plan sponsors, making research and investigation difficult. An insurance company's typical compensation is the difference between the underlying fixed income portfolio yield and what they are paying the client. In many cases this spread can be anywhere from 0.50% to 2.5%, and is seldom disclosed. With the popularity of guaranteed investment products, the internal costs of these products are very important. Plan sponsors should request that providers fully disclose the portfolio yield, the interest rate that is declared on the account, and the profit the company is making on monies invested in these contracts.

Market Value Adjustments (MVA)

MVAs are associated with investments recorded by the investment manager at book value versus market value, so investors in these vehicles do not see any reduction in principal as the market moves. Typical names for these investments are Stable Value Products or Guaranteed Investment Products. When a plan sponsor terminates a vendor that has this type of product, a market value adjustment may be passed on to the plan sponsor or the participants. In other words, if the market value of the portfolio is less than the book value at liquidation, someone has to make the account "whole." Typically, if the MVA is large, the plan sponsor isn't going to force the loss onto participants. As a result, this type of product may link a plan sponsor to the vendor and significantly limit flexibility in replacing the vendor. However, liquidity in these products is improving due to increased competition, and many vendors are open to negotiating new contracts with the vendor taking on the risk of market value adjustments instead of the plan sponsor and participants.

Distribution Costs

Some plan administrators will charge for withdrawals (e.g., Roll-overs, Systematic Payments, Qualified Domestic Relations Orders (QDROs), etc.) from participant accounts. Until recently, the IRS did not allow the individual participant to pay for those costs and the cost had to be borne by the plan. However, that legislation has changed and many plan sponsors are taking the opportunity to amend their plan document to allow those charges to be directly passed on to the participant that created the charge. The plan sponsor still needs to make sure that these transaction costs are reasonable, but this may be a better way of assigning these types of fees.

Brokerage Windows

Brokerage windows offer plan participants the opportunity for greater investment flexibility outside the plan's core investment lineup through a brokerage account. These

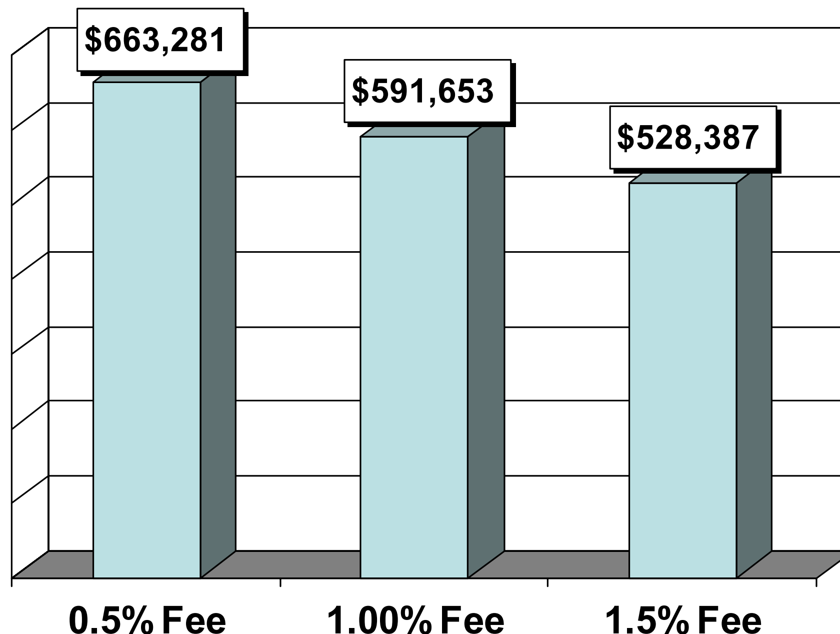
investments are typically mutual funds, but can also include individual stocks and bonds. Plan sponsors, in their fiduciary role, have the responsibility to monitor the costs of these brokerage windows. Typically the costs will include an annual administrative charge to administer the "window" and then transaction charges to purchase investments. Again, the reasonableness of these charges needs to be measured.

Investment Advice

Investment advice can take many forms including computer-based modules, face–to-face meetings, or a combination of both. As the newness of advice has worn off, costs have come down. Many vendors do not charge anything for the service. Others charge a minimal amount to each individual participant that uses the service. In addition to understanding the cost impact, plan sponsors need to focus on who is delivering the information and what is their motivation. Commissioned sales people delivering investment advice can be a recipe for disaster unless they are provided with strict guidelines and are monitored closely by the plan sponsor. Typical is the situation where a commissioned educator has sold outside products to participants, where participants saw the vendor as being sanctioned by the plan sponsor.

Conclusion

While monitoring and controlling fees in an industry with complex expenses is a difficult challenge, it is extremely important. The following graph illustrates the difference in an ending account balance for a participant contributing $4,000 per year for 35 years and earning an 8% return per year before fees. The only difference in each scenario is the amount of the fee being paid. The difference in this example between a 0.5% fee and a 1.5% fee is over $130,000.



The increased scrutiny of the financial industry and the subsequent disclosure of historically hidden payments between mutual funds and retirement plan vendors has allowed plan sponsors to calculate total plan costs and given them greater opportunity to perform their required due diligence in evaluating the investments offered within their plan. It is the duty of every plan sponsor to ensure that their participants are getting a good value for the cost.

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