# Muddy Waters

**A common industry practice masks the true cost of your 401(k) plan**

BY LYNN O'SHAUGHNESSY

401(K)

BACK IN THE GOOD old days, say 1999, when you could depend on your 401(k) statement to bring happy news, you probably did not give much thought to the costs of your plan—how much of your money gets paid out and to whom. That there's even a cost to individuals comes as a shock to many workers, says Ted Benna, president of the 401(k) Association, who created the original 401(k) plan more than two decades ago. "Most people think that their 401(k) is free," he says.

Still, you'd expect the corporate managers attending a conference sponsored by *Pensions & Investments* newspaper last year in California to thoroughly understand the nuances of their companies' 401(k) plans. But during a panel discussion on revenue sharing—a common but little-known industry practice—your confidence would have begun to waver.

The low point came during the Q&A period, when one of the presenters, a mutual fund executive, blurted out, "This isn't new. Everybody knows about revenue sharing." Alan Valenca, an industry consultant who was sitting in the audience, said the crowd's reaction was immediate. "All the plan sponsors were looking around at each other with quizzical expressions," he recalls.

If the concept of revenue sharing mystifies the HR types who oversee our 401(k) plans, it's no surprise. The financial industry, which manages the nation's $1.64 trillion 401(k) program, has never felt the urge to publicize these arrangements. But whether the corporate managers entrusted with running your plan realize it, the practice of revenue sharing could be inflating costs and jeopardizing employees' ability to adequately save for their retirement.

Critics suggest that revenue sharing masks the true costs of corporate 401(k) plans, making it extremely difficult to determine whether the expenses—which workers shoulder largely on their own—are reasonable or outlandish. And few participants understand that revenue sharing compels workers with higher balances to pay hundreds or even thousands of dollars more in annual fees to subsidize an office's lousy savers.

On the surface, revenue sharing seems innocuous enough. The term refers to the industry's practice of using cash generated by 401(k) investment fees to cover the costs of many, if not all, of the other services that a workplace retirement program demands, from recordkeeping to those enrollment meetings held in corporate cafeterias. (This practice is similar but not identical to the mutual fund industry's "revenue sharing" described in "The Fund Industry's Dirty Little Secret," March 2002.)

The cash comes from the 401(k) participants. Money is automatically withdrawn from their accounts. Ostensibly, workers are paying for the professional money management of their assets. Most individuals have sunk their retirement money into mutual funds, so typically

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cavernous super warehouse, you receive a discount. Buy a case of wine, you expect a discount. But when a corporation selects a financial institution to manage $25 million, $100 million or, heck, $15 billion in retirement assets, you can often forget it.

Paying full fare wasn't always the norm. When 401(k)s were new, some major corporations used institutional money managers to oversee the assets. Sometimes, the same institutional shops that managed a corporation's pension funds assumed responsibility for the 401(k) money, too. Institutional money managers generally charge a fraction of the prices that retail funds demand, so as a consequence, employees paid rock-bottom prices for professional investment, which allowed them to hold on to more of their retirement savings.

In the early days, workplaces often picked up the tab for all the other costs, but that began to change as plan sponsors (i.e., employers) increasingly relied on retail mutual funds to absorb the costs of servicing the accounts. In return for retail-size fees, paid by participants, the mutual fund firms either picked up some or all of the administrative tasks—and costs—previously borne by the boss, or jobbed them out to a third party.

As assets have exploded in the 401(k) pipeline over the last two decades, some industry insiders have questioned the continued heavy reliance on retail mutual funds rather than institutional investment choices, especially for companies with hefty assets and high average account balances. Some corporations, like IBM, do rely on institutional managers for their plans. An IBM worker pays an average expense ratio of a mere 10 basis points for funds managed by

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it's the expense ratio of each fund that dictates how much a worker's account gets dinged. (A wrap fee—an annual fee on account assets—may be added on top of that.) According to the Securities and Exchange Commission, the average retail mutual fund today maintains an expense ratio of 1.36 percent. So someone with a $100,000 balance in an account stuffed with average-priced funds would owe, for the year, $1,360.

Under the revenue-sharing approach, a 401(k) mutual fund gathers the money generated by the expense ratio and pays off the investment management tab. The provider then disperses excess cash to cover other bills. In this pooled arrangement, the revenue or "soft money" is shared by the various parties—plan recordkeepers, marketers, service providers, and others—that are entitled to a cut. (If the mutual fund is within the same company as the plan provider, as with a firm like Fidelity, it will, in effect, dispense money to itself for recordkeeping and other services.) On the surface, this practice may appear logical and fair. After all, what you're paying often covers far more than the expenses of the portfolio managers because there are additional costs to 401(k) plans. Look below the surface, however, and you'll discover some potentially troubling developments.

Revenue sharing can discourage cheaper investment alternatives. It exists because many employees are paying retail for their 401(k) funds. Considering the scale of business that a Fortune 1,000 firm can generate, for example, this might seem strange. After all, when you buy 100 rolls of toilet paper at a

such institutional players as Deutsche Asset Management and State Street Global Advisors. The nest eggs of employees who pay such prices enjoy a greater chance of growing dramatically larger. Compare two individuals, each with $100,000 account balances, who contribute $11,000 annually to their 401(k)s for 20 years. Each account earns an annualized 10 percent return. One is charged a 1.36 percent expense ratio and the other is charged 0.1 percent, or 10 basis points. After 20 years, the first employee's portfolio would be worth $1,089,240. But the portfolio of the second worker would have grown to $1,343,167, a $253,927 difference.

Industry insiders, who often view revenue sharing as neither a good nor bad practice, maintain that employees like investing in brand-name funds that they can track in the newspaper. They also contend that the revenue-sharing phenomenon has encouraged far more companies to offer 401(k)s because it's pushed the costs onto the workers' shoulders.

But revenue sharing makes cost accountability difficult, since companies don't have much financial motivation to grill 401(k) vendors about the fees they charge. Consequently, there are not enough inquisitive executives pulling back the curtain to determine whether the fees their employees absorb are reasonable for the services being provided. This is a crucial exercise because, critics argue, revenue sharing, which is predicated on asset-based pricing, can create a disparity between expenses and compensation. As assets grow, so does the revenue generated by fees, even if expenses remain fairly static.

For instance, the cost to provide recordkeeping and related services to the average participant is about $150 a year, according to McHenry Consulting Group, a Berkeley, California, pension plan adviser. But if a plan's assets balloon from $20 million to $50 million and the costs of recordkeeping pretty much stay the same, doesn't that mean a boatload of extra cash is being pocketed by somebody? "Within the 401(k) industry, as assets continue to grow, there is a strong argument to be made that we are paying more for the servicing of these accounts than needs to be paid," says Donald Trone, a consultant, who is also president of the nonprofit Foundation for Fiduciary Studies in Pittsburgh. "Of course, that translates to less money for the participants."

Fund industry supporters counter that it's impossible to reduce a retail fund's expense ratio for major 401(k) clients, even if economies of scale warrant it, because federal securities laws prohibit funds from giving discounts to special customers. But Walt Bettinger, president of Charles Schwab Corporate Services, suggests the argument is bogus, because they could still create a special fund class to accommodate 401(k) accounts. "Fund companies have been very happy to create a plethora of funds that have higher and higher expenses," he adds. "They can create fund classes with lower costs, but there has to be a motivation."

Another problem is that revenue sharing encourages conflicts of interest. Because costs are bundled, employers don't typically see a breakdown of expenses. Yet if costs were routinely itemized, some of the expenses might attract as much attention as a purple elephant. A potential showstopper is the fate of the money generated by something called the 12b-1 fee. The 12b-1 fee, which Morningstar estimates is embedded into 62 percent of all mutual funds, was originally created to primarily help small retail funds with marketing costs so they could attract attention in the overloaded market place. Today, 401(k) plan providers and vendors routinely use the 12b-1, which can go as high as 100 basis points, to pay intermediaries, such as brokers, who

have brought them new clients. In some cases, the yearly compensation that a broker pockets for just one fortuitous referral can reach into six figures. And this lucky person will be entitled to that yearly windfall as long as his or her fund selections remain cemented in a workplace plan.

Consultants hired by companies to advise them on which plan to choose dip into the same cookie jar. A consulting firm may ask a potential 401(k) provider for "due diligence" money so it can investigate the candidate's worthiness, says Ward Harris, a consultant with McHenry Consulting Group. In another scenario, a consulting firm could encourage a potential 401(k) provider to help sponsor a professional conference on a cruise ship or at a resort. An employer, who is paying a consulting firm to conduct a search for an ideal 401(k) provider, may have no idea that its consultant is simultaneously receiving goodies from the 401(k) funds.

Meanwhile, a fund company will use 12b-1 fees to compensate a 401(k) vendor for including its funds in a workplace's 401(k) menu. Today's investors are no longer happy with a straight party ticket of, say, strictly American, Fidelity, Putnam, or Vanguard funds. They expect variety. But often a fund firm won't be invited to join the lineup unless it's prepared to pony up money to the vendor, observes Alan Valenca, a senior vice president with Walker MacRae, a New Hampshire firm that identifies and recaptures revenue-sharing money for employers.

With money being paid to brokers who sell certain funds, consultants who recommend them, and providers who carry them in their programs, a worker might wonder if his 401(k) funds are the best of the bunch, or simply the ones with the deepest pockets. "Plan sponsors need to know why certain fund families were included and some were excluded," Valenca says. "It quite often comes down to dollar-and-cents revenue sharing." Noting the sums of money fueling the industry, Trone suggests that companies could be vulnerable to lawsuits by not keeping expenses to a minimum. Department of Labor regulations prohibit excessive 401(k) compensation. "Having a finder walk away with hundreds of thousands of dollars every year just for nailing an introduction, that's the kind of thing that a jury or a judge will grasp," Trone says.

Revenue sharing also penalizes diligent savers. Whether you have $250,000 stashed in your 401(k) or $250, you receive the same level of services. But the high-balance participants foot a stiffer bill for identical benefits. For example, in an average-priced fund with an expense ratio of 1.36 percent, somebody with a $250,000 balance would pay $3,400 for that year's investment costs. In contrast, a worker with a $2,500 balance would owe $34. "In some people's view, this is a form of taxation," Harris observes. "You're taxing high-balance employees to subsidize low-balance employees. What bothers me is when you don't tell people they're being taxed."

The alternative? A workplace could embrace inexpensive investments, such as institutional or index funds that would not spin off tons of extra cash for other expenses. To compensate, the employer (preferably) or the employee would pay a flat rate for administrative costs. In this scenario, everyone pays his or her own freight. Some experts suggest this might discourage poorly paid workers from participating. But with a flat rate, the more employees save, the more they keep. And the shadowy world of high fees and revenue sharing hurts all 401(k) participants. "We've been horrified by the billions we've lost in retirement plans to companies like Enron, but it pales in comparison to what we lose every year from the unintended mismanagement of 401(k)s," says Trone. ■

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## *What's a Worker to Do?*

Are your 401(k) fees insufferable or inscrutable? Some steps to take:

**1.** Get a copy of "Revenue Sharing in the 401(k) Marketplace, Whose Money Is It?" for yourself and your employer. The report, by the McHenry Consulting Group, provides an overview of the good, the bad, and the ugly in the industry. You can download a lengthy summary of the report for free from the firm's Website at www.mchenry-consulting.com.

**2.** Urge your employer to get a better handle on 401(k) costs and explore cheaper alternatives. There is movement in the industry to provide detailed accounting for all those fees. That's a first step toward shrinking costs. The Vanguard Group and Charles Schwab provide breakdowns of expenses and revenue sources to plan sponsors. Walker MacRae (www.walkermacrae.com) is one firm that helps corporations identify revenue-sharing money and pinpoint exactly where it is going.

**3.** Seek a voice on your company's investment committee. This is the group making the decisions about the 401(k) plan. If you work for a small employer, it's likely no committee exists. In fact, companies near the bottom of the corporate food chain are more likely to pick plans based on personal relationships, such as the boss's stockbroker or insurance agent.

Gerry Mullane, a principal at Vanguard, says that the dismal performance of the stock market has prompted more 401(k) plan sponsors to ask tough questions. "We have seen a trend in the last six months of people taking a closer look at their programs, what they are getting and what they are paying, and whether there's a better way to do it." —*LO*