Fund Fees Can Devastate 401(k) Savings: Towers Watson

By Editor Test *Wed, Mar 31, 2010*

“Most employees are losing a very material amount of their retirement assets due to fee-related erosion,” the consulting firm said.

Fund expenses can shave up to 30% from the value of a retirement account over a lifetime of savings and shorten the life of the account by as much as 15 years, according to a new analysis of target-date fund fees by the consulting firm Towers Watson. TDFs are widely used in 401(k) plans.

Differences in TDF fees, which can range from less than 20 basis points per year for passively managed TDFs to more than 180 basis points for actively managed TDFs, have a much bigger impact on variation in cumulative returns than the amount of equities in the fund or the fund’s design, the analysis showed.

“Most employees are losing a very material amount of their retirement assets due to fee-related erosion,” Towers Watson said. “While 20 basis point fees reduced retirement income by one to three years, fees of 50-100 basis points eliminated 7-12 years of retirement income for most participants.

“For savings rates of 8% or more, a 100 basis point fee reduced the age of savings depletion by 9-15 years for all salary levels. The analysis included the effect of Social Security payments, which helped lower-salary employees improve their years of retirement income but also meant they lost more security due to fees compared with high-salary employees at an 8% savings level.”

The study considered four salary levels ranging from $25,000 to $125,000, three savings rates (4%, 8% and 12% of salary), and three fee levels (20, 50, and 100 basis points).

Towers Watson assumed that the participant worked and saved from age 25 to age 62 and drew a retirement income from Social Security and 401(k) savings equal to 70% of their salary. Generally, the higher the salary, the higher the fees, and the greater the savings rate, the greater the impact of fees on the life of the portfolio.

The analysts suggested that some sponsors might persist in offering high-fee funds because they lack economies of scale, they are limited to their record keeper’s fund options, or because they use actively managed TDFs.

Plan advisors and plan sponsors may not like the idea of reducing fund fees in 401(k) plans, if statements made in a March 28 Investment News article are any indication.

The article quoted several advisors and officials expressing disagreement with a recent Department of Labor initiative suggesting that fees and expenses should play a bigger role than historical performance in the evaluation and choice of funds as 401(k) options.

Several advisors appeared to be outraged at the suggestion, implicit in DoL’s latest proposal on regulations governing investment advice for plan participants, that low-cost index funds are better for investors than actively managed funds. They were also evidently out raged that a shift to index funds might lower their revenues.

The article said in part:

“If the agency does set a bias toward passively managed funds, it could mean less business for financial advisers, experts said. If a plan sponsor decides to include only index funds in its plan, the client might not feel that it needs an adviser to help choose funds, said Thomas Clark Jr., vice president of retirement plan services at Lockton Financial Advisors LLC.

“It could also mean increased costs to plan sponsors because index funds offer less in revenue-sharing dollars than actively managed funds, and thus there is less money to cover record-keeping expenses, he said.

“Most advisers oppose the [DoL’s] questions mainly on principle. ‘This makes no sense to me,’ said Manny G. Erlich, managing director at The Geller Group. ‘They need educating.’ Any advice that doesn’t take into consideration the past performance of funds isn’t good advice, Mr. Francis said.

“A bias toward passively managed funds, leading to more 401(k) plan sponsors adding index funds to their lineups, would also have a negative impact on employee engagement in saving for retirement, said Paul R. D’Aiutolo, vice president of investments, advisory and brokerage services at UBS Institutional Consulting.

“‘The purpose is to keep people engaged in their plans,’ he said. While index funds may perform well over the long term, it’s often the ups and downs of actively managed funds that keep plan participants paying attention,’ Mr. D’Aiutolo said.”