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401(k) Plan Fees Benchmarking

Why is this important?
How do I benchmark?
How often should I benchmark?

FRESH Look

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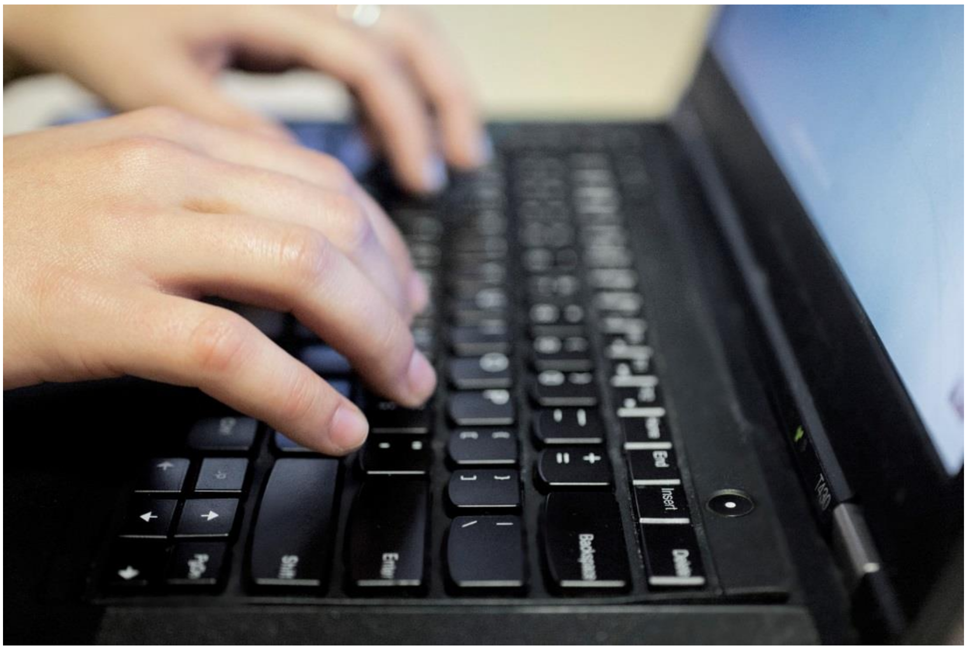


Why Benchmark?

Helps you know your plan better & what you are paying for

Work with new tools to improve plan efficiency

It can also help you …. SAVE COSTS!!!

Work with us for a FREE Benchmark!

Learn about Fee Benchmarking

401(k) Plan Fees Benchmarking

By Bonnie Yam, CFA, CFP

Bonnie Yam is the Principal of Pension Maxima Investment Advisory, a 401(k) consulting company.

Bonnie makes frequent presentations to small business owners and financial professionals to help them understand the importance of retirement planning and tax deferred savings.

Why this is important

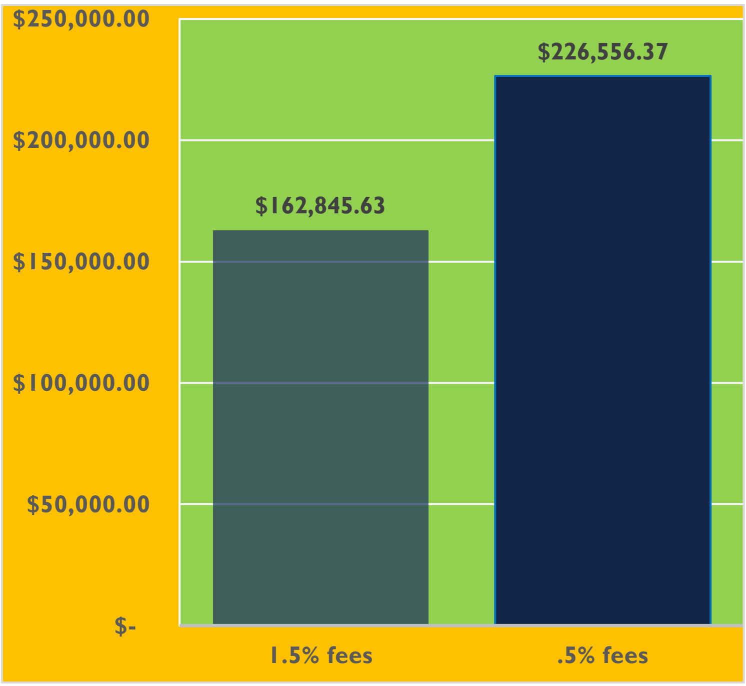
We can't predict returns, but we can certainly be more mindful on the fees that we are paying. It is important to note that cheap is not necessarily everything. However, as fiduciaries we should get a better understanding on our fees. Exactly, what are we paying?

Fees Matter: Even a small expense could have a huge impact over a long horizon.

To illustrate the impact, the Department of Labor (DOL) put forth an example of someone retiring in 35 years and an account balance of $25,000. At a 7% return each year and expenses of 0.5%, the account grows to $227,000 at the end of 35 years. If fees and expenses are 1.5%, the ending account balance would only be $163,000. That is a difference of 28%. Although one percent is a small difference, over 35 years the impact is huge.

The other reason to be conscientious about cost is the savings potential when assets increase. The cost of servicing do not rise proportionally as the set up fees are being absorbed by an increase in assets. If the plan has been established for over three years, it is a good time to review its costs. The three year horizon also happens to be DOL's recommended review period.

Fee Disclosure. 401(k) plan fees are notoriously complex and challenging to understand. In order to facilitate a better exchange of information, the DOL has established new rulings on service agreements, cost disclosures and conflicts of interest disclosures. The objective is to help the plan sponsor manage plan costs and assist plan participants in making more informed investment choices. Starting in 2012, there are required cost disclosures that go to the plan sponsor and plan participants. The two disclosures are 408(b)(2) and 404(a)(5).



408(b)(2) - Effective July 1, 2012

401(k) plan sponsors are required to enter only "reasonable agreements" with covered providers defined as entities that receive a **payment of $1,000** or more. Covered providers must provide **information on the services** that they will be providing, their fiduciary status and their **compensation arrangement**, whether they will be paid direct or through revenue sharing. This applies not only to new but also existing providers. Plan sponsor must determine whether the specified services from covered providers are necessary and reasonable relative to alternative service providers in the market place. Failing to receive required information and properly evaluate service could **result in prohibited transaction under ERISA.** This could lead to penalties for both the service provider and the plan sponsor.

The new regulation requires plan sponsors to proactively review contracts of service providers and to select the best service for the plan by following a sound fiduciary process.

404(a)(5) - Effective August 30, 2012

Many participants actually believe that their plan is "FREE" or that plan expenses are being paid by their employer. They do not realize that fees could be deducted from their accounts. Under the 404(a)(5) regulation, plan sponsors are required to **report all expenses that are deducted from plan assets or from participant accounts**. This includes how revenues are being captured from various investment alternatives and revenue sharing arrangements to offset recordkeeping charges, TPA fees, legal, accounting and/or advisory fees. This information is intended to help plan participants understand the cost of their investments and the cost of the plan and make appropriate decisions to manage their retirement assets.

Violation of 404(a)(5) rules may also result in liability as a **fiduciary breach** for the plan sponsor.

Know Your Fiduciary Rules

FIDUCIARY DEFINITION
•Anyone **specifically named** in the plan and individuals who **by their responsibility or action**:
•Exercise any discretionary authority or responsibility in the administration of the plan
•Exercise any authority or control concerning the management and disposition of plan assets
•Render investment advice with respect to plan assets, or has any authority or responsibility to do so **for a fee**.

FOUR TYPES OF FIDUCIARY
•**Named Fiduciary** – all plans must have at least one
•**ERISA 3(16) Plan Administrator** - responsible for day-to-day administration, interpreting plan documents and authorizing distributions
•**ERISA 3(38) Investment Managers** - assume full control over investment management
•**ERISA 3(21) Investment Advisors** – share fiduciary responsibility, renders investment advice for a fee

FIDUCIARY RESPONSIBILITIES UNDER ERISA
•Act in plan participant's best interests
•Act prudently
•Follow the terms of the plan document
•Diversify Investments
•Pay reasonable plan expense

Chapter THREE

401(k) Plan Service Model

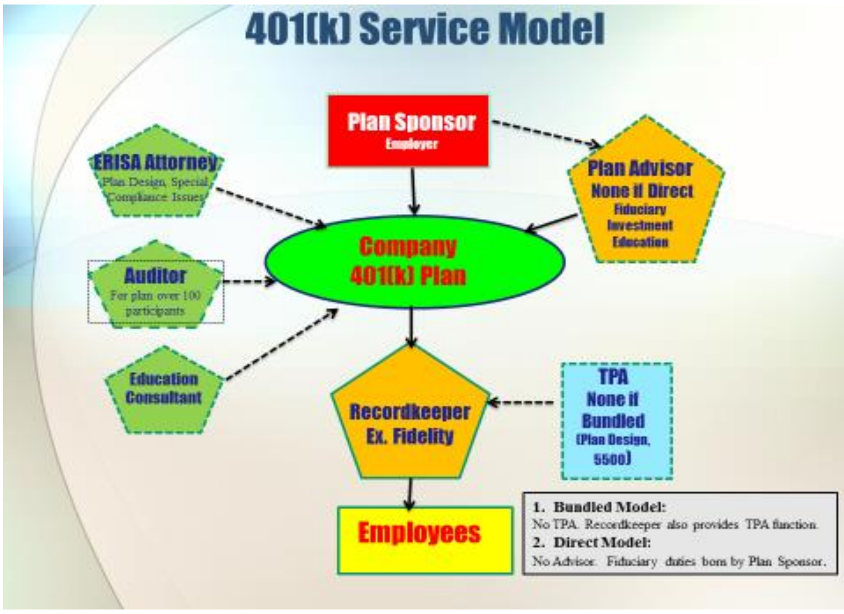
There are five service components in a 401(k) platform:

1. Recordkeeping – handling of statements and account balances and a trading platform for the funds.
2. Administration – filing of 5500, non discrimination tests; vesting, loan and withdrawal monitoring.
3. Trustee/custodian
4. Investments
5. Education for participants

The services can be delivered bundled or unbundled. It is important to know the differences between these two models and how they impact fees, service and delivery.

Bundled. The bundled model is where one single vendor provides all the services including plan administration. There is little customization. To minimize costs, investment choices may have to select proprietary funds of the provider. This is common, but not universal. Since there are less moving parts, many small plans elect a bundled provider for simplicity and cost reasons.

Unbundled. The unbundled model allows the plan sponsor to carve out certain job functions. One of the top unbundling features is to incorporate an outside TPA or a Third Party Administrator to unlock plan design flexibility. A TPA can custom design plan features to accommodate eligibility , vesting or tier employees groups in order to optimize profit sharing to a particular group.



Direct Sold Plans/Advisor Plans. Plans can be sold with or without an advisor. An advisor's (fiduciary or non fiduciary) key function is to assist the plan sponsor fulfill its plan fiduciary functions such as monitoring investment options and educating participants. Not all plans have advisors. Plans which do not have an advisor or Direct Sold plans share the function of an advisor between the 401(k) vendor and the plan sponsor.

Plan Audit. When plans exceed 120 participants, it requires an audit. The fees can be quite substantial. To avoid auditing fees, some plans would split employee groups and adopt two plans instead of one.

ERISA Attorney. In complex situations, such as a company merger, special plan designs or correcting plan mistakes, there might be a need to work with an ERISA attorney.

Other Consultants. Education consultants.

401(k) Plan Pricing Factors

Here are a few key factors in pricing a 401(k) plan:

1. Asset Size – (Revenue function)
   - Provides a general estimate on revenue sharing will come in from investment providers.
2. New Contributions each year – (Revenue function)
   - How fast can the asset grow, another element asset size
3. Number of Participants – (Cost function)
   - How much the 401(k) vendor needs to provide?
4. Fund Map (Revenue function)
   - Vanguard funds have no revenue sharing
   - Proprietary funds have higher profit margins

Based upon the number of participants, the 401(k) provider can quickly estimate the costs of servicing the plan in relation to amount of revenue sharing received.

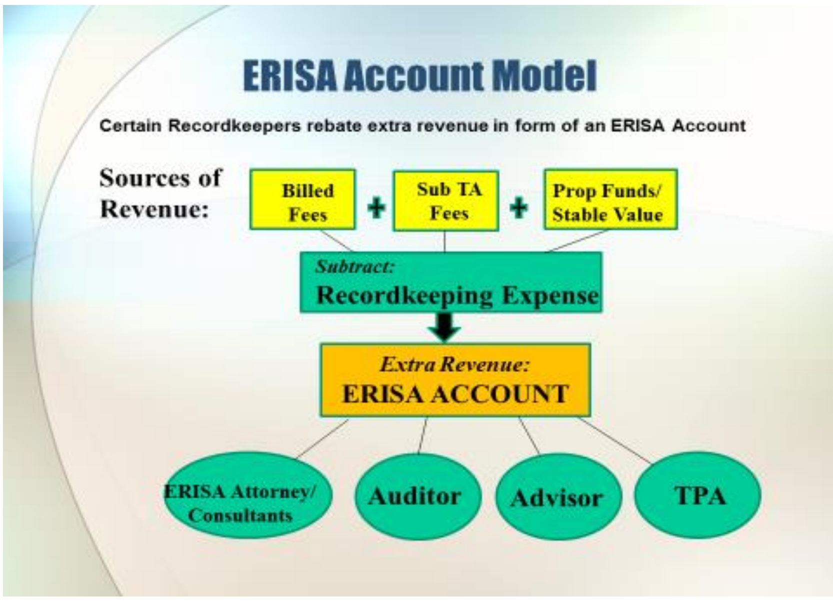
1. If Revenue sharing > Costs => No additional fees
2. If Revenue sharing < Costs

   Option (1): Direct Billing to Plan Sponsor

   Option (2): Charged to Plan Participant
3. If Revenue sharing > Costs

   Option (1): Keep the extra revenue

   Option (2): Rebate extra revenue to an **ERISA Budget Account** to pay for ongoing **operational expenses**.



ERISA Budget Account
Revenue sharing that exceeds the required recordkeeping expense besides can also be deposited into an ERISA budget account. The money can be used to pay for ongoing plan operating expense such required IRS amendments, plan audits or investment advice. Any balance at year end is reallocated back to participants.

Settlor versus Operational Expenses Expense pertaining to the ongoing operation of the plan can be paid from the ERISA account. Any expense associated with plan sponsor's business decisions must be paid by the plan sponsor.

Settlor's Expense:

- Plan Design Fees
- Amendment not required to maintain plan's qualified status

Operational Expense:

- Investment Fees
- Third Party administration expense
- Trustee fees
- Advisory fees
- Audit fees
- Custodial fees

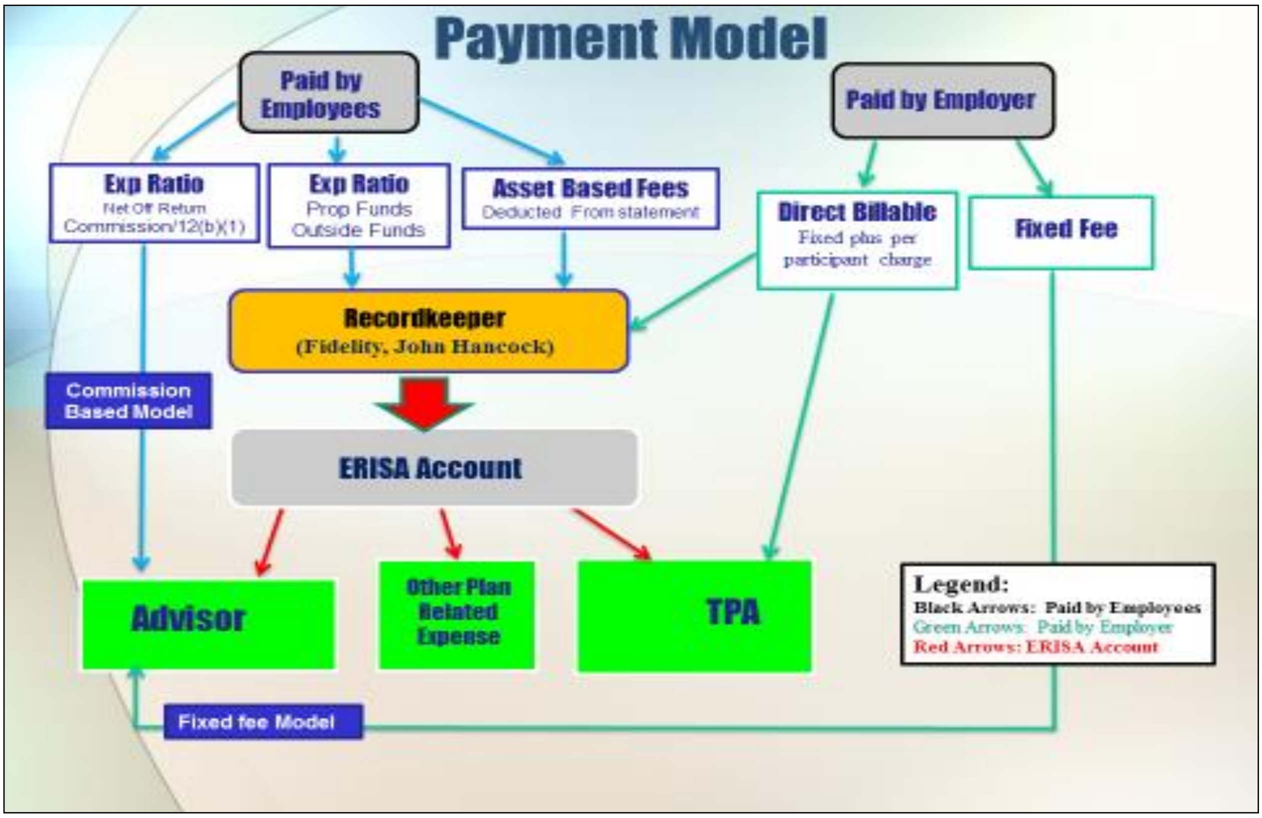
Advisor Fees. **B/D Advisors** are paid through commission or 12(b)(1). This fee is paid directly from the expense ratio. No billing is required. **Registered Investment Advisor or RIAs** have the option to charge a fixed fee or an asset based fee. Their fees can be billed directly to the plan sponsor, deducted off plan assets or paid directly from the ERISA Budget account. **TPA Fees**. Most TPAs bill plan sponsors directly. Their fees is normally a flat fee plus a per participant charge. They may also receive incentive payments from the 401(k) provider which they may use it to offset their own fees. It is not required since the incentive payment is not paid from plan assets but from the assets of the 401(k) plan provider.

Fund Expense Ratio

Fund expense ratio is a percent based fee that is deducted off your investment return. It includes payment to the investment manager, and also payment to vendors as legitimate marketing or servicing fees. The marketing fees range from 0.25% to 0.5%, but can go as high as 1%. Primarily, there are three types of payments, 1) 12(b)(1) fee – commission to broker, 2) SubTA fees – payment to recordkeeper in managing an "omnibus" account to help eliminate small business accounts in exchange for one big account, 3) Others - custodial, legal fees

Example: Annual fund operating expenses (deducted from fund assets)

	Class A	Class B	Class C	Class F
Management Fees	0.28%	0.28	0.28	
Distribution/ 12(b)(1) Fees	.25%	1.00	1.00	.25
Other Expenses	0.012	0.012	0.012	0.011
Total annual fund operating expense	.65	1.4	1.47	.64

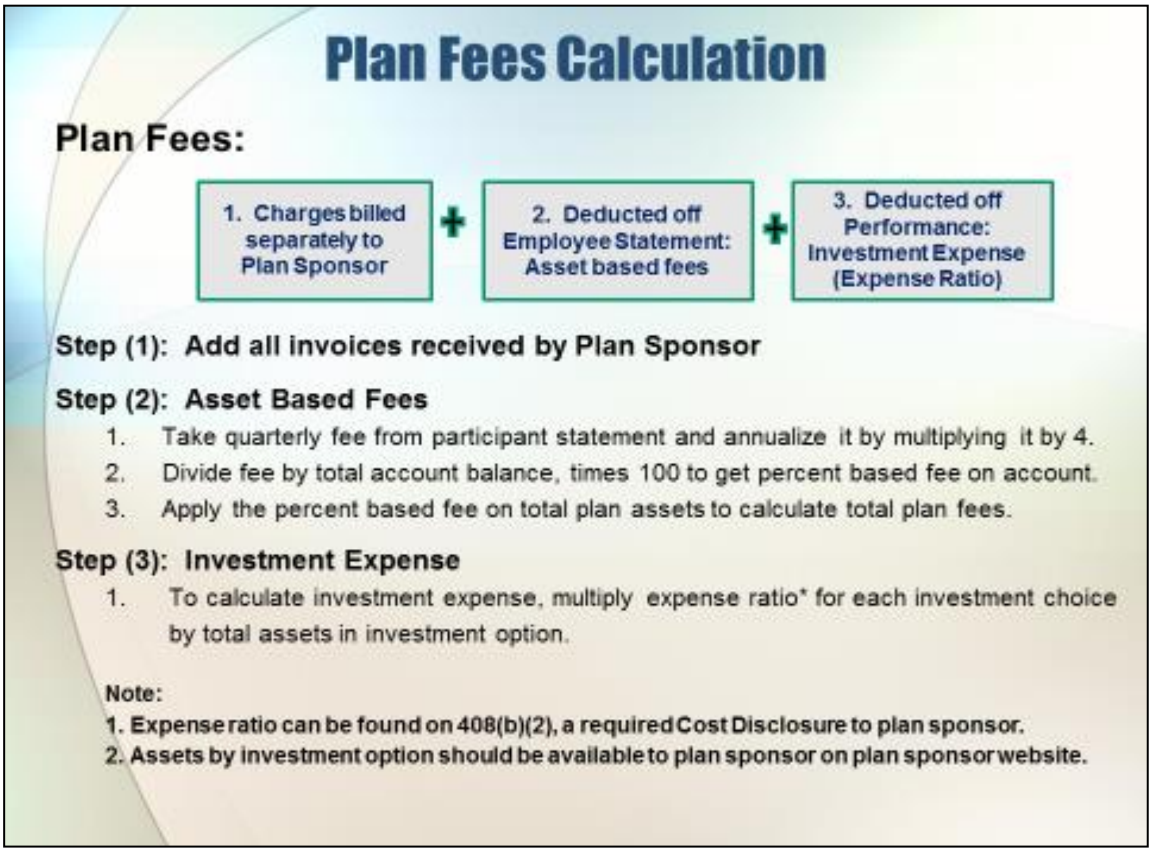


Calculating Plan Fees

Now the we have a basic understanding of the pricing structure and revenue model of the plan, we are ready to calculate plan fees.
There are three parts to the costs.

1. Fees billed directly to plan sponsor
2. Fees deducted from participant statements
3. Fund Expense Ratios

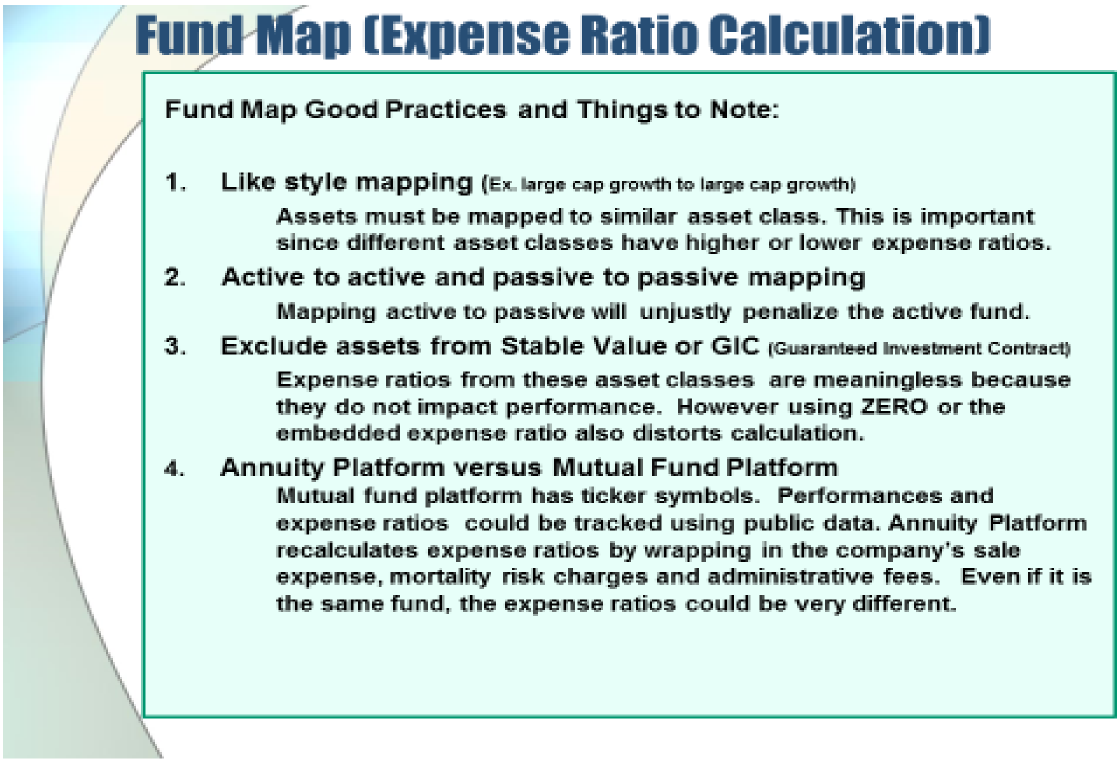
We can refer to 404(a)(5) and 404(b)(2), annual cost disclosure statements to plan participants and plan sponsor.



The Art and Science of Benchmarking

It is recommended that every three years, plan sponsors should undertake benchmark their plan expense to see if it continues to be competitive. The simple reason is that when plan assets grow, asset based fees also grow. If nothing else changes, it would be paying more for the same service from three years ago. When requesting for a competitive bid, a recommended process is to go through a detailed cost analysis using the 401(k) Fee Worksheet.

One of the trickiest part of the exercise is how to map funds to a new competitive platform. What funds you pick has tremendous impact on costs simply because of the implicit revenue sharing arrangement from each fund. When picking funds, besides fund performance, you should also be mindful in trying to map funds to similar investment styles and asset classes (such as passive to passive, active to active and large blend to large blend etc.) Also watch out when the fund shows no expense ratio. What this means is that the fund expense is being netted off performance. Finally, watch out for proprietary funds. These funds are key revenue generator for the provider, so it will help lower expense by having them on the platform. However, it can also be a problem when they underperform because it could mean you would have limited replacement candidates.
To perform the fund map properly, it involves the decision to balance cost, return and investment choices.



Calculating Plan Fees

401(K) FEE WORKSHEET

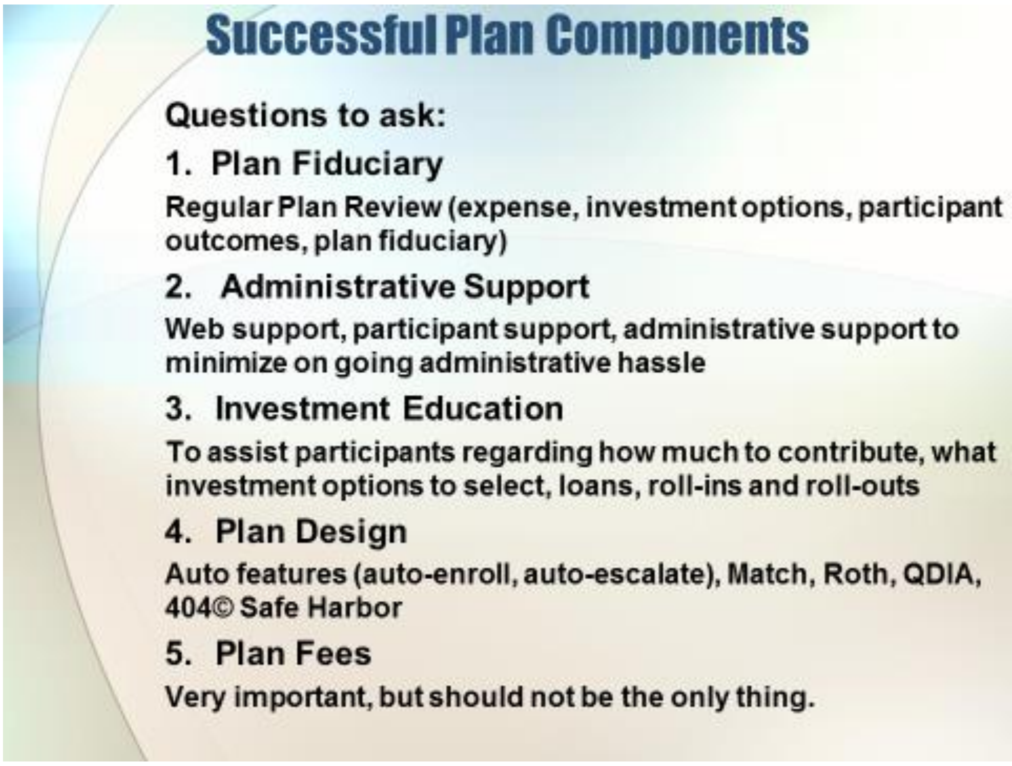
COMPANY NAME						Plan Expense
Total Participants						
Total Assets						$
RECORDKEEPING EXPENSE						
Base Fee						
		# Participants			*Fee*	
Per participant				*x*	*$*	$
		Wrap Fee			*Assets*	
Wrap Fee (asset based)			*%*	*x*	*$*	$
Total Recordkeeping & Administration Expense						$ (1)
INVESTMENT EXPENSE						
Calculate expense for each fund on platform						
		Expense Ratio			*Assets*	
Stable Value/Money Market	*Stable Value/Money Market*		*%*	*x*		$
Fixed Income	*Fixed Income*		*%*	*x*		$
Balanced	*Balanced*		*%*	*x*		$
Lifestyle	*Lifestyle*		*%*	*x*		$
US Equity Large Cap	*US Equity Large Cap*		*%*	*x*		$
US Equity Mid Cap	*US Equity Mid Cap*		*%*	*x*		$
US Equity Small Cap	*US Equity Small Cap*		*%*	*x*		$
International	*International*		*%*	*x*		$
Miscellaneous	*Miscellaneous*		*%*	*x*		$
Total Investment Expense						$ (2)
INVESTMENT ADVISORY						
		Asset Based				
Investment Advisor			*%*	*x*		$ (3)
ERISA BUDGET						
		Asset Based				
ERISA Budget (Expense offset)			*%*	*x*		$ (4)
GRAND TOTALS						
Total Plan Expense	(1 + 2 + 3 - 4)					$
Total Plan Fees Per Participant	Total Plan Expenses divided by total participants					$
Total Plan Fees as a % of Assets	Total Plan Expenses divided by Total Plan Assets					%

Comments:

1. In our example here, plan sponsor pays all the direct billed expenses or $15,500. Participants pay asset based fees, (sum of 2 and 3) or $16,000. Total plan expense is actually $31,500 or 3.1% or total assets even though expense ratio is 1.2%.
2. It is important to **pay attention to asset based fees**. It increases when there are returns from the market or new contributions to the plan. Participant based fee is a more reasonable fee since it is calculated based upon additional service rendered from an increase in participants.

Afterthoughts

Finally, it can't be all about fees. The goal is to pay reasonable fees without sacrificing service. You need a responsive team that can bring the best service to your participants. There are so many moving parts in a 401(k) plan, having an experienced advisor is also critical.



RESOURCES

General Information about Retirement Plans

1. **Department of Labor**

   http://www.dol.gov/ebsa/publications/401kplans.html

2. **401(k) Help Center**

   www.401khelpcenter.com

3. **Plan Advisor**

   www.planadvisor.com

4. **National Association of Plan Advisor or NAPA**

   www.napa-net.org

5. **American Society of Pension Professionals & Actuaries**

   www.asppa.org

Expense Benchmarking Tools

1. **401(k) Averages Book**

   www.401ksource.com

2. **Fiduciary Benchmarks**

   www.fiduciarybenchmarks.com

3. **Brightscope**

   www.brightscope.com

Fund Benchmarking Tools

1. **Fi360**

   www.fi360.com

RESOURCES

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