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A GUIDE TO RETIREMENT PLAN FEES & EXPENSES

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In this paper, we will discuss retirement plan fees and expenses to assist plan sponsors in achieving a greater understanding of their plan operations. Generally, retirement plan fees can be classified into three main categories, but the associated services can apply to multiple categories. For the purposes of this paper, we will categorize the fees and then detail the specific functions typically related to each expense.

- Asset-Based Fees and Expenses are calculated as a percentage of plan assets and can be based on a portion or all assets of the plan.
- Participant-Based Fees and Expenses are calculated based on the number of participants in the Plan, and are typically used to pay for services such as monthly or quarterly statements and other administrative expenses.
- Itemized Service Fees and Expenses are typically applied as a fixed charge for a specific service provided, such as a participant loan or hardship distribution, plan implementation or plan termination.

Asset-Based Fees & Expenses

The evidence shows that the largest element of costs for retirement plans are asset-based fees and expenses; typically imposed as expense ratios of the investment products, mortality and expense fees imposed on assets in group annuities, and wrap fees. Asset-based fees generally comprise 75% to 95% of the total fees and expenses paid from plan assets. Asset-based fees are found in three categories: *Investment Products*, *Insurance Charges*, and *explicit Asset Charges*.

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Investment Products

Investment products come in a variety of forms. Listed below are the most common investment product expenses listed by product type.

Mutual Funds

A mutual fund is a professionally-managed type of collective investment product that pools money from many investors and invests it in stocks, bonds, short-term money market instruments, and/or other securities. They typically have a fund manager that trades the pooled money on a regular basis. The net proceeds or losses are typically distributed to the investors annually. Mutual funds typically have the following types of fees and expenses related to them.

Expense Ratio: An expense ratio is a fee charged as a percentage of the assets invested in a particular mutual fund. A typical mutual fund expense ratio can range between 0.20% and 2.0% of fund assets. The expense ratio can be broken down into three main categories: Investment Management, Administrative and Revenue-Sharing.

Investment Management Fee: This fee is charged to pay for the function of investment management; mainly the portfolio manager's time, the internal research and support of the investment management organization, and other associated expenses related to deciding which securities the mutual fund will acquire or sell. Typically, this fee ranges from 0.25% to 1.0% of assets in the fund.

Special Note on Trading Expense: Trading costs are part of the costs associated with investment management but they are not included in the expense ratio of a fund. Instead, they are paid by the actual shareholders out of the invested assets. In practical terms, this fee represents the cost of buying and selling securities. It includes the commissions charged to buy or sell a security; the liquidity cost for trading the security, which is represented by the spread between the bids and ask price; and the market impact of trading. These expenses can range from an average

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0.27% for low turnover domestic equity funds to 1.65% for high turnover domestic equity funds.¹

Administrative Expense: A portion of a fund's expense ratio is allocated to overhead expenses, such as the cost of registering the mutual fund, mailings, maintaining a customer service line, etc. Although these are all necessary costs, they vary in size from fund to fund. Typically, this fee ranges from 0.05% to 0.40% of invested assets.

Revenue-Sharing: This fee usually consists of 12b-1 Fees, Shareholder Servicing fees, Sub-Transfer Agency Fees, and Commissions. We describe each of these fees below.

12b-1 Fees: 12b-1 fees are charged by some mutual funds (*see* "Sales Charges" under "Other Expenses") to cover the expense associated with marketing and distributing the product. These fees are generally paid to an intermediary, often called the broker of record, for placing clients' assets in the fund. Additionally, these fees can be used to compensate a broker for education, or a Third Party Administrator (TPA) for plan administration or recordkeeping services. We find that this fee generally ranges between 0.25% and 1.0% of invested assets.

Shareholder Servicing Fee: Shareholder servicing fees are similar to 12b-1 fees, but are typically used by no-load mutual fund products. Only service providers such as TPAs, and not brokers, can receive these fees, which can be used to compensate a TPA for recordkeeping, annual administration, and education services. No-load fund products can pay up to 0.25% of

¹ Karceski, Jason; Miles Livingston; and Edward S. O'Neal. 2004. Mutual Fund Brokerage Commissions. *Zero Alpha Group*

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invested assets as a shareholder servicing fee without being required by SEC rules to call it a 12b-1 fee.

Sub-Transfer Agency Fees (Sub-TA Fees): Usually a payment to a TPA or recordkeeper who holds an omnibus account at the mutual fund company. Omnibus accounting eliminates the need for the mutual fund company to maintain individual participant accounts. Instead, participant accounts are maintained by the TPA or recordkeeper. Because this reduces the cost for the mutual fund company, they pay the TPA or recordkeeper a fee for this service. Typically, this fee ranges from 0.10% to 0.35% of invested assets.

Commissions: Commissions are usually paid from plan assets to a broker for servicing the retirement plan account. We have found that this fee typically ranges from 0.25% to 1.0% of invested assets.

Collective Investment Trust Funds or Commingled Investment Funds

These products are funds managed by a bank or trust company that pools investments of retirement plan assets from multiple plan sponsors in a manner similar to a mutual fund. These products have similar fee structures to mutual funds, in that they have an explicit expense ratio with a portion of the fees charged used to cover investment management expenses, while the remainder of the fees cover administrative costs and any potential revenue sharing that has been built into the product. Depending on the intent of the company that created the product, the usually lower administrative fee of this product can be passed along to investors in the form of a lower expense ratio, or it may be offset by higher revenue sharing that may be used to compensate a TPA for recordkeeping, annual administration, and education services. The fees associated with these investment products are similar in magnitude to mutual fund expenses.

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Stable Value Accounts

Stable value accounts are commonly used within defined contribution retirement plans to provide higher yields than money market funds, with similar stability of principal. These products generally invest in bonds with yields higher than what is available to money market funds, coupled with some sort of insurance guarantee on the portfolio to maintain a stable share price. Products within this asset class can be structured in many different ways.

These products have a similar fee structure to mutual funds in that they have an explicit expense ratio, with a portion allocated to cover investment management expenses, insurance fees, and administrative costs, and any revenue sharing that has been built into the product.

General Account Products or Guaranteed Investment Contracts

General account products are offered through an insurance company and promise principal preservation with a guaranteed fixed or indexed rate of return. In general account products, the guarantee is provided by the insurance company and is subject to their ongoing financial viability. The general account assets of the insurer support these products.

In contrast to the other types of investment products discussed in this article, these products do not have a stated expense ratio. Instead, the insurance company generates revenue by investing the assets in instruments with a higher yield than what it has guaranteed to their contract holders. The resulting “spread” is kept by the insurance company.

The fees charged are typically implicit, and may be used to cover investment management expenses, insurance fees, administrative costs, and any revenue sharing that has been built into the product. Because these fees are not explicit, it is very difficult to determine the actual cost to a retirement plan or its sponsor. In some cases, the “spread” cost may exceed 2.0% of assets invested in these products.

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Insurance Fees & Expenses

Variable Annuity Contracts

Insurance companies frequently use variable annuity contracts as the funding vehicle for retirement plans. The investment products are generally a mix of proprietary and non-proprietary investment products contained in separate accounts offered to participants. The variable annuity contract can include a “Variable Asset Charge” or other additional fees wrapped around the investment alternatives. Participants select from among the investment alternatives offered, and the returns to their individual accounts are reduced by the amount of any additional charges built into the contract. Variable annuity contracts also include one or more insurance elements. Generally, these elements include an annuity feature or interest and expense guarantees, and sometimes a death benefit is provided during the term of the contract. However, most of the Variable Asset Charge will pay for general administration, recordkeeping, participant services, and commissions paid to the selling agent and/or broker. In addition to investment management fees and administration fees, the following fees are often associated with variable annuity contracts:

Mortality and Expense (M&E) Fees: This is a fee charged by an insurance company to cover the cost of the insurance features of a variable annuity contract, including the guarantee of a lifetime income payment stream, interest and expense guarantees, and any death benefit provided during the accumulation period. M&E fees are typically imposed as an asset-based fee on the total assets invested.

Insurance-Related Charges: These charges are associated with investment alternatives that include an insurance component. They include items such as sales expenses, and the cost of issuing and administering contracts.

Surrender and Transfer Fees: An insurance company may charge these fees when an employer terminates a contract (in other words, withdraws the plan’s investment) before the term of the contract expires, or withdraws a significant amount from the contract. Surrender

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and transfer fees may be imposed if one of these events occurs before the expiration of a stated period and commonly decrease and disappear over time.

Fees related to variable annuity contracts typically range between 0.4% and 1.5% of invested assets.

Wrap Fees & Expenses

In cases where the vendor does not receive revenue sharing and does not utilize an insurance contract, they may assess a wrap fee on the retirement plan. The wrap fee is an all-inclusive asset-based fee imposed on the value of total assets in an account. These fees are a catch-all that can be used to pay for plan services from compliance testing to trust reporting. A wrap fee may cover all the expenses with the exception of itemized fees and investment management costs, and will be in addition to the fees the investment products charge.

As outlined, asset-based fees are charged as a percentage of plan assets, and are frequently deducted directly from the participants' accounts without the participants' knowledge. These fees can cover:

- Recordkeeping;
- Custodian services;
- Administrative services, including annual compliance testing and the preparation and filing of the retirement plan's Form 5500 ; and
- Participant services, including educational materials, enrollment meetings, statements, and a retirement plan website and call centers.

Participant-Based Fees

Participant-based fees are calculated as a flat charge multiplied by the number of participants in or employees eligible for the retirement plan. These fees are traditionally used to pay for employee education and communications options that were not included in the vendor's base package, such as additional enrollment books, and the use of non-electronic data inputs.

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These fees are similar to itemized expenses in that they can be charged for recordkeeping and administration. The difference is that these fees are based on the total number of people for which the service is performed, rather than on the specific service being performed.

Participant-based fees are typically assessed as a per participant charge in addition to the annual base fee. Depending on how the retirement plan is structured, the expenses are charged directly to the participant's account, or billed directly to the plan sponsor. A typical fee structure could range between \$10 and \$50 per participant for each additional service.

Itemized Service Fees

Itemized Service Fees are generally charged on an as-incurred basis, and may be paid by the plan sponsor, by the retirement plan, or by the participant. They are fees for specific services detailed in the vendor's service agreement. Some itemized fees are participant-based (i.e., fees charged on a per participant basis) while others are charged for a specific service to the entire retirement plan.

Examples of itemized services that would be paid by the plan sponsor, the retirement plan or the participant are services related to creating or terminating a retirement plan, acting as the retirement plan trustee, the preparation and filing of the Form 5500, originating and maintaining a participant loan, and making distributions from the retirement plan.

Examples of an itemized service fee include \$50 for the origination of a participant loan with \$10 per quarter loan maintenance fee; \$1,500 for annual non-discrimination testing; and \$2,500 for trustee services.

Brokerage Window Fees

A brokerage window is a plan investment option that allows a participant to establish a self-directed brokerage account inside the retirement plan. To allow this type of option within the retirement plan, there can be a plan-level charge, as well as a participant-level charge for each participant electing this option. Additionally, the participants may have to pay brokerage commissions on each trade within the self-directed brokerage account.

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Investment Advice Fees

More and more sponsors of individual account retirement plans (e.g., Code Section 401(k) plans) are entering into agreements with organizations that agree to provide individualized investment advice to retirement plan participants. In exchange for fees that are paid by either the plan sponsor, from the assets of the retirement plan or from the accounts of the participants who elect to use the advice services, the organization agrees to be a fiduciary of the retirement plan. From our experience, these fees range – on average – between .40% and .75% of invested assets.

Outside Asset Fees

Outside asset fees are a catch-all category of fees charged for hard-to-trade, illiquid assets (e.g., real estate) or assets held by a former vendor that the current vendor cannot access for daily valuations. Fees for outside assets will vary, but usually there will be a fixed fee charged for the manual recordkeeping process required to maintain the asset.

These fees are typically structured as an annual fee, along with either a small asset-based fee or per participant charge. The fees are highly dependent on the asset in question, and the total revenue generated by the retirement plan for the vendor.

Custody Fees

Custody fees are expenses associated with a service provider (such as a bank) holding the assets of the retirement plan. Custodians often carry the responsibility and liability associated with executing trades, investment directions, and distribution requests from participants, recordkeepers, and plan administrators.

A typical fee structure for custody services might include an annual fixed expense for ownership of a custody account, and possibly include a small asset-based fee as well.

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Trustee Fees

Trustee fees are expenses associated with a service provider holding retirement plan assets in trust, and preparing all tax filings and documents associated with the trust. Some providers do not offer to serve in the capacity of trustee. Among those providers that offer the services, some provide them at no additional explicitly-billed cost. When trustee fees are charged, however, they vary widely and are dependent on the scope of trust services provided. A directed trustee serves primarily as the custodian of plan assets with limited liability, as they are “directed” exclusively by the plan sponsor or the plan administrator as to investments. A discretionary trustee, on the other hand, has additional exposure to liability because it acts in an expanded fiduciary capacity, with discretion over investments.

Traditional fee structures include a flat fee regardless of retirement plan asset size and a sliding fee scale based on assets in the retirement plan. However, even these sliding fee structures generally have ceilings that make the fees lower when calculated per participant as asset size increases. In most instances, trustee fees average a few basis points per year.

Other Expenses

The fees discussed so far in this article are the most common types of fees paid for the ongoing services provided to retirement plans. The other expenses that might be charged include Sales Charges, Redemption Fees, and Market Value Adjustments.

Sales Charges

One set of expenses that is becoming less common, although some retirement plans still pay them, are sales loads. Many mutual funds have sales loads. There can be a front-end sales load investors pay when they purchase fund shares or a back-end or deferred sales load investors pay when they redeem their shares. For all but the smallest retirement plans, these two sales loads are usually waived.

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While front-end or back-end sales loads are relatively rare for retirement plans, another type of back-end fee is still in use. These back-end fees are usually built into an insurance contract or the recordkeeping service agreement. This back-end fee is sometimes called a "contingent deferred sales charge" (CDSC).

The CDSC is charged by vendors to help them recoup the initial costs they incur for taking on a new plan. Taking over a plan from another vendor requires a significant amount of work. Most vendors do not charge an implementation fee, and those that do rarely charge a fee that covers their total costs in the first year. Instead, the vendors amortize that implementation cost over the number of years they expect to provide services to the retirement plan. As a result, they may include back-end fees in case their services are terminated earlier than anticipated. The period of time that these charges typically apply ranges from two to ten years.

Depending on the circumstances, a CDSC can be the same for all participants in a group plan or specific to each participant in an individual agreement. (Individual agreements are commonly found in Code section 403(b) plans.) In most cases, the timeline during which a CDSC may be applied begins from the date of initial transfer of retirement plan assets into the contract. However, in some insurance contracts, each contribution into the retirement plan can have its own timeline.

The amount of the charge will depend on what the plan sponsor agreed to in the contract and how long the investor (e.g., a retirement plan) holds its shares. The charge is typically graded; decreasing to zero if the investor maintains his or her shares for sufficient time. For example, a CDSC might be 5% if an investor holds its shares for one year, 4% if the investor holds its shares for two years, and so on until the CDSC is eliminated. The rate at which this charge will decline will be disclosed in the fund's prospectus.

Exchange Fees/Early Redemption Fees

Mutual funds, particularly those that invest in less liquid asset classes, may also charge exchange/early redemption fees designed to limit short-term trading in the fund. These fees are charged by the fund to an investor as a back-end expense when the investor sells out of a fund after a short period of

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time (usually 60 to 90 days). Although a redemption fee is deducted just like a deferred sales load, it is not considered to be a sales load because it is paid back into the fund to compensate the fund for the costs of the investor's short-term trading activity. The SEC generally limits redemption fees to 2% of invested assets.

Market Value Adjustments

A market value adjustment (MVA) is the cost that is incurred to liquidate an investment earlier than what was initially anticipated. It is found on investment options where liquidity is limited and is dependent on the market environment at the time liquidation is initiated. The most common examples are stable value or guaranteed investment products. The way an MVA works is simple. If an investor makes an early liquidation of an investment that has an MVA provision, the market value of the investment product may be higher or lower than the book value that is reported to the investor at the time money is withdrawn. For example, if interest rates in the market are higher than when the investor initially purchased the annuity, the adjustment may cause the redemption value to be lower. Similarly, if interest rates in the market are lower than they were when the investor invested in the annuity, the redemption value may be higher than it would be without the MVA.

Conclusion

The retirement plan market is host to a myriad of fees that can make it difficult for plan sponsors to truly understand the cost that they, and plan participants, bear for maintaining their retirement plan. This is compounded by the convoluted way by which many vendors get paid. Fortunately, market forces are pushing retirement plan vendors to better disclose the revenue they receive and to simplify the way they price their services. It may be some time before costs are fully transparent, but it starts with each plan sponsor understanding what is being charged for the services being provided to their retirement plans.

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You can find more information on understanding plan fees at the Department of Labor's website. Below, we provide links that you may find useful:

DEPARTMENT OF LABOR/EMPLOYEE BENEFITS SECURITY ADMINISTRATION

www.dol.gov/ebsa

401(K) PLAN FEE DISCLOSURE FORM

www.dol.gov/ebsa/pdf/401kfefm.pdf

UNDERSTANDING RETIREMENT PLAN FEES AND EXPENSES

www.dol.gov/ebsa/pdf/undrstndgrtrmnt.pdf

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