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THE RETIREMENT SAVINGS DRAIN

THE HIDDEN &
EXCESSIVE COSTS
OF 401(K)S

BY ROBERT HILTONSMITH

ABOUT DĒMOS

Dēmos is a non-partisan public policy research and advocacy organization founded in 2000. Headquartered in New York City, Dēmos works with policymakers around the country in pursuit of four overarching goals—a more equitable economy with widely shared prosperity and opportunity; a vibrant and inclusive democracy with high levels of voting and civic engagement; an empowered public sector that works for the common good; and responsible U.S. engagement in an interdependent world.

ABOUT THE AUTHOR

Robert is a Policy Analyst in the Economic Opportunity Program at Dēmos. He joined Dēmos in March 2010 to provide research and analysis on issues surrounding retirement security in the United States, with a particular focus on how these issues affect young people. Since then, he's written on a wide variety of topics, including tax policy, fiscal policy, health care, and the labor market. Robert's research has been widely covered in the press, including the *Washington Post*, *Newsweek*, *Marketwatch*, *Reuters*, and *Kiplinger*. His writing has appeared in a variety of news outlets including *POLITICO*, *Newsday*, and *The American Prospect*.

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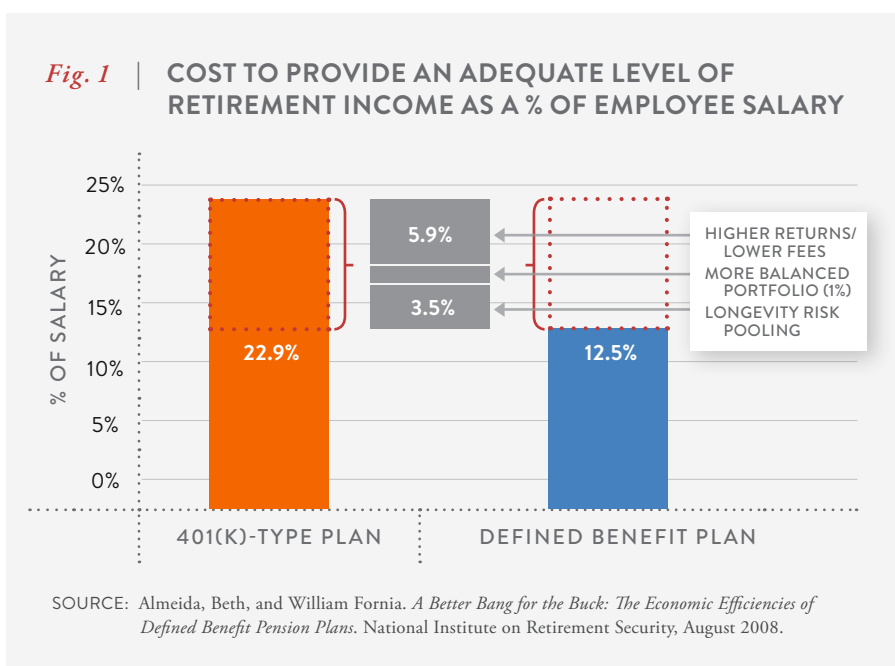
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INTRODUCTION

Do you know how much you pay for your retirement plan? If you're like many Americans saving for retirement in a 401(k)ⁱ, the answer is “no.” An AARP survey¹ found that 65 percent of 401(k) account-holders had no idea they were even paying fees, and 83 percent, or 5 out of every 6, lacked even basic knowledge about the many fees and expenses that everyone with a 401(k) pays. These include fees to cover the costs of advertising the plans and the companies who run them, fees to pay various investment managers of the funds in the plan, even fees to cover the costs of buying and selling the underlying stocks and bonds in which retirement accounts are invested. These fees, however, are taken “off the top” of investment returns or share prices—in other words, the rates of return and share prices reported to you in account statements and plan documents are post-fee. Because of this, retirement and bank account statements contain no evidence of these fees, and thus accountholders generally have no inkling how much all of this costs them.

Excessive 401(k) fees can take a surprisingly large bite out of the retirement savings of American families who are already struggling to save amidst long-stagnant wages and an idling economy. Dēmos has calculated that an “ordinary” American household (details provided later in this brief) will pay, on average, nearly \$155,000 over the course of their lifetime in effective total fees. To put this in perspective, this household could have bought a house with the amount they paid in fees. This is a price that families already trying to weather the risks of the contemporary U.S. economy can scarce afford to pay. The country needs to implement one of the many more efficient retirement savings ideas that have been proposed by institutions and individuals across the political spectrum to give all Americans a reasonably-priced means to save for retirement.



Though some might counter that fees are simply the price we pay for expert investment management², there is ample evidence that these fees are excessive—i.e. more than necessary to deliver excellent returns to savers—and can cost savers tens or even hundreds of thousands of dollars over the course of their lifetimes. As Figure 1 illustrates, the National Institute on Retirement Security estimates that administering the average defined benefit plan, or traditional pension, costs 46 percent less than a typical 401(k) to provide the same benefit level in retirement, largely because of the higher fees and lower investment

ⁱIn this brief, “401(k)” is used as shorthand to refer collectively to all types of individual retirement savings accounts, including 401(k)s, 403(b)s, 457s, IRAs, Keoghs, SEPs, etc.

returns of 401(k)s and the ability of defined benefit plans to pool risk.³

This brief will show that the excessive fees of the 401(k) system are due to the inefficiencies of an individualized retirement system. These fees, which are almost exclusively paid by savers, are an inherent part of that system, this brief argues, thus that any reforms to 401(k)s short of a complete overhaul can't eliminate, but only marginally reduce, excessive fees. Such reforms include oft-suggested fixes such as increased investment in index funds⁴ or regulatory tweaks, like the new Department of Labor fee disclosure rules slated to take effect on July 1st. These rules require most, but not all, fees charged by a mutual fund to be disclosed transparently to investors in a similar format to the interest rate-disclosure rules imposed on credit cards by the CARD Act. The new rules are a welcome step in the right direction, and will likely help reduce fees as sophisticated employees realize for the first time how much their retirement plan is costing them. However, as this brief will show, simply disclosing fees more transparently cannot correct the other factors that keep fees high nor can it fix the other weaknesses of an individualized retirement system⁵—market risk and longevity risk, among others. The multitude of risks and excessive fees are in reality consequences of the 401(k)'s individualized,

inefficient structure, and are an inherent part of that structure. If we want a retirement system that reduces savers' exposure to risk and charges them reasonable fees, the 401(k) cannot be the basis of such a system; simply, it needs to be replaced. What the new fee disclosure rules will do, however, is expose to 401(k) savers for the first time just how bad of a deal 401(k)s are, and build popular support for the wholesale reform of the retirement system that is needed to ensure that Americans have a chance to enjoy a comfortable retirement.

The brief simplifies the complex world of 401(k) fees by exposing four major fee categories: administrative, marketing, asset management, and trading. It details the costs of these fees, nearly all of which are borne by employees, and explains why these fees are so high. It ends with our calculations of the real costs of fees to several types of savers, and argues that the inherent inefficiencies of the 401(k) system necessitate a complete overhaul, rather than a tweak, of that system.

WHY ALL THIS TRADING?

Every mutual fund incurs trading costs each time it buys or sells the underlying stocks and bonds in which the fund is invested. Mutual funds buy or sell assets for two reasons: to fulfill the fund's investment objectives and whenever an investor buys or sells shares of the fund.

In the first case, actively-traded funds, which seek to maximize returns by rapidly buying and selling assets, incur much higher trading costs than passive funds, such as index funds, which simply invest in a set diversified portfolio or in a fixed mix of assets.

In the second case, each time an investor buys shares of the mutual fund, it must then purchase additional assets, incurring a trading cost. And each time an investor sells shares, the fund must pay the investor either out of its cash reserves or by selling some of its assets, also incurring trading costs. Thus, trading costs rise the more active the mutual fund's investment strategy; and the more investors trade the shares of the mutual funds itself.

TYPES OF 401(K) FEES

When an employee invests in a 401(k), they must choose from a set menu of investment options chosen by their employer. These options are primarily mutual funds, but can also often include company stock. A plan's mutual funds, in turn, must generally include a range of investment strategies, focusing on stocks (domestic and international), bonds (corporate or government), money market investments, or a mixture of assets. Each mutual fund in a 401(k) has a range of operating costs; costs which savers, who are the sole source of the funds' assets and investment firms' profits, pay in the form of fees. These fees, however, are mostly hidden from savers, because they're taken off the top of both mutual fund returns and share prices. Fees, therefore, don't appear on 401(k) account statements; they're generally disclosed only in the fund prospectuses or additional documentation for each fund in a 401(k)—documents which many savers don't read or couldn't reasonably understand. These fees/costs broadly fall into 4 categories (summarized below and in Figure 2):⁶

- **ADMINISTRATIVE FEES:**

Fund expenses for keeping records, providing statements, processing transactions, ensuring the plan complies with applicable regulations, answering savers' questions, and providing customer service. Administrative fees generally range from 0.2 percent to 0.4 percent annually.⁷

- **ASSET MANAGEMENT FEES:**

Salaries for portfolio managers (who oversee different portions of a fund's assets), investment researchers, and the other employees responsible for fund's investments. Asset management fees generally range from 0.5 percent to 1 percent annually.⁸

- **MARKETING FEES:**

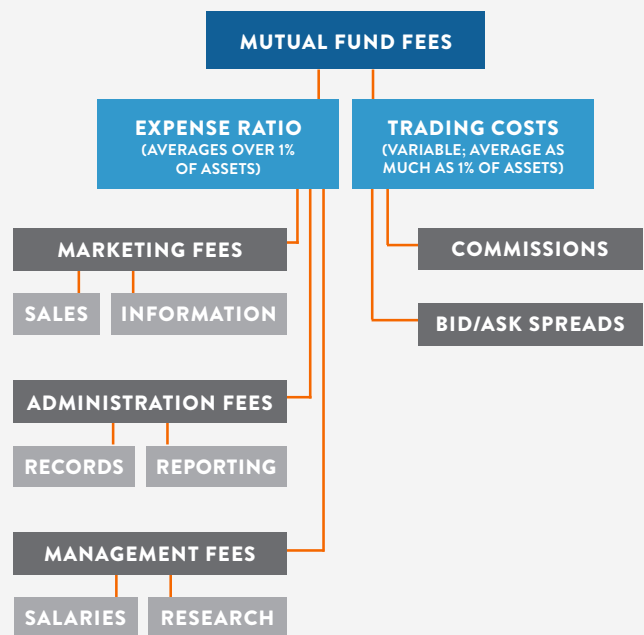
Also called 12b-1 fees, these include the expense of informing savers and potential savers about the mutual fund, including advertisements, brochures, and other informational material. Increasingly, mutual funds are lumping together a number of other costs under the umbrella of 12b-1 fees, including rebates to 401(k) "recordkeepers"—the companies that bundle various mutual funds into a 401(k) plan, sell it to

employers, and then keep the records for the savers in the 401(k)s. Marketing fees are limited to a maximum of 1 percent annually.⁹

- **TRADING FEES:**

The costs incurred by the fund when buying and selling the securities (bonds, stocks, etc.) that comprise a mutual fund's underlying assets. The reasons why mutual funds trade their assets are several, and summarized in the box below. Each mutual fund pays a commission to a securities broker each time it buys or sells a security, and it loses small amounts of money on "bid/ask spreads" that represent the difference between the actual buy or sell price for a security and its market value. In other words, if the fund wishes to sell a security, it generally must do so at a price that is slightly lower than its market value, and vice versa. If a mutual fund sells large blocks of a security, it must often do so at a progressively lower price, increasing costs. These fees vary from year to year depending on both the number of shares of a mutual fund bought and sold in a year, and on the frequency with which fund managers buy and sell the securities that comprise the underlying assets of the fund.

Fig. 2 | THE COMPONENTS OF MUTUAL FUND FEES



SOURCE: Adapted from Kopcke, et al. "The Structure of 401(k) Fees." *Issue in Brief* (2009): 9–3

Administrative, management, and marketing fees—a mutual fund’s (relatively) constant costs—are summarized in a fund’s expense ratio, as depicted in Figure 2. The expense ratio is the ratio of these fixed costs, calculated annually, divided by the total assets of the mutual fund. However, the expense ratio, which is intended to summarize the fund’s total cost to investors, does not include any of the fund’s variable costs, the most significant of which are trading fees. Because they’re not included in the expense ratio, trading fees are nearly completely hidden from retirement savers, though they can be nearly as large as the expense ratio itself. According to the Investment Company Institute, the trade association

of the investment industry, the median expense ratio of funds in 401(k) plans was 1.27 percent in 2010. However, because most retirement savers are in larger plans, the median expense ratio paid by savers was 0.78 percent.¹⁰ The expense ratio for the funds in a 401(k) can be found in the summary documents for the 401(k) plan that savers are given when they begin a job or enroll in the plan; they can also be found in the prospectuses for the individual mutual funds themselves. Because mutual funds’ expense ratios are fixed, and cannot be raised without the consent of the shareholders of the fund, the ratios are reported in 401(k) plan summaries in a table that often resembles Figure 3.

Fig. 3 | DEMOS EMPLOYEE 401(K): MENU OF MUTUAL FUNDS, YIELDS, AND EXPENSE RATIOS

INVESTMENT FUND	FUND INCEPTION DATE	10-YEAR YIELD	YIELD, INCEPTION TO DATE	EXPENSE RATIO
SSgA Government Money Market Fund	03/01/1983	1.52	3.79	0.75
JPMorgan Government Bond Fund - Class A	03/05/1993	5.89	5.88	0.76
PIMCO Investment Grade Corporate Bond Fund – Class A	07/30/2004	N/A	7.23	0.90
DWS Unconstrained Income Fund – Class A	06/23/1977	7.69	8.58	1.08
Fidelity Advisor Freedom Income Fund – Class T	07/24/2003	N/A	3.56	0.99
Fidelity Advisor Freedom 2010 Fund – Class T	07/24/2003	N/A	4.25	1.14
Fidelity Advisor Freedom 2020 Fund – Class T	07/24/2003	N/A	4.64	1.20
Fidelity Advisor Freedom 2030 Fund – Class T	07/24/2003	N/A	4.38	1.26
Fidelity Advisor Freedom 2040 Fund – Class T	07/24/2003	N/A	4.36	1.30
Fidelity Advisor Freedom 2050 Fund – Class T	06/01/2006	N/A	0.01	1.32
BlackRock Global Allocation Fund, Inc. – Investor A Class	10/21/1994	8.12	9.54	1.17
Janus Balanced Fund – Class S	07/06/2009	N/A	9.78	1.09
Davis New York Venture Fund – Class A	02/17/1969	3.37	11.47	0.89
SSgA S&P 500 Index Fund	01/01/1978	2.26	10.39	0.70
Thornburg Value Fund – Class R4	02/01/2007	N/A	-4.03	1.25
Calvert Equity Portfolio – Class A	08/24/1987	3.28	7.04	1.23
Goldman Sachs Capital Growth Fund – Class A	04/20/1990	1.26	8.16	1.14
SSgA S&P MidCap Index Fund	09/01/1988	6.31	11.22	0.70
SSgA Russell Small Cap Index Fund	10/01/1996	4.85	7.72	0.95
Alger Small Cap Growth Institutional Fund – Class I	11/08/1993	6.08	8.49	1.23
Thornburg International Value Fund – Class R4	02/01/2007	N/A	-1.00	1.25
Invesco Developing Markets Fund – Class A	01/11/1994	15.43	5.81	1.53

SOURCE: Demos 401(k) Plan Summary Documents

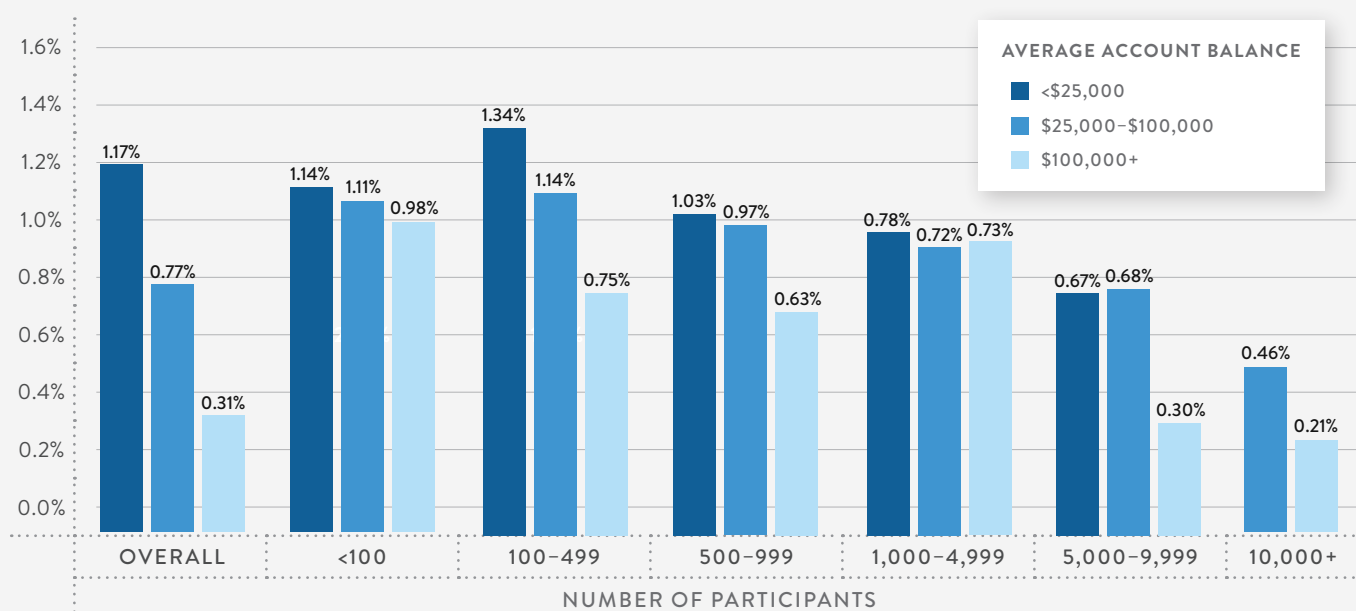
THE TRUTH ABOUT FEES

Examining the menu of mutual funds available in a real-world 401(k) helps to illuminate the true impact of fees. Figure 3, from Dēmos’ own 401(k), lists, in columns running from left to right, our organization’s available investment funds (mostly mutual funds), the date the mutual fund was created, the average yearly yield (return) for each fund over the past 10 years, the average yield overall since the fund was created, and the fund’s expense ratio, all expressed as percentages. The expense ratios, in the last column, range from 0.7 percent to 1.32 percent and are fairly typical for a smaller 401(k). However, the average expense ratio of these funds, 1.1 percent, is slightly lower than the median of 1.27 cited above. According to the Investment Company Institute, asset-weightedⁱⁱ expense ratios average 0.7 percent for bond mutual funds (funds that are mostly or wholly invested in bonds) and 1 percent for equity mutual funds;¹¹ the funds in Dēmos’ 401(k) are a mix of the two kinds. These fees are taken “off the top” of the funds’ yields, meaning that fees have already been deducted from the yields listed in the table. In other words, a Dēmos employee who had invested in these funds over the past years would have actually earned the yields listed.

Figure 4 helps to put Dēmos’ 401(k) plan into context in the universe of 401(k) plans. Though Dēmos, with 70 employees, is not a small employer by the standards of the Bureau of Labor Statistics, its 401(k) plan is a small plan, according to data from a recent study by the Investment Company Institute and Deloitte.¹² Though about three-quarters of all 401(k) plans are smaller than Dēmos’ in terms of assets and participants, because most savers are part of large plans, nearly 90% of all savers belong to a plan larger than Dēmos’. And as Figure 4 shows, size matters. The average expense ratio of the mutual funds in a 401(k) plan decreases precipitously as both the plan’s assets and its number of participants rise. The smallest plans, with 10 participants and an average account balance of \$10,000 have an average expense ratio of over 1.4 percent, while the expense ratios of the largest plans average less than a third of that, less than 0.4 percent. This difference, as the following example shows, can have a profound effect on the size of savers’ nest eggs when they retire.

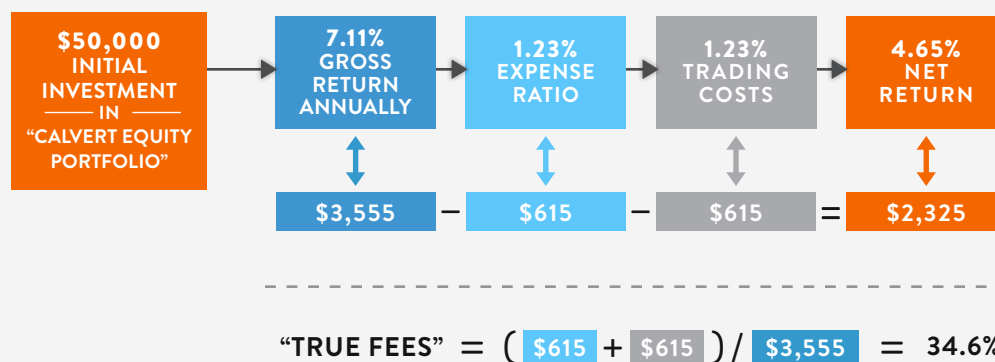
ⁱⁱAn asset-weighted average is the industry-wide average expense ratio, calculated by weighting the expense ratio of each fund by the value of assets that are invested in that fund. The asset-weighted expense ratio is lower than the “vanilla” average or median because a large share of total 401(k) assets are invested in large 401(k) plans, whose funds generally have lower expense ratios.

**Fig. 4 | MEDIAN MUTUAL FUND EXPENSE RATIO:
BY AVERAGE ACCOUNT BALANCE & NUMBER OF PLAN PARTICIPANTS**



SOURCE: Rosshirt, Daniel. Inside the Structure of Defined Contribution/401(k) Plan Fees. Deloitte/ICI, November 2011.

Fig. 5 | MUTUAL FUNDS' TRUE COSTS: "CALVERT EQUITY PORTFOLIO" EXAMPLE



SOURCE: Demos Analysis.

An example investment with actual dollar values helps to clarify the impact of the expense ratio on retirement savers' account balances. Let's pretend that I have \$50,000—the median amount that households with retirement savings have in their retirement account(s)¹³—invested in the “Calvert Equity Portfolio” fund, located about ¾ of the way down in Figure 3's list of funds. The Calvert fund has averaged a 4.65 percent net return, or yield, over the past decade, and for simplicity's sake, let's pretend it also yields 4.65 percent, net, in the coming year. So, at the end of the year, my \$50,000 investment will have grown to \$52,325. This seems simple enough, but in reality, this \$52,325 is actually my balance **after** the Calvert fund has deducted, behind the scenes, its explicit fees—i.e. its expense ratio—of 1.23 percent. As mentioned above, this is 1.23 percent of my entire account balance, so Calvert actually deducted its \$615 in fees before it gave me my return. In reality, Calvert actually invested my \$50,000 and earned (\$2,325+\$615=) \$2,930, in gross investment returns, which works out to be 5.88% of my original \$50,000. It then took its fixed 1.23%, \$615 in my case, and gave me the remainder, which happens to work out to the 4.65 percent return listed.

However, reporting fees as a percentage of assets actually disguises their true cost. In much of the rest of the business world, transaction fees are generally expressed as a percentage of the value added by a purchased service, or by the value of a purchased good, not as a percentage of our own assets. If you purchase a ticket to an event online and the company selling you the ticket charges you a service or convenience fee of, say, 5 percent, they mean 5 percent of the

value of the good they're selling you—the price of an event ticket—not as a percentage of your bank account balance. But that's exactly what mutual funds are doing: they list fees as a percentage of your account balance. But investors aren't paying mutual funds to store their money; they're paying them to earn returns on their investment. A more accurate way, therefore, to express mutual fund fees would be as a percentage of gross returns they earn investing savers' money, not as a percentage of assets themselves. Using our above example, Calvert deducted \$615 in fees from the \$2,930 they earned investing my money. If we express fees as a percentage of gross return then Calvert actually charged me 615/2930=20.9 percent in fees. Calculating fees in this more accurate fashion reveals that fees are actually far larger and, as we'll show in our real world example below, more harmful to workers' retirement prospects than the seemingly-small expense ratios imply.

The 20.9 percent “true fee” calculation above, however, doesn't include trading fees, which are not accounted for in the fund's fixed expense ratio, which is often purported to measure a fund's cost to investors. Despite this exclusion, savers also bear the costs of trading fees. Savers (and sometimes employers, depending on what share, if any, of the costs of a 401(k) they choose to pay) by definition pay these fees for mutual funds: since savers provide the only source of capital for investment funds, all trading fees incurred by the fund must necessarily come out of that savings or the income earned on that savings.

So why then are trading fees, which often cost savers as much as or more than the explicit expense ratio,¹⁴ only disclosed in cryptic “Statements of Additional Information,” which even then only report aggregate, not per-participant, trading costs? The answer given by most mutual funds is that trading costs vary, sometimes substantially from period to period. This is certainly true: the frequency of both types of trades that incur trading fees—when the mutual fund trades its underlying assets and when the shares of the mutual fund itself are traded—varies substantially with market conditions. The more important reason, perhaps, for funds’ lack of transparency around trading fees is that mutual funds are not legally required to disclose trading costs except in the aforementioned arcane “Statements,” and so, these statements are only place they do disclose them. Mutual funds have an incentive not to disclose trading costs any more transparently because, according to basic economic theory, hiding the true costs paid by 401(k) savers will dissuade fewer potential investors and therefore increase profits.

Including trading fees in our above example fee calculation reveals that 401(k)s’ true costs to savers are even larger. Using the Calvert Equity Portfolio fund (an actively-managed mutual fund) again as an example, if its explicit expense-ratio fees, are 1.23 percent, then we can estimate, given previous research, that its trading fees are likely equally costly, meaning that its total, true fee burden is double the expense ratio: 2.46 percent. So, updating our previous calculation, the fund has actually earned an average gross return in the past decade of 7.11 percent, and according to our “true fee” calculation, takes a surprising 34.6 percent of that rate of return to cover its expenses, as shown in Figure 5. But even this 34.6 percent number understates the Calvert fund’s fees. The 7.11 percent gross return is what economists call the fund’s “nominal” return, i.e. before the effects of inflation are taken into account. Since inflation generally averages about 2 percent per year, the Calvert fund actually earned a real, inflation-adjusted return of 5.01 percent in the past decade. Thus, after adjusting for inflation, the fund’s true fees are $2.46/5.01$, or an astronomical 49.1 percent!

WHY ARE FEES SO HIGH?

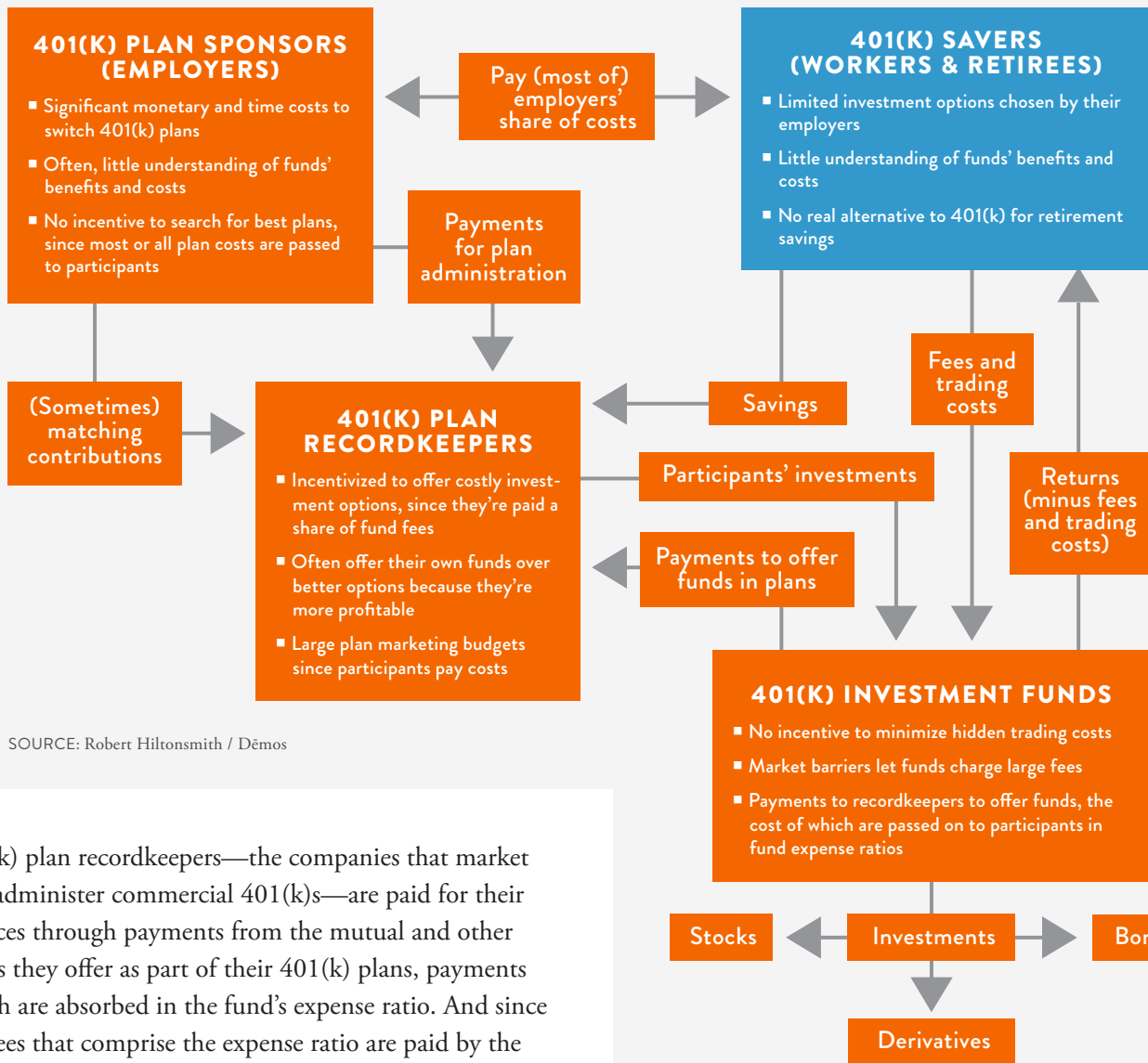
More than 30 years after the great shift in our country’s retirement system from defined benefit pensions to 401(k)s and similar plans, why are fees, which limit Americans’ already-scarce retirement savings, still so high? The answer is that the market for individual-account retirement savings is neither efficient nor competitive. 401(k) savers and plan-sponsoring employers lack information about the true costs or even existence of retirement plan fees and how they reduce returns. Both employers and employees also face difficult barriers to switching between investments or plans. Both these barriers and the lack of fee information combine to make the market for 401(k)s inherently uncompetitive. And this lack of competition in turn allows the sellers in the retirement market—the investment funds and 401(k) providers—to charge the buyers—employers and workers—whatever price for their services that maximizes the sellers’ profits. This price is further inflated by the inefficiencies of the individualized, atomized mutual fund industry. Because 401(k) savers’ assets are spread between thousands of essentially-identical or similar mutual funds, many savers, particularly those in smaller 401k plans, are unable to benefit from efficiencies—lower costs—from what economists call “economies of scale.”

To detail why these inefficiencies are an inherent part of the 401(k) market, we first need to clearly name and understand all of the “players” in this market since its complexity is a major reason why providers are able to charge such high fees. Figure 6 depicts the four different players in the market and the capital flows between them, and outlines some of the advantages and disadvantages each player faces.

Complexity

The first reason that fees are high is the inherent complexity of the system. As Figure 6 shows, the many players between 401(k) savers and the underlying assets—stocks, bonds, derivatives, etc.—in which savers’ funds are actually invested both increase the complexity of the 401(k) system and create additional costs, the vast majority of which are borne by invested workers and retirees.

Fig. 6 | THE PLAYERS & FLOWS IN THE 401(K) MARKET



SOURCE: Robert Hiltonsmith / Dēmos

401(k) plan recordkeepers—the companies that market and administer commercial 401(k)s—are paid for their services through payments from the mutual and other funds they offer as part of their 401(k) plans, payments which are absorbed in the fund's expense ratio. And since the fees that comprise the expense ratio are paid by the unwitting savers, mutual funds have little incentive to keep those payments to recordkeepers low, and so they engage in bidding wars to be included in the most lucrative plans. Along with payments to middlemen in the 401(k) system—such as the stockbrokers and exchanges paid commissions to execute purchases and sales of assets for the funds, as well as the high salaries and expenses of the mutual funds themselves—the expenses incurred by all layers of this complex system are passed directly on to investors. Combined with the complacency of employers and the high barriers to finding the best retirement plan, the 401(k) system is a very bad deal for workers.

Employees' Lack of Knowledge

As the previously-mentioned AARP study shows, most workers who contribute to 401(k)s have extremely little knowledge of the costs of their retirement plan. This ignorance, however, is hardly unjustified: deciphering the complexities of the opaque, confusing 401(k) system is practically a full-time job, one which most people simply do not have time for on top of the already-overwhelming responsibilities of work, family, and life; in fact,

deciphering complex financial markets is precisely what professional financial advisors do. 401(k) savers perhaps assume that, given the limited menu of funds offered in their employer plan, their employer has done their homework for them, and all of the available investment options are safe and relatively interchangeable. In practice, savers frequently choose unwisely: a majority of 401(k) investors believe that higher fees guarantee higher returns,¹⁵ when in fact the opposite is true—lower-fee index funds often have higher net returns than higher-fee actively managed ones.¹⁶ This lack of knowledge of the costs of their retirement plan hurts them in other ways, as well: it allows the other players in the 401(k) system—employers, recordkeepers, and the funds themselves—to pass the costs of the system on to workers, leaving them holding a large bill.

Employers' Lack of Knowledge

Employers offer 401(k)s to their workers because they believe that offering a retirement plan helps them attract and retain skilled employees. However, because employers have little incentive to ensure that they offer their workers the best possible retirement plan, they look to minimize the cost to themselves of offering those benefits, which they do in several ways. When shopping for a retirement plan, recordkeepers typically offer employers several versions of the same plan, versions that have identical investment options but higher or lower expense ratios for those options depending on how much or little employers want to pay, yearly, to the recordkeeper for plan administration. Employers are increasingly choosing plans with little or no employer costs but higher expense ratios, passing on the costs to their employees. A 2011 survey by the Investment Company Institute reported that employees currently pay 91 percent of all fees, a steep rise from the 78 percent they paid just two years earlier.¹⁷

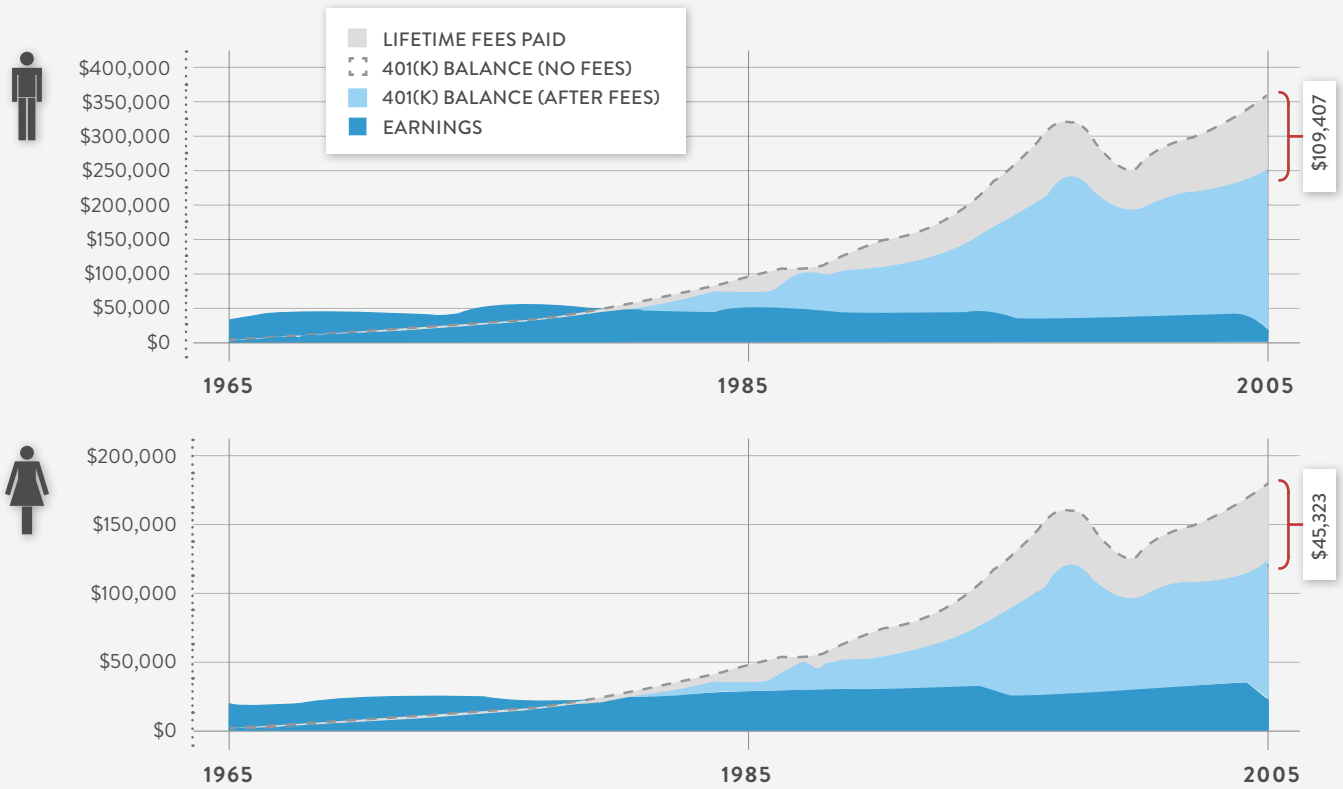
Fees are also driven up because switching retirement plans can be quite expensive to employers, in terms of lost employee time. Therefore, the less that employers directly pay for their retirement plan, the less incentivized they are to look for a lower-cost one, leaving their employees stuck with a costly plan. Other employers might not even consider switching retirement plans, not realizing how

costly their plan is to their employees. At many companies or organizations, particularly small ones, there is a single employee in charge of administering the retirement plan, and plan administration is often just a small portion of their job responsibilities.¹⁸ Decoding the complexities of a retirement plan's fee structure may be impossible given their limited time and knowledge.

Inefficient Market Structure

The final reason why mutual fund fees are excessive is simply the structure of the individualized retirement market itself. In this market, the \$9.2 trillion that savers had invested in IRAs and 401(k)-type plans, as of 2010, is divided between thousands of “different” mutual funds in dozens of investment classes, which in reality (by class) differ little from one another: the long-term standard deviation of funds from class-average performance is actually quite low. This dispersion of 401(k) assets actually hurts savers much more than it benefits them. The division of assets amongst so many funds prevents 401(k) savers from benefitting from the lower costs and pooling of risk resulting from “economies of scale.” Large asset pools, such as state and local pension funds, can also use the leverage that comes from size to negotiate lower asset management fees, and administrative costs per investor are naturally lower since those costs are divided amongst a greater number of people. In addition to reducing costs, asset pooling benefits investors in other ways as well. When investors pool their assets and returns are shared evenly, market risk to these investors is reduced, since the asset managers can invest in a more diversified portfolio with a longer-term horizon. Asset managers of large investment pools also have access to certain asset classes, such as private equity and hedge funds, in which small investors are barred from investing.

Fig. 7 | MODEL ESTIMATES OF LIFETIME 401(K) BALANCE & FEES



SOURCE: Dēmos’ Fee Model Estimates (See Appendix for Methodology).

MODELING THE LIFETIME COST OF FEES TO “IDEAL SAVERS”

How much, exactly, do all these fees from the complex, opaque 401(k) system end up costing workers over the course of a lifetime of saving for retirement? After all, there would hardly be cause for concern if fees added up to only a few dollars, or even a few hundred, minimally impacting workers’ retirement prospects. But the reality is that, even for middle-income households, under ideal savings scenarios, the lifetime costs of 401(k) fees can be hundreds of thousands of dollars.

To calculate how much these fees cost over a lifetime, we used a hypothetical two-earner household, each of whom earned the median income every year from age 25 to their retirement at 65, beginning in 1965 with steady contributions through 2005. We selected this time frame

to estimate the effects of a lifetime of savings and fees, with an end—where their lifetime returns weren’t inflated or deflated by an expansion or recession (see Appendix for details on our methodology). Based on actual average contribution rates²⁰, we assume that this household begins their career saving 5 percent of their combined gross income in a 401(k), and steadily increases 8 percent by retirement. Though both members of our household earn the median income, they are actually “ideal” retirement savers because they both save consistently over their entire careers without interruption or withdrawing any portion of their savings early. In the real world, many families experience significant drops in their income over the course of a lifetime as they suffer through unemployment and economic downturns, or cut back on their hours to take care of their children or parents. They also often cut back

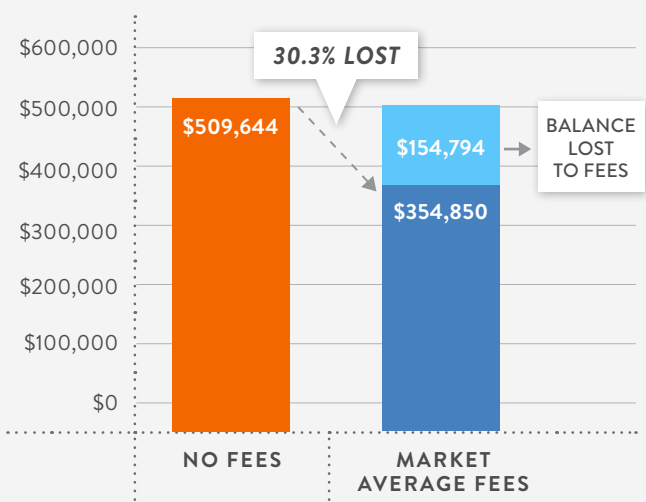
or stop saving for retirement at some point during their working lives, or withdraw from their retirement savings.

We do not take into account any employer contributions; our fee calculation is simply intended to reflect the returns lost from savers' own savings. We presume that they invest their savings equally in a mutual fund which invests primarily in bonds and a fund which focuses on stocks. The household's stock and bond mutual funds each annually earn the average, index return for their asset class, and the returns on the household's savings are compounded annually. As per the Investment Company Institute's most recent data on fees²¹, we assume these funds carry the (asset-weighted) mean expense ratio for their asset class: 0.72 percent for bond mutual funds and 0.95 percent for stock mutual funds. Finally, we presume, according to the consensus among retirement experts, including the CRR²² and Brightscope²³, that funds all have trading fees that equal the explicit expense ratio. For more detail on the methodology behind our calculation, see the appendix.

Taking all this into consideration, how much would this "ideal" household have paid in retirement account fees over its lifetime? Figure 7 depicts the results of the model, showing the progression of each household member's earnings, hypothetical 401(k) balance, and fees over their working lifetimes. Figure 8 summarizes the household's aggregate 401(k) balance at retirement, and shows fees' lifetime costs: as much as **\$154,794**. To put that in perspective, that's the average cost of a house in many parts of the country, or more than the cost of a public-university education, including room and board, for two children. So, for this ordinary household, paying mutual fund fees cost them that home they could have bought with their retirement nest egg. And even worse, for most households, these fees don't stop at retirement; in fact, if a household leaves most of its assets in its 401(k) (as many do), these fees can be quite substantial. To give an idea of the magnitude of these post-retirement fees, let's assume that our "ideal" household, who, as shown in Figure 7, retires with a combined 401(k) balance of \$357,872, keeps its entire nest egg in its 401(k) upon retiring. In the first year of their retirement, they would effectively pay, in expense-ratio fees and trading costs, \$5,723 in total fees in that first year of retirement alone.

As another example of how much fees can cost a household over its working lifetime, consider a higher-income household, one who earns more income than three-quarters of American households, and who saves and invests identically to the "ideal" household above, can expect to pay an even steeper price: (as much as) **\$277,969**, according to Dēmos' calculations. Considering that a significant portion of these fees goes to paying the high salaries and expenses of the investment professionals managing these funds, asking struggling American households to pay these prices to save for retirement is more than patently unfair, it's immoral.

Fig. 8 | FEES' COSTS TO AN "IDEAL" HOUSEHOLD: 401(K) BALANCE AT RETIREMENT



SOURCE: Dēmos' Fee Model Estimates

TOWARD A MORE IDEAL SYSTEM

Between the complexity and many layers of today's retirement market, the barriers that employers, particularly small ones, face in choosing the best retirement plan or switching to a better one, and the lack of control that employees have over their investments, it's clear that the high costs of the country's individual, 401(k)-style retirement system cannot be solved by regulatory tweaks or even the increased transparency that the Department of Labor's new rules will engender. These structurally-high fees, combined with the multitude of risks—such as losing one's savings to a market downturn, outliving one's saving, and several others—faced by 401(k) investors make 401(k)-style plans entirely unsuitable to be the primary income supplement to Social Security in retirement, as they are for most workers today.

What's the solution, then, if 401(k)s can't be fixed? Simply, this country needs a new private retirement system. All workers need a safe, low-cost secure account to save for retirement, one that can also provide a lifetime stream of income when they retire; in other words, an account that protects workers from the severe risks and high costs of 401(k)-type plans. Individual Retirement Accounts (IRAs), the vehicle for administration's "Auto IRA" plan included in the proposed FY2013 budget, don't meet these criteria. IRAs expose savers to the same set of risks as 401(k)s, and according to the Government Accountability Office, have even higher fees than their employer-based counterparts.²⁴

So, if not the Auto-IRA, then what kind of accounts should be created? Retirement USA, a coalition of organizations concerned about the inadequacies of the country's private retirement system, has proposed 12 principles, detailed on page 14, that a good retirement savings vehicle should meet—including ensuring such a vehicle is low-cost by requiring that assets be pooled—and highlights several plans that meet those principles. The highlighted plans—including Dēmos Distinguished Senior Fellow Dr. Teresa Ghilarducci's "Guaranteed Retirement Account" (GRA) proposal²⁵—would not only mitigate many of 401(k)s' risks but cost savers far less than the average 401(k) as well. GRAs, in particular, would have total fees near the level of the average defined benefit pension plan, since the plan

shares many of the advantages of DBs, including pooling, that drive down their fees, as well.

Whether through the creation of GRAs or another similarly-featured proposal, one thing is clear: the country's retirement system is in desperate need, now, of reform, so that workers saving for retirement today can be spared from paying the high fees of an inherently broken system.

RETIREMENT USA'S TWELVE PRINCIPLES FOR RETIREMENT

CORE PRINCIPLES

Universal coverage. Every worker should be covered by a retirement plan in addition to Social Security.

Secure retirement. Workers should be able to count on a steady lifetime stream of retirement income to supplement Social Security.

Adequate income. Everyone should be able to have an adequate retirement income after a lifetime of work.

SUPPORTING PRINCIPLES

Shared responsibility. Retirement should be the shared responsibility of employers, employees and the government.

Required contributions. Employers and employees should be required to contribute a specified percentage of pay, and the government should subsidize the contributions of lower income workers.

Pooled assets. Contributions to the system should be pooled and professionally managed to minimize costs and risks.

Payouts only at retirement. No pre-retirement withdrawals or loans should be permitted, except for permanent disability.

Lifetime payouts. Benefits should be paid out over the lifetime of retirees and their partners.

Portable benefits. Benefits should be fully and easily portable between jobs.

Voluntary savings. Additional tax-favored voluntary contributions should be permitted, with reasonable limits.

Efficient and transparent administration. The system should be administered by efficient and transparent government agency or non-profit institution with a board representative of all stakeholders.

Effective oversight. Oversight of the new system should be by a single government regulator dedicated solely to promoting retirement security.

SOURCE: Retirement USA Website, www.retirement-usa.org/ourprinciples

APPENDIX: DETAILED METHODOLOGY FOR FEE MODEL

Our calculation uses the example of a household with two income earners, a man and a woman, each of whom earns the median income for their age and gender each year of their working lifetimes, which we define as the 40 years between ages 25 and 65. We decided to use a historical working lifetime, settling on the years between 1965 and 2005, as opposed to projecting a future working lifetime. By using past historical returns and income data, we avoid the imprecise science of estimating future earnings and market returns decades into the future. We constructed our model as if 401(k)s had been available since the beginning of our household's working lifetimes in 1965, though in reality 401(k)s have only been available since the early 1980s, and only common since the mid-1990s.

In our model, each earner saves a set portion of their individual salary in a separate but identical 401(k) account. Their yearly savings rates are set at the actual average rates for 401(k) savers broken down by age, gender, and income, as detailed in Copeland (2009); as a result, both individually begin their careers at age 25 saving 5.3% of their salary in their 401(k), and gradually increase to their savings rate to 9.2% by age 65. Both earners save every year of their working lifetimes without interruption, and never withdraw or borrow from their 401(k).

Both earners invest their savings in an identical 401(k) with only two investment options: a stock index fund and a bond index fund. For simplicity of calculation, we assume that both earners invest exactly half of their savings in each option each year, with no portfolio rebalancing. To produce a conservative estimate of the lifetime fee cost, we presume that each fund has a constant expense ratio equal to the asset-weighted average expense ratio for its asset class; thus, according to Reid (2011), we set the bond index fund's expense ratio at 0.72 percent and the stock index fund's expense ratio at 0.95 percent. This is a conservative estimate because mutual fund expense ratios have declined by about 50% since 401(k)s were introduced, according again to Reid (2011). We also assume, according to the research consensus cited above, that the stock index

funds has trading costs equal to its expense ratio (0.95 percent), and the bond index fund has trading costs of 0.5 percent, or about 70 percent of its expense ratio.

Finally, the returns on each of the two funds in our model's hypothetical 401(k) are set to the historical returns earned by each asset class in each year, compounded annually, minus fees and inflation. For its stock index fund, we use the real return of an S&P 500 index fund less fees and inflation; for example, in 1989, the S&P 500 index increased by 22.01 percent, and thus our stock index fund returned 14.57 percent, real, after fees and inflation of 4.83 percent. Similarly, its bond index fund, which we assume to be invested equally in U.S. treasury bonds (10- and 30-year) and corporate bonds, produces a return that is the average of the treasury rate and a corporate bond index rate; for example, also in 1989, the bond index fund earned a return of 8.68 percent, nominal, and 2.43 percent, real, after inflation and fees. Each earner's yearly portfolio balance, both before and after fees, is shown in Figure 7.

ENDNOTES

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