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The Impact of Fees on Participant Outcomes

November 21, 2012 (PLANSPONSOR.com) - More employees are relying on defined contribution (DC) plans to be the largest or at least a significant source of their retirement income.

To reach the goal of retirement readiness, employees need to concentrate on a savings program that accumulates an account balance that is sufficient to meet their targeted income replacement during retirement. The variables in an effective savings program include early participation, adequate savings rate, realistic returns on investments, and plan fees. For employees this means that they need to start participating as soon as possible, save at an adequate rate, and allocate investments properly to provide institutional-like returns. For plan sponsors this means that they need to periodically review to ensure plan fees are reasonable.

What Makes Up Plan Fees?

To better understand how plan fees effect participant retirement savings you need to review what makes up the underlying cost structure and how fees are charged. Plan fees generally fall within three categories: Recordkeeping/Administration Fees, Investment Fees, and Individual Participant Fees.

- Recordkeeping/Administration Fees are the costs associated with the day-to-day operations and servicing of the plan. These operations and services include plan and participant daily valuation and accounting, portals to access information and initiate changes (voice-response systems, toll-free customer service and online), providing communication and education, compliance and custody/trust, and reporting. These fees are either paid by the plan sponsor or passed along to participants. Many times these fees are covered by revenue sharing from investment fees that are being deducted from investment returns.
- Investment Fees are the investment management fees identified with each investment option made available in the plan. Investment expenses typically associated with investment managers include management fees, 12b-1 fees (mutual funds), and other fees. Management fees, also known as investment advisory fees, are the charges for managing the assets of the investment portfolio. Rule 12b-1 fees are charges used to pay for the marketing of the fund, and pay brokers and plan service providers for distributing (selling) the fund. Other fees are those charges related to the day-to-day operations and administration of the investment product, including recordkeeping, portals to investment and account information, and furnishing statements. Each of these fees are ongoing asset-

based charges deducted from the investment performance and may be used in revenue-sharing to help cover plan recordkeeping/administration fees.

- Individual Participant Fees are the charges for services associated with the optional features offered in the plan. These optional features that can be initiated by participants can include loans, distributions, QDRO's, fund short-term redemption fees, investment advice and managed accounts, and the use of a self-directed brokerage account. These fees are charged directly to the account of the participant who chooses to utilize one of these plan features.

With an understanding of what makes up a plan's underlying cost structure, we can move on to what plan providers consider when determining fees and the range of fees that are currently being paid by plan sponsors.

Absent any custom communication campaigns or heavy onsite education, the initial consideration by providers has been the asset size of the plan. This was an important consideration since it helped plans absorb large start-up costs and provided recordkeepers with scale allowing them to drive down their unit costs. As asset-based investment-related fees became more common, plan asset size became less important and plan providers started paying more attention to the number of participants and the average participant account balance when determining the fees they charged.

Based upon our experience working with plan sponsors, participation in industry groups, and review of fee surveys and benchmarking studies we are comfortable providing a representative range of fees paid by defined contribution [401(k), 403(b), and 457] retirement plans. We have determined that plans with assets between $10 million and $100 million, fall within a range of fees (as a percentage of assets) between the highest fee of 1.70% and the lowest fee of 0.50%, with the average fee being 1.15%.

What Is The Impact Of Fees On Participant Savings?

Plan sponsors know that a participants' ending account balances will determine the amount of retirement income they will receive from the plan. While the contributions to their accounts and earnings on their investments will play a big role in their final account balances, fees paid by participants may substantially reduce the growth of their accounts. Using the information from the representative range of fees, Figure 1 shows the growth of a participant's account under each of the three fee scenarios.

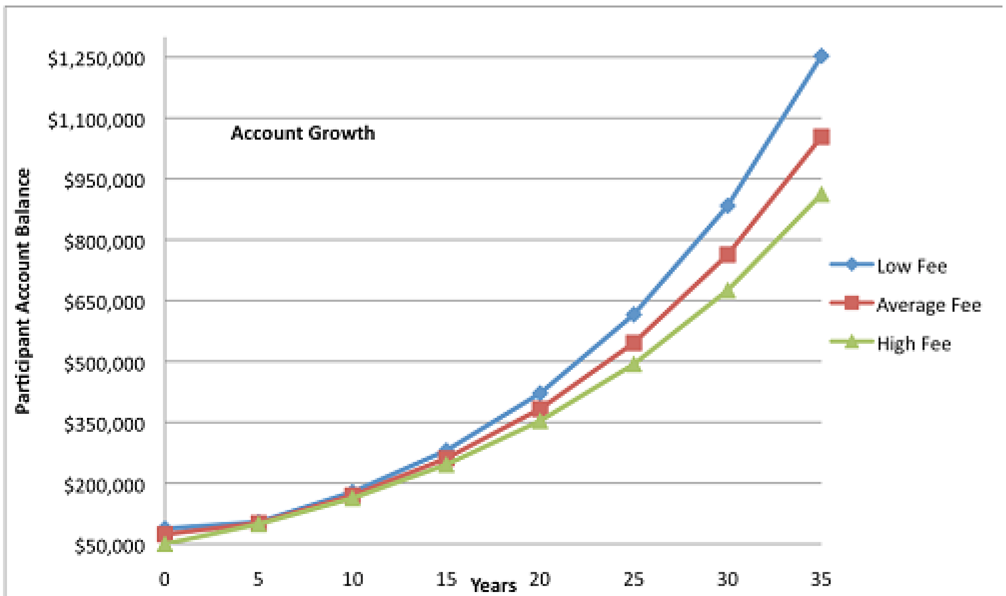

Figure 1: Participant account growth of a low, average and high fee plan.

All projections assume an initial participant account balance of $50,000; monthly contributions made to the plan of $500; average annual growth rate of 7% (before fees); fees are paid by participant; time period is 35 years.

A summary of the chart shows that the low cost plan would provide the participant with an ending balance of $1,253,271, while the average and high cost plans would provide a participant with ending balances of $1,053,932 and $912,196 respectively. The differences in accumulated assets comparing the low cost plan versus the average and high cost plans were $199,339 and $341,075, or nineteen (19%) and thirty-seven (37%) more in the low cost participants account over a thirty-five year period. These differences are meaningful and also translate over into the participant's retirement income. Based upon the accumulated values in the prior scenarios, a participant withdrawing at a five (5%) rate over a twenty-five year period would be able to withdraw $13,984 and $23,927 more a year in the low cost plan versus the average and high cost plans.

All things being equal, lower plan fees remove a significant hindrance on the growth of participant account balances, especially those participants with a long-term investment time horizon.

What Can Plan Sponsors Do?

Plan sponsors should review and understand their plan's contracts, services, and cost structure (including expenses and revenues). Once they have a good understanding of the services being provided, they need to determine the cost of each service and how and who are paying these costs. In addition, the plan sponsor needs to be aware of the investments in the plan that are providing revenue-sharing and the level of revenue that is being generated to pay the recordkeeping/administration costs. And if the revenue-sharing being generated is in excess of reasonable plan costs, the plan sponsor needs to make arrangements to lower the revenue-sharing or capture it within the plan for the benefit of the plan and its participants.

If the plan sponsor decides that prudence requires considerations beyond their current knowledge, hiring a consultant for help may prove to be valuable. Consultants bring a strong knowledge of the market and an outside perspective of provider service quality and costs. Consultants can help plan sponsors evaluate the reasonableness of their fees through comparisons with their other clients, recent service provider proposals they have received, and benchmarking surveys that they subscribe to. And if a plan sponsor wishes to gather more specific service and fees information regarding their plan, they can use a consultant to request and compile competitive responses from service providers through either a request for information (RFI) or a request for proposal (RFP).

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