Fees Run High for Small Business 401(k) Plans

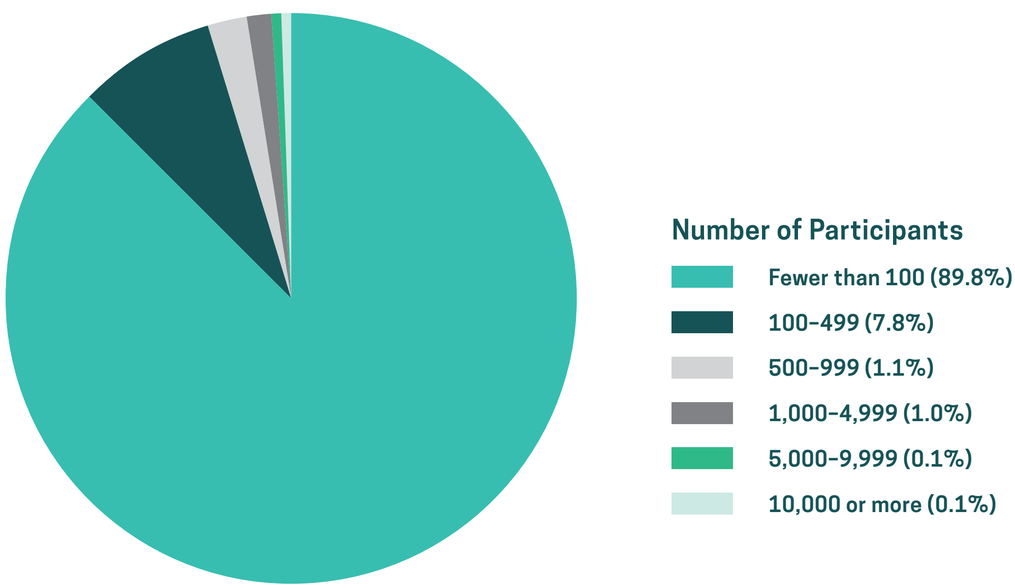
Introduction

The vast majority of 401(k) studies (and the media articles written about them) are compiled using data from the publicly available Form 5500 which is required of all 401(k) plan sponsors. The challenge is, for plans under 100 participants, the government only requires a "short" Form which contains very little data and excludes very pertinent information such as:

- The name of the plan provider,
- The compensation paid to brokers and advisors,
- The compensation paid to record-keepers and third-party administrators, and
- The mutual funds in the plan along with their corresponding expenses.

Thus, the information discussed and disseminated by the industry effectively excludes the plans with under 100 participants. This is a massive blind spot because of the approximately 533,000 401(k) plans in the US, 89.8% of them have under 100 participants. By omitting nearly 90% of all 401(k) plans from comprehensive analysis, one might draw false conclusions about broader industry trends such as the lowering of fees or greater access to low-cost index funds.

Figure A:



Source: The BrightScope/ICI Defined Contribution Plan Profile - A Close Look at 401(k) Plans, 2014 - See Page 11

The Challenge

Until the release of this white paper, there were virtually no extensive studies of plans with under 100 participants. Only by requesting documentation directly from the plan sponsors/business owners can one obtain and analyze the key data points otherwise missing from the short Form 5500.

Over the past five years, America's Best 401k has received thousands of fee disclosures from both participants' Form 404(a)(5) and plan sponsors' Form 408(b)(2) from virtually every provider in the industry. Keep in mind that fee disclosure did not become a legal requirement until 2012, nearly 30 years after the advent of the 401(k).

For this white paper, we decided to focus only on the topic of "asset-based" fees because these are extracted from the participants' accounts and have the greatest effect on the desired outcome of each participant — financial security. For the purposes of this white paper, asset-based fees include the average mutual fund expense ratios, broker or advisor compensation, recordkeeping/custody fees and any contract asset charge or account maintenance charges that are deducted as a percentage of the plan balance.

We find this to be a crucial analysis because according to public policy think-tank Demos, the average worker will lose $154,794 to 401(k) fees over his/her lifetime (based on annual income of approximately $30,000 per year and saving 5% of his/her income each year). A higher-income worker, making approximately $90,000 per year, will lose upward of $277,000 in fees in his/her lifetime (Source: The Retirement Savings Drain: The Hidden and Excessive Costs of 401(k)s). We recognize that there is no situation in which fees are eliminated because a 401(k) plan has a number of service provider requirements and the underlying investments are managed professionally. However, it's simple math that a reduction in fees, whenever possible, is important for the financial future of plan participants. The 401(k) is an incredibly valuable tool when used correctly, and especially when prioritized for the primary benefit of participants.

The Providers

We have selected 11 providers for our fee analysis. Based on the 2016 survey by *Plan Sponsor*, these providers account for a substantial majority of the small plan market. Of the 11 chosen, nine are on the list of the top 10 providers for defined contribution plans with under $10 million in assets (see *Figure B*).

Figure B:

Provider	# of Plans with under $10 Million
Paychex	71,800
ADP Retirement Services	54,306
John Hancock	54,206
Principal	48,692
American Funds	45,139
Voya Financial	44,737
Ascensus	44,115
Nationwide	37,264
Empower	32,265
VALIC	31,183

Source: *Plan Sponsor* 2016 Recordkeeping Survey

Full Disclosure: The analysis we performed for this white paper is not necessarily indicative of other plans offered by the provider. The analysis is conducted using only data from the fee disclosures we were able to collect from plan sponsors. We readily acknowledge that fees vary from plan to plan and fees in other plans may be higher or lower than the averages we found in this sample. We are also not suggesting that fees across all plans from each respective provider are as high as we found in this sample. Note that other large providers, such as AXA Financial and VALIC, were omitted from the analysis because a large-enough sampling of fee disclosure documents has not yet been obtained.

The Findings

Below is a graphic (see *Figure C*) showing the breakdown of the number of plans analyzed from each provider, the average plan balance, the average number of participants, and the average asset-based fees of the plans in the sample.

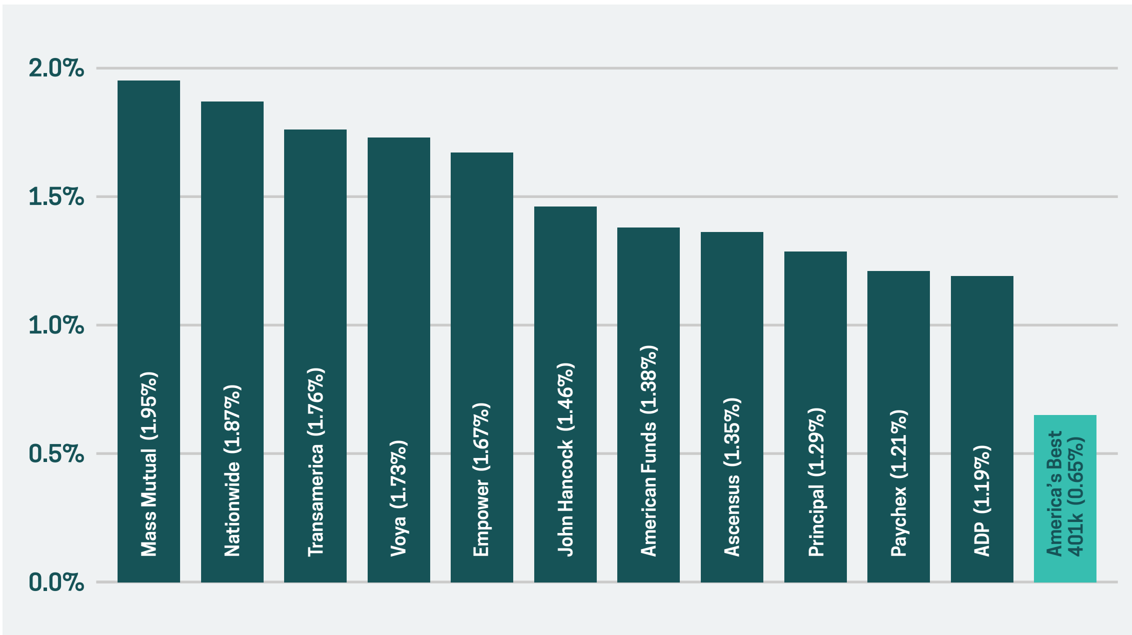
Figure C:

Provider	# of Plans	Average Plan Balance	Average # of Participants	Average Asset-Based Fees
ADP	27	$1,610,963.00	22.22	1.19%
Nationwide	21	$1,101,333.33	19	1.87%
American Funds	26	$734,923.12	17.27	1.38%
Paychex	24	$483,958.33	17	1.21%
Ascensus	15	$1,755,066.67	14.8	1.35%
Principal	16	$1,460,400.00	21	1.29%
Empower	11	$1,308,818.18	24	1.67%
Transamerica	22	$775,727.27	25	1.76%
John Hancock	32	$1,535,738.44	24	1.46%
Voya	23	$1,659,956.52	26	1.73%
MassMutual	26	$1,200,153.92	27	1.95%

Source: Plan Provider Filings Collected by America's Best 401k.

The following graphic *(Figure D)* shows the average asset-based fees for the plans analyzed. When applicable, we specifically did not include any additional "hard dollar" costs which are often paid directly by the company. By not including any hard dollar administration costs, we created a fairer "apples to apples" comparison but we are also aware that in many cases, the true costs could be higher than listed if those hard dollar fees were converted to asset-based charges.

Figure D:



Source: Plan Provider Filings Collected by America's Best 401k

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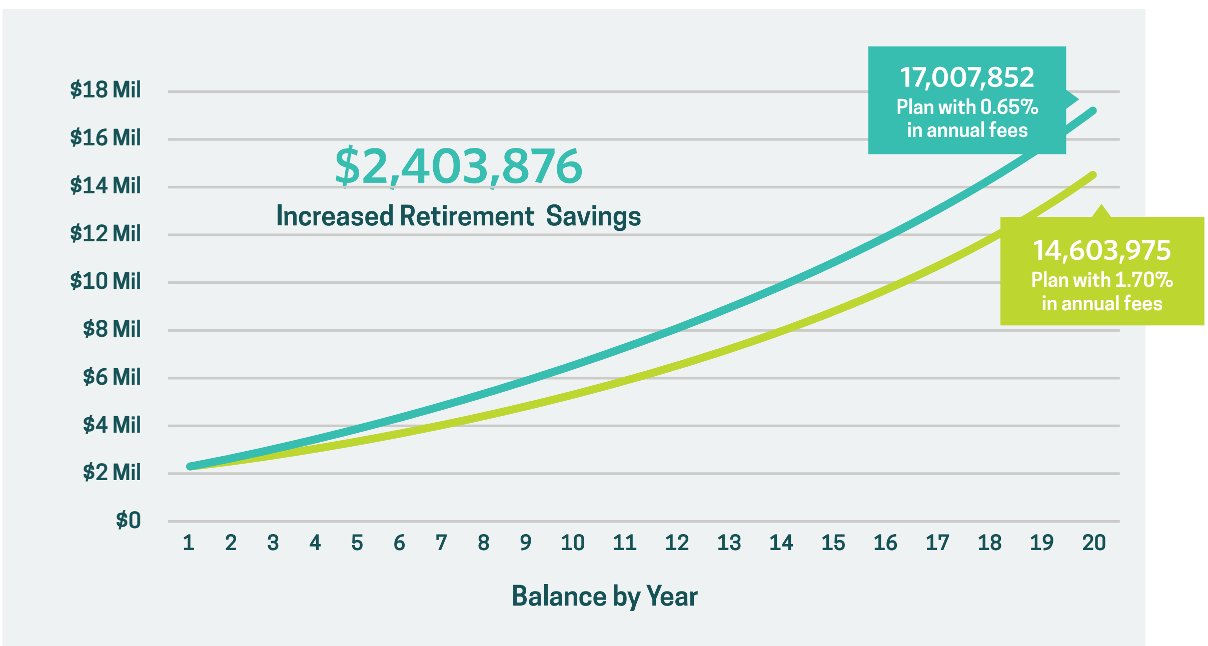
The Impact of Fees

When reviewing the asset-based fees of any plan, it's important to move beyond a static percentage and analyze the true impact of those fees over time. Assuming all things being equal in terms of performance, any reduction of fees will go directly back into the pockets of plan participants in the form of higher account balances. This will lead to greater financial security for both the owner and employees. This should also have ancillary benefits such as higher employee retention rates.

The chart below shows the impact of fees over time on a typical small business plan (below 100 employees) with a starting balance of $2 million, annual contributions of $250,000 and annualized performance of 7%. You can see that a savings of approximately 1 percentage point in annual fees can lead to seven figures of recouped retirement savings that would have otherwise gone to fees.

Figure E:



Source: America's Best 401k

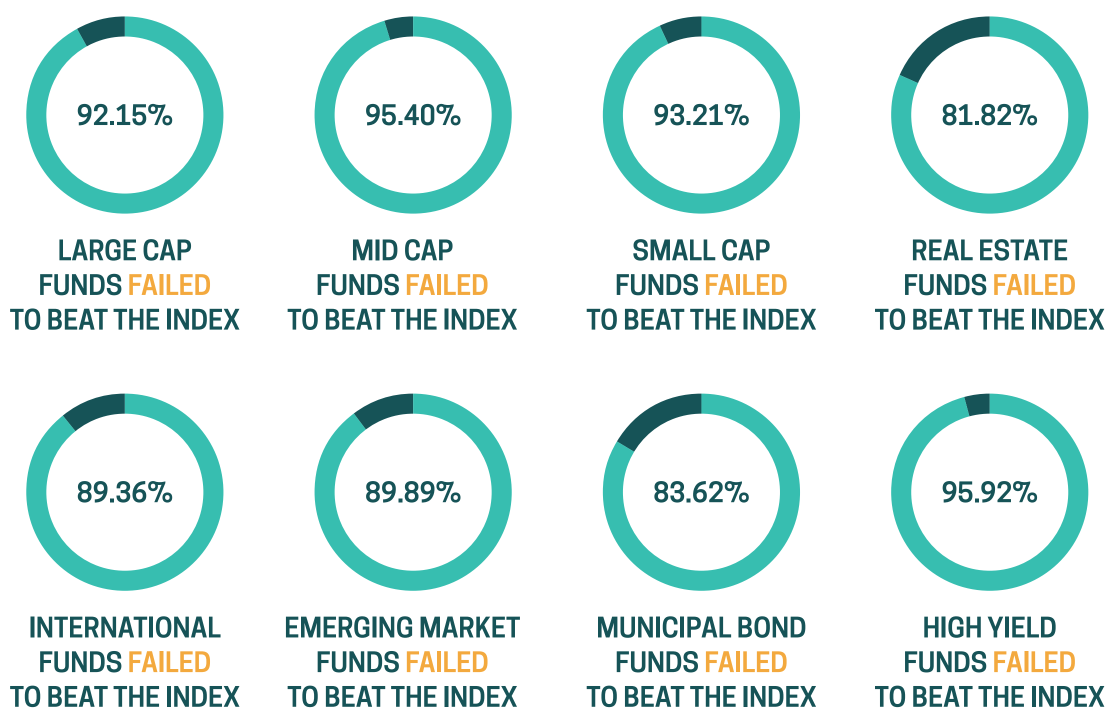
Performance

Although we did not include a deep dive into the performance of the funds within these plans, it's worth pointing out that most of the plans had limited or no access to low-cost index funds. Certain plans, typically those with under $1 million in assets, are told they do not yet qualify for low-cost index funds until the asset size reaches a minimum level.

Most plans in the analysis had exclusively, or a substantial majority, actively managed funds. These are significantly more expensive than index funds and may also deliver a portion of their revenue to the providers or brokers (in a practice known as "revenue-sharing").

The graphic below shows the percentage of active managers who failed to beat their benchmark index (for the 15-year period ending in 2016).

Figure F:



Source: SPIVA Scorecard

Although past performance does not have any bearing on future performance, it's safe to say that for the recent past, a large percentage of small plans have been burdened with high fees for actively managed funds that have underperformed their benchmark.

Key Observations

In conducting this analysis, we have noted several key observations below:

- The annual cost of 401(k) plans with less than 100 participants is substantially higher than for plans with 100 participants or more. Employees of these companies are unfairly penalized for their choice of employer. The industry median for plans with 100 participants or more and $1 million or more in assets is just 0.93% of plan assets per year, with the rate dropping sharply as assets exceed $10 million or more to as low as 0.27% of plan assets per year. (Source: BrightScope-ICI Dec 2017 report, page 50.)
- Most of the plans had limited or no access to index funds as it's the stated policy of many large providers to not provide access to index funds until plans reach a certain size. Some did provide access, but there were often significant mark-ups to their retail expense ratios. For example, one plan we reviewed offered the Vanguard Total Stock Market Index Fund for an astonishing 1.61% annually when the true direct cost from Vanguard is just 0.05%. This is a 3,120% mark-up.
- In certain instances, in which an insurance company was the provider, the 401(k) was put into a group annuity contract which created additional expenses not found in traditional 401(k) plans. In addition, some of these plans were still under the contractual surrender charge period, which would force the plan sponsor to pay a significant penalty if he/she wanted to change providers before this time period ended.

Disruption

The small business marketplace is seemingly ripe for disruption. Next-generation providers are leveraging open-architecture solutions that eliminate brokers (and associated commissions) and sell plans direct to business owners. Local representation has become irrelevant because on-demand technology allows participants to engage with their plan whenever they want, and on any device they want. Video-based education/tutorials are available to walk the participants through enrollment meetings, set their retirement goals and accomplish virtually any task they desire (i.e. taking a loan, changing deferral rates etc.). Coupled with live one-on-one investment advice from a professional, a combination of high-tech and high-touch is changing the small business 401(k) landscape.

Many of these next-generation providers are using low-cost index funds as the core line-up and don't get paid a share of the revenue (thus eliminating most conflicts of interest). These providers create a more level playing field by offering a similar fee structure for all plans, regardless of size, and giving participants access to the same institutional class shares that much larger plans enjoy.

In terms of cost, most next-generation providers can average asset-based fees between 0.55% and 0.75% annually, and this includes the cost of the funds in the plan, custody/recordkeeping fees and financial advisory services.