“Fact check” of testimony on 401(k) Plan Investment Expenses and Fees

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IMC Fact Check – March 6th House Committee on Education and Labor – Matthew Hutcheson written/oral testimony on 401(k) fees

Point	Agree	Disagree	Explanation
To illustrate the egregiousness of 401(k) fees with consideration of hidden and excessive fees, an example was cited of an average investment expense of 1.13%, but the real fee to the 401(k) plan participant is 2.99%. The 3% example was also cited by Chairman Miller.		✓	Witness used out-of-date data and data not applicable to 401(k) plans that overstated transaction and spread costs by a factor of 3:1, and then even more mistakenly, miscalculated 401(k) expenses to get to 2.99%. IMC estimates the real number at 1.28%.
States the average mutual fund transaction and spread costs run 1% (100 basis points). Testimony was on 401(k) fees.		✓	IMC's data indicates the real cost of these items to 401(k) active investments to range from 18bps to 45bps. On average, a reasonable number would be 30 bps and not 100 bps.
States revenue sharing payments average 50 bps.		✓	Not all plans use revenue sharing. For those that do, revenue sharing, on average is: Micro market plans 35 to 60 bps Small market plans 25 to 40 bps Mid market plans 25 to 35 bps Large market plans 20 to 30 bps Mega market plans 10 to 20 bps
Uses an example to show the affect of active vs. index choice costs on 401(k) participant retirement dollars, 47 years down the road, of over $500,000.		✓	Illustrates cost difference of 1.50%. The real world 401(k) difference is one third that – 0.49%. Of course, actual fund performance would determine which choice created the higher balance.
Made the case that today's 401(k)s include structural and fiduciary designs that promote practices contrary to the best interests of plan participants.	✓	✓	It is difficult to obtain the information needed to do apples to apples cost and services comparisons. The industry's regulations exist to support 401(k), and not as the witness would lead one to believe, to foster a status quo favoring financial service industry interests over those of plan participants.

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In essence, states that 401(k)s today include many features that are unnecessary, that add costs, provide havens for bad actors to fleece plans and participants, and in some cases, actually provide participants with choices contrary to their best long-term interests.		✓	Hutcheson completely fails to understand how choice and education, and access to funds in the form of loans and hardship withdrawals (and the like), promote higher plan participation rates and opportunity for individual preference.
States that the industry's arrangements among service providers are secretive in nature and difficult to get to the bottom of to decipher possible conflicts of interest.	✓		Transparency has improved in the last 6 months to a year, but has a long way to go. This is one of the primary objectives of the Pension protection act.
States that the mutual fund industry is now the world's largest skimming operation – negatively effecting the financial security of Americans and their households.		✓	Some mutual funds are truly not cost competitive. Bad examples do exist. However, Hutcheson tars the entire industry with a brush that applies to a minority.
States over and over again the superiority of market index funds over the large majority of active mutual funds. Applies general mutual fund performance to 401(k)s.	✓	✓	It's quite common for 401(k) plans to offer both index and active options. Plan sponsors choose an array of the best and most reasonable funds for their plan menus. Some sponsors are better at this than others.
States that plans and participants are often guided to higher cost choices where advisors and service providers out of self-interest are in collusion.	✓	✓	IMC sees a lot of plan data and knows most of the industry's key players. There is a need for apples to apples costs and services comparisons and full disclosure that is missing in 401(k)s today. The vast majority of poor practices reside in plans below $5 million.

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Trading costs are hidden and average 80 bps.		✓	Trading costs vary by fund, strategy, year, turnover, and their disclosure is not a regulatory requirement. Witness misunderstands how funds trade, and their costs; and in particular, practices applicable to funds most often used in 401(k)s. Hutcheson overstates trading costs by a factor of between 4:1 and 2:1 depending on the type of fund.
Soft dollars are unaccounted for, and when added to 12b-1 fees and other compensation vehicles, compromise persons acting as fiduciaries to make decisions not solely in the best interest of plan participants.		✓	This was measurably true 20, 15, 10, and 5 years ago. Today the practice Hutcheson cites is illegal and the SEC has excellent means at its disposal to catch perpetrators.
Sub-agency transfer fees and 12b-1 fees are hidden and excessive and negatively affect the income security of 401(k) participants. The effect of the harm escalates over time as account balances grow.	✓	✓	These fees, which are the primary instruments of revenue sharing, are included in mutual fund expense ratios. In 401(k)s they are used to pay for recordkeeping, education and communications, web, phone, participant materials, legal and accounting services and more. Fully disclosing all sources of revenue, who receives them, for what services and how much, is going to be an outcome of PPA. Hutcheson has a point that this revenue, if not monitored, can become excessive as participant balances become larger.
Variable annuity wrap fees are full of hidden and misunderstood costs which benefit financial service companies and advisors at the expense of plans and their participants.	✓	✓	These types of vehicles are primarily found in plans under $5 million and 403(b) market plans. Some of the institutional varieties of these vehicles can be cost competitive, but many in fact, are priced outrageously. The PPA will likely put an end to the later.

Point	Agree	Disagree	Explanation
Shadow index funds and other improperly benchmarked and overpriced options are a problem in 401(k)s.	✓	✓	Enhanced index choices are a hybrid of active and passive styles. They require appropriate custom benchmarks and costs. These choices can be attractive for 401(k)s. Proper evaluation and ongoing monitoring requires expertise.

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<table>
<tr><th>Point</th><th>Agree</th><th>Disagree</th><th>Explanation</th></tr>
<tr><td>Those 401(k) plans with excessive investment costs can cost their participants as much as a 20% reduction in their retirement nest eggs versus plans with reasonable costs.</td><td>✓</td><td></td><td>IMC has extensive data on 401(k) plan costs by market segment. Our numbers suggest that plans whose entire investment menu costs are unreasonable may exceed a reasonableness standard by as much as 20 to 50%.</td></tr>
<tr><td>The segment of the 401(k) marketplace where investment costs abuses are the most widespread is in small company plans – those companies lacking full time benefit and HR staffs.</td><td>✓</td><td></td><td>Butler's assertions here and his explanation mirror our own findings.

Considering that over 97% of all 401(k) plans are small company plans, this is a system wide problem that will require focused attention.</td></tr>
<tr><td>Many of the recordkeepers in 401(k), who also manage money, stack the deck in favor of the vast bulk of participant dollars ending up in their proprietary choices. Butler states that 70% to proprietary investments is commonplace.</td><td>✓</td><td>✓</td><td>Here butler comments on the state of the 401(k) open investment architecture in general. It is more accurate to look at industry practices by market segment. IMC's open architecture findings on industry practices are outlined below:

Proprietary Investment Capture by Market Segment
<u>IMC Data 2006</u>

<table>
<tr><th>Plan size (millions)</th><th># of choices out of 15</th><th>% of assets</th></tr>
<tr><td>$5</td><td>10-15</td><td>70-90%</td></tr>
<tr><td>$25</td><td>8-12</td><td>60-90%</td></tr>
<tr><td>$50</td><td>8-12</td><td>50-80%</td></tr>
<tr><td>$100</td><td>6-12</td><td>40-75%</td></tr>
<tr><td>$250</td><td>6-10</td><td>30-70%</td></tr>
<tr><td>$500</td><td>5-9</td><td>25-70%</td></tr>
<tr><td>$1,000</td><td>2-7</td><td>20-70%</td></tr>
<tr><td>$5,000</td><td>0-7</td><td>0-40%</td></tr>
</table></td></tr>
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The most egregious practice in 401(k) is with mutual fund or annuity products that pay commissions and feature long-term surrender/withdrawal charges that can run as high as 5%, while simultaneously charging participants annual fees as high as 3%. These products are largely the domain of small company 401(k) plans.	✓		Butler is right on the money in his comments here.
The use of these high cost products is a mainstay of many brokers and advisors who "sell" 401(k) plans to small companies. The distribution of these products in 401(k) is dependent on the provision of incomplete and often misleading information to uninformed plan sponsors buying on trust.	✓		Our own findings over the past 16 years echo Butler's point of view. IMC is currently updating our 2004-2005 investment and 401(k) practices in the small company plan market segment(s) – the results of our study will be made available to policy makers in April, 2007.
The witness has seen many cases in 401(k) where large financial services companies' bundled offerings are compliant and satisfy the basics of providing education and communication; but in the end, the plan sponsor and participants remain confused and poorly served.	✓		We believe Butler's opinion here is on solid ground. There is much more to success in 401(k) than compliance and meeting basic needs. After twenty-five years of 401(k)s there is much progress needed, even at the level of best practices.
Butler sees unbundling of investments from the recordkeeper as the most important step to eradicating high/unreasonable costs and the provision of less than satisfactory services. Ideas were presented in written testimony to change the way 401(k) investments and services are typically paid for.		✓	Here we disagree. IMC's data shows four approaches used to pay for recordkeeping services, with some variations among them. Low cost/high service results are being achieved across each of these arrangements, from fully bundled to recordkeeping only.

Point	Agree	Disagree	Explanation
Inadequate disclosure and reporting requirements may leave participants without a simple way to compare fees among plan options and the DOL is without the information it needs to oversee fees and identify questionable 401(k) business practices.	✓		Bovbjerg's and the GAO's first step position is the key. Provide full information and an ability to do apples to apples comparisons so problems are identified and solutions made apparent. This year IMC will be offering a practical, cost attractive total 401(k) marketplace approach, that will exceed GAO recommendations.
While some participants have 401(k) accounts of \$100,000 or more, 37% of 401(k) participants have less than \$10,000. The median 401(k) participant account in 2005 was just \$19,328.	✓		401(k) like the economy and the nation as a whole, include haves and have nots. Costs are one component in assessing 401(k)s for success. Participation, deferral amount, asset allocation, starting soon enough and working long enough, are just a few of the other factors that 401(k)s <u>must</u> help employees to consider.
401(k) plans generally can chose to enter into bundled or unbundled arrangements with service providers. The DOL needs more information on business practices and resulting fees in order to oversee current business practices.	✓		IMC's plan data resources capture the following 401(k) business practices: 1) Bundled 2) Modified bundled 3) Recordkeeping only – fees paid separately, 4) Recordkeeping only with revenues sharing OK through all non-proprietary investments. These arrangements can be subject to an escalator and to excess revenue collections that return funds at either the plan or participant account levels. All arrangements have success stories as well as disappointments and abuses.
The largest cost to 401(k) plans (2005 data) is investment costs, which as a percentage of total fees, range from 84.5% in very small plans to 99% for the largest plans. By inference, fees can't be analyzed and managed without a full understanding of investment costs.	✓		IMC's data supports GAO's findings

Point	Agree	Disagree	Explanation
The GAO believes a disclosure requirement to provide participants a means of assessing the costs of choices is central to improving 401(k)s.	✓		This is the best “hold feet to the fire” means of getting everyone’s complete attention and arriving at best outcomes for PPA. In April, IMC will be ready to share to policy makers its ideas for these reports, what we believe they will accomplish, why they will be meaningful to participants, and what they will cost to produce.
The DOL and plan sponsors must have information on service provider business arrangements that steer sponsors toward investments benefiting the providers that may not be in the best interest of their participants.	✓		There is no better tonic for this problem than providing plan sponsors with benchmarks, the ability to see what similar plans offer and their costs. By yearend, IMC will offer this capability across all 401(k) market segments.
Specifically, hidden fees may mask the existence of conflicts of interest.	✓		This position, like the others taken at the GAO, on the face of it is completely true. IMC’s solutions for PPA will include an ability to review all explicit cost components of products and services through actual costs disclosures. Where implicit – costs will be reviewed against applicable comparisons gathered from the rest of the marketplace. Sponsors will be able to follow the money to assure plan funds are being spent appropriately at reasonable dollar amounts for products and for services rendered.

IMC Fact Check – Robert Chambers (American Benefit Council) Written and Oral testimony on 401(k) Plan Fees (3/6/2007)

Point	Agree	Disagree	Explanation
System is lacking disclosure to plan fiduciaries of direct and indirect fees that service providers receive from the plan or from unrelated third parties.	✓		Absolutely accurate and essential for plan sponsors to prudently manage and control relationships with their service providers. IMC will be in a position to present solutions in this area in April.
Any real fix of 401(k) problems relating to fees and expenses and conflicts of interest will need to include clear and meaningful disclosures to participants.	✓		Chambers is right on both accounts. The information is needed at the participant level <u>and</u> it needs to be easy to understand and useful. IMC will be presenting its ideas for solutions to policy makers in April.
Policy makers should take care that regulatory actions (though well intentioned) not result in overly complicated and burdensome requirements that push employers away from sponsoring 401(k) plans.	✓		This concern is well founded and policy makers should take care that the medicine does not generate undesirable side effects.
Chambers states the importance of reviewing fees and expenses within the context of the services provided. Fees should not be seen in a vacuum	✓		Any evaluation of a service – and investment management and recordkeeping are services – is half-baked if it doesn't look at costs, complexities, services, and results. What you get for what you pay for – apples to apples comparisons are key.
Concern was expressed that a singular focus on 401(k) fees would blunt initiative and result in choice limitations that actually harm the 401(k) system, plans, and participants.	✓		IMC believes fees are a central focus and agrees with Chambers that emphasizing fees at the exclusion of value stifles initiative and encourages commoditization. In an industry in so much need of breakthroughs and choices, IMC believes Chambers concern is insightful.

Point	Agree	Disagree	Explanation
The American Benefits Council (ABC) expresses concern that simplistic and incorrect measures may be applied that cause policy makers to reach wrong conclusions. The example cited is that the higher participant and plan level costs for a small plan could, on the surface, look inappropriate. However, a somewhat higher fee may no longer seem out of order after consideration of number of participants which the recordkeeper has to amortize its costs – recordkeeping, phone, web, print material specifications, admin and fiduciary plan needs, etc.	✓		The 401(k) market is divisible into at least 12 major groupings that lend themselves to performing appropriate apples to apples comparisons Sponsor characteristics and product/service packages must be factored in for comparisons as well. This is not at all impossible or overly burdensome to do, and it is worth doing right.
ABC believes arrangements between service providers are not the root of the problem. Rather, the root is the failure to provide full and timely disclosure. ABC does not see the industry's use of revenue sharing as a business practice inherently at cross purposes with the interest of plans and their participants.	✓		Plan sponsors have many different approaches and economic realities to consider when distributing costs. IMC has in-depth industry data for appropriate comparison purposes. Our data can be applied to compare how fees are distributed across the industry and by peer groups. We also have a white paper coming out in the third quarter of this year on fees and fairness.
ABC concludes that 401(k) plan investment fees have come down, and cites an ICI 2006 study that shows the average asset weighted expense ratio for 401(k) plans investing in stock mutual funds was 0.76%, compared to 0.91% average for all stock mutual funds.	✓	✓	IMC agrees 401(k) fees have come down a bit as the market has grown and as average participant balances have grown along with it. The ICI study in our judgment represented a simplistic statistical method with the intent to put 401(k) investment costs in the best possible light. IMC data finds that patterns are different across market segments, and vary equally as much across plans. Some plans include terrific overall investment costs and other show much room for improvement.