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A Poorly Structured Workplace 401(k)

I recently had a chance to help a friend sign up for a new workplace 401(k) investment plan. I typically enter these discussions with great enthusiasm as investors are being provided an attractive and systematic way to invest for the future in a tax-deferred product that may be accompanied by an employer match as well as income tax benefits. While I'm still a proponent of participation in 401(k), 403(b), 457(b) and similar defined contribution plans, I left this meeting scratching my head.

Employers that offer workplace retirement plans such as 401(k)s typically outsource the administration, record keeping, plan design and reporting to a third-party "provider". This is quite understandable in light of employers possibly having limited knowledge or time to oversee the process while the plan participants may additionally benefit from the use of an unaffiliated provider.

My friend's 401(k) plan offered the single choice (disregarding the "opt out" alternative) between the ***standard option*** or a ***custom option***. To my surprise and disappointment, **a seemingly simple standard option was anything but standard - or very participant friendly**. Under this plan option, the participant paid **60 basis points** (6/10th of 1%) to the provider who then engaged a 3rd party investment firm that would come up with an asset allocation plan for my friend at the cost of an additional **95 basis points** annually (representing a managed account fee). This third party manager would then pick from a collection of their in-house fund options which typically entailed a fund-level fee of an additional **75 basis points**. So all-in, **the standard option costs approximately 230 basis points (2.30%) in fees annually, calculated on assets under management.** This may be in addition to non-provider administrative expenses.

To help in interpreting the 2.30% in combined fees, it's valuable to look at the recent returns on a popular equity (stock) index. In 2015, the S&P 500 delivered a total return (including dividends) of 1.38%, approximately one percentage point ***less than*** the combined fee outlay under the subject standard option. To be fair, a longer-term comparison shows that the S&P 500 index had an annual average total return of 12.56%, 7.30%, 5.00% and 8.18% for the 5, 10, 15 and 20 year periods, respectively, since 2015. For additional context, currently cash essentially returns 0.00% and the 10-year US Treasury bond yields about 1.50%. In all cases, losing 2.30% to fees would be a meaningful drag on performance.

While Shannon Investment Management consistently cautions against paying high fees or commissions at the advisor level, at the fund level or for general administration, in the subject's situation an investor has no choice other than deciding to participate or decline. **As unappealing as the high fees may be, participation in such employer-sponsored, tax-advantaged savings plans may be well worth the cost – particularly when "matching funds" are available. Another bit of good news is that when an employee departs the sponsoring company, the investment alternatives typically open up should they undertake a rollover to an IRA - wherein a more thoughtful and thrifty investment management approach may be pursued.**
Shannon Investment Management is available for a no-cost analysis of taxable and tax-deferred plans as well as for a discussion of the merits of a rollover IRA and the possibilities for a significant reduction in associated fees.