Mountain or Molehill ~ Part 1

An examination of the impact of fees in a 401(k) Plan

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Fees? They're part of investing sure but what do they mean over time? There is wide variety of fees to be aware of and they can really add up.

Account fees, investment expenses, advisory fees, record keeping fees, custody and trading fees, and advisor compensation are all expenses that you may be paying. The fees you pay depend on the type of account you have and the services you are receiving. How much you pay and how you pay your fees can make a huge difference on the value of your investments.

This analysis will examine how fees may impact a 401(k) over time. In part one of this case study two different fee structures will be reviewed for a 401(k) plan. In part two the differences for an average participant in the plan and a shareholder of the corporation also in the plan will be reviewed.

For any financial projection there has to be a set of underlying assumptions that frame the analysis.

In this analysis perhaps the biggest assumption is that there is no secret sauce. The investment industry has billions of dollars riding on the idea that they have the secret to beating the market. This is no easy feat and over extended periods of time very few funds have outperformed their corresponding benchmarks. There is no magic recipe. With this in mind over extended periods of time fees become a key differentiator.

Recently a number of lawsuits including a case that was decided by the United States Supreme Court (Tibble v Edison) have brought fees for 401(k) plans under the microscope in a way that really hasn't happened before. Brand name firms like Boeing, Fidelity and Ameriprise have agreed to tens of millions of dollars in settlements with their employees over the issue of fees. The litigation train may only be gathering steam as folks become more aware of how fees can sap their retirement.

In this case study we will get to know the ANYCO 401(k) plan. ANYCO is a fictional small family manufacturing company. Being managed by the second generation, ANYCO has about seventy employees with fifty-five participating in their 401(k) plan. The plan has roughly $2 million invested for participants and are adding $150,000 annually, net of distributions.

There are a few other assumptions that are important in this analysis. Inflation is assumed to increase year by year at 2%. Fixed fees or fees not tied to assets are assumed to grow with inflation as are the net contributions to the plan. The tax rate for ANYCO is assumed to be 25% and services paid for outside of the plan's assets are assumed to be deductible. The last assumption is that the gross return before any expenses for assets in the plan is 7%. Asset based expenses expressed as percentages are subtracted from the gross return for each fee structure presented.

The ANYCO 401(k) plan currently is invested in funds with average investment expenses of 1.2%. For a small plan this is about average. This represents about $12 per $1,000 invested or $12,000 per million invested. As an asset based fee, when ANYCO's plan grows in value their fees go up even if the level of service doesn't necessarily change.

ANYCO's plan is bundled and the investment expense includes the record keeping for the plan, custody and trading of the plan's assets, the fund's expenses for investing and compensation for the advisor. Those services are all built in and their cost, paid for from the plan's assets, can be a drag on the plan with the participants who have larger balances effectively paying more.

The other significant expense is $5,000 for plan administration which is being paid by the company with deductible dollars outside of the plan's assets. Every year the plan needs to file a tax return and conduct the required testing for 401(k) plans. As these service related fees are not paid from the plan assets and are fixed related to an underlying service they won't fluctuate with the value of the plan and do not impact the plan's value. As a percentage of a two million dollar plan this would be about 0.25% of the plan's assets but this percentage becomes smaller and smaller as the plan's assets grow. Because this is a deductible expense, after taxes this would work out to 0.1875% in the first year.

It is key to remember that services for the plan, from providers like the plan's administrators, are negotiated by the plan sponsor. The sponsor can select just the services they want, paying for only those services and then paying with deductible dollars. This can apply to financial advisors as well.

Converting asset based fees to fees paid outside of the plan's assets with deducible dollars can create a real savings that may add up for participants with larger value account holders standing to benefit more from this shift.

In the course of reviewing their plan, the trustees of ANYCO's 401(k)plan were presented with an unbundled option with lower investment expenses, separate fees for record keeping, custody and trading as well as advisor compensation.

This new option has fund expenses of 0.20%. Custody and trading expenses would add another 0.07% to the asset based fees. The cost per thousand would be $2.70 or $2,700 per million invested. There is an annual record keeping fee of $60 per participant, which for ANYCO will total $3,300 and this is deducted from each participant's account. As a percentage of the plan this is 0.165%. Total fees coming from the plan expressed as a percentage is 0.435%. Or about 0.765% lower than their existing plan. This is about 63% lower in the first year.

Plan administration expenses were lowered to $2,520 based on the number of employees for the company or about 0.126% in the first year as a portion of the plan's initial balance or 0.09% after taxes. Also included in the plan was $12,000 for the financial advisor to conduct enrollments and education, meet with participants as required, assist with the formation and facilitation of a Retirement Plan Committee, and to meet regularly with the plan trustees to review the plan. As a percentage of the initial plan balance this works out to 0.60% before taxes and 0.45% after taxes.

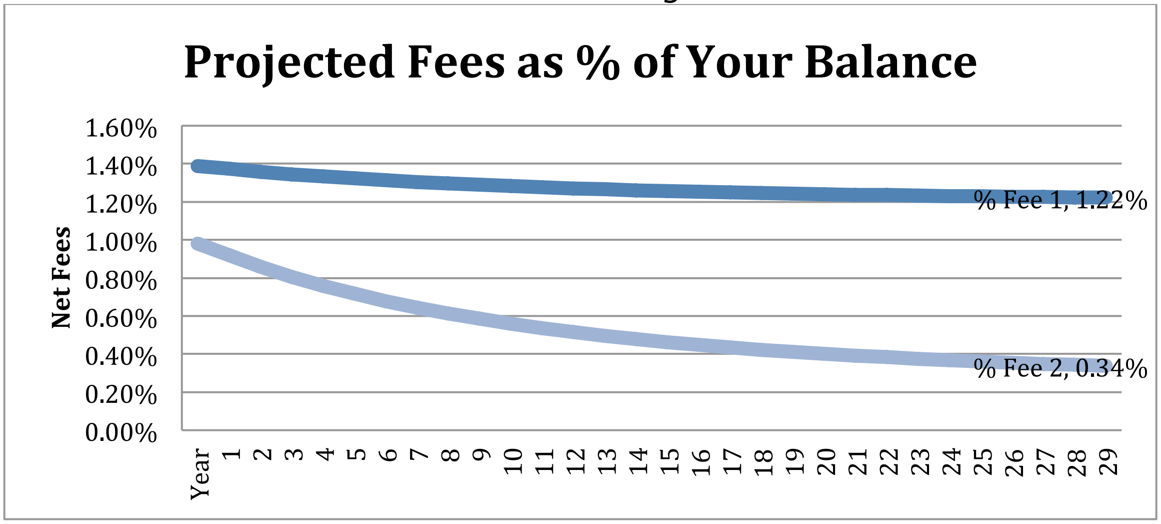
Table 1 ~ Net Fees as a % of Initial Plan Balance

Fee Description	Plan #1 Fee %	Plan #2 Fee %
Fund Expense*	1.20%	0.20%
Custody and Trading*	0.0%	0.07%
Record Keeping	0.0%	0.17%
Advisor's Fee	0.0%	0.45%
Plan Administration	0.19%	0.09%
Total % After Taxes	1.39%	0.98%

*denotes an asset based fee

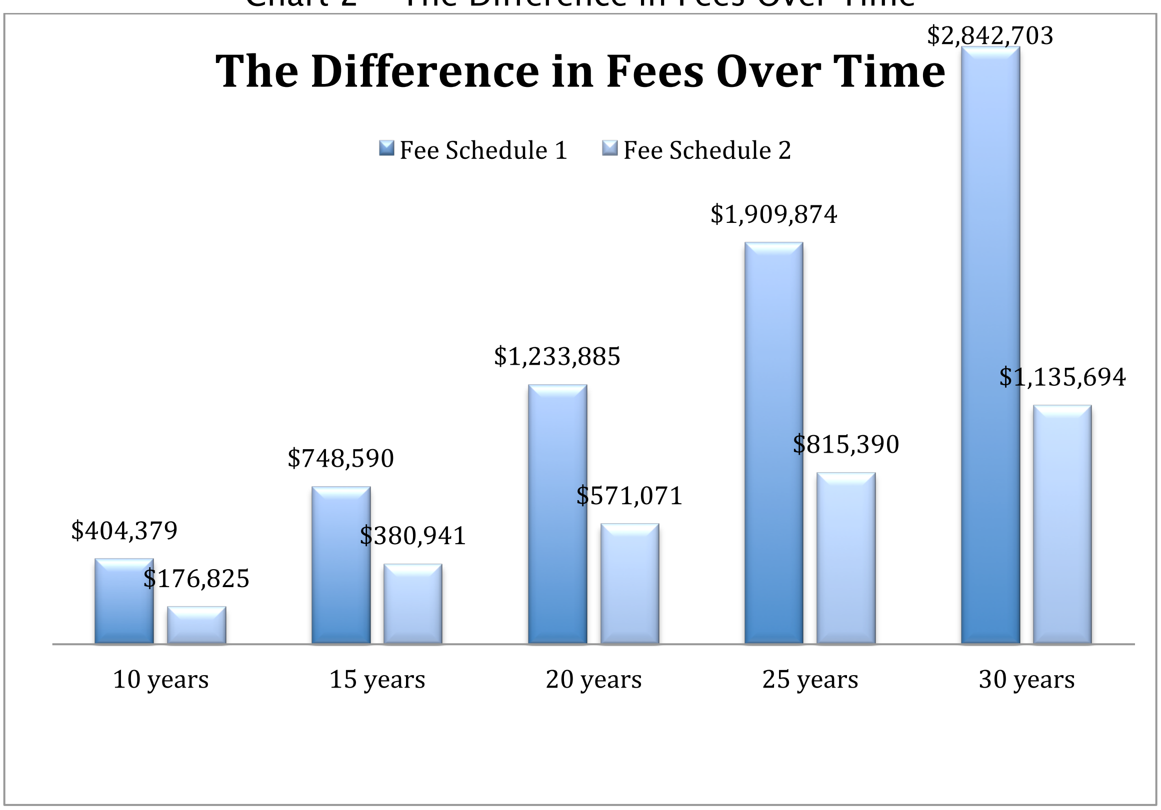
The difference is 0.41% or $4.10 per $1,000 invested or $4,100 per million invested and for ANYCO it is a difference of $8,200. Over time the new plan option, because of the higher portion of fees that are not based on the assets, will see the fees as a percentage of the plan will go down as the plan grows.

Chart 1 ~ Net Fees as a Percentage of the Plan Balance



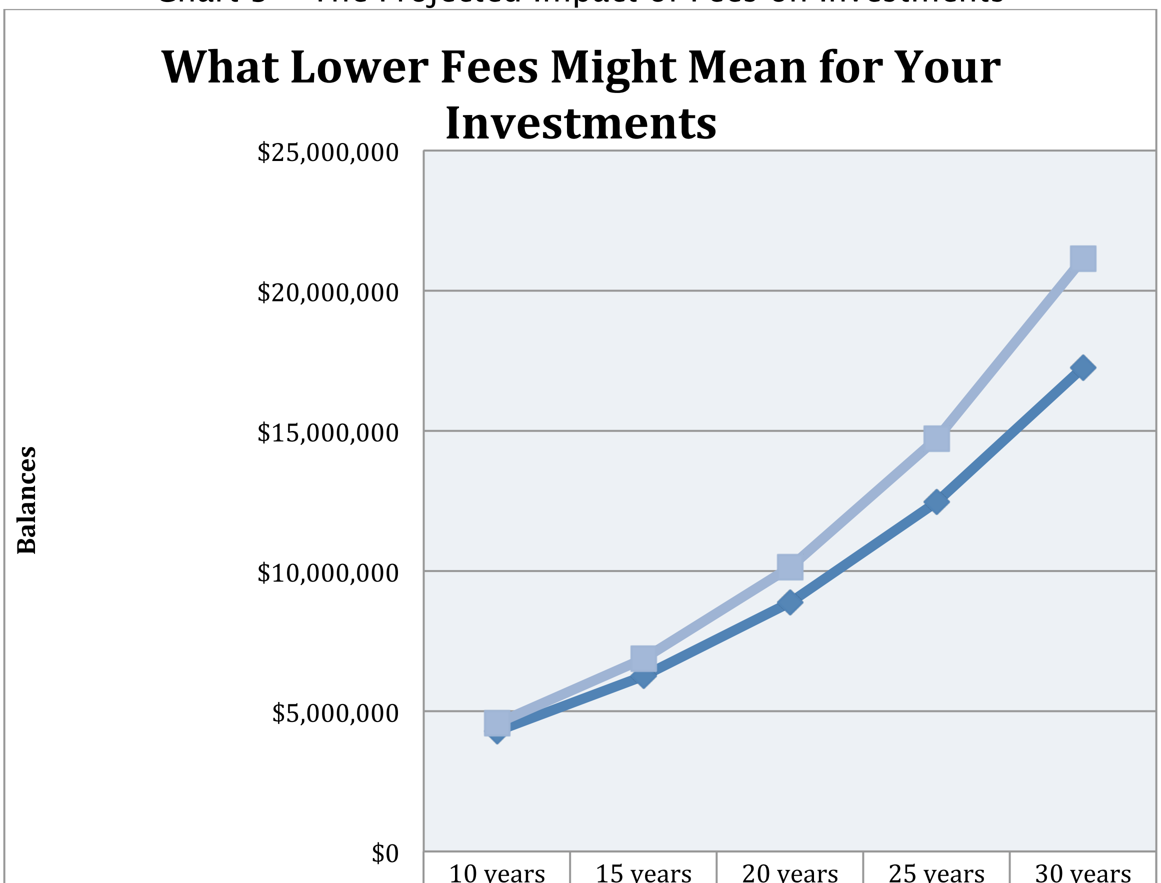
Reviewing the chart above, after thirty years given the assumptions outlined, the new plan option presented to ANYCO would result in the fees being 0.34% of the projected plan balance. This is slightly more than a quarter of the 1.22% of their existing plan for the same period. This difference is stark when examined in the dollars of expenses incurred over this period. The new option's fees are 72% lower.

Chart 2 ~ The Difference in Fees Over Time



The first year difference of $8,200 grows to almost $228,000 after ten years. ANYCO's existing plan is projected to cost almost twice as much as the proposed plan after fifteen years. The differences from there only grow over time. The important question is how might this, because of the mathematical magic of compounding, impact the value of the plan's assets over time?

Chart 3 ~ The Projected Impact of Fees on Investments



	10 years	15 years	20 years	25 years	30 years
Balance with Fee Schedule 1	$4,294,910	$6,246,471	$8,891,105	$12,460,499	$17,262,412
Balance with Fee Schedule 2	$4,572,870	$6,882,016	$10,139,265	$14,715,712	$21,125,954

The impact of lower fees after fifteen years could mean over half a million dollars more for the plan's assets and its participants. Ten years later it is more than two million dollars, with the lion's share of these benefits going to participants with larger balances. This may mean almost $36,000 more in retirement for the average participant.

How you pay for your retirement plan and the services you want may make a significant difference. Shifting fees from asset-based charges to deductible expenses can help your plan's bottom line for you and your participants. You can take control of your plan. Start by demanding clearly defined fees and then select and clearly define the services appropriate for your plan. Over time these changes may make a clear in difference in your retirement and for that of your employees.

Keep on the lookout for part 2 of Mountain or Molehill. In our next installment we will explore in more depth the potential differences for both an average participant and an employee-owner.

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Important Disclosures:

These projections are purely hypothetical. Rates of return, tax rates and expenses will vary over time and it is important to work closely with your advisor to monitor your progress and your goals.

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