The Fees Ate My Savings

By Editor Test *Wed, Dec 7, 2011*

A gerontology professor argues in a new article that Americans' 401(k) holdings are coming up trillions of dollars short, thanks to high investment management fees.

To what extent do mutual fund fees undermine Americans' attempts to save for retirement?

Cost-conscious investors have long observed that while mutual fund management fees may represent only a tiny fraction of an individual investor's account balance, they often constitute a sizable portion of the individual's returns—especially when those returns are low.

It's also been widely observed that expenses can reduce cumulative returns over an average investor's lifetime by tens of thousands of dollars—and that the reductions can frustrate even the best-laid plans to amass enough savings for retirement.

With increasing scrutiny of 401(k) plan fees, which tend to be smaller at larger plans and vice versa, and with the Department of Labor deadline for full fee transparency only about five months away, the fee question has rarely been as widely discussed as it is now.

As it happens, Stewart Neufeld, Ph.D., an assistant professor at the Institute of Gerontology at Wayne State University in New York, addresses that question in the current issue of the *Journal of Financial Planning*. He recommends that plan investment fees be cut to the price of an ETF fund, or no more than 10 bps a year.

In his provocatively titled paper, "The Tyranny of Compounding Fees: Are Mutual Funds Bleeding Retirement Accounts Dry?" he reports his analysis of the way the returns of the S&P 500 have been divided between the financial services industry and the investing public over various 10, 20, 30, 40 and 50-year historical periods.

"The bottom line is, mutual fund cost structures contribute substantially to inadequate accumulations in retirement accounts," Neufeld writes. He then tries to remedy what he believes has been a general failure "to model the likely gap between market returns and that of the typical mutual fund over time frames relevant to individuals saving and investing for retirement."

Neufeld considers three hypothetical equity funds whose fees reduce their annual returns relative to the market average (as represented by S&P 500 returns) by either 50 bps, 100 bps or, in a worst-case scenario, 250 bps a year. Then he looks at the performance of the S&P 500 during different periods and calculates the amount of average gains that would go to the client and the amount that would go to the fund company.

He finds that:

> "if mutual funds underperform the S&P 500 by 250 bps annually, then after 10 years the financial

services industry gets about 46% of the market gains on average, leaving the investor with 54%. Mutual fund investors fare considerably better when the level of mutual fund underperformance is only 50 bps annually—investors receive on average 82 percent of market gains over a 10-year time frame.

"As the investment period lengthens, the proportion of market gains that go to the industry becomes larger. For example, if mutual fund performance lags that of the S&P 500 by 250 bps annually over a 50-year investment period, the financial services industry captures about 74% of the market gains on average. If the performance lag is only 50 bps annually, then the proportion of market gains accruing to the industry after 50 years is about 23%."

Neufeld goes on to assert that America's 21^{st} century retirement savings crisis might go away—or might have been prevented—by lower 401(k) fees:

"The current value of equity mutual fund assets in IRAs and defined-contribution plans is about $2.8 trillion (Investment Company Institute 2011). Assuming historical market returns, this amount would increase to $71 trillion (inflation adjusted) over 50 years. A performance lag relative to the S&P 500 of 250 bps annually would leave investors with about $20 trillion in their retirement accounts, a difference of market versus achieved returns of $51 trillion.

"To put this into perspective, this potential loss to investors is several times larger than the entire U.S. national debt, as it currently stands. An additional $51 trillion in retirement accounts over the next several decades would contribute significantly to solving the problem of inadequate retirement savings."