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Companies must decipher 401(k) fees

Those that administer employee savings plans have a duty to be watchful for buried mutual fund costs.

By Diane Berthel

The more than $1.9 trillion invested in 401(k) plans creates a rare opportunity for small individual investors to band together and invest with the big guys. But many participants of these plans are no better off than when they invest alone because the people watching out for them are getting less than the best advice — and paying a higher price for it.

You would expect companies to demand nothing less than the most favorably priced funds for their employees' 401(k). After all, 401(k) plan investments usually are in the hands of company officers, fiduciaries who decide which investments their plan will offer. Federal law, namely the Employee Retirement Income Security Act (ERISA) is clear: Fiduciaries are expected to act with the skill and prudence of an "expert investor" and exclusively for the benefit of plan participants.

But all too often, fiduciaries responsible for these decisions are unaware of the ins and outs of the mutual fund industry, especially the tangle of buried fees.

Consider that 401(k) fiduciaries can pick from more than 16,000 publicly traded mutual funds. While there are plenty of providers and consultants willing to help sort through this list, most of them are compensated from the mutual fund fees. One of their goals is to maximize the fee pie from which they take their slice.

Yet turning over investment decisions to a provider or consultant with the incentive to satisfy their profit goals directly conflicts with the fiduciaries' duty to act solely for the benefit of participants.

Fee pitfalls are abundant. Mutual funds charge an expense ratio — a fee for operating expenses and management of the fund's assets. These fees can turn a top-performing fund into a laggard if they get too high.

Expense ratios often include a 12b-1 fee, which allows funds to charge investors for the fund company's marketing expenses. These 12b-1 fees can add as much as 1 percent to a fund's expense ratio — sometimes more than doubling it. The result: lower returns for investors.

For example, consider PIMCO Total Return, one of the largest mutual funds available. The fund is big for a reason: It's perennially a top performer in its class and a popular option for 401(k) plans. The fund has seven different share classes. Only the fee is different.

The effect of PIMCO's 12b-1 fee structure is so powerful that share classes with the highest such fee actually underperform their index benchmark. Any benefit of the fund's superior performance disappears along with the retirement income it represents.

How big an effect can these fees have? Consider a plan with $10 million invested in PIMCO Total Return Fund. Plan fiduciaries, the folks responsible for acting in the best interest of the participants, might be presented with one of seven different classes of the same fund. When the "institutional" class of shares is used, the cost to participants is $43,000 a year. The cost for class A, or median-priced shares, is $90,000. Then there are B and C classes — the most expensive — for which participants pay $165,000. That amounts to $122,000, or 280 percent, more than the institutional class — a much bigger fee pie — every year. And it comes directly from a participant's bottom line.

All of this is not to pick on PIMCO. It is an industry-wide trend that creates a considerable challenge for plan fiduciaries. And the influence of fees doesn't end there.

Many 401(k) plans bundle administrative services with mutual fund companies or broker dealers. Most such providers offer a supermarket of funds in addition to the funds managed in-house. This is another arrangement where money — to the service provider, not the plan participant — rules the day.

When bundled providers recommend a lineup of funds, they first promote in-house funds. Again, this has little to do with performance and much to do with their financial well-being. In-house funds allow the provider to capture all fees. Next they have a bias toward outside funds with the highest 12b-1 fees to share. Meanwhile, funds or share classes with low expense ratios rarely show up on the provider's recommended list. Why? They share little revenue with providers.

Participants contribute most of the dollars invested in 401(k) plans, and they make the investment decisions. So what benefit does the company 401(k) plan offer? The answer should be access to what the big guys get: competitively priced, high-quality investments.

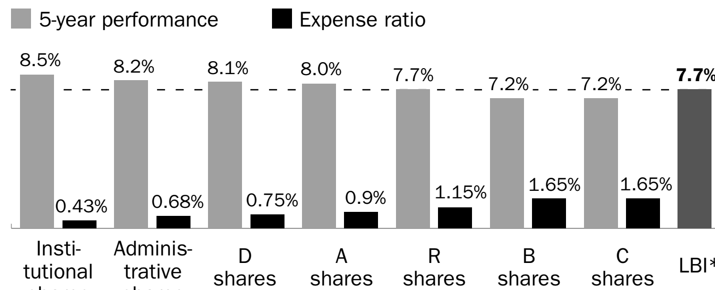
At a time when the small investor has lost faith in the mutual fund industry, 401(k) plan fiduciaries can save the day — but not if they squander the best opportunity their employees have to invest with the big guys.

About the author

Diane Berthel is a principal and co-founder of St. Paul-based Berthel Schutter, an independent investment adviser. She has more than 20 years of investment experience, including management and institutional client advisory positions at Merrill Lynch and Piper Jaffray.

Tracking expenses

The same mutual fund can generate significantly different returns, depending on the class of shares owned and their expense ratios. PIMCO's Total Return Fund, for example, has seven classes of shares. The lowest-cost-shares are institutional shares, which are sold to the largest customers. B shares and C shares carry the highest costs. Five-year returns are compared to the benchmark Lehman Bond Index.



* Lehman Bond Index

Source: Morningstar, PIMCO