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Fees & Expenses: The Hidden Landmines Confronting Every Fiduciary

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Fiduciaries of retirement plans bear a tremendous burden of responsibility to their participants, as they design and manage their plans to help employees meet their financial and retirement goals. Most fiduciaries undoubtedly carry out their duties diligently and with the desire to do the right thing by employees, yet overlook a critical but poorly understood area that, if left unchecked, can materially affect returns, introduce conflicts of interest, and lead to breaches of fiduciary duty. We are referring to fees and expenses.

There are many reasons to be concerned about fees and expenses in a retirement plan, both legal and practical. On the legal front, ERISA [§404(a)(1)] is very clear that a fiduciary can only use plan assets to provide benefits to participants and to defray reasonable expenses of the plan. The operative word is reasonable; fiduciaries must never be involved in relationships or transactions that are self-dealing or come at too high a cost to the plan. The Department of Labor (DOL) is becoming more interested in this area, and is subjecting plans to more scrutiny and increased enforcement actions. They have also put out several publications to help fiduciaries understand the many types of expenses a retirement plan can incur, and have put together a Fee Disclosure Form for plan sponsors to use when interviewing new service providers or evaluating current fees (available on the DOL's website at http://www.dol.gov/ebsa/pdf/401kfefm.pdf).

Monitoring and reducing fees and expenses also make practical sense. Rather than chasing performance by hiring a manager who has high returns net of expense, fiduciaries need to consider how high the expenses are. Those high net returns may or may not materialize; high expenses will recur year after year. What expenses the plan pays are under the fiduciary's control; whether or not the money manager can add enough value to offset the higher fees is anybody's guess.

Consider the compounded growth in retirement assets that can be lost over time through higher fees. An example: an employee who contributes $8,000 per year (in even monthly installments) to the company retirement plan for 30 years and earns a 7% annual rate of return will, at the end of the 30 years, have accumulated approximately $818,100. But if the same person had earned 7.5% annually instead (solely because of reduced plan expenses), he or she would have accumulated about $903,900, a difference of $85,800. Just a very slight reduction in fees could add a year or two's worth of living expenses for this employee, and is the equivalent of more than ten extra years of contributions.

The types of fees and expenses encountered by retirement plans come in many forms, shapes and sizes, and are levied on all services provided to the plan. We will limit our discussion to consultants, investment management and the custodian.

Consultants help plan sponsors manage the investment process, not the money itself. When advising sponsors of 401(k) plans, consultants often are the ones who recommend the menu of investment options for the plan. The plan sponsor pays them a fee upfront, but they also may

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receive additional compensation from mutual fund companies that goes undisclosed. This is called revenue sharing, where part of the 12b-1 (distribution & marketing) fees gets paid to the consultant as a reward for directing business toward that particular money manager. This is an expense of the fund and gets deducted from the participants' returns. It is also often undisclosed, and can result in a perpetual income stream for the consultant. This is a conflict of interest for the consultant, and is currently receiving heavy scrutiny from the SEC.

Mutual fund investment managers incur expenses in their day-to-day management of the fund's assets. Their operational costs are covered (with a profit margin) by the fund's investment management fee, which is disclosed in the prospectus. But other costs are less clearly disclosed. When funds trade in securities, they have to pay brokerage commissions. But unless the broker works to find the best execution (lowest commission and bid price), the mutual fund manager may be paying too high a price for each trade, which hurts returns. In some cases, this may actually be deliberate. When a money manager pays a broker more in commissions than necessary, the broker extends "soft dollar" credits to the manager, to purchase research or other services. These are rarely if ever disclosed to plan sponsors, and are an expense of the plan that may not benefit the participants, which is a fiduciary breach. It is thus often true that the purchaser of soft dollar services would be better off directing the trades to the broker most likely to deliver the lowest overall transaction costs (taking into account the efficiency and reliability of the trades), and then paying for research and other services separately, as needed.

Custodial and record-keeping expenses must also be borne by the plan. It is just as important for the fiduciary to understand and monitor these fees. This is especially the case when custodial, investment manager, brokerage, and consultant expenses are wrapped together in one bundled package. Typically, when a plan is just getting started and assets are small, the plan can receive these bundled services for one fee. However, as assets grow, fiduciaries need to consider whether this fee is still reasonable, or whether better pricing could be achieved by getting competitive bids for each service separately. This is known as "unbundling."

Hopefully this review has pointed out the need to pay close attention to the wide variety of fees and expenses that retirement plans typically bear. Fiduciaries have a duty to monitor fees and make sure all the plan's expenses are reasonable. Failure to do so is detrimental to the interests of the plan's participants, and is a breach of fiduciary duty.

However, most fiduciaries lack the time or training to make this analysis, and their consultants or other service providers may have a vested interest in keeping expenses high. Independent advice is critical, and a set of guidelines can be very useful. The Foundation for Fiduciary Studies has published 27 Prudent Investment Practices that provide guidance to fiduciaries on how to manage the entire investment process, including monitoring expenses. They also train professionals in the 27 Practices and certify them to perform full reviews of the investment process (or limited reviews of investment expenses) for plan sponsors, helping them meet their fiduciary duties. The unnecessary fees discovered in this review often more than pay for the cost of the review itself. For the prudent fiduciary, it is an investment well worth making.

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