Final Report

Pension and Welfare Benefits Administration

STUDY OF 401(K) PLAN FEES AND EXPENSES

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SECTION I

INTRODUCTION AND BACKGROUND

This study was sponsored by the Office of Policy and Research of the Department of Labor's Pension and Welfare Benefits Administration. The purpose of the study is to examine the incidence, structure, and magnitude of fees and expenses charged to sponsors of and/or participants in 401(k) plans. It encompasses issues and information addressed at public hearings held by the

Department of Labor on November 12, 1997.

The findings of this study include a description of the various mechanisms used to provide administrative and investment management services for 401(k) plans. The study describes differences in fee structures faced by plan sponsors when they purchase services from outside providers. Where possible, the study describes the range of expenses resulting from those fee structures, including differences in costs by size and type of investment as well as plan size. The study is limited to a review of the available literature and secondary data sources, not original survey research.

SIGNIFICANCE OF 401(k) AND OTHER DEFINED CONTRIBUTION PLANS

Employer-sponsored retirement plans customarily are classified into two major categories: defined benefit and defined contribution. In defined benefit plans (DB), the employer promises to pay specific benefit amounts to retirees who meet certain eligibility criteria. In its most typical form, a DB plan pays a lifetime monthly benefit to retirees who fulfill specific age and service requirements. Benefits are usually linked to the amount of service and based on final average salary. Employees during their careers, and as they approach retirement age, can reasonably rely on a known and expected benefit level; although protection against post-separation inflation is usually limited and/or uncertain. The plan sponsor may also provide an alternative lump-sum "cash-out" of the defined benefit entitlement. Until relatively recent times, the DB was the dominant form of employer-sponsored retirement program.

The most recent data show that approximately 41 million private sector active, retired, and separately vested workers are covered by defined benefit plans (U. S. Department of Labor, Pension and Welfare Benefits Administration). These plans are funded by investments that in 1996 totaled $1.7 trillion dollars. The Employee Retirement Income Security Act (ERISA) mandated the creation of the Pension Benefit Guaranty Corporation that monitors the funding of DB plans and insures their obligations (subject to certain maximums) through premiums paid by plan sponsors.

In defined contribution (DC) plans, the employer uses a tax-deferred qualified plan to invest employer and/or employee contributions. The terminating employee receives the proceeds in a current or deferred lump sum or annuity. Since the benefit is not defined, the retirement outcomes are not known in advance. This study deals with DC plans established in part under section 401(k) of the tax code.

In 1978, section 401(k) of the Internal Revenue Code authorized the use of a new type of DC retirement savings plan for the benefit of employees of most private firms. 401(k) plans offer advantageous tax-deferred status to employee and employer contributions.

401(k) plans have proven to be popular with employees for several reasons. The tax deferral is obviously high on this list of reasons. Others include the increased portability of this plan, employer matching contributions, and the increased control associated with self-direction of investments (Fink). As a consequence, the plans established under section 401(k) have been a major factor in the restructuring of employer-sponsored retirement benefits during the 1980's and 1990's.

The advent of the 401(k) plan, coincident with changes in employment patterns and increased Federal regulations of DB plans, influenced a decline in the relative importance of DB plans to the retirement income security of American workers. The absolute number of workers covered by DB plans has been in the range of 39 million to 41 million since 1983 (EBRI Issue Brief 190); however, the growth in the size of the labor force has resulted in a substantial reduction in the percentage of workers covered by DB plans. (The percentage of full-time workers covered by DB plans in medium and large firms declined from 63% in 1988 to 54% in 1995.) (Bureau of Labor Statistics, July 1997) Further, the number of firms offering DB plans has shrunk, and the incidence of DB plans in small and medium firms is low.

There has been a corresponding increase in the importance of defined contribution plans to retirement income security. Assets held by DC plans totaled $1.2 trillion in 1996, and it is estimated that they will grow at a rate of 20-22% annually for the next five years (Access Research).

For participants in 401(k) plans, the level of fees and expenses may affect the potential growth of retirement account savings. At issue is whether the wide range of 401(k) plans' administrative and investment management fees that has been observed substantially erode the size of account balances for retirement age 401(k) plan participants in some plans (Wang, April 1997; Rowland)? Furthermore, when fees and expenses are paid by an employer, the issue is a concern for stockholders. However, the study will demonstrate that a substantial portion of 401(k) plan fees and expenses are charged against the account balances of plan participants and that this trend is increasing (Hewett Associates, 1997).

Expenses of operating and maintaining an investment portfolio that are debited against the participant's account constitute an opportunity cost in the form of foregone investments in every contribution period. The laws of compound interest dictate that these small reductions in investment are magnified greatly over the decades in which many employees will be 401(k) plan participants. Observers have concluded that some plan providers are charging as much as 100 basis points in fees and expenses over the prevailing average rates (Benna; Butler, November 12, 1997). The effect of such higher levels of expenses would be to reduce the value of potential future account balances for these participants.

An example in *Forbes* Magazine shows this effect. Two employees each contribute the same amount annually into mutual funds. The funds each return 9% annually, but one has an expense ratio of 0.2% while the other has an expense ratio of 1.2%, a difference of 100 basis points. At the end of 35 years, the less expensive fund has a balance 23% higher than the other (Baldwin).

Some observers postulate that some plans are paying fees and expenses that are too high. Evidence for this conclusion is offered by studies that show extraordinary variance in price quotations given by providers for essentially comparable services (Wang, April 1997; Butler, November 1997). It has been argued by these observers that, when a plan incurs higher fees and expenses, the plan sponsor has not exercised adequate care in selecting and monitoring the plan's service providers.

A second issue of concern to many observers is that sponsors (and participants) lack adequate information on the structure and extent of fees and expenses to make informed choices about service providers and investment options. Thus, the inadequate disclosure of information may be a factor in the existence of the large variance in fees and expenses of 401(k) plans.

This study reviews available data and analyses regarding the level and structure of 401(k) plan fees and expenses. It is important to know more about how these plans operate, how much they cost to administer, and how costs are paid, in general and among various segments of the universe of plan sponsors. The scope of this study does not allow for original survey research, the study relies on existing sources of data for information about the relative levels of fees and expenses being charged to 401(k) plans. The study will seek to answer the following questions: What is the range of fees and expenses being charged to 401(k) plans? To what extent are the costs of administering and managing 401(k) plans being passed on to plan participants, as opposed to being paid by plan sponsors? To what extent is information about fees and expenses being disclosed to plan sponsors and participants?

SECTION II

CHARACTERISTICS OF 401(k) PLANS

2.1. INTRODUCTION

The structure of fees and expenses borne by 401(k) plans and their magnitude are dependent in part on the nature of these plans, their features, assets, and the organizational arrangements plan sponsors choose to manage them. This section will offer an explanation of the characteristics of 401(k) plans. The following issues will be discussed:

- To what extent are 401(k) plans used?

- What features are found in typical 401(k) plans?
- 401(k) plan investments
- 401(k) plan asset holdings
- How is the administration of 401(k) plans structured?
- Who are the providers of 401(k) plan services?

The popularity of 401(k) plans results almost entirely from their origin in the tax code in 1978. They offer both employees and employers the ability to defer current income from federal and state income tax liability. This tax deferral increases the magnitude of funds available for investment. (There is a ceiling on the amount of before-tax deductions that an employee can elect to contribute to a 401(k) plan each year. This ceiling is adjusted periodically to reflect rising earnings. In 1997 the ceiling was $9,500. In 1998 it is $10,000.) Employee contributions are matched in many firms by employer contributions, by a percentage formula as a share of the employee's contributions or through a variable profit-sharing basis.

These funds, which include the deferred taxes and employer matching contributions, are invested in a variety of instruments that provide compounded earnings until the participants' accounts are distributed. The effect of compounded earnings, applied to the deferred taxes and employer contributions, provides a substantial leverage to the employees' contributions and a substantial incentive to participate in this retirement plan. Generally, upon separation from service, employees may withdraw the proceeds of their accounts in a variety of modes. If done in conformance with the tax code, these withdrawals are then taxed at ordinary income tax rates in the years received.

2.2. TO WHAT EXTENT ARE 401(k) PLANS USED?

Between 1975 and 1993, the number of qualified private sector DC plans rose steadily from 208,000 to 619,000 (U.S. Department of Labor, Pension and Welfare Benefits Administration). Over the same period, the number of private sector DB plans rose from 103,000 in 1975 to 175,000 in 1983, then began to decline sharply to a total of only 83,000 plans in 1993. Thus, DC plans increased from 67 percent of private sector plans in 1975 to 88 percent of plans in 1993. Undoubtedly the emergence of 401(k) plan options in the 1980s played a major role in the general expansion of DC plans.

During the same 1975-1993 period, the number of participants in private sector DC plans increased from 12 million to 44 million (U.S. Department of Labor, Pension and Welfare Benefits Administration). The number of participants covered under DB plans rose from 33 million in 1975 to 40 million in 1983. This number then fluctuated modestly from 1983 to 1993, within the range of 39 million to 41 million.

Of particular interest is the extent to which a DC plan is the only

employer-sponsored retirement plan. In these instances, the growth potential of employees' accounts, and the effect of fees and expenses on that growth, are especially significant for future retirement income security.

The General Accounting Office compiled important historical findings based on Department of Labor analysis of IRS Form 5500 data. Among all private sector employers sponsoring single-employer pension plans, the portion sponsoring *only* a DC plan increased from 68 percent in 1984 to 88 percent in 1993. Of all participants covered under these plans, the portion covered *only* by a DC plan rose over the same period from 27 percent to 45 percent.

More detailed data illustrate that this overall trend toward sole reliance on DC plans extended widely across different categories of employers. The table below shows the movement toward DC plans from 1984 to 1993 among employers of different sizes.

Table II-1

Employers Sponsoring Single-Employer Retirement Plans

% of Employers Offering only a DC Plan

Number of Employees	1984	1993	Change
2-9	69.0	88.8	+19.8
10-24	73.6	91.2	+17.6
25-49	71.1	91.6	+20.5
50-99	67.8	91.8	+24.0
100-249	58.4	88.9	+30.5
250-499	51.7	84.1	+32.4
500-999	40.7	78.7	+38.0
1,000-2,499	27.2	62.4	+35.2
2,500-4,999	24.4	52.6	+28.2
5,000-9,999	12.6	52.0	+39.4
10,000-19,999	18.2	47.4	+29.2
20,000-49,999	13.5	33.5	+20.0
50,000 or more	12.0	54.7	+42.7

(Source: GAO, 1996)

As these figures demonstrate, the prevalence of sole reliance on DC plans continues to be strongest among smaller employers. However, the general growth of the DC-only practice spans all employer sizes. It reflects an especially dramatic shift in retirement plan sponsorship among larger employers, where the movement toward DC plans is recent and significant. The broad reach of the movement toward sole reliance on DC plans is also evident when employers are categorized by industry.

Table II-2

Employers Sponsoring Single-Employer Retirement Plans

% of Employers Offering only a DC Plan

Industry	1984	1993	Change
Agriculture	77.9	88.2	+10.3
Mining	64.0	82.4	+18.4
Construction	72.2	92.3	+20.1
Manufacturing	56.8	82.5	+25.7
Transportation	63.1	88.5	+25.4
Communications and Utilities	44.6	71.1	+26.5
Wholesale Trade	68.7	89.7	+21.0
Retail Trade	72.8	93.4	+20.6
Finance, Insurance, Real Estate	61.7	83.4	+21.7
Services	70.5	92.5	+22.0
Tax-Exempt Organizations	44.9	58.2	+13.3

(Source: GAO, 1996)

These findings indicate, again, that the general movement toward sole reliance on DC plans is pervasive throughout the U.S. retirement system. Defined benefit plans continue to play a substantial role. However, the extent to which a DC plan is the only source of employer-sponsored retirement income, is significant and growing.

GAO reported an interesting pattern within this overall growth of DC plans. Only three percent of all private sector employers sponsored both a DB and a DC plan in 1993. This low overlap would seem to suggest that the growth of DC plans represented a virtually universal use of DC plans among newly established private sector firms, coupled with some substitution of DC plans for prior DB plans among older, established firms (U. S. General Accounting Office).

However, the GAO also found that among employees offered any retirement plan at all, 43 percent were covered under both a DB and DC option. This fairly high figure, compared to the three percent of employers offering both options, indicates that the combined use of DB and DC plans is concentrated among a relatively small number of larger, older firms.

In general, this rapid growth in the use of DC plans has been particularly significant among newer, smaller, and non-unionized private sector firms. Conversely, DB plans continue to have a substantial presence among older, larger, and unionized firms. DC plans also have become somewhat more common among public sector employers, although government retirement systems still retain a strong DB orientation.

The universe of DC plans includes both taxable and tax-deferred plans. According to Access Research, the number of qualified 401(k) plans was

228,000 in 1995, the last year surveyed (Barneby). These plans contained approximately 22.3 million participants. The larger plans may contain most of these participants; however, the majority of 401(k) plans are offered by some of the 1.8 million small (less than 100 employees) companies in the United States (Richardson, May 1996).

2.3. WHAT FEATURES ARE FOUND IN TYPICAL 401(k) PLANS?

The specific design features of 401(k) plans vary widely within a generally universal plan structure. Virtually all plans are based on particular employer choices spanning several major plan elements. The following highlights are drawn from recent studies of employer-provided or employee benefit programs (Buck; Foster Higgins; HayGroup; Hewitt, Willette).

The HayGroup survey data capture a wide range of information about benefit design practices from 1,043 respondents, 723 of which reported sponsoring a 401(k) plan. The survey encompasses detailed features of plan design. The Hewitt survey captures 401(k) plan practices and trends among 460 employers as of the summer of 1997. The plans in the Hewitt survey include about 2.8 million participants and total assets of $177 billion. The Buck report reflects the practices of 668 respondents offering 401(k) plans. Data collection occurred in June and July of 1997. Almost two-thirds of the survey respondents were firms with 1,000 or more employees.

The Foster Higgins report includes responses from 743 organizations surveyed in June 1996. While the Foster Higgins report includes some DC plans without a 401(k) feature, 90 percent of the respondents provided 401(k) plans. For employers offering multiple savings plans, responses were based on the largest plan, and for 86 percent of the responses this was a 401(k) plan.

In a recent survey published November 24, 1997 (Willette), *USA Today* reported on the key plan design features of 401(k) plans among the 100 largest U.S. employers. Through an initial questionnaire and subsequent follow-up consultations, this survey provides a full and consistent snapshot of current practices among the very largest 401(k) plans.

2.3.1. Eligibility Age. Among employers reporting a minimum age for 401(k) plan participation, the age range was from 18 to 21. The mean was 20.6 years, suggesting that age 21 is the most prevalent age minimum.

2.3.2. Eligibility Service. Employees generally cannot begin contributing to a 401(k) plan until they have fulfilled some minimum period of service with the employer. In the HayGroup survey, the range of reported service requirements was from one month to three years. Most employers require service waiting of six months, nine months, or one year, and the mean service requirement was 10 months. Willette reported that 32 of the 100 largest plans allowed immediate eligibility, 51 required a one year waiting period, with the remaining 17 imposing

a waiting period of less than a year.

2.3.3. Maximum Employee Contribution. Under the IRS annual deferral limit, all 401(k) plans have a maximum dollar limit on employee contributions in any given tax year. Additionally, the overwhelming majority of employers incorporate plan-specific maximums, usually in the form of a uniform maximum percentage of each employee's compensation. The Buck 1997 survey reported that about two-thirds of plans have a uniform percentage limit for all employees. Among these plans, the limits usually fall in a range from 10 percent to 16 percent of pay. The average limit in the 1997 Buck survey was 13.9 percent. Willette found that among large plans, contribution ceilings vary widely, but are predominantly clustered in the range from 15-17 percent of pay.

2.3.4. Employee Contribution Subject to Employer Matching. The most common form of employer contributions in 401(k) plan takes the form of "matching" contributions, usually structured as a certain portion of the employee's contributions that is then matched at a certain percentage rate. Within the HayGroup database, the employee contribution subject to matching varies from one percent to 20 percent of compensation, with a mean of 5.5 percent. Five and six percent are the most common matchable ceilings, and the means across various employer size groupings fall within a narrow range from 5.3 percent to 6.2 percent. Willette's findings are comparable for the largest employers. Of the 100 plans cited, 43 provide matching on up to 6% of pay, 11 on a larger portion of pay, and 25 on a smaller portion of pay. The remaining 21 have no matching or match through profit-sharing formulas not directly related to the amount of employee contributions.

2.3.5. Matching Contribution Rate. The second part of the matching formula, the percentage rate applied, differs widely. However, the mean reported matching rate was 62.3 percent of the employee's contribution. Again, the mean values for different employer size groupings are fairly uniform, ranging from 53.3 percent to 65.0 percent. The vast majority of employers provide a matching contribution somewhere in the range from 50 percent to 75 percent of the employee's contributions. Combining the average matching rate with the average ceiling on employee contributions subject to matching, the average total match available is slightly more than 3 percent of compensation.

2.3.6. Number of Investment Options. Within the HayGroup survey, over 90 percent of respondents indicated that they offer employees four or more investment options for their 401(k) savings accounts. Foster Higgins reports an average of 7.7 investment options in 1996, more than double the average number offered in 1990. There is, among very large employers, evidence that this trend is continuing upward. Of the 100 largest plans, the median number of investment options is seven. However, 26 of the plans offer 10 or more investment options, with one plan reporting 137 participant choices. In addition, six of the plans offer self-directed brokerage options within the plan, effectively providing thousands of stock, bond, and mutual fund choices to their

participants.

A recent General Accounting Office report expressed the concern that employers in recent years have been expanding the number of investment options. While this development may offer employees greater freedom in constructing their plan portfolios, it raises the issue of whether offering more funds makes the typical plan more expensive to administer. Adding new investment options — or frequently changing the available options — could increase administrative expenses in such areas as information and education services, open season administration, valuation of assets, processing of inter-fund transfers and preparation of account balance statements.

2.3.7. Opportunities to Shift Investments. Another plan feature that can affect administrative expenses is how frequently employees can change the allocation of their 401(k) accounts among the available investment options. There is a strong trend toward offering participants the opportunity to shift investments on a daily basis. The 1997 Hewitt survey reported that 64 percent of plans allow daily investment transfers, up from 41 percent in the 1995 survey. In the Buck 1997 survey, 61 percent of plans offered daily transfers.

2.3.8. Valuation of Assets. Among 296 respondents to the HayGroup survey who reported on their valuation procedures, there was a fairly even distribution among daily (28 percent), monthly (30 percent), and quarterly (38 percent) valuation of assets. It would seem that the more frequent the valuation of assets, the greater the associated administrative expenses. However, the use of mutual funds as plan investment options — with the costs of daily fund valuation already spread over many mutual fund investors — may reduce the extra marginal cost of offering more frequent asset valuation.

2.3.9. In-Service Loans and Withdrawals. The availability of in-service loans and withdrawals adds another category of administrative expenses, in the form of program communication, loan and withdrawal processing, collection of loan repayments, and tax-reporting requirements. According to Foster Higgins, 81 percent of plans have a loan provision, 90 percent allow in-service withdrawals in cases of financial hardship, and nearly two-thirds allow non-hardship withdrawals. Within the HayGroup sample, 91 percent of all respondents indicated that they limit in-service withdrawals to cases of documented financial hardship. About 82 percent permit employees to receive loans from their accounts. In another survey, Hewitt discovered that, in 1995, an average of 20% of plan participants had an active loan (Hewitt Associates). Foster Higgins estimated that about 4% of plan assets are in outstanding loan balances. Employers may face a double-edged sword in this area. On the one hand, loans and withdrawals make the plan more complicated and potentially more expensive to administer. They may also have the long-term effect of reducing employees' ultimate savings for retirement. On the other hand, the availability of loans and withdrawals may induce some employees to begin contributing, continue contributing, or contribute more over time.

2.3.10. Communications Services. Plans typically employ a range of information-sharing devices to improve employees' understanding of the 401(k) plan. Most employers view these devices as worthwhile for their positive effects on plan participation, contributions levels, and investment allocation decisions. Foster Higgins reported the following use of several key mechanisms: summary plan descriptions, 97 percent; newsletters/brochures, 91 percent; fund prospectuses, 88 percent; personalized statements, 86 percent; employee meetings, 91 percent; and integrated voice response systems, 61 percent.

The above are among the most important plan features in terms of their possible effects on plan administrative complexity and associated administrative expenses. It is clear that the growth in the numbers of options that employees and employers demand in their 401(k) plans, together with the reporting and recordkeeping requirements that sponsors must provide, are important factors in the magnitude of administrative costs. An important goal of the study is to capture and analyze available information regarding the variations in administrative costs that these plan features may generate.

2.4. TYPES OF 401(k) PLAN INVESTMENTS

Access Research estimated that the assets of 401(k) accounts had a total 1996 value of $675 billion (Barneby). The Investment Company Institute, the trade association of the mutual fund industry, has separately estimated this value to be $857 billion (Reid and Crumrine). The average account balance in 1996 was reported to be $32,000, with over 1.9 million individual accounts of $100,000 or more (Barneby). How are these funds invested?

- The typical 401(k) plan offers participants the choice of a variety of investments, and in many plans this choice includes investments from differing categories of financial instruments. (The selection of investment instruments influences the magnitude of fees imposed on 401(k) investment accounts, as will be discussed further in Section III.) Listed below are these investment choices. This is followed by a discussion characterizing these investment choices.

- Mutual Funds

  -- Retail Mutual Funds
  -- Mutual Fund Windows
  -- Institutional Mutual Funds

- Stable Value Accounts
- Company Stock
- Money Market Funds
- Self-directed Brokerage Accounts

The allocation of funds in 401(k) plans, as measured by a 1997 RogersCasey survey, is shown in Table II-3.

Table II-3
Allocation of assets in 401(k) Plans (End 1996)

Type of Investment	% of All 401(k) Plan Assets
Equities	47%
Bonds	4%
Balanced	13%
Stable Value Accounts	19%
Company Stock	10%
Money Market Accounts	5%
Self-Directed Brokerage Accounts	1%
Other	2%

(Source: RogersCasey, 1997)

This distribution may not be an absolute indication of employee preferences among these investment options, because not all plans contain all of these investment choices. For example, in 1995, 95 percent of DC plans contained an equity mutual fund option while only 59% contained a stable value account option (Foster Higgins, 1996).

2.4.1. MUTUAL FUNDS

In a **mutual fund**, contributions to the plan are used to purchase mutual fund shares on the same basis as an individual investor would buy the fund shares. These mutual funds may be retail funds, available to the general public and whose prices are quoted daily in the financial press or institutional mutual funds, available to a limited set of investors.

Mutual funds are pools of financial instruments that may include stocks, bonds, commercial paper, cash, and other instruments. Shares of mutual funds are bought by investors, including 401(k) plans. The shares represent an undivided common interest in the pool of investments. The share holders benefit by receiving the earnings of the investments in the form of additional shares and by a capital gain when the shares are redeemed from the mutual fund.

In 1996, for the first time, mutual funds became the largest segment of assets held in 401(k) plans, constituting just over 40% of asset value (Foster Higgins). However, for several years the inflow of funds to mutual funds had been greater than to other investment options. The shift of investment by 401(k) plans into mutual funds has been dramatic, increasing from 5% of assets in 1990

to 40% in 1996 (Reid & Crumrine).

2.4.1.1. Retail Mutual Funds

Mutual funds are marketed to a wide spectrum of investors including individuals. Mutual funds may be categorized by the type of underlying security — equity, bond, or mixed — and by the investment objective. Investment objectives are often expressed, at least in part, in the terms of the risk-return considerations. The following table illustrates the range of retail mutual funds that are likely to be found in typical 401(k) plans (Sheets, 1996).

Table II-4
Typical Mutual Fund Categories

Underlying Assets	Investment Objective
Stock Funds	Aggressive Growth Long-Term Growth Growth and Income Sector International/Global
Bond Funds	High Quality Corporate Junk (high-yield) Government Mortgage Securities

The distribution and marketing of mutual fund shares is governed by the Securities and Exchange Commission (SEC) which prescribes how expenses of the fund must be disclosed. These expenses are expressed as an annual ratio of expenses divided by total assets. The expense ratio is debited from shareholders' assets as compensation for the fund's investment management services.

Retail mutual funds are widely advertised, and their expense ratios are published weekly in the financial press. About 80% of 401(k) mutual fund assets are in retail funds (Wang, April 1997). Expenses of retail mutual funds vary widely according to investment objective, whether or not actively managed, category of instruments held, sales commissions, and other criteria. The range of expenses in funds likely to be found in typical 401(k) plans begins at 20 basis points for the least expensive index funds to over 200 basis points (*Fortune*, December 23, 1996).

2.4.1.2. Mutual Fund Window

A recent development in the design of 401(k) plans is the addition of an

option allowing participants to chose from a larger variety of funds. The mutual fund window provides access to one or several families of mutual funds. The mutual fund window can be either the sole investment vehicle for all options, or it can be one of many options within an array of investment offerings. In 1997, 3.7% of plans offered access to a mutual fund window, according to one survey of plan sponsors (Buck Consultants).

Fees and expenses for mutual fund windows are similar to those for other mutual fund options, and they will likely be the retail expense ratio.

2.4.1.3. Institutional Mutual Funds

Many of the larger financial service providers - banks, mutual fund families, stock brokers, or insurance companies - offer sets of mutual funds that are bought by institutions and are not available for sale to individuals. Among the purchasers of institutional funds are 401(k) plans, other DC plans, and the trustees of DB plans who might buy institutional mutual funds to fund their defined benefit liabilities.

Institutional mutual funds resemble retail funds. They display a similar range of investment objectives and may invest in similar ranges of securities — equities, fixed income, large capitalization versus small, U. S. versus international, etc. However, they are not sold through broker/dealers, and their performance is not generally displayed in the financial press.

Institutional mutual funds typically charge lower expense ratios than do the retail funds with similar holdings and risk characteristics. One estimate is that the typical institutional fund has an expense ratio that is 50 basis points lower than comparable retail funds (Wang, April 1997).

Larger 401(k) plans often obtain some savings in their investment management expenses by taking advantage of a type of institutional mutual fund known as the **commingled account**. In this arrangement, a set of established investment vehicles is available to a pool of participating plans. These institutional funds are similar to retail mutual funds, in that they typically reflect a range of broad asset allocation objectives. Many of them are provided by the major retail mutual fund families. Other major providers include the trust departments of larger banks and insurance companies.

However, these funds are only sold to larger investors, including 401(k) plans. Investment in any of the investment vehicles within the commingled account typically requires a minimum investment of $1 million to $2 million in the commingled account (Hack).

Very large plans can achieve even greater investment management savings by establishing **separate accounts** for their 401(k) assets. In such an arrangement, the sponsor can define its own investment objectives and target

portfolios. The investments are administered either through an external investment manager or in conjunction with the sponsor's DB plan investment apparatus.

Separate accounts require substantial minimum investments of $15 million to $25 million per account. However, large plans typically, with total assets of over $500 million, can realize substantial savings through such instruments. Total investment management expenses can commonly be reduced to one-fourth of the expenses incurred through retail mutual funds (RogersCasey).

In general, direct use of retail mutual funds or the provider's institutional funds is the most common investment arrangement among smaller plans, those with assets of $50 million or under. Mid-sized plans, those with assets of $50 million to $500 million frequently add commingled accounts. Finally, separate accounts are found among very large 401(k) plans, those with assets over $500 million (Hack).

2.4.2. STABLE VALUE ACCOUNT

Stable value accounts represent the second largest class of holdings by 401(k) plans after mutual funds, constituting 19% of 401(k) assets in 1997 (RogersCasey). These contracts represent a claim on the future investment earnings of the seller's investment portfolio or on a segregated group of the assets in this portfolio. Stable value accounts include guaranteed investment contracts (GICs), typically offered by insurance companies and bank deposit accounts (BDAs). The investor in a stable value account receives a guaranteed rate of return over a specified period of time, typically three to five years. The yield on a stable value account is comparable to that of a high quality fixed income investment. In 1995 the average net return on GICs held by DC plans was reported to be 6.5% (Foster Higgins).

Stable value accounts are appealing to investors who are risk adverse. This investment shields the purchaser from the credit and interest rate risks to principal that would be assumed by the purchase of a fixed income mutual fund. These instruments also have low rates of return compared to the historical long-term returns on equities, and particularly compared to the recent performance of equity investments. The trend in recent years has been for increasing percentages of 401(k) contributions flows to be directed to equities rather than stable value accounts and other fixed income investments (Foster Higgins).

Administrative fees and expenses placed on GICs and BDAs are typically not disclosed directly to the purchaser. Investment management fees and distribution charges are incorporated into the computation of the guaranteed rate of return. Thus, there typically is no disclosure of these expenses to the sponsor nor to the participants (Hack).

When stable value accounts are provided by a full service provider from an outside source, there will be a separate charge to the plan for recordkeeping. This is typically a fixed charge.

2.4.3. COMPANY STOCK

Company stock may be an investment option for employee contributions to 401(k) plans. (However, some analysts view company stock as potentially very risky for an employee saving for retirement, since it represents a narrow, undiversified investment option and links future and current income to the same source.)

One survey of plan sponsors showed that 37% of plans offered this investment option in 1997 (Buck Consultants). In 1996, 9% of the assets of DC plans were invested in company stock (Foster Higgins). A 1997 survey of 401(k) plans reported 10% of total assets invested in company stock (RogersCasey). Company stock is also typically offered as part of the employer contribution to the plan or in a combined 401(k)/profit sharing arrangement. In 1997, 21% of the 401(k) plans making matching contributions provided company stock or a combination of stock and cash as the company match.

The bundled service provider typically charges a recordkeeping fee to plans that includes company stock as an investment option. These fees are charged in a variety of ways: per-capita charge, fixed fee, fixed fee plus per-capita charge, or stock commission.

2.4.4. MONEY MARKET ACCOUNTS

Money market accounts are actually mutual funds that invest in short term (typically 90 days or less), fixed income securities. As such, they are often considered as cash equivalents. In the unusual conditions prevailing in the mid-80's, with an inverted yield curve, these accounts were widely used as prime investment instruments. However, in recent years, money market accounts are most often used as parking accounts for money waiting to be invested in other instruments, as sweep accounts for the collection of dividends, or by very risk averse investors. Money market accounts were offered by 58% of DC plans in 1996, but just 7% of assets were invested in these instruments (Foster Higgins). A 1997 survey of 401(k) plans reported 5% of total assets invested in money market accounts.

2.4.5. SELF-DIRECTED BROKERAGE ACCOUNTS

A small number of plans offer participants access to a self-directed brokerage account (1.6%, Buck Consultants; 4%, RogersCasey). This type of account is similar to a mutual fund window, but it offers the ability to purchase individual stocks and bonds in addition to mutual funds.

Self-directed brokerage accounts have appeared in response to demand from certain types of 401(k) plans. These accounts are generally appealing to companies where the typical individual account is large and the participants are financially sophisticated. Typical plans offering self-directed brokerages would be professional corporations such as law firms, accounting firms, and medical practices.

Providers are charging administration fees for self-directed brokerage accounts in a rather uniform way, generally on a per-capita basis. The range of charges is typically $50 to $100 per participant per year (Cerulli). Participants also pay the transactions charges levied by their brokers for trades in the accounts.

2.5. 401(k) PLAN ASSET HOLDINGS

The assets of 401(k) plans are generally held and invested in common under the control of the trustee of the plan. With the exception of the self-directed brokerage assets, the holdings of individual participants are not discretely identified except by accounting entries.

Contributions to the plan, by the individual participants and by the sponsor, are invested in accordance with the instructions of the individual participants and their accounts are annotated to indicate where the investments were made. Similarly, investment gains are apportioned among the individuals' accounts in the plan's portfolio of assets.

2.5.1. INSURANCE PRODUCTS

When the provider of 401(k) investment products is an insurance company, the plan's assets are often packaged in a characteristic insurance product, the **variable annuity**. Such a plan's asset holdings would contain a set of investment instruments similar to those in plans serviced by other providers. However, when wrapped into an annuity, usually by an insurance company provider, such an account then becomes an insurance product and is exempt from the Securities Act of 1933.

The group annuity wrapper qualifies the plan as an insurance product. This provides certain tax preferences and excludes it from the accounting and disclosure provisions that apply to regulated securities. (The tax preferences do not provide any advantages to 401(k) plans since such plans already receive tax preferences.) An advantage to the provider in this arrangement is that the fees are not subject to the SEC rules that apply to other 401(k) products (Hack).

2.5.1.1. Group Variable Annuity.

The group variable annuity is simply a wrapper placed around a bundle of

other investment vehicles such as mutual funds and general account investment options. The wrapper consists of a set of guarantees that include:

- A minimum death benefit expressed in terms of the member's and firm's contributions,
- A post-retirement rate of return, if the participant elects a pay-out in the form of an annuity, and
- A guaranteed level of expense to be assessed against the assets of the account.

In a group annuity, each participant has an individual account, but the guaranteed annuities apply to every participant identically. The group annuity arrangement requires daily recordkeeping of accounts at the participant level.

Administrative fees and expenses are assessed on two levels within the group annuity (plus itemized expenses that may be charged directly to the plan). There are investment management fees assessed against the individual mutual funds and general account investments within the annuity wrap. In addition, there is a wrap fee assessed against the total assets in the annuity.

2.5.1.2. Individual Variable Annuity.

This product is similar to the group annuity except that the individual accounts are separately designed and packaged for each participant. This adds to the administrative cost of recordkeeping and administration. The individual annuity is usually used for very simple, small (less than 25 participants) plans (Hack). A typical use would be in a company with highly compensated, professional employees such as a law or accountancy firm.

The administrative fee and expenses structure for individual annuity plans is similar to those for group plans, but the wrap fees are substantially higher. One estimate suggests that the mortality and expense fee (see Section III for a definition) plus distribution charges would total 200 to 300 basis points for individual annuities (Hack).

2.5.2. REPRESENTATIVE 401(k) INVESTMENT OPTIONS

A 401(k) plan sponsor typically will select a variety of investment options from which the plan participants may select targets for their contributions to the plan. These options are typically pre-defined retail mutual funds correlated to a particular category of financial instrument or to a general asset allocation objective. They may be also include institutional funds with specified objectives and investment parameters, with plan sponsors directing assets to these funds on a pooled basis through a commingled account, or on their own through a separate account.

However, as a background to developing assessments of typical plan

investment costs, some notion of benchmark 401(k) plan portfolios should be defined. A recent and useful typology was offered by Pellish and Buehl (*Journal of Pension Plan Investing*). They articulate three prototype model portfolios that might be offered within a 401(k) plan. Within each of the three model portfolios, specific investment vehicles are listed in order, starting with those expected to have lower risk and lower returns over time, ending with those expected to have higher risk and higher returns over time.

2.5.2.1. "Core Options" Portfolio

A potential array of investment options for newly-forming plans, and/or plans with participants who are relatively unsophisticated about investment strategies is displayed below. This is a simple portfolio; relatively easy to shop for, purchase, and administer; and well-equipped to minimize participant confusion.

1. Stable value account (e.g., GIC) or short-term bonds
2. Balanced fund
3. Large cap U.S. equity fund
4. International equity fund
5. Smaller company U.S. equity fund

2.5.2.2. "Enhanced Core" Portfolio

This plan would diversify the options available at the low-risk/low-return end of the investment spectrum. It would also introduce pre-packaged "lifestyle funds" intended to provide a composite set of investments designed to achieve a particular overall asset allocation objective.

1\. Money market fund
2\. Diversified bond fund
3\. Conservative lifestyle option
4\. Moderate lifestyle option
5\. Aggressive lifestyle option
6\. Large cap U.S. equity
7\. International equity fund
1\. Smaller company U.S. equity fund

2.5.2.3. "Full Array" Portfolio

This model portfolio maintains the notion of a plan-defined array of specific options. However, it diversifies the options at the higher-risk/higher-return end of the spectrum, and introduces the use of mutual fund windows and/or self-directed brokerage approaches. These features typically are targeted to the demands of participants who consider themselves highly informed about investment strategies, and consider the traditional core offerings as unduly restrictive.

1. Money market fund
2. Diversified bond fund
3. Conservative lifestyle option
4. Moderate lifestyle option
5. Aggressive lifestyle option
6. Large U.S. cap equity fund
7. International equity fund
8. Smaller company U.S. equity fund
9. Emerging market equity fund
10. Mutual fund window
1. Self-directed brokerage

These prototypical sets of investment options illustrate the range of choices typically offered to 401(k) plan participants. Within each of the fund types, investment management expenses vary widely. Section IV presents information concerning the range of investment management expenses observed for different types of investment options in recent years.

2.5.3. ACTUAL 401(k) PLAN ASSET ALLOCATIONS

There are several factors complicating the attempt to draw reliable pictures of the actual investment of 401(k) plan assets. The available investment options vary widely from one plan to the next. These options are assigned to different definitional categories by different providers and observers. Employees' asset allocation decisions are constantly shifting over time.

The 1996 Foster Higgins survey provides useful data on typical 401(k) plan holdings. It addresses the dual issues of how often particular investment options are offered to employees and the share of assets that are invested in the various options when they are offered.

Table II-5
Major Categories of 401(k) Investment Options

Option	% of Plans Offering Option	% of Assets in Option When Offered
GIC/BDA	59%	33%
Equity, Actively Managed Growth	78%	26%
Equity, Actively Managed Core	36%	21%
Equity, Indexed	42%	15%
Equity, International	56%	6%
Money Market / Short-Term	58%	22%
Company Stock	26%	12%
Balanced	74%	16%
Bond	60%	10%

2.6. HOW IS THE ADMINISTRATION OF 401(k) PLANS STRUCTURED?

The administration of any 401(k) plan is substantially prescribed by the provisions of law and Federal regulation. Current law requires the development of a plan document as a part of the set-up of the plan as well as the submission of annual reports (Form 5500) that require extensive recordkeeping and preparation. Additionally, the tax code requires annual nondiscrimination testing to ensure that highly compensated employees do not contribute in excess of their ceiling. In 1995 a survey found that 61% of 401(k) plans discovered that the contributions of highly compensated employees must be restricted or adjusted as a result of nondiscrimination testing (Hewitt Associates). However, recent legislation enables plan sponsors to determine the allowable contributions of highly-compensated employees on a prospective basis, eliminating the need to make ex-post account adjustments.

These administrative requirements impose a cost. ERISA and its interpretive regulations require additional recordkeeping including periodic account statements to plan participants, at some cost to plan sponsors, participants, or both. Many plan sponsors choose to purchase this administration from service providers in lieu of using internal staff. A survey disclosed that in 1996 less than 5% of plans were being administered in-house exclusively and only 30% by in-house staff supported by vendors (Spencer & Associates).

The administration of 401(k) plans is also driven by the set of services that plan sponsors provide as conveniences to their employees or as inducements to increased participation. Some of these services are the participant's ability to obtain a loan from the plan, daily valuation of account balances, education and the communication of information about the plan, the ability to transfer assets among investment options frequently, and call centers. Larger plans can provide these services at relatively low per-capita costs, but for smaller plans they can be very expensive (Stone).

2.7. HOW ARE 401(k) PLAN SERVICES DELIVERED?

Plan sponsors have adopted a variety of arrangements to provide 401(k) plan services to their employees. The service delivery mechanisms they select may potentially affect the level of plan expenses, the extent to which they are charged to the plan, and the degree to which they are disclosed to sponsors and participants.

2.7.1 FULL SERVICE PROVIDERS

The first type of providers are the **full service providers**. These are the "bundled" service providers that are able to provide the entire range of administrative services to a plan sponsor. Full service providers include mutual

fund companies, larger banks and insurance companies. In one estimate there are just over 200 full service providers available to plan sponsors (Valletta, February 1997). However, they must control a large segment of the market, since in a recent survey, it was estimated that 59% of 401(k) plans use bundled services from full service providers (Spencer & Associates). This study revealed that the full service providers are mutual funds (50.4%), banks (24.4%), insurance companies (14.1%), consultant/TPA alliances (8.1%), and others (3.0%).

Relying on one full service provider to furnish all services to the plan appears to be the most common approach to 401(k) plan administration. Administrative expenses are revealed to the extent that they are invoiced to the plan sponsors. When any of those expenses are paid by the plan, they are recorded on the Form 5500 report and borne by the participants. In most cases, however, at least some of the fees are not reported directly but are netted in the annual performance results of the investments. In this case they are also borne by the plan participants.

Bundled services are more prevalent among small and medium sized plans. According to one study, among plans with fewer than 250 participants, 85% rely on bundled services; among plans with from 250-1,000 participants, about 75% use this product (Fink). A smaller scale survey in 1996 estimated the percentage of plans using bundled services to be 59% (Spencer & Associates). (The latter survey may have been biased toward larger plans; the number of respondents was only 298.)

2.7.2. ALLIANCES

A smaller group of plans have taken an intermediate approach, receiving asset management and recordkeeping services from an alliance, while providing other services with in-house staff or independent providers. Spencer & Associates report that 6.1% of respondents to their survey use this approach. Another arrangement of this type would be one in which an ostensibly full-service provider out-sources the recordkeeping tasks, allocating 15-20 basis points from the investment management fee or expense ratio for this service (Rowland).

2.7.3. UNBUNDLED SERVICE PROVIDERS

Plan sponsors may provide services through a combination of in-house staff and independent service providers. In this approach the plan sponsor becomes the "bundler." This practice appears to be more prevalent among the larger plans that have adequate resources to manage such a plan (Tiemann). One study suggests that about one-third of plans (30.1%) use the unbundled approach with a combination of in-house and vendor resources (Spencer & Associates). An additional 5% provide services to the plan with in-house staff alone.

2.7.4. ACCESS TO 401(k) SERVICE PROVIDERS

The costs of 401(k) plan services are somewhat dependent on the information that a plan sponsor has about the range of prices in the marketplace that are charged by these providers. A search of the literature shows that gaining visibility of the universe of thousands of service providers would be difficult to impossible for any plan sponsor with limited resources. For example, Valletta (February 1997) estimates that there are in excess of 1500 third party administrators and over 3,000 firms offering asset management services to 401(k) plans.

The directories cited offer only a small segment of the available vendors, although the majority of the larger providers are displayed. For example, the *401(k) Provider Directory*, one of the best known, only contains information about the 94 of the larger full service providers (HR Investment Consultants). The other directory located in the literature search, the *(k)form Catalog*, contains information about both full service providers as well as TPAs and alliances. However, the *(k)form Catalog* lists only 79 such providers. (The publisher states that these 79 providers service over 50% of 401(k) plans in the country.)

Information about service providers is also available from associations, advertising, and the Internet. In addition, the 401(k) plan provider industry is very aggressively seeking to make their services known, frequently through well structured sales networks. However, the plan sponsor relying solely on information furnished by those service providers that establish contact through a sales force, would have incomplete knowledge of the marketplace.

The foregoing discussion suggests that the market for 401(k) plan services is not particularly efficient for the plans that do not have the resources or interest to search for information that would allow a comparison of available services and prices.

SECTION III

401(k) PLAN FEES AND EXPENSE STRUCTURE

3.1. INTRODUCTION

This section will categorize and describe the fees and expenses that are typically paid by or on the behalf of 401(k) plans. We will also cite the typical range of these expenses as revealed in the literature. In the next section we will identify the ranges and averages of expenses paid by plans of various sizes.

3.2. BASIS FOR COMPUTING FEES

One dimension that is useful in understanding fees and expenses is the basis for computing them (Tiemann). **Asset-based fees** are computed as an annual percentage charge on the total assets of the plan. **Census-based fees** are imposed on a per capita participant basis and **itemized fees** specify a fixed charge for a specific service.

A typical price quotation might show fees and expenses of all three types. For example, a mutual fund provider might charge an investment management fee as an expense ratio on the funds (asset-based), a per-participant recordkeeping fee (census-based), and a fixed charge for set-up and conversion (McNabb).

3.3. TYPOLOGY OF 401(k) FEES AND EXPENSES

A useful way to classify expenses and fees, for the purpose of this analysis, would relate directly to the services being provided to the 401(k) plan. Therefore the following set of fees and expenses is proposed that focuses on the functions related to each expense category.

- Set-up and conversion fees
- Recurring administrative costs
- Communications expenses
- Investment management fees
- Distribution fees
- Mortality and expense risk fees

3.3.1. SET-UP AND CONVERSION FEES

There are one-time costs associated with the establishment of a new 401(k) plan or with the conversion of a plan's records to another administrator's custody. Set-up entails the preparation of a plan document, often by adapting a prototype document, and the enrollment of participants. It also includes entering the participant data on the service provider's computer system, reconciling the existing plan's assets (if any), and setting up existing participant loans.

Set-up costs are relatively fixed, although the typical provider charges a fixed amount plus a variable, participant-based fee. The range of costs for set-up is $500 to $3,000; however, many providers charge a lesser amount and recoup the difference from investment management fees (k(la), (k)form Catalog). In one sample of providers, the range of average set-up charges for plans of 25, 50, and 100 lives was $992, $1102, $1,202 (HR Investment Consultants*, Averages Book*).

3.3.2. RECURRING ADMINISTRATIVE COSTS

These fees cover trustee services, recordkeeping, compliance, distribution of account proceeds to departing participants, loan processing, and withdrawals.

Trustee expenses typically are the smallest component of the total set of expenses, representing about 3% of fees on a typical plan with 500 participants and assets of $10 million (Stone). Trustee services are often offered at no additional, separate charge when the provider's funds are purchased by the plan.

Compliance costs include the preparation of tax forms (Form 5500) and nondiscrimination testing. When administrative services are separately priced, the compliance expenses are typically included in the base charge rather than being separately priced.

Recordkeeping is the largest component of recurring administrative expenses. This expense category includes enrollment, contribution and investment election processing, loan origination and processing, withdrawal processing, individual account maintenance, and preparation and mailing of account statements and summary annual reports. The 401(k) provider industry has made the investment in computer equipment and software to provide this recordkeeping in an efficient and relatively low cost manner.

The recordkeeping expenses for a small plan can be quite high. Typically recordkeeping consumes about 14% of total expenses for a $10 million plan (Stone). However, providers make their margin on asset management, and where recordkeeping and asset management are done by the same provider, recordkeeping may be viewed as a loss leader, being included with the asset management fees. On a start-up plan, the provider may lose money for two to five years until the average account grows large enough so that the margin on asset-based fees is sufficient to cover the loss on recordkeeping (Richardson, May 1996). Larger funds experience substantially lower cost percentages. For a 500 life plan, for example, recordkeeping costs may be about 7% of total fees and expenses and may be even lower for a much larger plan (Valletta, November 12, 1997).

In bundled mutual fund arrangements, recordkeeping expenses are included in the expense ratios. Where mutual fund providers out-source recordkeeping to third party administrators (TPA) alliances, there is typically a 15-20 basis point transfer from the expense ratio to the alliance for this expense (Rowland).

3.3.3. COMMUNICATIONS EXPENSES

Communications services typically include meetings with employees, printed and video materials describing the plan features and encouraging

participation, basic election materials, and newsletters. More elaborate services might include a call center, interactive voice response system, participant asset allocation software, and Internet access. Communications services are valuable to the sponsor in that they encourage employee participation in the plan. They also help satisfy the disclosure requirement contained in section 404(c) of ERISA.

For example, one typical, large full service provider offers all of the communications services listed above except participant software. There is no additional charge for these services except for a $500 setup, $6 per participant charge for the interactive voice response system support (HR Investment Consultants).

3.3.4. INVESTMENT MANAGEMENT FEES

The main purpose of investment management fees is to compensate the provider, who recommends the allocation of funds flowing into a particular 401(k) plan investment option from the universe of financial instruments available for this fund. For an equity mutual fund, for example, the investment management advisor selects the stocks that will be bought and sold. The investment management fee pays for the research that supports these buy-sell decisions. In addition, these fees compensate the mutual fund manager for the pro-rata operating expenses of the fund attributable to each 401(k) plan that buys shares. (These operating expenses include items such as rent, staff compensation, supplies, etc.) In practice, the distinction between investment management fees and other type fees is blurred.

Investment management fees are the largest charges assessed against the plans. In plans where the assets are invested in mutual funds, for example, the investment management fee has been found to exceed 80% of total fees and expenses of a typical plan ("Retirement Planning;" Stone). Valletta found that the investment management fees may be as much as 90% of the total (Valletta, November 12, 1997). However, as will be seen below, these statistics may include certain other expenses such as marketing and distribution costs that are not separately disclosed.

Other investment instruments, typically group variable annuities, include management fees in the "wrap." A wrap fee is an all-inclusive annual fee imposed on the value of total assets in an account. Wrap fees typically include expense elements other than investment management fees.

3.3.5. DISTRIBUTION FEES AND COMMISSIONS

Often, 401(k) providers rely on elaborate distribution networks to market their products. Distribution fees are charged to cover the expense of maintaining this network. For example, a large insurance, full service provider may market its products through one of three modes:

- In-house sales force,
- A network of affiliated third party administrators, and
- Unaffiliated broker/dealers.

Such a provider will establish commission schedules to compensate the sales force at all points in this network. When 401(k) plan investments are purchased through this distribution network, distribution fees are typically charged against the participants' accounts. Distribution fees compensate the distribution network participants for their labor.

In the case of retail mutual funds, the sales commissions are disclosed in the prospectuses. Sales commissions can be collected in two ways: as front-end loads paid on new contributions to the fund (Class A shares) or as 12b-1 fees (combined with deferred contingent sales charges) deducted annually based on the fund's assets and reflected in the fund's net asset value (Class B shares). These sales commissions, whether collected when contributions are received or charged over a number of years against assets, are in the range of 3-4 percent of contributions (Schultz; Tuczak). For class B shares, the mutual fund manager pays sales commissions to broker/dealers up front and then recoups these funds over a number of years in the form of 12b-1 fees (Tuczak). Since the SEC limits the 12b-1 expenses to 100 basis points annually, a contingent deferred sales charge is imposed on the shares, typically for five years, to ensure that the mutual fund can recapture the sales commissions that were paid. A contingent deferred sales charge is only collected when the shares are sole during the contingent period.

Insurance company providers (and other providers using a wrap fee) can collect distribution fees at two levels. On the first level, 12b-1 expenses are charged against the annual value of an individual mutual fund and transferred to the distributor. On the second level, part of the wrap fee imposed on the value of all instruments included in the group variable annuity may be used to pay for distribution costs. The amount of each 12b-1 fee is disclosed in each fund's prospectus, but the portion of the wrap fee that is devoted to distribution charges is not disclosed.

Sales commissions for insurance products, including group and individual annuities, may be structured with two components. Deposit commissions are paid on balances transferred from other providers as well as periodic contributions into the plan. Trail commissions are paid on assets under management, including the growth from investment returns, and continue as long as the plan continues with the same insurance provider. The direct and trail commissions are typically combined and incorporated as part of the wrap fee.

3.3.6. MORTALITY AND EXPENSE RISK (M & E) FEES

Insurance products, such as group and individual annuities, bear costs

that are unique to these products and that reflect the insurance risk of each product. These risks include the mortality and expense guarantees inherent in the annuity contracts. (See Section II, Insurance Industry Products, for a discussion of these guarantees.) The M & E fees pay these costs.

M & E fees are highest for individual variable annuities, generally ranging from 100 to 200 basis points (Hack). However, since distribution fees are often grouped with M & E fees, the total wrap fee for individual annuities might be in the range of 200 to 300 basis points.

In the case of group variable annuities, the M & E fees are usually based on plan size (Hack).

- For very small plans, less than 50 participants and $500k assets, 100 to 200 basis points,
- For small plans, more than 50 participants and greater than $500 k assets, 75 to 150 basis points,
- For medium sized plans, greater than 500 participants and $5MM assets, 30 to 75 basis points, and
- For large plans, greater than 1,000 participants and $15MM assets, less than 50 basis points.

M & E fees are typically imposed as wrap fee based on the total assets in the annuity accounts.

3.4. APPROACHES USED TO ASSESS THESE EXPENSES

The preceding discussion related administrative fees and expenses to the functions that they support. The following subsection describes the structure of fee payment modes.

- Invoiced expenses
- Sales charges
- Expense ratios
- Wrap fees
- Net asset value computations

3.4.1. INVOICED EXPENSES

Invoiced expenses are generally for recordkeeping and administration. They are often charged on an itemized basis, and may be paid by the sponsor, by the plan, or shared. There should not be any issue concerning disclosure by service providers to plan sponsors, for the sponsor can read the charges from the plan contract or from the periodic invoices or statements from the provider. Examples of invoiced expenses that would be paid by the sponsor or the plan are start-up fees, annual base fees, trustee fees, tax form filing, and

recordkeeping for company stock purchases. Examples of invoiced expenses that might be paid by individual participants (or the plan) are loan origination, loan maintenance, and distributions.

Some invoiced fees are census based, i.e., fees charged as amounts per participant. These fees are similar to itemized expenses in that they are charged for recordkeeping and administration and in that there should be adequate disclosure of their extent to sponsors. Census-based fees, charged as a fixed amount per participant, are typically paid from plan assets or by the sponsoring firm. Examples of census-based fees are a per-capita addition to the annual base fee, additional fees for communications options that are not in the basic package, adding investments from outside providers, and the use of non-electronic data inputs. Some expenses are charged as itemized expenses by some providers and as census based fees by other providers.

3.4.2. SALES CHARGES

Regulated securities, such as mutual funds, may impose sales charges on purchases and/or reinvested dividends. Where up-front sales charges are imposed, they are disclosed to the sponsors and participants in the prospectuses. Contingent deferred sales charges combined with 12b-1 expenses may be used to assess sales charges (as described above). These charges are also fully disclosed.

3.4.3. EXPENSE RATIOS

Mutual funds impose asset-based administrative fees and expenses that are disclosed in the form of expense ratios. Expense ratios, which are incorporated in the prospectuses and published in the financial press (for retail funds), show the amount of fees and expenses that are deducted from the assets of each fund annually. Since expense ratios reflect deductions from the assets of a fund, these expenses are borne by the individual participants in a plan by a charge against net asset value of the funds in their individual accounts.

The Securities Act of 1933 requires the disclosure of the magnitude of fees imposed on mutual funds. The industry has developed a standard display of expense ratios:

- Management fees
- Marketing and distribution fees
- Other administrative expenses

Management fees represent a percentage of the fund assets paid to the fund's investment manager. These fees include the costs of research, the manager's compensation, and the firm's profit margin, among other costs. The

identity of items included in the management fees for any fund is typically not disclosed.

Mutual funds charge additional fees to support the **marketing and distribution** costs of the fund. These fees are authorized by the Securities and Exchange Commission as section 12b-1 expenses. They may not exceed 100 basis points. There is a trend, however, to use 12b-1 fees for other purposes. One such use involves the transfer of a portion of the marketing and distribution fees to consultants through 12b-1 fees; one author suggests that this may be as much as 25 basis points (Richardson, January 1997). Bundled providers are also observed to be out-sourcing recordkeeping services and charging plan sponsors 15-20 basis points in 12b-1 fees that are rebated to the recordkeeping provider (Rowland).

Other administrative expenses is a category that primarily includes the servicing of shareholder accounts, such as providing statements, reports, dispersing dividends, as well as custodial services.

The net effect of these expense ratios is that it is difficult to separate the investment management fees from the administrative fees using the published information. For example, there has been a dramatic increase, 44%, in the total expense ratio of the average diversified stock fund since 1980. However, if we look at the detail in the ratios, we see that the cause of this increase has been the shifting of sales charges from a front-end load to the 12b-1 segment of the expense ratio. "Other expenses" have fallen while the 12b-1 share of the expense ratio has increased. The real increase in investment management expenses (apart from marketing and distribution) since 1980 is closer to 17% than to 44% (Sheets).

3.4.4. WRAP FEES

A wrap fee is an all-inclusive annual fee imposed on the value of total assets in an account. Originally developed to use with separate account money managers to pay the manager's fee as well as transaction costs, wrap fees are often associated with funds that still have internal expense ratios (Stone). For example, one large insurance company provider offers a variety of mutual funds to smaller 401(k) plans. Each of these mutual funds contains its own expense ratio. In addition, this provider charges an asset based wrap fee on the overall value of all of the mutual funds in the plan participants' accounts (Ryan).

Wrap fees are typically charged by insurance providers, who package their 401(k) investments in the form of group or individual annuities. In these plans, wrap fees typically include M & E expenses and distribution fees in addition to the cost of plan services and investment management fees. Wrap fees may also be charges by some bank and investment management company providers. The magnitude of wrap fees (as a percentage of the 401(k) fund) is observed to be inversely proportional to the value of assets in the 401(k) plan

(HR Investment Advisors).

The magnitude of the wrap fee in any plan is disclosed to the plan sponsor (and, in some plans, to the plan participants). However, information about the portion of the wrap fee devoted to the elements of expense (M & E, distribution, services, investment management) is generally not disclosed (HR Investment Advisors). Since the typical wrapped account is an annuity, it is qualified as an insurance investment and not required to be registered nor to disclose fees in the detail required of mutual funds under the Securities Act of 1933 (Hack).

3.4.5. NET ASSET VALUE COMPUTATIONS

Certain investment products do not directly disclose any of the fees and expenses imposed on the plan participants. Instead, these charges are netted into the periodic net asset value (NAV) computations. Stable value accounts, such as GICs and BDAs use this technique to impose fees. In such accounts the provider guarantees a specified annual rate of return on each account. However, the fees and expenses are converted into a percentage charge against the assets in the account and are built into the formula for crediting investment returns. The plan sponsors and participants will be provided with the NAV and may be given the net rate of return used to compute the NAV, but the percentage devoted to fees and expenses will not generally be disclosed (Hack). (This is in contrast to mutual funds where fees and expenses are netted into the NAV but where the magnitude of fees and expenses are disclosed in prospectuses.)

3.5. ISSUES AFFECTING EXPENSES

The plan sponsor seeking to minimize the fees and expenses imposed on a 401(k) plan is constrained by a number of issues that bear on the magnitude of fees and expenses. An important strategy for minimizing costs is to obtain competitive bids from a number of 401(k) service providers. Other considerations related to costs of services are:

- Plan size
- Plan features and investment options
- Behavior of plan participants
- Portfolio turnover

3.5.1. PLAN SIZE

Plan size is clearly an important dimension in the amount of fees and expenses a plan will absorb. This is largely a result of the fact that there are certain fixed costs of providing services to a plan that are not highly sensitive to the number of plan participants, and the fewer the participants, the higher the

per-capita expenses. More and more vendors, especially mutual funds, focus only on the larger plans, those with 200 or more lives (Richardson, July 1997).

Another consideration related to plan size is that many small plans are new accounts with few assets. Access Research is reported to be encouraging technology companies to set up automated service bureaus that would handle administration for multiple 401(k) service providers as a cost savings for small plans (Richardson, July 1997).

Some sponsors may remain too small to easily afford a 401(k) plan. For firms with substantially less than 100 employees, the SIMPLE IRA plan or a profit-sharing arrangement may be a more affordable solution. Also, those small firms with higher than average income workers may prefer the higher maximum contribution limits in 401(k) plans over the SIMPLE IRA.

3.5.2. SELECTION OF PLAN FEATURES AND INVESTMENT OPTIONS

Decisions by the plan sponsor have a considerable influence on the magnitude of fees and expenses that will be charged. These decisions involve the specification of services that will be provided to the plan as well as the selection of investment options that will be offered to the participants.

An extensive set of services is available to 401(k) plans, and many of them are more elaborate than the minimum requirement mandated by law and regulation. When the plan sponsor chooses to include more elaborate services than the minimum requirement, albeit in response to employee demand, the administrative costs are increased. For example, the sponsor might specify that the plan allow employees to change their investments daily, and the service provider would quote an incremental price for this additional service (Quinn, January 1998). Increasing the frequency of compliance testing is an example of another service for which most providers would charge an additional fee (HR Investment Consultants, *401(k) Provider Directory*).

Another significant influence of plan sponsors' decisions on plan fees and expenses is in the selection of the suite of investment options that will be offered to participants. The plan that offers a wide spectrum of investment choices is likely to include investment options that have a higher than average expense ratio. For some investment options, for example employer stock and instruments purchased from institutions other than the full service provider, the provider will charge an additional itemized or census-based fee (HR Investment Consultants, *401(k) Provider Directory*). Finally, including investment instruments that impose sales commissions on their purchases will increase the expenses being charged to participants who select these options.

Plan sponsors influence the magnitude of fees and expenses when they select a service provider that only offers investments loaded with sales charges or that packages investment options in a group annuity. An example might be

the typical major insurance provider that offers a set of investment options that feature choices among mutual funds. These funds are included in a group annuity wrapper and an asset-based wrap fee is imposed (except for the larger plans) (HR Investment Consultants, *401(k) Provider Directory*). A similar set of investment options could be provided by a non-insurance provider, absent the group annuity. This does not suggest that the group annuity does not have value, only that it comes with an additional cost. Similarly, the plan sponsor that selects a full service mutual fund provider that offers only loaded retail funds, could find another provider that offers a set of no-load funds with similar risk-return characteristics.

3.5.3. BEHAVIOR OF PLAN PARTICIPANTS

Participant behavior directly affects transaction costs. The typical plan provider charges additional fees for transactions such as withdrawals and loans. In the case of loans, there are charges for both loan origination and monthly maintenance (HR Investment Consultants, *401(k) Provider Directory*).

Participant behavior selection of the investment instruments also drives the level of fees and expenses. To the extent that participants understand the investment management fees imposed on alternative investment choices (mutual fund expense ratios, for example) they have the opportunity to influence the amount of expenses that will be charged to their accounts. This does not suggest that the rational choice is always the lowest cost fund.

The participant's selection of actively managed versus passive investments will have an effect on investment management fees. The average expense ratios for particular fund categories encompass wide ranges from low to high expense ratios across individual funds (*Fortune,* December 23, 1996).

One key factor in this wide range of expense ratios is the notable difference in expense ratios generally observed between indexed (or passive) funds and actively managed funds. In an indexed fund, the investment manager seeks to maintain a portfolio closely tracking an appropriate market performance indicator. For example, a U.S. large company stock fund might be benchmarked to the Standard & Poor's 500; a small company stock fund to the Russell 5000; an international stock fund to the Morgan Stanley EAFE (Europe, Australia, Far East) Index. Other fund categories have similar benchmarks meant to capture the overall performance of particular segments of stock and bond markets. In actively managed funds, the investment manager expends more costs on research, investment selection, and buying and selling.

Similarly, the choice of equity versus fixed income investments affects expenses. Inspection of mutual fund expense ratios reveals that bond fund expenses are significantly lower than are those for equities (Sheets).

3.5.4. PORTFOLIO TURNOVER

Portfolio turnover is another factor affecting expenses. Higher portfolio turnover increases the transaction costs of buying and selling the individual securities in a mutual fund or other investment account. These transaction costs are not usually separately identified but are netted with the investment return, so it is difficult to observe them. Portfolio turnover results from decisions made by the investment manager, and is not under the direct control of the plan sponsor nor of the participants. However, portfolio turnover is often disclosed in the case of mutual funds and thus is indirectly controlled by sponsors and participants who select certain investment options in spite of the knowledge that the managers of that option are active traders. Portfolio turnover is an issue that should be considered by plan participants in choosing between actively managed and passive investments, as discussed in the preceding section.

3.6. WHO PAYS 401(K) PLAN FEES AND EXPENSES?

The evidence shows that the largest element of expense for 401(k) plans is the investment management fees that are imposed principally as expense ratios in the case of mutual funds or as wrap fees imposed on assets in group annuities. It has been shown that investment management fees typically range from 75% to 90% of the total administrative fees and expenses imposed on a plan. The participants in a typical plan bear the mutual fund expense ratio and annuity wrap expenses.

Recent surveys provide information showing that, apart from the investment management fees, participants are bearing a substantial fraction of the costs of administering 401(k) plans. Plan participants are more likely to pay non-mutual fund/group annuity investment management fees, while plan sponsors are more likely to pay other fees and expenses. Buck Consultants report that, in 51% of plans surveyed, participants paid all of the investment management fees; while sponsors shared in these fees in 19% of plans. The Profit Sharing/401(k) Council of America survey indicated that in 62% of plans participants paid all of the investment management fees. Hewitt Associates reported that, in 1997, participants paid 56% of non-mutual fund investment management fees.

The opposite is the case with administrative fees (non-investment management fees). RogersCasey reports that, on average, 54% of plan sponsors pay all of these administrative fees, while 28% share these costs with participants. Larger plans (>10,000 lives) are more likely to shift administrative fees to participants. The Profit Sharing/401(k) Council of America survey results mirror these findings.

The following table shows the results of a 1997 survey that asked plan sponsors how administrative fees and expenses are paid.

Table III-1

Who Pays Plan Expenses?

	Percent of Plans[1]		
	Participant Pays	**Employer Pays**	**Shared Expense**
Audit fees	24%	73%	3%
Internal administrative staff compensation	4%	93%	3%
Employee communication	14%	75%	11%
Investment education:			
Seminar/workshops	9%	83%	8%
Other media	10%	82%	8%
Non-mutual fund investment management fees	56%	39%	5%
Legal/design fees	9%	85%	6%
Recordkeeping fees	35%	58%	7%
Trustee fees	40%	55%	5%
Other administrative fees	24%	61%	15%

(Source: Hewitt Associates, 1997)
1 (441 plans reporting)

The trend in recent years has been for plan sponsors to shift administrative and non-mutual fund expenses of the plans to plan participants (Hewitt Associates, 1997). The following table illustrates this trend.

Table III-2
Plan Expenses Paid by Participants Only

			Percent of Plans[1]	
	1991 Survey	**1993 Survey**	**1995 Survey**	**1997 Survey**
Audit fees	16%	17%	18%	24%
Internal administrative staff compensation	4%	3%	4%	4%
Employee communication	5%	10%	10%	14%
Investment education:				
Seminar/workshops	--	--	--	9%
Other media	--	--	--	10%
Non-mutual fund investment management fees	44%	50%	56%	56%
Legal/design fees	9%	7%	10%	9%
Recordkeeping fees	22%	27%	29%	35%
Trustee fees	27%	32%	33%	40%
Other administrative fees	14%	17%	18%	24%

(Source: Hewitt Associates, 1997)
1 (656 plans reporting in 1991; 486 plans reporting in 1993; 429 plans reporting in 1995; and 441 plans in 1997)

Another survey research study conducted over a four year base yielded comparable results. Table III-3 displays the results of this study.

Table III-3
Plan Expenses Paid by Participants Only

			Percent of Plans[1]
	1992 Survey	**1994 Survey**	**1996 Survey**
General Recordkeeping	11.6%	13.1%	22.0%
Compliance	10.4%	8.9%	12.3%
Communications	5.2%	8.8%	13.8%
Asset Management	35.8%	34.4%	53.9%
Investment Education			18.7%
Loans			46.4%

(Source: Spencer Associates, 1996)
1 (229 plans reporting in 1996)

The evidence that there is a trend to shift expenses from plan sponsors to plan participants is reinforced by a survey conducted in 1996 that asked plan sponsors to indicate their intentions for the future. This survey indicated that a modest but significant number of respondents intended to pay a lower percentage of such fees in the future. Table III-4 displays the results of this survey.

Table III-4
Future Payment of Administrative Fees

	Percent of Plan Sponsors		
e	**Participant Pays In 1996**	**Employer Pays in 1996**	**Shared Expens in 1996**
Company will pay a *higher* percentage of fees	1%	0%	2%
Company will pay a *lower* percentage of fees	7%	15%	24%
Company will pay the *same* percentage of fees	91%	85%	73%
Number of respondents	(82)	(245)	(128)

(Source: RogersCasey)

3.7. ARE PLAN SPONSORS AND PARTICIPANTS ADEQUATELY INFORMED ABOUT FEES AND EXPENSES?

The adequacy of the disclosure of fees and expenses to both plan sponsors and participants has been introduced as an important issue. (This was the focus of the public hearing held by the Department of Labor on November 12, 1997.) It is clear from evidence in the literature that not all investment products disclose the fees and expenses charged to a 401(k) plan, nor are all of

the fees and expenses charged by service providers disclosed. For example, we have demonstrated that the fees imposed on stable value accounts are not usually identified and that other charges, such as sales fees, are often not disclosed. Adequate disclosure of fees and expenses should be important to sponsors as they select 401(k) service providers and monitor their performance. The disclosure of fees and expenses is also important to plan participants as they select among available investment options. ERISA charges DC plan sponsors with a fiduciary responsibility to act in the best interests of the plan participants. This implies that plan sponsors will know the costs of the services they procure and will apply due diligence to minimize these costs in the light of the level of services desired.

There is evidence, however, that there is a lack of information about costs that may affect the level of some administrative fees and expenses. A Dalbar study in 1992 shows that 78% of plan sponsors did not know how much their costs were, largely because there are about 80 different ways in which vendors charge fees (Benjamin). Some observers have suggested that some plans absorb as much as 100 basis points in higher fees and expenses presumably due to ignorance about the extent of fees being charged (Butler, November 12, 1997). The logic supporting this assertion is that, absent knowledge of the fees and expenses, many plan sponsors will select a higher cost provider than would be selected with detailed cost information.

The existence of such a large number of service providers suggests that competition in the marketplace should serve to minimize 401(k) plan fees and expenses. However, some observers believe that sponsors are not especially price sensitive in their purchasing decisions (Butler, November 12, 1997). Perhaps this is due to a lack of knowledge about the total fees and expenses being assessed. It also appears that some segments of the market are more efficient than are others. It is asserted, for example, that competition makes the market for large corporation plans very efficient (Barry). However, a valid distinction can be made between competitiveness in the market for services to large and small plans. This suggests that smaller plans do not benefit from this price competition (Cronin).

Another issue related to whether sponsors need a greater disclosure of fees and expenses is the costs of the many plan features that are now characteristic of a typical plan. More services are being provided to plan participants today than was the case ten years ago — indeed — many did not exist ten years ago (interactive voice response systems, for example) (Saxon). The provision of these services is driven by demand. A valid question is: if participants knew how much optional features of their plans cost, would they demand so many (O'Brien). In a recent study conducted on the Internet, 85% of the 1000 respondents voted for greater investment returns versus more services from their plans (Butler, November 12, 1997).

The imperatives for a greater disclosure of fees and expenses to

participants are less clear. In one opinion, given in testimony at the public hearing before the Department of Labor on November 12, 1997, additional information would not benefit plan participants (Barry). They have one of two choices to make among the inventory of options offered by their plan. These decisions are yes or no for each investment option, and all they really need to know is now disclosed including historical rates of return and investment objectives. This argument would be much more persuasive if the evidence showed that plan sponsors have complete knowledge of fees and expenses and are acting responsibly on this information to minimize costs.

An opposing view is that employees deserve the same access to information that the plan sponsors should be receiving when they select plan providers and investment vehicles. This argument starts from the construct of the DC benefit and especially of 401(k) plans in relation to an employee's retirement income security. Responsibility has been placed on employees to direct their own investments and to assume the risk of making bad decisions. Thus, they are entitled to all of the relevant information bearing on these decisions (Fink). Another factor arguing for the disclosure of information about plan costs to participants is that they have influence on the decisions of the plan sponsors in many firms. This influence may be exerted through employee advisory committees, their bargaining units, or through informal channels of communication. Thus participants deserve access to the information they need for informed participation in the sponsor's selection process.

ERISA requires that participants receive information about the amount of fees and expenses charged against their plan in the summary annual report. In addition, plans are encouraged by section 404(c) (the ERISA safe harbor provision) to provide full disclosure of fees and expenses. However, except for investments covered by the Securities Act of 1933, for which a prospectus must be furnished to participants, there is generally no requirement in the law or Federal Code for a complete disclosure of investment expenses to plan participants (Fink).

The disclosures required by plans seeking to comply with section 404(c) do not always display the full range of expenses charged to participants. Only that information relevant to the participant's capability to make rational choices among the investment options must be included. Thus, items such as the wrap fee and internal computations of the net asset values for stable value accounts would not necessarily be disclosed.

What do the stakeholders in the 401(k) universe think about the adequacy of available information about fees and expenses? Testimony before a public hearing held by the Department of Labor revealed differing perspectives on this issue by industry and advocacy group representatives. The mutual fund industry appears to be solidly for a full disclosure of all fees and expenses to both plan sponsors and participants (McNabb; Fink).

The Vanguard representative presented a model for a disclosure format that would appear to be acceptable to the mutual fund industry (McNabb; Fink; Tiemann). However, the industry's position on disclosure may be somewhat self-serving. The Securities Act of 1933 already requires them to disclose their administrative and investment management fees in a prospectus. Therefore, under current law, they are somewhat at a competitive disadvantage because they are subject to more stringent disclosure requirements than are insurance and bank investment products that are not similarly regulated and whose fees and expenses are often concealed in the net asset valuation computations. The Vanguard model disclosure would combine the asset-based, census-based, and itemized expenses into one "all-in" cost expressed as an expense ratio on total plan assets (McNabb). (This model disclosure is included in Appendix B, where several such models are displayed.)

Representatives for the banking industry stated their support for adequate disclosure of information about fees and expenses but believe that such information is now available (Barry; Dudley). Strong sentiment was expressed that no actions should be taken to mandate what fees and expenses could be charged (Barry). Such an action would disrupt the structures that have been created to service the 401(k) industry. There was additional comment opposing the establishment of mandatory disclosure requirements (Barry; Saxon).

The insurance industry was underrepresented at the hearing; the one insurance firm offering testimony operates in a niche market that offers mutual fund products wrapped in a group annuity to mostly small plans (Ryan). Anecdotal evidence was offered that some insurance companies would object to changes in their disclosure procedures that would separately identify their fees and expenses, such as distribution and M & E fees incorporated in the annuity wrap fees, to plan sponsors or participants (Butler, November 12, 1997; Snyder; Schultz).

Testimony from individuals representing participants in 401(k) plans strongly advocated the need to provide participants with detailed information on the fees and expenses being charged against their accounts (Benna, O'Brien, Snyder).

SECTION IV

COST ANALYSIS FINDINGS

4.1. INTRODUCTION

Systematic and reliable measurements of the fees and expenses incurred by 401(k) plans and their participants are difficult to establish. Within the 401(k) plan universe, the mechanisms through which recordkeeping and administration

services are delivered, the manner in which expenses are charged for those services, and the expenses associated with the management of plan investments all vary widely. Additionally, there are difficulties in measuring the differences between the total expenses involved in administering plans and the expenses actually paid by the plan participants.

Most 401(k) plans purchase all or most of the essential plan administrative services from external providers, or alliances of multiple providers. For such plans, there are some data available regarding the structure and level of the fees quoted by the providers. However, at least three factors restrict the use of these data in this research effort.

First, complete quantitative documentation of the major service providers' fee structures is not available for this study. A limited sample of fee structures was presented at the Department of Labor's public hearings (Valletta, November 12, 1997).

Second, providers' fee quotes may reasonably be regarded as typical "asking prices" within the 401(k) marketplace. They do not necessarily reflect the actual "buying prices" that emerge after negotiations between plan sponsors and the providers.

Third, many plans purchase some plan services from outside vendors, but provide other services using internal staff and resources. While there is some limited survey data suggesting which types of services are more likely to be provided internally, there is no systematic basis for identifying the expenses incurred in doing so.

Another major difficulty in assessing the types and levels of major plan expenses results from the wide variations in products and fee structures. Two examples are particularly noteworthy. Providers may offer identical arrays of plan services – investment management, recordkeeping, loan administration, trusteeship, and so on – under very different fee arrangements. For example, one provider may offer comparatively low investment management fees, but charge separate and additional fees on a per capita or per transaction basis for all other services. A second provider may offer many administrative services at no charge, but generate revenue to finance these services by charging comparatively high investment management fees. As a result, it is difficult to establish benchmarks for individual fee components.

Information reported by plan sponsors on Forms 5500, 5500-C, and 5500-R provide a measurement of *some* of the plan expenses that are charged against plan assets. Here however, there are significant uncertainties about the significance and implications of the data. First, the expenses reported on the Form 5500 do not include investment management expenses debited directly from the earnings that accrue in participants' accounts. Depending on plan size and participants' asset levels, these "hidden" fees may comprise 75% to 90% of

total plan expenses (HR Investment Consultants, *Averages Book*).

Second, expenses reported on the Form 5500 include only the portion of other expenses that plan sponsors charge against the plan assets. They do not include the portion of the expenses paid out of general corporate funds, and therefore do not provide a reliable indicator of the actual total expenses involved in administering the plan. An preliminary analysis of the Form 5500 data shows promise for further investigation, but did not merit inclusion in this report.

Within this ambiguous context, the project team has attempted to develop a "best sense" notion of the general range and tendencies of 401(k) plan administrative expenses. The findings are based on multiple sources from the available literature in the area and the limited body of somewhat systematic data about provider fees

4.2. COMPONENTS OF PLAN EXPENSES

There are various ways to categorize the components of total plan expenses. The following discussion is based on four categories that capture distinct sets of service functions.

1. Costs associated with the investment and management of plan assets (not including trading costs);

2. The costs of plan administration and recordkeeping;

3. The charges incurred for processing participant loans; and

4. Trustees' fees.

For each functional area, plan sponsors typically either provide the services internally or purchase them from outside providers.

4.2.1 INVESTMENT-RELATED EXPENSES

Three major components largely determine investment-related expenses when investment management services are purchased from outside providers:

1. Expenses ratios incurred for the management of mutual funds and other plan accounts, typically charged through deductions from the earnings of each participant's 401(k) account (not including trading costs);

2. Other asset fees attached to plan accounts over and above the expense ratios, used most extensively – but not exclusively -- by insurance companies as additional charges for their plan

management services and certain guarantees and benefit enhancements they provide to the plan; and

3. Sales charges that may attach to the investment of new plan contributions, fund transfers from other plans, and withdrawals from the plan (deferred sales charges).

Generally speaking, as plan size increases, investment-related expenses grow in absolute terms, but decline as a percentage of total plan assets. Larger plans carrying more substantial pools of total assets are able to take advantage of discounted expense ratios and/or the waiver or reduction of additional asset fees and sales charges. In particular, as described in Section III, larger plans have access to institutional accounts that can significantly reduce investment-related fees.

Expense ratios decline gradually as plan size increases. Other asset charges vary more significantly by plan size. This likely reflects two factors. First, insurance company offerings tend to be more prevalent among smaller plans, and frequently include additional asset charges, such as "wrap fees," as discussed in Section III. Second, some providers who assess "front-end loads" or other sales charges often exempt larger plans with larger asset volumes from payment of these additional charges. Overall, larger plans enjoy a broader range of lower-cost options within the 401(k) marketplace.

The following table shows the average expense ratios for various major categories of retail mutual funds (Sheets, 1996). The expense ratio is expressed as a percentage of fund assets, and is debited from shareholders' assets as compensation for the fund's investment management services. These estimates are for retail funds. Institutional funds have been observed to offer expense ratios that typically are 50 basis points lower (Cerulli Associates).

Table IV-1
Average Expense Ratios, U.S. Mutual Funds, by Fund Category, 1995

Fund Categories		Average Expense Ratio
Stock Funds	Growth and Income	1.32%
	Long-Term Growth	1.42%
	Aggressive Growth	1.56%
	Sector	1.69%
	International/Global	1.76%
Bond Funds	High Quality Corporate	0.93%
	Government	1.02%
	Mortgage Securities	1.11%
	Junk (high-yield)	1.41%

(Source: Sheets)

The expense ratios of individual mutual funds, and average expense ratios within fund categories, can fluctuate from year to year. There is some evidence that retail mutual fund expense ratios have been increasing in recent years. Using broader, more aggregated categories, (Anand) estimated that among all equity (stock) funds, the average expense ratios were 1.205% in 1994, 1.252% in 1995, and 1.283% in 1996. Among all balanced/mixed funds, the averages were 1.162% in 1994, 1.246% in 1995, and 1.283% in 1996.

Anand posits that the booming U.S. stock market and resulting large inflows of mutual fund investments – fueled in large measure through 401(k) plans – has contributed to the upward cost pressure. Although aggregate asset holdings have grown substantially, there are millions of new investors with relatively small account balances. On a percentage basis, these small balances are relatively expensive to administer. Additionally, the growth of the mutual fund industry as a whole has spawned the emergence of thousands of new funds. These new funds typically have higher administrative costs than older funds (Anand).

The average expense ratios for particular fund categories encompass wide ranges from low to high expense ratios across individual funds. *Fortune* (December 23, 1996) reported the following ranges of expense ratios for eight major fund categories. The categories are arranged from lowest to highest average expense ratios, beginning with government treasuries funds and ending with international stock funds.

Table IV-2
Expense Ratios for Year Ending October 31, 1996

Fund Category	Low	Average	High
Government Treasuries	0.15%	0.77%	2.19%
General Corporate Bond	0.21%	1.04%	2.18%
Growth and Income	0.19%	1.34%	3.81%
Equity Income	0.45%	1.35%	2.46%
Balanced	0.20%	1.39%	3.27%
Growth	0.20%	1.42%	6.49%
Aggressive Growth	0.74%	1.71%	6.25%
International Stock	0.35%	1.80%	3.61%

(Source: *Fortune*, December 23, 1996)

One factor in this wide range of expense ratios is the substantial difference in expense ratios generally observed among indexed (or passive) funds versus actively managed funds. In an indexed fund, the investment manager seeks to maintain a portfolio closely tracking an appropriate market

performance indicator. For example, a U.S. large company stock fund might be benchmarked to the Standard & Poor's 500; a small company stock fund to the Russell 5000 index; an international stock fund to the Morgan Stanley EAFE (Europe, Australia, Far East) Index. Other fund categories have similar benchmarks meant to capture the overall performance of particular segments of stock and bond markets. In actively managed funds, the investment manager expends more costs on research, investment selection, and buying and selling. In the past few years, during a period of strong market performance in general, the indexed funds have been able to generate very favorable returns at low expenses.

Table IV-3 depicts a range of average investment management expenses for six investment objective categories, for various types of investment mechanisms. The findings were developed by Cerulli Associates and reflect data for 1996 from Bernstein Research, the magazine *Pensions & Investments*, and Lipper Analytical Services. For each investment category Table IV-3 shows the average expense ratio for retail mutual funds, the average expense ratio for institutional mutual funds, and the average account management fees for separate accounts based on a $25 million investment by a large plan. For four of the investment categories, Cerulli also computed an average expense ratio for "Top DC Options," based on the expenses in funds most heavily used by sponsors of defined contribution plans.

Table IV-3
Mutual Fund Expense Ratios and Separate Account Management Fees, 1996 (as % of assets)

Funds	Retail Mutual Funds	Institu-tional Mutual Funds	Top DC Options	$25 Million Separate Account
Active Large Equity	1.47%	.91%	.83%	.63%
Active Small Equity	1.57%	1.01%	1.06%	.95%
International Equity	1.95%	1.15%	1.33%	.75%
Indexed Equity	.59%	.35%	.27%	.13%
Active Fixed-Income	1.35%	.69%	NA	.37%
Global Fixed Income	1.66%	.83%	NA	.50%

(Source: Cerulli Associates)

As these figures illustrate, there are considerable differences in average expenses, depending on the type of fund used. The average expenses estimated by Cerulli for retail mutual funds are generally consistent with the expenses cited in earlier tables.

Average expenses decline significantly when plans take advantage of institutional funds or separate accounts. Across all six investment categories, estimated expenses for institutional mutual funds fall in the range of 50-65 percent of retail expenses. Management fees in large-plan separate accounts are 30-45 percent of retail mutual fund expenses.

4.2.2 RECORDKEEPING AND ADMINISTRATION EXPENSES

When recordkeeping and administration services are purchased from outside vendors, fees directly attributable to these services reflect widely varying combinations of several fee elements. The most commonly used fee components are:

1. Base administrative charges;

2. Per-participant or per-eligible additional charges;

3. Any minimum charges that exceed the charges generated by the base and per capita charges;

4. Charges for discrimination testing;

5. Charges for filing of the Form 5500 by the service provider; and

6. Charges for payment of distributions from the plan.

Expenses directly charged for recordkeeping and administration services vary widely. Some providers offer many recordkeeping services at no specific charge. In those cases, the expenses are included in the overall charge.

At the Department of Labor's hearings on November 12, 1997, one major 401(k) bundled service provider offered its perspective on the factors it considers in determining appropriate plan administration fees. Six major considerations were cited:

- Number of plan participants;

- Number of potentially eligible participants;

- Number and diversity of payroll sources;

- Level of administrative activities outsourced to the provider;

- Frequency of transmission of contributions; and

- Participant education needs.

Taking these and other factors into account, the provider negotiates a fee structure with the plan sponsor. Typically, the resulting basic administrative charge is either a flat per-plan fee or a per-participant charge. The sponsor, in turn, then decides whether to pay the administrative fees, or to pass some or all of the costs to plan participants (McNabb, November 12, 1997).

In this expense category, there are significant economies of scale enjoyed by larger plans. Significantly higher per participant costs for smaller plans reflect several aspects of how recordkeeping and administrative fees are structured. First, most providers charge a base fee, then add per-participant or per-eligible charges on top of the base amount. Second, the additional per capita charges typically include a downward-sliding scale, such as $25 extra for each of the first 100 participants, $20 for each of the next 200 participants, and so on. Third, most plans impose a mandatory minimum fee for very small plans. Fourth, among those providers that charge additional fees for plan testing and/or preparation of the Form 5500, most charge uniform fees regardless of plan size or, at best, only a slightly lower charge for small plans.

Table IV-4 shows estimated average recordkeeping expenses based on the price quotations of major 401(k) service providers. Actual fees billed and expenses incurred can vary widely, based on fee negotiations.

Table IV-4
Average 401(k) Plan Recordkeeping Fees, 1995
By Number of Plan Participants

Number of Participants	Costs Per Participant
200	**$42**
500	$37
1,000	$34

(Source: HR Investment Consultants, November 12, 1997, as published in *Corporate Cashflow*, May 1996.)

Basic per-participant administrative charges typically reflect minimum charges and sliding scales that substantially reduce per capita costs as plan size increases. Average per-distribution charges are fairly constant across all plan sizes. The average charges for plan testing and Form 5500 preparation increase in absolute terms as plan size and asset volumes grow. However, on a per participant basis, or as a percentage of plan assets, larger plans generally benefit from economies of scale in these cost categories as well (Valletta, November 12, 1997).

4.2.3 LOAN EXPENSES

Loan expenses typically reflect charges for the origination of new loans and per-annum charges for the maintenance of existing loans. As with basic recordkeeping and administration charges, some providers offer loan-related services at not additional charges. Presumably, in these instances, the costs of offering the loan services are offset by revenues generated elsewhere in the provider's fee structure.

A 1997 survey by Hewitt Associates captured the range of loan-related charges within a sample of 460 plans. Among 205 respondents, loan application fees ranged from $3 to $100 per loan. The median fee was $40, and the most common fee was $50. Among 102 respondents, loan maintenance charges ranged from $3 to $75 per year. The median charge was $15 and almost half the charges were from $10 to $15.

There are, however, many different fee permutations. Some providers charge a relatively high loan origination fee, but no fee or a low fee for loan maintenance. Others do the exact opposite. Still others provide both services at zero or very low cost, but recoup this discount elsewhere in the fee structure.

4.2.4 TRUSTEES' FEE EXPENSES

Trustees' fees are expenses associated with the service provider holding the plan assets in trust, and the preparation of all documents associated with the trusteeship. Some providers do not offer trustee services at all. That is why trustees' fees are shown as a separate cost item outside of the "bundled services" typically offered by major providers.

Among providers who offer trustee services, some provide them at no additional cost. When trustee fees are charged, however, they vary widely. Most providers charge either a flat fee regardless of plan size, or a sliding scale fee that rises slightly for larger plans. However, even these sliding fee structures generally have ceilings that make the per-participant fees lower as plan size increases. In most instances, trustees' fees fall in the range of a few hundred to a few thousand dollars.

Some providers, however, charge trustees' fees as a percentage of plan assets. These fees can be substantial. Among providers charging fixed or modestly increasing fees, there are some fee structures that can generate high per-participant costs for small and medium size plans. However, a small or medium plan faced with high trustee fees from a particular provider has a significant number of lower-fee alternatives available in the 401(k) marketplace.

4.3. SUMMARY OF TOTAL PLAN EXPENSES

Estimated total plan costs can be developed from provider-based fee schedules. The estimates reviewed in this section reflect the combination of

bundled expenses for the full array of major plan services -- investment management, recordkeeping and administration, and loan processing, plus trustees' fees.

The *401(k) Provider Directory Averages Book* provides a summary of the variations in observable plan expenses based on the fee schedules reported by major providers of services within the 401(k) marketplace. Because these data include the major banks, insurance companies, and mutual funds that dominate the 401(k) marketplace, the findings appear to provide the most systematic measurement of the range of estimated plan expenses across the universe of providers offering the full array of plan-related services.

For comparison purposes, ESI also reviewed a 401(k) plan "price-shopping" survey conducted by Stephen J. Butler of Pension Dynamics Corporation and published in *Money Magazine* (Wang, April 1997). The survey solicited price quotations for two plans – one with 100 participants and $2 million in assets, a second with 4,000 participants and $20 million in assets. Cost estimates for the smaller plan reflect the average of quotations from 17 major 401(k) providers. Estimates for the larger plan are based on 8 quotations.

Butler's survey findings can be compared to the two most comparable plan prototypes presented in the *Averages Book.* In order to standardize the cost estimates across differing assumptions about asset volumes, we have translated our "dollars-per-participant" estimates into "basis points" as a share of plan assets. Under this presentation, per-participant costs of $300 in a calculation assuming $30,000 of assets per participant, would equal costs of 1% of assets, or 100 basis points. The results of this comparison are shown in Table IV-5.

Table IV-5
Comparison of Estimated Total Plan Costs
401(k) Provider Directory and Butler Survey
Costs as Basis Points Applied to Plan Assets

Source	Butler Survey	40l(k) Provider Directory	Butler Survey	40l(k) Provider Directory
Plan Size	100 Participants $2 million assets	100 Participants $3 million assets	4,000 Participants $20 million assets	2,000 Participants $60 million assets
Average Cost	132 basis points	**140** basis points	99 basis points	110 basis points

(Sources: Butler, Pension Dynamics Corporation, as reported in Wang, *Money*, April 1997; H.R. Investment Consultants, 401(k) Provider Directory Averages

Book, 1997)

4.3.1 RANGE OF ESTIMATED PLAN COSTS

The Butler survey is based on a limited sample of major 401(k) service providers. It does, however, effectively capture the wide range of expenses that result from the diverse fee structures within the 401(k) marketplace. Table IV-6 illustrates the range of fee quotations for the prototype plan with 100 participants and $2 million in assets.

Table IV-6
Projected Total Annual Plan Fees
100 Participants, $2 million Assets
(17 major service providers)

Total Annual Fees As:

	Total Fees	Dollars per Participant	Percentage of Plan Assets
Lowest	$11,375	$114	0.57%
Mean	$26,435	$264	1.32%
Median	$25,600	$256	1.28%
Highest	$42,775	$428	2.14%

(Source: Butler, Pension Dynamics Corporation, in Wang, *Money*, April 1997)

Based on fee quotations from only 17 of the approximately 200 firms providing fully bundled 401(k) plan services, projected plan expenses vary widely. The highest projected cost is nearly four times the lowest projected cost.

4.3.2 REPRESENTATIVE SERVICE-PROVIDER FEE STRUCTURES

The wide variation in projected total expenses for a standardized plan prototype reflects the disparate – and potentially confusing – manner in which service providers charge for the full package of services involved in administering a 401(k) plan. The following discussion illustrates three possible fee structures and the expenses these structures would generate for a 401(k) plan with 100 participants and $2 million in total assets. The three fee structures represent potential fee structures that would result in low, average, and high expenses for such a plan.

Table IV-7 shows the component elements of three illustrative fee structures for a plan with 100 participants and $2 million in assets. Each fee structure includes a possible mix of fixed-dollar, per-capita, per-transaction, and asset-based charges typically involved in the purchasing of 401(k) plan services. The examples do not represent the advertised or quoted fees of any particular

401(k) plan provider. They reflect ranges in various fees and charges within the bounds identified in the available literature.

Table IV-7
Illustrative 401(k) Plan Fee: Schedule of Charges
Plan with 100 Participants, $2 million in Assets

	Provider A	Provider B	Provider C
Recordkeeping / Administration			
Base administrative fee	$8,500	$2,000	$1,500
Charge per participant	$ 25	$ 28	$ 33
Charge per distribution	$ 0	$ 0	$ 35
Nondiscrimination testing	$ 0	$ 500	$ 0
Filing of Form 5500	$ 0	$ 350	$ 0
Loan Processing			
Loan origination fee	$ 35	$ 75	$ 95
Loan maintenance fee	$ 20	$ 25	$ 0
Trustee Fees	$ 0	$2,800	$ 500
Investment Fees (% of assets)			
Average expense ratio of funds	0.42%	0.92%	0.80%
Other asset fees	0.00%	0.00%	0.90%

The potential impact of diverse provider fee structures can be shown by aggregating the costs that would result from the three sets of fees shown above. Table IV-8 shows the fees that would occur for a plan with 100 participants and $2 million in assets. Non-investment expenses reflect the total of all base charges, per-participant charges, and per-service charges that each provider includes in its fee structure. Distributions charges assume 10 payments per year. Loan charges reflect 10 new loans each year and 30 loans outstanding per year. Investment expenses reflect the application of the expense ratios and asset fees to an asset base of $2 million.

Table IV-8
Illustrative 401(k) Plan Fee: Total Fees
Plan with 100 Participants, $2 million in Assets

	Provider A	Provider B	Provider C
Recordkeeping / Administration	**$11,000**	**$ 5,650**	**$ 5,150**

Base administrative fee	$ 8,500	$ 2,000	$ 1,500
Participant charges	$ 2,500	$ 2,800	$ 3,300
Distribution charges	$ 0	$ 0	$ 350
Nondiscrimination testing	$ 0	$ 500	$ 0
Filing of Form 5500	$ 0	$ 350	$ 0
Loan Processing	**$ 950**	**$ 1,500**	**$ 950**
Loan origination fees	$ 350	$ 750	$ 950
Loan maintenance fees	$ 600	$ 750	$ 0
Trustee Fees	**$ 0**	**$ 2,800**	**$ 500**
Investment Fees (% of assets)	**$8,400**	**$18,400**	**$34,000**
Cost of expense ratios	$8,400	$18,400	$16,000
Other asset fees	$ 0	$ 0	$18,000
TOTAL FEES	**$20,350**	**$28,350**	**$40,600**
Total Fees per Participant	$ 204	$ 286	$ 406
Total Fees as % of Assets	1.02%	1.42%	2.03%

The distributions and variations of the component costs suggest some of the uncertainties faced by plan sponsors seeking to obtain plan services at reasonable costs. Provider A's fee structure generates the highest recordkeeping and administration fees. However, those are more than offset by significantly lower investment expenses. Provider C offers the lowest non-investment expenses, but its combination of expense ratios and other asset charges drives up the total cost significantly.

A new plan, with low average asset values, could – at least for a few years – face an exactly opposite total cost equation. Thus, an additional element facing plan sponsors shopping for plan services is how best to gauge the most advantageous fee structure over a forward-looking time horizon. As a given plan matures, and average asset values grow, total costs and the distribution of those costs are constantly shifting.

An attractively priced provider at a given point in time may present a much less attractive cost equation within a few years. However, if the growth and shift in costs are largely unseen or unknown, effective decisions may be delayed or not accurately assessed.

4.4. SUMMARY OF FINDINGS

The preceding analysis of provider-based information on 401(k) expenses captures several noteworthy aspects of how the 401(k) marketplace works. The following observations describe the essential features of how providers' fee structures translate into estimated costs for plan sponsors and/or participants.

1. Total plan costs are determined substantially by investment-related expenses. Investment expenses typically constitute 75 to 90 percent of total plan expenses.

2. There are significant variations in observed investment fees across the full array of 401(k) plan service providers. For a given amount of assets in a plan, expensive providers can generate fees several times higher than lower-cost providers.

3. Plan sponsors have control over overall investment-related expenses. Within a diverse marketplace with thousands of available funds, there is substantial opportunity to pursue fee reduction strategies. To some extent, the literature suggests that one problem sponsors face is the appeal of "name-brand" retail mutual funds to many participants. This appeal is often reinforced by the free or low-cost communication and education services that sponsors can obtain from these providers.

4. The other major expense categories – recordkeeping and administration, processing of loans, and trustees' fees – exhibit wide variations in the level of providers' fees and the manner in which those fees are structured. Some providers charge relatively high per-capita or per-transaction fees for certain services, while providing other services at low or zero charge. Plan sponsors shopping for the best price for a given package of services must assess the total effect of all of the components of the fee structure.

5. Larger plans enjoy potentially significant economies of scale. In the case of investment expenses, they have access to more providers offering a wide range of investment vehicles at lower cost. Very large plans may be able to reduce investment expenses even more through fee-reduction negotiations with the providers or use of lower-cost institutional accounts. In other expense categories, the combination of flat (or nearly flat) fees regardless of plan size, plus declining per-capita charges in the basic administration fee, reduce per-participant administrative costs among larger plans.

The 401(k) marketplace is diverse and complex. Different providers offer widely ranging packages of services, with significant variations in estimated costs. All plan sponsors have opportunities to pursue cost reduction strategies. Larger plans, through the market power of their larger asset holdings, can obtain additional price advantages.

SECTION V

SUMMARY AND CONCLUSIONS

5.1. SUMMARY

The introduction to this study discussed the important role that 401(k) plans now occupy in the future retirement security of American workers. This role is becoming more important, year-by-year, as the fraction of retirement assets in defined contribution plans grows. There has been a parallel shift in the responsibility for safeguarding the financial soundness of future retirement income streams, as individual workers assume the roles of investment decision makers for their accounts, supplanting the pension trustees who make decisions about defined benefit plan investments.

401(k) participants are responsible for selecting and funding the investment instruments, from the choices furnished by the plan, that, when added to the other components of their retirement plan, will achieve their retirement income goals. Informed participants make their selections based on their evaluations of the risk-return considerations of each investment available in their plans. They also should consider the relative costs of these investments in terms of their fees and expenses. However, participants have limited control over the fees and expenses charged for the investments among which they can select. In selecting a 401(k) provider, a plan sponsor has effectively acknowledged that the plan's fees and expenses are reasonable. Thus, plan sponsors, as a group, have established the "acceptable" range of fees and expenses.

The popular financial press has published a number of articles in recent months suggesting that many 401(k) plans charge "excessive" fees and expenses with the consequence that workers' opportunities to achieve their financial goals will be diminished. The purpose of this study has been to assess the nature of 401(k) fees and expenses, determine their magnitude, and assess the availability of information about these fees and expenses for making rational investment decisions.

5.2. CHARACTERISTICS OF 401(K) INDUSTRY

Section II of this report describes the structure of the 401(k) industry. This structure has an influence on the nature of fees and expenses charged to 401(k) plans.

In the 17 years since the first 401(k) plan was developed, a large subset of the financial industry in America has evolved to service the 401(k) market. The 401(k) industry has become sophisticated and complex. Section II of this report describes the major features of this industry. It is important, however, to note that the 401(k) industry is highly integrated with the overall financial sector, nationally and internationally. The full service 401(k) providers – banks, insurance companies, stockbrokers, mutual fund families, investment managers – are dominant in their own spheres apart from their positions in the 401(k) market.

The market offers 401(k) plans a full range of financial products, and plan sponsors have, over time, tended to expand the number of investment choices available to participants. Today the typical plan offers seven or more choices and many enable participants to choose among instruments displaying a large range of risk-return characteristics.

The services provided by typical 401(k) plans are elaborate. They evolved, in part, from the requirements of ERISA – annual reporting to the Internal Revenue Service, compliance testing, safeguarding of assets, for example. Over the years, services have become more elaborate in response to the demand of participants and sponsors. Many plans now offer features such as call-centers, interactive voice response systems, daily valuation of assets, elaborate information services, immediate loan processing, and other optional services for the convenience of participants and sponsors. Providing these services may be a significant factor affecting the schedule of fees and expenses.

Providers of 401(k) services are diverse and widely distributed. The larger full-service providers maintain elaborate, nationwide distribution networks. On the regional and local level, over 3,000 third party administrators and investment advisors are available to service plans through local alliances or by facilitating access to the national, full-service providers. Competition among these providers is keen, but surveys indicate that price is not usually the dominant discriminator used to select a provider (RogersCasey).

5.3. CONCLUSIONS ABOUT CURRENT ISSUES

This section summarizes the observations reported in Sections III and IV of the report. These remarks are structured to respond to three questions that the PWBA might reasonably ask about the fees and expenses charged to 401(k) plans.

5.3.1. WHAT IS THE LEVEL OF FEES AND EXPENSES BEING CHARGED TO 401(K) PLANS?

The scope of the study did not allow for original survey research on the fees and expenses charged to 401(k) plans; however, other measures are available to assess the levels and ranges of these fees and expenses.

A simple measure of the level of fees and expenses is to gauge whether 401(k) plans are charged more or less for investment instruments than are other participants in financial markets. This is possible since many instruments commonly offered by 401(k) plans are available to a wider range of buyers, retail and institutional. Section IV reported results from two plan-pricing surveys suggesting that the annual fees and expenses of a typical small plan of 100 participants would be about 140 basis points. This compares favorably with the average expense ratio of a set of retail mutual funds comparable to those offered

in a typical 401(k) plan, as reported in the financial press (Tables IV-2, 3), even though the 401(k) plan offers services not required by the retail investor. The price advantage of 401(k) plans improves when the economies of scale offered by larger plans are considered. Even at the low end of the size scale, the average 401(k) plan investment instruments are not more expensive than the offerings in the retail market.

The typical 401(k) plan compares favorably with retail investments when consideration is given to the ancillary services that such plans offer. Communications services, loans against account balances, access to a wider range of investment instruments, and rapid access to account valuations are examples of services often provided by 401(k) plans.

Another simple measure of the level of fees and expenses is to observe the range of fees being charged for comparable plans by different providers. Our review indicates that this range of fees and expenses is quite large. Steven Butler's price comparison, discussed in Section IV, had a very small sample, but many of them are among the nation's largest (Wang, April 1997). In this survey, the most expensive plan (in the small plan comparison) was 62% more costly than the mean, and the range from high to low was about 160 basis points.

This observation appears to underlie the conclusions reached by some observers that some 401(k) plans are paying too much for services. Their logic, apparently, is that a plan sponsor choosing a provider with costs substantially higher than the costs of other providers offering similar services is incurring excessive costs. The rational choice would be to choose the lower cost plan if the expected values of the plan investments and additional services are comparable. However, this hypothesis is not testable with the data currently available. It is reasonable to conclude, for example, that providers charging higher fees and expenses <u>do</u> offer extra services that justify the differences in price. Another possibility is that the type of investment requires greater research and monitoring than the average plan. For instance, an actively managed international equity portfolio needs, and can justify, much higher expenses than a passively managed US bond portfolio.

What factors would lead to a plan sponsor to accept a provider whose prices are not the lowest available? The evidence suggests that the 401(k) market is inefficient. In an efficient market, all the participants have access to all of the information that pertains to transactions. However, in the 401(k) market, many plan sponsors are not aware of the full range of providers' prices.

This observation may be more pronounced among the smaller firms that do not have ample benefits staff resources to research the sources of 401(k) provider services. A related factor in this inefficiency is that the 401(k) industry does not have a uniform protocol for displaying price information.

Survey results described in Section II illustrate that, for many plan

sponsors, price is not high on the list of considerations that are used to select a plan provider. Other data suggest that plan sponsors turn to the institutions that furnish the firm other financial services - banking, insurance, defined benefit plan management - to provide their 401(k) plan services and may not make an independent search for the lowest cost provider.

5.3.2. ARE FEES AND EXPENSES BEING INCREASINGLY PASSED TO PLAN PARTICIPANTS?

The largest component of administrative fees and expenses of 401(k) plans is the investment management fee. Evidence examined in this study shows that participants in 401(k) plans pay the majority of investment management fees. In the case of mutual fund expense ratios or where the investment management fees are otherwise incorporated in net asset valuation computations, participants pay all of the fees. Survey research shows that participants also pay all of the non-mutual fund investment management fees in over half of the plans surveyed.

The opposite is the case with other categories of administrative fees and expenses. Plan sponsors are more likely to pay all of these fees and expenses in the majority of plans surveyed. In one survey, conducted in 1997, for example, plan sponsors paid all of the non-investment management fees in 56% of the plans and shared in these costs in another 28% (Hewitt Associates, 1997). Other survey research confirms these data.

However, there is a small but distinct trend to pass more of the plan fees and expenses to the participants. The Hewitt survey, conducted bi-annually from 1991 to 1997 illustrates this trend (Table III-2). Similar results were obtained by Spencer Associates over a four-year baseline (Table III-3). Finally, an interesting result was obtained by RogersCasey in 1996. Table III-4 shows that a modest number of the plan sponsors surveyed expressed the intention to pay a lower percentage of the administrative expenses of their plans in future years.

5.3.3. DO PLAN SPONSORS AND PARTICIPANTS HAVE ADEQUATE INFORMATION ABOUT FEES AND EXPENSES?

The literature reports that the disclosure to sponsors and participants of fees and expenses imposed on 401(k) plans is often not complete and that this lack of information may affect the costs to the plans. Incomplete disclosure may take the form, for example, of the failure of a provider to disclose the fees used in the internal build-up of net asset values. This appears to be more common with investments such as stable value accounts and may also apply to wrap fees.

Another disclosure problem is reported to occur when plan sponsors are not able to determine the total costs incurred by their plans because of an inability to accurately assess all of the fees and expenses charged to the plan.

One study estimated that 78% of plan sponsors did not know their plan costs (Benjamin). This lack of knowledge of the plan cost structure precludes the ability to monitor plan performance and to control plan costs.

Participants in many plans are not being furnished information about the total amount of fees and expenses being charged against their accounts. The summary annual reports disclose itemized and census-based charges, but asset-based fees and expenses, in general, are not included. A major category of fees, the investment management fees imposed on mutual fund assets, is revealed only in prospectuses which are not always furnished to participants (and which may not be read in detail and with comprehension).

Many plans have taken steps to comply with the safe harbor provisions of ERISA, section 404(c). It might seem that this would eliminate the information shortfall for such plans. However, evidence suggests that the industry is interpreting the law such that only the expense information relevant to employee choices of investment instruments is being disclosed and that other fees and expenses, including wrap fees and the internal expense structure of stable value accounts, are not available.

The issue of whether plan sponsors and participants have adequate information about 401(k) plan administrative fees and expenses was the subject of public hearings held at the Department of Labor on November 12, 1997. A broad selection of stakeholders in this issue provided testimony. A frequently expressed opinion was that additional information about fees and expenses would be useful to both participants and plan sponsors, although this view was not unanimous. The most effective means of providing greater information remains unclear. The increased focus of plan sponsors and participants on fees and expenses may generate enhanced disclosure.

APPENDIX A

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A review of the table of contents suggests that this report does contain some information on fees and expenses of 401(k) plans but would not cover the entire range of such costs. Some of the useful exhibits include 1) average total recordkeeping fee per participant (1995 and 1996), 2) separate account management fees and mutual fund expense ratios (1996), and 3) a case study: IBM Corporation Savings Plan – Cost Comparison with Regular Mutual Funds (1996).

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This directory contains a schedule of both services and fees charged by 122 401(k) service providers including a representative selection of all categories of providers. The majority of the entries are for full service providers, including most of the largest. Thus the prices displayed represent those charged by the managers of well over half of all

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APPENDIX B

SAMPLE DISCLOSURE FORMS

A number of observers have proposed that plan sponsors use a standard format to record the fees and expenses that a provider would charge for a proposed plan. Such a form would reduce these costs to one, "all-in" price or to

a short list of costs. Such a form could also be used to communicate information about 401(k) fees and expenses to plan participants. Two such forms are enclosed (enclosures withdrawn from the Web edition of this report).

1. Vanguard has proposed a form that reduces all fees and expenses to a single expense ratio. It is suitable for use at the plan level or to display costs for a single participant's account.

2. HR Investment Advisors have provided a form that plan sponsors can use to collect standard sets of cost data. This form would be most useful in comparing the prices offered by two or more providers for similar plans.