The New York Times
Your Money

Revealing Hidden Costs of Your 401(k)

By RON LIEBER
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Your 401(k), 403(b) or other similar plan isn't free. In fact, it's probably pretty expensive, costing you tens of thousands of dollars in lost retirement money over the course of your career.

Luke Sharrett/The New York Times

Phyllis Borzi is the assistant secretary of labor and oversees the department's Employee Benefits Security Administration, which is pushing for more transparency in 401(k) fees. In her office is a photo of President Gerald R. Ford signing the Employee Retirement Income Security Act.

Have you tried to investigate how your 401(k) or similar plan is paid for? And if you didn't like what you found, did you have any luck trying to fix it?

But just try to figure out how those costs break down. Several weeks ago, I talked about the biggest cost, the underlying expenses of the mutual funds in your plan. You can keep those low by begging your employer for more low-cost index funds, which have the added benefit of outperforming most actively managed funds over the long haul.

But there are also various administrative fees that come with a workplace retirement plan, and you usually pay for those, too. It is the rare employer, however, that breaks out those costs for you.

Instead, the costs are embedded in the expenses of many of the mutual funds you pick. In a practice known as revenue sharing, fund companies refund some of the expenses to the service provider running your plan to pay for its administrative costs.

This all seems very tidy at first glance, since neither the employer nor the employee has to write a check each year to pay for running the retirement plan. But the system tends to disproportionately punish both big savers and people investing in actively managed mutual funds, since people with higher balances and higher expense ratios on their investments end up subsidizing their fellow workers.

At long last, the Labor Department, which oversees 401(k) plans, is forcing everyone involved to confront the hard numbers. Starting next year, it is making investment companies itemize all of the various expenses employers are paying and make the underlying mutual fund costs distinct from administrative ones.

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Workers, meanwhile, will get account statements that make their mutual fund fees clearer and will at least learn that revenue sharing is going on.

The Labor Department claims to have no strong feelings on the appropriateness of revenue sharing. "I'm not sure we have any opinion on this," said Phyllis C. Borzi, the assistant secretary of labor who oversees the department's Employee Benefits Security Administration. "We surely don't have one right now. Whether over the long term we might have one is not clear."

But it is pretty clear that the department hopes the new disclosure rules will lead to some good old-fashioned consciousness-raising, particularly among smaller employers that often have no idea that any of this is going on behind the scenes.

"It's so cloudy, so you can get away with a lot," said Chad Parks, president and chief executive of the Online 401(k), which helps small companies start plans and charges employees and employers flat fees for the privilege. "It's got to be one of the last industries where you're paying for a service but you don't actually have any idea how much you're paying for it."

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So how did the system evolve into something so opaque that it required government intervention?

When 401(k) plans first emerged in the 1980s, employers, also known as plan sponsors in the world of workplace retirement plans, generally paid the administrative costs. They often put employee contributions in the hands of outside money managers, possibly those who were already running the company's pension plan.

Then two things changed, according to Ted Benna, who created the first 401(k) plan. First, human resources departments came under pressure to cut costs. "That was the main motivation," he said. Second, employees started agitating for investments that they could actually look up in the newspaper every day.

The solution was to put 401(k) money in mutual funds, and the fund companies were happy to help. Many of them charged employers nothing — and put participants into the fund companies' own mutual funds, using the profits from the funds to cover the costs of setting up and running new 401(k) plans. When employees eventually demanded a broader choice of fund families, other fund companies realized that the quickest way to get onto an employer's 401(k) menu was to refund some money from the investment fees they already charged each fund's investors to help the employer pay for its plan.

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It all seems pretty logical, until you stop to examine the winners and losers. "There's a bit of a Robin Hood discussion around whether a plan should charge the rich to pay for the poor," said Steve Utkus, a principal at Vanguard, which does not pay employers and their retirement plan administrators any revenue sharing but accepts it from other fund companies when it serves as a record keeper for a company's retirement plan.

Think about it this way: If, say, 20 basis points (each basis point is one-hundredth of a percentage point) of a retirement plan participant's fund expenses go toward administrative costs each year, someone with a $100,000 balance contributes $200, 10 times as much as the $20 paid by someone with an identical allocation but only a $10,000 balance. That would presumably raise some eyebrows, especially if employees knew that a large plan might need only $25 or $50 a person annually to pay those administrative costs.

A 401(k) plan provider's representatives might just shrug their shoulders at this. After all, that's how mutual funds outside of 401(k) plans work, too; expenses are mutualized by definition.

"Many plan sponsors view that as fair and equitable, and it encourages younger people to get in," said Ralph Derbyshire, senior vice president and deputy general counsel for Fidelity. The same thing is true for lower-paid workers, too. After all, nobody wants to discourage workers from participating, and using a flat annual fee might scare off employees with low or no balances, given that the fee might eat up 5 or 10 percent of their contributions in the first year.

Mr. Parks, of the Online 401(k) has trouble with the Robin Hood approach, though. "If you make $150,000 and I make $30,000 and we want to buy the same Toyota FJ Cruiser, should you have to pay more?" he said

Then there's the cross-subsidy issue. Let's say an employer sets up a retirement plan that has some expensive actively managed funds that engage in revenue sharing and some cheaper Vanguard index funds or other investments that don't. The people in the active funds will be paying the administrative costs for the retirement plans of those who are only in the Vanguard funds. In fact, the plan literally can't pay for itself unless a bunch of people pile into the active funds.

That has the potential to make investors in actively managed funds losers on two counts: They are likely to earn less money over time because of the long-term underperformance of actively managed funds and they're also paying the expenses of the people three cubicles over who have made different investment choices.

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"Plan sponsors are becoming increasingly sensitive that this is difficult to explain to participants, and it might drive behavior that is unintended," said Lori Lucas, who is the defined-contribution practice leader at Callan Associates, a consulting firm.

So why not get rid of revenue sharing, and levy a separate fee to cover each account's costs? "I think a lot of it remains a participant P.R. issue," Ms. Lucas said. "If there was no revenue sharing, they'd have to state an explicit dollar amount for fees. It would look like the fees had increased, and now participants think they are paying more."

In fact, many of them wouldn't be paying more at all. Moreover, such a transformation would probably persuade employers to abandon some of their high-cost actively managed funds and include more index funds and exchange-traded funds in their plans. That could lead to better returns over the long haul, which would benefit everyone.

So let's hope that the improved transparency literally rubs employers' noses in what they are choosing to make their workers pay. While larger employers may already have a pretty good sense of how all this works, the smaller companies may simply not know that there is a better way to run a retirement plan because the chief financial officer has 50 other things to keep track of.

That said, the consciousness-raising starts with all of us — we who do not pick the investments that end up on our retirement plan menu but must pay the bill anyway. We still have a lot to learn, and it's hard to overstate the importance of all of this given that it is the most important component of many financial plans.

"I don't think people understand any of this stuff," said Ms. Borzi of the Labor Department. "Which is why we undertook this project in the first place."

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