Center for American Progress

Building 401(k) Wealth One Percent at a Time

Fees Chip Away at People's Retirement Nest Eggs

Christian E. Weller, Senior Economist

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Progressive Ideas for a Strong, Just, and Free America

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Introduction

Preparing for retirement in the United States today requires individuals to pay growing attention to financial markets and the cost of investing. More and more people save for their retirement through so-called defined contribution plans, of which 401(k) plans are the most popular variety. Employees and sometimes their employers contribute a portion of employees' earnings to these plans, with income in retirement dependent upon the plan's investment returns during employees' careers. Employees, however, must pay fees to the administrators and fund managers of these plans from their annual investment income, which over time can cut sharply into their eventual retirement savings.

Fees charged on 401(k) plans can often appear to be deceptively low, ranging from less than one percent of assets under management to more than two percent of assets, depending on the size of the defined contribution plan and on the level of services offered to employees. Although these fees as a percent of assets may appear small, over the course of a full working career, typical fees in 401(k) plans can reduce employee savings by 20 percent to 30 percent, as the table below makes clear. Calculated another way, employees would need to postpone retirement for up to three years to compensate for the lost investment income to 401(k) fees over a course of a full career.

Table 1: Illustrative examples for reduction in DC plan assets and additional months of work required following varying levels of fees

Annual fees as share of assets (in percent of assets)	Reduction in asset accumulation compared with case with no fees (percent of assets)	Additional months required to receive the same inflation adjusted monthly benefit (months)
0.5 percent	11.6	16
1.0 percent	24.2	32
1.5 percent	37.7	48
2.0 percent	52.3	64

Source: Center for American Progress. *An explanation of the calculations supporting this table can be found on page 7.*

People are often not fully aware of the fees that they are charged and of the potential impact of these fees on their retirement income security. The disclosure of 401(k) fees is increasingly the subject of review by the U.S. Department of Labor, which polices private employer pension plans and state authorities, who watch over state pension plans. So far, these actions have not translated into more comprehensive and more easily understandable fee disclosure. How that should be done is one key focus of this paper.

Even with better disclosure, however, some workers would always face higher fees than others. The reason: Size matters for the level of fees. Small-business employees and low-wage workers tend to face substantially higher 401(k) fees than those who work for larger companies or predominantly higher paying companies. The costs of managing a 401(k) plan are typically fixed. Pooling more money in a larger defined contribution, or DC plan, can reduce the fees relative to the size of the savings in that plan. That's why smaller plans pay higher fees relative to the savings in each employee's account.

A more promising approach for small employers and their employees is for the U.S. government to set up a large, but very basic 401(k) plan so that these businesses and their workers can take advantage of these economies of scale, too. Our nation's small business community could then also offer their employees a low-cost option to save for retirement.

How would such a system work? The easiest solution would allow private sector employees to join existing 401(k) programs run by state governments and the federal government for their own employees. The underlying model here is the Thrift Savings Plan, or TSP, which offers federal employees a limited range of investment options and services in exchange for low fees. Of course, employers who want to offer a DC plan with more choices and more service options, such as 24-hour call centers, could still purchase these plans in the private market.

The bottom line: If all Americans are given the opportunity to save for their retirement free of excessive 401(k) fees, everybody—employers and employees—can more effectively do their part to provide for a secure middle-class retirement as a reward for a lifetime of hard work. Achieving this goal should be a shared responsibility. Public policy can do its part to foster the common good of a secure middle-class retirement.

Keeping more money for employees

Administering an employee's 401(k) account is largely a fixed cost, regardless of the account's balance. Managing the funds in a DC plan is also to a large degree a fixed cost, whether the plan has $20 million or $200 million in assets. For small businesses with low-wage workers, these fixed costs are spread over fewer accounts and smaller account balances, which means the costs relative to the account balances will be larger than for other businesses. Simple economics dictates that 401(k) fees are going to be higher relative to employees' account balances for small businesses and their employees than for larger companies and their workers. Gregory Baer and Gary Gensler point out in their book, *The Great Mutual Fund Trap: An Investment Recovery Plan*, that employers, even those with fewer than 10 employees, face administrative costs of $3,000. They write that "for the 37 percent of businesses with fewer than four employees, administrative costs could be more than $1,000 per employee"".[1]

That's one of the reasons why many small businesses do not offer their employees 401(k) plans. It's simply too costly. A number of public policy proposals aim to correct this situation by providing a lower 401(k) fee option to private sector employers who want and need one. These proposals envision federal or state governments establishing large funds that private sector employers could join if they so desired.

The underlying model is the Thrift Savings Plan for federal employees. The TSP's DC plan offers a limited range of investment options and services in exchange for low fees.[2] While the administration of the TSP is handled by government, the funds are managed by professional management companies. Investment options are limited to a few index funds, which spread their investments across a large number of assets, such as stocks and bonds, to mirror the stock market or the bond market at large. Fees on these types of funds are naturally low because they don't require active management.

The costs of the TSP to the federal government and federal employees is minimal for a number of reasons. Administration costs are low because the government is not seeking to profit from the TSP. The plan takes advantage of already existing economies of scale. Investment options are limited, thereby reducing costs and encouraging savings. And the investment options are passively managed funds, such as index funds, thereby reducing fees and boosting employees' returns on their investments as money not spent on fees contributes to the rate of return on their 401(k) plans.

The TSP model is the basis for a number of low-cost, no-frills DC plan proposals for private sector employers. Former Clinton Treasury officials Gregory Baer and Gary Gensler argue that a lot could be learned from TSP's fee structure.[3] Originally, Dean Baker, co-director of the Center for Economic and Policy Research, suggested that the government should establish a default investment option modeled on the TSP.[4] Others have included the idea in their proposals to improve retirement income security, such as former national economic advisor to President Clinton, Gene Sperling, who includes it in his proposal for a "universal 401(k)" plan.[5]

The idea of pooling small account balances is also supported by conservatives. For instance, a similar proposal was included in President Bush's proposal to privatize Social Security.[6] The administration estimated that the combined costs for fund administration would amount to 0.3 percent of assets annually.[7] Also, in their proposal for "automatic IRAs," Mark Iwry from the Brookings Institution and David John of the Heritage Foundation include a call for pooled, low-cost government administered accounts.[8]

At the state level, too, this type of publicly administered but privately managed 401(k) plan is under serious discussion. The Economic Opportunity Institute in Seattle, for example, included it in their Washington Voluntary Accounts proposal for Washington state.[9] Similar proposals by the Keystone Research Center and 19 other groups in Pennsylvania are now under discussion in the state capital,[10] and Gov. Jennifer Granholm of Michigan is pushing similar measures in her state.[11]

These are all very good proposals. Enacting such low-cost investment options would be beneficial in two ways. For one, it would eliminate hurdles for small employers to offer a retirement plan to their employees. Even better, the biggest beneficiaries from enacting such a proposal would be employees working for small employers, where employer-sponsored retirement savings plan coverage is comparatively thin. In the 2003 Small Employer Retirement Survey, setup and administration costs of providing a 401(k) plan to employees was the second most common reason employers give for not offering a retirement plan, accounting for 15.9 percent of responses on average for all small employers (those with one to 100 employees), after the top reason "revenue too uncertain," which was chosen by 27.2 percent of these employers. What's more, the share of respondents who cite administration and setup costs go up as employer size goes down. Among employers with one to five employees, 22.5 percent cite administration and setup costs as the most important reason for not offering a 401(k) plan, a close second to "revenue too uncertain," which 24.5 percent of these small employers gave as a reason for not offering a retirement plan.[12]

Secondly, a government administered but privately managed 401(k) plan would reduce the cost of saving for retirement for low-income employees working for small businesses. These workers today are more likely to have small 401(k) account balances—if they have a retirement savings plan at all—and thus are more likely to pay higher fees. The new retirement plan proposals now on the table in Washington and in several state capitals would allow low-income workers to see their account balances grow faster, allowing them either to retire earlier or enjoy a higher standard of living in retirement.

Fees, fees, fees, wherever you look, there are fees

Setting up these kinds of public-private 401(k) plans would go a long way toward boosting the retirement incomes of millions of American workers, but other action is also necessary to ensure that a multitude of 401(k) fees do not eat into the retirement savings of hundreds of millions of Americans. The reason: Participants in DC plans are charged a variety of fees, which reduce the annual earnings on an account.[13]

Regardless of plan size, the majority of fees in a 401(k) plan are investment fees. Investment fees cover all services related to operating the investment options offered in a 401(k) plan, such as mutual funds. Fees cover the selection and management of the stocks and bonds that constitute most mutual funds as well as the compensation paid to the brokers who sell the funds. These fees are typically automatically deducted from investment returns as a fixed percentage of assets, and are not always apparent on statements.

The second-largest portion of 401(k) plan fees are record-keeping fees. These fees are used to cover administrative activities related to main-

The Rise of 401(k) Plans

Traditionally, the primary source of retirement savings in the United States, excluding Social Security, was a defined benefit, or DB pension plan, which guarantees employees a fixed annual income upon retirement. Since the 1980s, DB plans have declined as the primary source of retirement savings in the private sector.

Defined contribution, or DC plans, which hold employees responsible for saving for retirement, have taken their place. The most popular DC plan is a 401(k) plan, named after a section of the Internal Revenue Code. These types of plans came about as part of tax reform in 1978, but did not enjoy broader support until the IRS clarified their tax treatment in 1981.[14]

In 1980, only eight percent of the private sector workforce had a DC plan as their primary retirement plan. By 1999, this share had grown to 29 percent. When the share of private sector workers who also had a DB plan is included, a total of 43 percent of private sector workers had a DC plan either as their primary or secondary retirement savings plan in 1999. At the same time, the share of private sector workers with a DB plan declined from 39 percent to 21 percent.[15] Since then, the shares seem to have stabilized. By 2006, 43 percent of private sector workers had a DC plan and 20 percent participated in a DB plan.[16]

Under a 401(k) type plan, an employee is allowed to defer part of his or her pre-tax income up to specified limits. In some instances, this amount is matched by a contribution from the employer. Employee contributions are not subject to income taxes, but subject to payroll taxes. Employees can typically determine the investment allocation of their savings, within limits. All gains and losses are typically borne by the employee.

In addition, all employees can, within certain limits, contribute to an Individual Retirement Account, or IRA. The tax advantages of IRA contributions are greater for workers who are not participating in an employer-sponsored plan. The contribution limits to IRAs, though, are substantially lower than the dollar contribution limits for employer-sponsored DC plans. Aside from their contribution limits, IRAs operate very similarly, although employees generally have more investment options.

taining a participant's account, such as tracking individual account contributions, allocating contributions to the chosen investment options, mailing statements, and handling plan distributions. Additional fees can include trustee fees to maintain assets as plan trustee, audit fees for plans with 100 or more participants, legal fees, investment consulting fees, communication fees for providing phone and Internet services, and fees for monitoring services to prevent misuse of contributions and fees related to selling products to customers including advertising expenses and sales commissions.[17]

A number of studies have looked at the level of these fees. The results show a fair amount of variation in the typical level of fees. Most recently, the Government Accountability Office concluded that one percent of assets is a typical level of fees.[18] An earlier study by the Congressional Budget Office also found that mutual funds typically charge 1.09 of assets and that DC plans charge between 0.8 percent and 1.0 percent of assets, depending on size.[19] Researchers at the Center for Retirement Research at Boston College concluded in a recent survey that fees in DC plans amount on average to about one percent of assets.[20] And the Council of Institutional Investors cites data from the Department of Labor showing that DC plans typically carry fees similar to those of mutual funds—between one percent and 1.4 percent of assets.[21]

At the low end, research by the Investment Company Institute found that mutual fund operating expenses averaged 0.71 percent of assets.[22] However, as the Council of Institutional Investors points out, these calculations exclude marketing and distribution fees, which can increase the costs by 0.25 percent to one percent of assets annually.[23] At the high end of the scale, fees could climb up to as much as 2.25 percent of assets, according to estimates by the Illinois Municipal Retirement Fund.[24]

Most studies come to the conclusion that typical fees for DC plans average about one percent of assets or slightly above. The level of fees, however, are also not particularly uniform.[25] Fees, for instance, vary by asset types offered in a fund. International funds often incur higher fees than domestic funds, presumably because they require more research.

For instance, the operating expenses of international equity funds averaged 1.38 percent of assets in 2002, while municipal bond funds averaged only 0.64 percent of assets at the same time. Allowing for more investment choices in assets also necessitates more recordkeeping, thus higher fees.[26]

Fees also tend to increase with the services offered by a DC plan. 401(k) plans with round-the-clock customer service, for example, generally include higher fees than plans with more limited customer service availability. Moreover, since many DC-plan fees are fixed costs that vary little with the size of assets that are managed, smaller DC plans tend to have higher fees relative to assets than larger fees.

A recent study revealed that fees for plans with more than 4,000 participants and $20 million in assets averaged 0.8 percent plus a flat fee of $24 per participant, while smaller plans had average fees of one percent of assets and flat fees of $60.[27] In addition, the operating expense ratio out of total assets varies depending on the size of mutual funds. That ratio for the smallest 10 percent of mutual funds averaged 1.78 percent in 1998, while the same ratio for the largest 10 percent of mutual funds averaged to 0.67 percent.[28]

Finally, funds that are actively managed incur larger fees due to more frequent trades than funds that are passively managed, such as index funds. These actively managed funds also often underperform compared with index funds.[29]

Fees substantially cut assets

401(k) fees can reduce the annual rate of return on DC plan assets by an amount between 0.7 percent and more than 2.0 percent, according to recent studies. The Government Accountability Office reported that a one percent increase in fees can reduce final retirement assets by 17 percent.[30] The Congressional Budget Office estimated that fees for a 401(k) plan with more than 4,000 participants and more than $20 million can reduce assets by 21 percent at retirement. For plans with 100 participants, assets can be reduced by as much as 30 percent.[31] Research conducted by the Center for Retirement Research concluded that a one percent increase in fees can lead to as much as a 20 percent reduction in retirement assets.[32] Other researchers found that workers receive a reduction of 29 percent over the course of their careers.[33]

To more specifically gauge the effect of 401(k) fees on an individual worker's retirement income, a few illustrative examples are in order. Consider an employee earning $39,800 in 2007, an amount considered average by the Social Security Administration, who also saves 10 percent of his or her income through a 401(k) plan over the course of a 40-year career. Then assume this worker earned a risk-free real rate of return of 3.3 percent[34] over those 40 years.

The total savings accumulated by that worker when charged fees of 0.5 percent, 1.0 percent, 1.5 percent or 2.0 percent annually are calculated. Table 1 then reports the changes in savings accumulated relative to a situation in which no fees apply. These differences in the size of asset accumulation over a lifetime are very telling. Few 401(k) plans will have fees as low as 0.5 percent or as high as 2.0 percent. So, the more important figures here are the comparison of fees of 1.0 percent to 1.5 percent relative to a situation in which no fees apply, which highlights the effect of these levels of fees. Fees in this more typical range reduce savings by 24.2 percent to 37.7 percent over the course of a 40-year career.

One way employees could compensate for a reduction in savings is by working longer. To see how long an employee would have to work to make up for the loss of savings from 401(k) fees, the table below also includes a column that converts the employee's 401(k) savings into simple lifetime annuities with the risk-free rate of return as the discount rate and a static life expectancy of 18 years after age 65 assumed. The initial monthly benefit is then adjusted for inflation.

The table presents the additional months that an employee would have to work to receive the same inflation-adjusted monthly benefit as with no fees. To compensate for the loss of retirement wealth due to the more typical level of fees, employees would have to work for another two-and-a-half to four years. Between one-sixth and one-fifth of employees' expected time in retirement would be lost to make up for the lost earnings due to 401(k) fees.

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0.5 percent	11.6	16
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Source: Center for American Progress.

Letting employees know where their money went

Not all variations in 401(k) fees is caused by the size differences of DC plans. Since employees can lose up to 30 percent of their savings over a lifetime due to 401(k) fees, policymakers need to consider how retirement wealth can be better protected. Current law already offers two protections; both are inadequate.

The Employee Retirement Income Security Act of 1974, or ERISA, requires that DC plans provide some disclosure documents, but within limits. Specifically, the current rules require information on plan operations, participant accounts, and the DC plan's financial status. Some fees are disclosed in the disclosure of the plan's financial status. Yet, employers are not required to disclose all fees to the Department of Labor, which has the regulatory authority that plan fees are not excessive.

For instance, employers are not required to report mutual fund investment fees deducted from investment results in their reporting to the Department of Labor. In addition, service providers may receive compensation from mutual funds for recommending their plans to a plan sponsor, which may lead to higher costs for participants.[35] Since the ERISA does not require full disclosure of fees, a participant often must request such information.[36]

All 401(k) plan participants should be informed about the fees that they are charged in their DC plans. Participants and employers may be willing to incur these fees if they fully understand them and if they choose to pay for the services that are covered by the fees. This, however, requires that fees are properly disclosed to employers and employees.

To address the shortcomings in the current disclosure of fees, a number of suggestions for improvements have been made.[37, 38, 39] First, changes to ERISA could require that fees are disclosed to 401(k) participants in such a way that participants can actually understand and compare the fees. That is, all fees should be disclosed, there should be a summary disclosure on one page, and fees should be compared in similar units, such as a percent of assets or as flat dollar amounts. An extension of this proposal would be to consider disclosure of the impact of fees on assets over time.

Second, disclosure could be required for all fees, including disclosure if a service provider is receiving compensation from mutual fund companies. Finally, the Secretary of Labor could require a summary of all fees paid out of plan assets or by participants from the DC plan sponsor. Better disclosure would allow participants to see fees in a comparable format, with all fees disclosed as either a percent of assets or as flat dollar amounts, which in turn would help to increase the transparency of the DC plan market for employees and employers.[40]

Employer responsibility in selecting fees

ERISA also requires that employers offering 401(k) plans ensure that fees are reasonable. Because fees are often directly borne by employees in DC plans—unlike in defined benefit plans, in which employers generally foot the bill up front (see sidebar, page 4)—the law needs to ensure that DC plan sponsors adequately represent the interests of their employees, who will pay the price for the employer's decisions. The concern is that employers do not have a direct vested interest in selecting the lowest available fees for the selected plan options, since the employer will most likely not directly pay the fees.

While ERISA does not limit the amount of permissible fees that a plan's fiduciary can select, it does require that fiduciaries pay reasonable fees to providers. This protection for 401(k) plan participants, though, has its drawbacks. For one, employers may not be fully aware of all the costs associated with the plan options that they have selected. Without improved disclosure of fees, employers cannot fully compare different plan options with each other. Second, because the standard of reasonable fees is subject to interpretation, participants may be charged relatively high fees without the employer having violated his or her fiduciary responsibility. Third, the enforcement of violations of the fiduciary standard occur after the fact.

Toward the end of 2006, litigation began against a number of employers offering 401(k) plans to their employees, including Lockheed Martin Corp., General Dynamics Corp., United Technologies Corp., Bechtel Group, Caterpillar Inc., Exelon Corp. and International Paper Co. The companies are alleged to have allowed the firms that manage their 401(k) plans to excessively overcharge employees.[41]

Lawsuits are one way to oblige companies to protect the retirement interests of their employees, but litigation is time consuming, costly, and occurs after participants have already been charged the alleged higher fees. Better disclosure requirements as outlined above are the better alternative.

Conclusion

Saving for retirement is one of the most important ways for Americans to accumulate wealth. As employees diligently invest their hard-earned money, they should ultimately receive the highest possible amount for retirement. This is good for our nation, too. Higher savings in retirement means more consumer spending by retirees and additional financial protection against health crises.

As this paper has demonstrated, however, 401(k) fees reduce people's retirement income and inhibit many small businesses from offering these types of DC plans to their employees. Typical levels of 401(k) fees can reduce employees' total retirement savings by 20 percent to 30 percent after a full career.

To achieve the same level of retirement income due to the loss of accumulated assets after paying annual 401(k) fees, employees would either have to save more or work two and a half to four years longer. What's more, existing legal protections to limit the amount of fees that participants pay for their DC plans are not without problems and do not seem to fully address the very real issue of poorly disclosed and sometimes excessive fees.

Consequently, many experts have suggested that the government should offer a low cost, limited DC plan option for private sector employers who wish to join such a plan. This new DC plan, offered by either the federal government of state governments, would be administrated by government officials but managed by private investment firms. Such a plan could operate at a low cost because it could take advantage of economies of scale and would offer limited investment choices of passively managed funds.

This type of proposal, which enjoys surprising bipartisan support, is gaining some ground in a number of states and in Washington. If enacted, lower income employees, particularly those working for small businesses, could see increased pension coverage and faster wealth accumulation. In tandem with serious reforms to tackle the opaque disclosure practices of most 401(k) plan providers, policymakers could boost retirement savings, especially among small businesses and low income earners, where the need for more savings is greatest.

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Endnotes

1 See Baer and Gensler (2002:242-243).

2 See CBO (2004a) for details.

3 See Baer and Gensler (2002).

4 See Baker (1999) for full details.

5 See Sperling (2005) for complete details.

6 Details are included in CSSS (2001).

7 The proposal for Social Security privatization included massive benefit cuts and would have contributed to a massive expansion of the federal debt. The inclusion of a low-cost account option does not offset the large cost increases and benefits cuts elsewhere.

8 See Iwry and John (2006) for complete details.

9 Details are available in Idemoto (2002).

10 See KRC (2007).

11 See Granholm (2006).

12 See VanderHei (2003) for complete details on this study.

13 See CBO (2004a), DOL (2007), and GAO (2006) for a summary discussion of the variety of fees.

14 See McDonnell (2005) for more details.

15 Data are from EBSA (2003).

16 See BLS (2006) or more details.

17 Additional fees can arise if participants want to convert their savings into lifetime streams of income by buying an annuity from an insurance company. Our focus here, though, is only on fees occurring during the build-up phase.

18 See GAO (2006).

19 See CBO (2004a).

20 See Munnell et al. (2006).

21 See CII (2006) and PWBA (1998).

22 See Collins (2003).

23 See CII (2006).

24 See Kosiba (1999).

25 See CBO (2004) for a discussion of the variation of fees.

26 DC plans with too many investment options tend to limit participants' ability to make informed decisions, which can reduce contributions to DC plans (Mitchell and Utkus, 2003). That is, participants may not only be paying higher fees, they may also save less than they otherwise would in DC plans that offer too many investment choices.

27 See CBO (2004a).

28 See Collins (2003).

29 See Bogle (1999) and Elton et al. (1996) for details.

30 See GAO (2006).

31 See CBO (2004a).

32 See Munnell et al. (2006).

33 See Geneakoplos et al. (1999).

34 This is the typical risk-free rate assumed for comparisons of individual accounts and Social Security. It reflects the long-term average on long-term Treasury bonds (CBO, 2004b). Importantly, a lower rate of return moots the effect of fees since the compounding of interest on foregone assets is reduced.

35 This practice received some attention, when Dutch owned ING was investigated by New York state attorney general Eliot Spitzer over lack of disclosure of such fees in operating the DC plans for the New York state and New Hampshire state retirement systems. In both instances, ING settled with the state (Sanders, 2006).

36 See GAO (2006) for a discussion of fee disclosure.

37 The Department of Labor is currently considering changes to the disclosure of 401(k) fees, but has not issued a final recommendation. The change in disclosure is considered as a result of changes to prohibited transactions under ERISA following the passage of the Pension Protection Act of 2006 (DOL, 2006b).

38 See GAO (2006) for a discussion of fee disclosure.

-40 While it is typically assumed that all or most fees are ultimately borne by the participant, it is the employer who typically makes the decisions on plan design, including the choices that determine the level of fees.

41 See Journal Star (2006) for more details.

Center for American Progress

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