

## The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2009

### KEY FINDINGS

- **401(k) plans are a complex employee benefit to maintain and administer, and they are subject to an array of rules and regulations.** Employers offering 401(k) plans typically hire service providers to operate these plans, and these providers charge fees for their services.
- **Employers and employees generally share the costs of operating 401(k) plans.** As with any employee benefit, the employer typically determines how the costs will be shared.
- **More than half of the \$2.8 trillion in 401(k) assets at year-end 2009 was invested in mutual funds, primarily in stock funds.** Mutual funds are required by law to disclose a large amount of information, including information about fees and expenses and portfolio turnover.
- **401(k) investors in mutual funds tend to hold lower-cost funds with below-average portfolio turnover.** Both characteristics help to keep down the costs of investing in mutual funds through 401(k) plans.
- **Expense ratios of stock funds and bond funds averaged slightly higher in 2009, compared with 2008.** The asset-weighted average expense ratio paid by 401(k) investors on their stock funds rose 3 basis points to 0.74 percent after having declined in the previous five years. The asset-weighted average expense ratio paid by 401(k) investors on their bond funds rose 2 basis points to 0.55 percent after having declined in the previous five years.
- **Money market fund expense ratios declined in 2009.** The asset-weighted average expense ratio paid by 401(k) investors on their money market funds fell 2 basis points to 0.36 percent.

### WHY EMPLOYERS OFFER 401(k) PLANS

During the past two decades, 401(k) plans have become a popular workplace benefit, valued for their role in providing employees a means to set aside a portion of their compensation on a tax-favored basis. Indeed, 401(k) plans have become the most common

defined contribution (DC) plan, holding \$2.8 trillion in assets at year-end 2009 (Figure 1).<sup>1</sup> In the past two decades, mutual funds have become a primary provider of 401(k) plan investments, with the share of employer-sponsored 401(k) plan assets held in funds increasing from 9 percent in 1990 to 55 percent at year-end 2009.

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Employers that decide to offer 401(k) plans, an optional employee benefit, are confronted with two competing economic pressures: the need to attract and retain qualified workers with competitive compensation packages and the need to keep their products and services competitively priced. As a firm increases overall compensation to its employees, it increases its ability to hire and retain workers, but it also increases the costs of producing its products and services. To provide and maintain 401(k) plans, employers are required to obtain a variety of administrative, participant-focused, regulatory, and compliance services. All of these services involve costs; generally, the plan sponsor and the plan participants share these costs.

### PAYING FOR 401(k) PLAN SERVICES

#### **401(k) Plans Are Strictly Regulated**

401(k) plans are complex to maintain and administer, and they are subject to an array of rules and regulations that govern their operation, including Section 401(k) of the Internal Revenue Code (IRC), which serves as the basis for their tax-favored treatment.<sup>2</sup> The Department of the Treasury and the Internal Revenue Service (IRS) enforce the tax code and impose numerous requirements that plans must satisfy in order to qualify for special tax treatment.<sup>3</sup> Furthermore, the plans must meet many statutory and regulatory requirements under the Employee Retirement Income Security Act of 1974 (ERISA), enforced by the Department of Labor (DOL).

#### **401(k) Plan Sponsors Provide Certain Services**

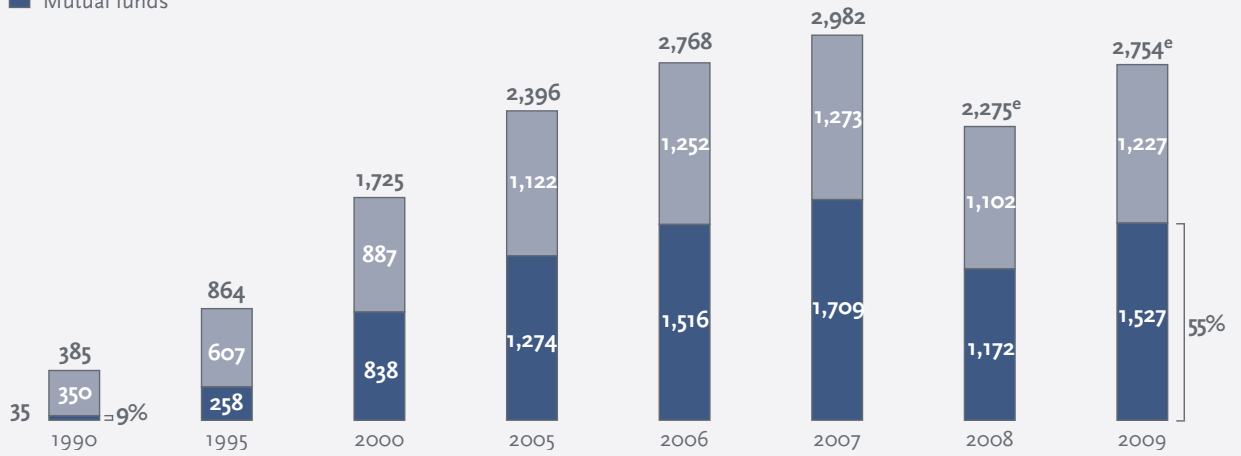
When an employer offers a 401(k) plan to its employees, it selects an individual or group of individuals, known as plan fiduciaries,<sup>4</sup> to oversee the administration of the 401(k) plan for the exclusive benefit of plan participants, consistent with the terms of the plan and ERISA. The plan fiduciaries must arrange for the provision of the many services required to create and maintain a 401(k) plan.

FIGURE 1

**401(k) PLAN ASSETS**

Billions of dollars, selected years

■ Other investments  
■ Mutual funds



<sup>e</sup>Data are estimated.

Note: Components may not add to the total because of rounding.

Sources: Investment Company Institute, Federal Reserve Board, and U.S. Department of Labor

**Administrative services.** These services maintain the framework of a 401(k) plan and include recordkeeping functions, such as maintaining plan and participant records and the creation and delivery of plan participant account statements (Figure 2). DOL regulations require plans to allow participants to make changes to their investment elections at least quarterly,<sup>5</sup> but most 401(k) plan participants are permitted to make daily transactions in their plans.<sup>6</sup> Administrative service providers support these activities, processing each and every participant transaction. In addition, plan fiduciaries must arrange for administrative services relating to setting up, converting, or terminating a plan, and trustee services.<sup>7</sup>

**Participant-focused services.** These services are geared toward helping employees fully achieve the benefits of their 401(k) plans. Sponsors provide participants with a wide array of communications, educational resources, and advice services to assist in investment and retirement planning (Figure 2).<sup>8</sup> In addition, the plan fiduciaries select a lineup of professionally managed investment options that cover a range of return and risk,<sup>9</sup> sometimes including a brokerage window through which participants may select securities not on the plan's line-up. If a 401(k) plan sponsor chooses to permit loans, plan fiduciaries must arrange for loan processing services. In addition, plans may opt to provide participants with access to annuity services at the time of retirement.

FIGURE 2

**SERVICES PROVIDED TO 401(k) PLANS**

**ADMINISTRATIVE SERVICES:**

**Recordkeeping**, including maintaining plan records; processing employee enrollment; processing participants' investment elections, contributions, and distributions; and issuing account statements to participants

**Transaction processing**, including purchases and sales of participants' assets

**Plan creation/conversion/termination**, requiring administrative services

**Trustee services**, providing the safe holding of the plan's assets in a trust, as required by ERISA

**PARTICIPANT-FOCUSED SERVICES:**

**Participant communication**, including employee meetings, call centers, voice-response systems, web access, and preparation of summary plan description and other participant materials

**Participant education and advice**, including online calculators and face-to-face investment advice

**Investment management**, typically offered through a variety of professionally managed investment options

**Brokerage window**, if offered, allowing direct purchase of individual securities by plan participants

**Maintenance of an employer stock fund**, if offered, to facilitate the purchase of employer securities within the plan

**Loan processing**, if a loan feature is offered

**Insurance and annuity services**, if offered, including offering annuities as distribution options

**REGULATORY AND COMPLIANCE SERVICES:**

**Plan document services**, including off-the-rack "prototype" plans

**Consulting**, including assistance in selecting the investments offered to participants

**Accounting and audit services**, including preparation of annual report (Form 5500)

**Legal advice**, including advice regarding interpretation of plan terms, compliance with legal requirements, plan amendments, and resolution of benefit claims

**Plan testing**, to comply with Internal Revenue Code nondiscrimination rules

**Processing of domestic relations orders**, ensuring that the split of accounts pursuant to divorce orders complies with ERISA

Sources: Investment Company Institute and U.S. Department of Labor

**Regulatory and compliance services.** These services ensure that a plan fulfills legal requirements imposed by statute, DOL and IRS regulations, and other guidance (Figure 2). Plans are subject to complicated restrictions on contributions,<sup>10</sup> lengthy audited annual reports to the DOL,<sup>11</sup> and tax reporting to the IRS. Plans may have additional compliance burdens under federal securities or state laws.<sup>12</sup> Furthermore, each particular investment option has its own compliance requirements. For example, mutual funds must comply with the Investment Company Act of 1940 and other securities laws, bank collective trusts with banking regulations, and group annuity contracts with state insurance rules.

### **Plan Sponsors Must Ensure That Service Costs Are Reasonable**

By law, plan sponsors have a “responsibility to ensure that the services provided to their plan are necessary and the cost of those services is reasonable.”<sup>13</sup> The DOL released in July 2010 regulations concerning the fee and compensation information that plan sponsors

must collect, and service providers must disclose, to ensure that a contract or arrangement for services is considered “reasonable” under ERISA.<sup>14</sup> DOL’s goal for this regulation, which is scheduled to become effective in July 2011, is to help ensure that plan sponsors can make informed decisions about important plan services and their costs and reveal any potential conflicts that a service provider might have.<sup>15</sup> Fees are only one factor among many that a plan sponsor must consider, along with the extent and quality of service and the characteristics of the investment options chosen.<sup>16</sup>

### **Plan Sponsors Select Service Providers and Investment Arrangements**

Plan sponsors select the service providers and choose the investment alternatives offered in their 401(k) plans.<sup>17</sup> The costs of running a 401(k) plan generally are shared by the plan sponsor and participants, and the arrangements vary across plans. The fees may be assessed at a plan level, participant-account level, as a percentage of assets, or as a combination of arrangements.

## **ABOUT THE DELOITTE/ICI DEFINED CONTRIBUTION PLAN/401(k) FEE STUDY**

In late 2008, Deloitte conducted a confidential, no-cost, web-based survey of plan sponsors. The goal of the survey was to address:

- the mechanics of plan fee structures;
- components of plan fees; and
- primary and secondary factors that impact fees (“fee drivers”).

Due to the variety of fee and service structures that exist in the DC/401(k) market, the study created an analytical tool—the “all-in” fee—that represents the bottom line in terms of all administrative and investment-related fees for each plan. The “all-in” fee incorporates all administration, recordkeeping, and investment fees whether assessed at a plan level, participant-account level, or as an asset-based fee, across all multiple parties providing services to the plan. The “all-in” fee excludes participant activity-related fees that only apply to particular participants engaged in the activity (e.g., loan fees). In addition, the “all-in” fee does not evaluate the quality of the products and services provided.

In total, 130 plans participated in the survey, providing detailed information regarding plan characteristics, design, demographics, products, services, and their associated fees. While the survey is not intended to be a statistical representation of the DC/401(k) marketplace, the demographics of the plans participating in the survey appear to be similar to the broader DC plan market (e.g., average account balance, number of investment options, average participant contribution rate, asset allocation, plan design). Although Deloitte and ICI believe the survey results are representative, they cannot be projected to the entire population of U.S. 401(k) plans.

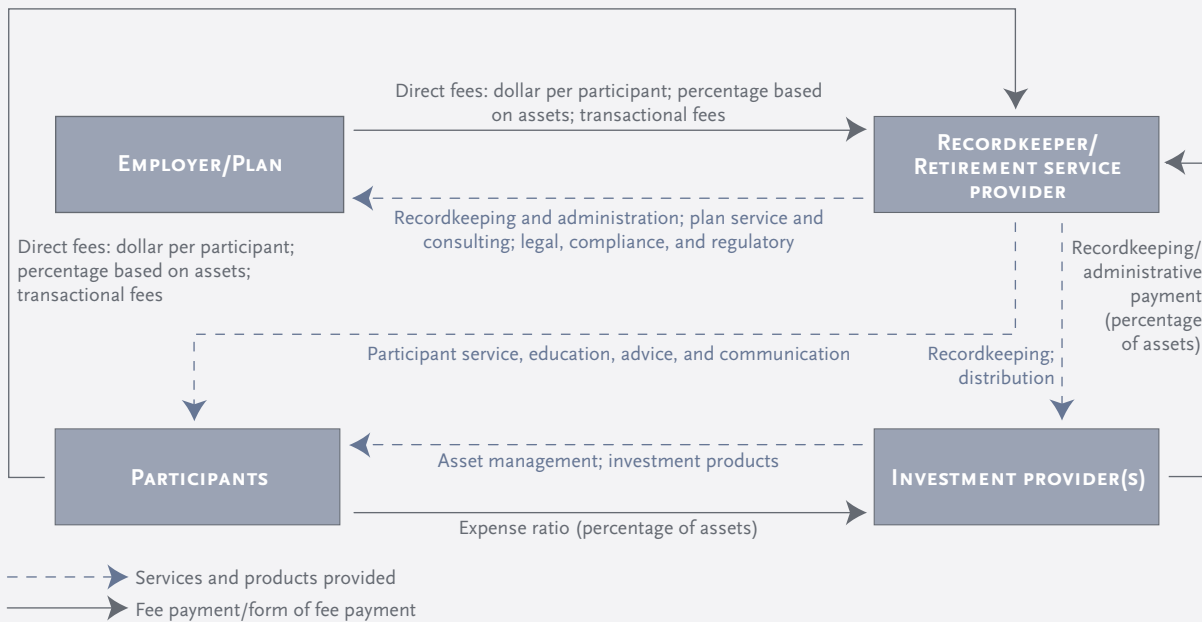
Figure 3 presents a schematic of fee and service arrangements possible in 401(k) plans. As shown in the boxes on the left-hand side of Figure 3, employers, plans, and participants consume services in 401(k) plans. The boxes on the right-hand side of Figure 3 highlight the recordkeeper or retirement service provider and investment provider that deliver the investment products or investment management services or both. The blue dashed arrows indicate the services and products provided. For example, the investment provider offers investment products and asset management to participants, while the recordkeeper provides services to the plan as well as to the participants. The solid black arrows illustrate the payment of fees for the services and products. Participants may pay directly for recordkeeping services, or the plan or employer may pay directly for such services. Participants may pay indirectly for recordkeeping services through investment

expense ratios (solid black arrow from participants to investment providers) if the investment provider covers some recordkeeping/administrative expenses by sending payment to the recordkeeper (solid black arrow at the far right) for recordkeeping services rendered (blue dashed arrow between recordkeeper and investment provider).

The DOL requires that the plan sponsor pay the costs associated with the initial design of the plan, as well as any design changes.<sup>18</sup> Beyond these design services, employers can share the costs of the plan services with their employees (Figure 3). However, many employers voluntarily cover some or all plan-related costs that legally could be shouldered by the plan participants. Any costs not paid by the employer, which may include administrative, investment, legal, and compliance costs, are, effectively, paid by plan participants.<sup>19</sup>

FIGURE 3

**A VARIETY OF ARRANGEMENTS MAY BE USED TO COMPENSATE 401(k) SERVICE PROVIDERS**



Note: In selecting the service provider(s) and deciding the cost sharing for the 401(k) plan, the employer/plan sponsor will determine which combinations of these fee arrangements will be used in the plan.

Source: Investment Company Institute summary of Deloitte/Investment Company Institute, Defined Contribution/401(k) Fee Study

### ***A Means to Compare: The “All-In” 401(k) Plan Fee***

As illustrated by Figure 3, a variety of fee arrangements occurs in the 401(k) plan arena, with fees possibly being assessed per plan, per participant, or per dollar invested (asset-based fees). To compare fees across plans, it is necessary to construct a measure—an “all-in” fee—that converts this array of arrangements into a single number for each plan. Constructing such an “all-in” fee as a percentage of plan assets permits comparison across plans to determine the key factors that influence plan fees.

***A range of fees is found across 401(k) plans.*** A survey of 130 plan sponsors in late 2008 found that the key driver of the “all-in” fee was plan size. Specifically, plans with more participants and larger average account balances tended to have lower “all-in” fees than plans with fewer participants and smaller average account balances.<sup>20</sup> Likely, this observed effect results in part from fixed costs required to start up and run the plan, much of which are driven by legal and regulatory requirements. It appears that economies are gained as a plan grows in size because these fixed costs can be spread over more participants or a larger asset base or both.

***Many factors affect the “all-in” fee.***<sup>21</sup> For example, lower “all-in” fees were also associated with plans where the participants and plan sponsor made a commitment to saving through higher participant and employer contribution rates or use of automatic enrollment. In addition, DC plan sponsors that had multiple relationships with their DC plan service providers had lower “all-in” fees.<sup>22</sup> Because equity investments are more costly to manage than bond or money funds, a plan with a lower allocation to equities tended to have lower fees compared to a plan more heavily invested in equities. Among small plan sponsors, those with fewer business locations tended to have lower fees than those with more locations. This perhaps reflects the servicing burden imposed by having more locations. For example, there are additional costs incurred by conducting employee meetings in multiple locations.

Other factors were examined but found to have a minimal impact on the “all-in” fee. For example, the number of payrolls did not significantly impact the “all-in” fee. The type of service provider (e.g., mutual fund company, life insurance company, bank, third party administrator), the size of the service provider’s platform (in terms of number of participants), and the length of relationship with the service provider were each analyzed and also did not appear to have a separate impact on the “all-in” fee. Finally, the percentage of plan assets invested in proprietary investment products—the investment products of the service provider—did not appear to have an impact on the “all-in” fee.

### Fees Paid by Employer, Plan, and Participants

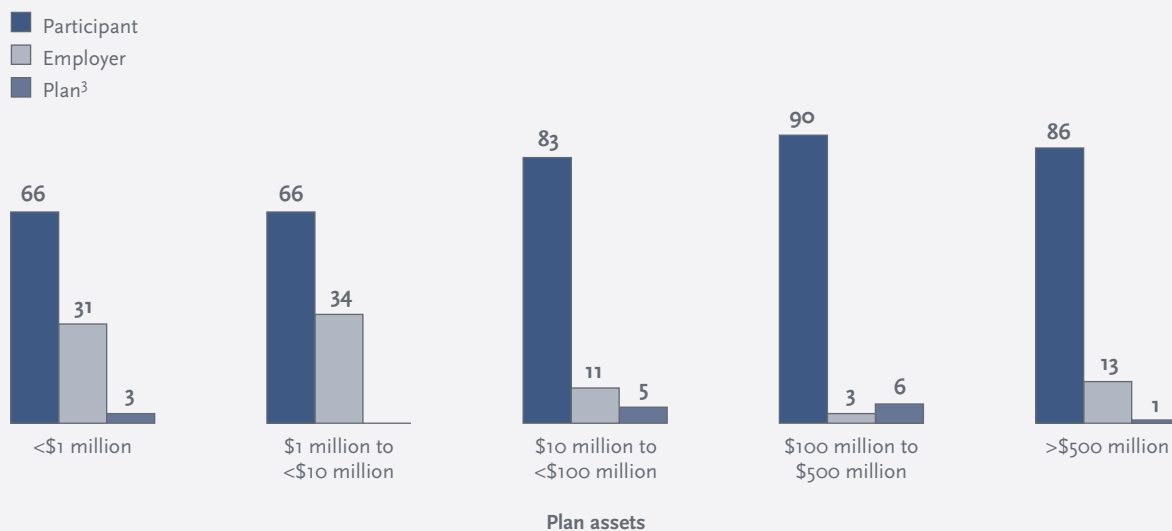
The fees and expenses related to 401(k) plan services and products can be paid by the employer, the plan, or the participants, with the allocation determined by the plan sponsor. The Deloitte/ICI survey of 130 plans found that employers that sponsor smaller plans (plans with less than \$10 million in assets), on average, carried a larger share of plan fees than employers sponsoring larger plans (plans with \$10 million or more in assets; Figure 4). As a result, the employer's decision to pay a portion of plan costs can have a significant impact on

the 401(k) plan fees charged to plan participants. It is often the case that the employer pays part or all of the administrative or recordkeeping expenses,<sup>23, 24</sup> which also can have an impact on the fees and expenses of the investment options in their plans.<sup>25</sup> For example, when the plan sponsor or plan participants pay direct account charges, the expenses on the investment products in these plans will tend to be lower than in those plans where there are no account-level charges and the recordkeeping expenses are included in the investment expenses.

FIGURE 4

#### PLAN FEE STRUCTURE VARIED BY PLAN SIZE

Percentage of "all-in"<sup>1</sup> fee by payer of fees by plan size,<sup>2</sup> 2008



<sup>1</sup>The "all-in" fee incorporates all administrative, recordkeeping, and investment fees whether assessed at a plan level, participant-account level, or as an asset-based fee, across all parties providing services to the plan. The "all-in" fee excludes participant activity-related fees that only apply to particular participants engaged in the activity (e.g., loan fees).

<sup>2</sup>Percentages within a given asset size segment may not add to 100 percent because of rounding.

<sup>3</sup>Other survey results suggest this is generally achieved through forfeited employer contributions (see text note 19).

Note: Figure based on sample of 130 plans surveyed in late 2008.

Source: Deloitte/Investment Company Institute, Defined Contribution/401(k) Fee Study



## LOOKING AT FEES AND EXPENSES OF MUTUAL FUNDS HELD IN 401(k) ACCOUNTS

Virtually all participant-directed 401(k) plans offer a variety of pooled investment options (such as a selection of mutual funds, collective trusts, and/ or separately managed accounts), but some also include guaranteed investment contracts (GICs),<sup>26</sup> company stock,<sup>27</sup> or a brokerage window that provides participant access to direct investment in stocks, bonds, and other securities.<sup>28</sup> All told, more than half (55 percent) of the \$2.8 trillion in 401(k) plan assets at year-end 2009 was invested in mutual funds (Figure 5).<sup>29</sup> Mutual funds are required by law to disclose their fees and expenses and, as part of ongoing research, ICI studies trends in those fees and expenses.<sup>30</sup> In addition, ICI separately tracks 401(k) plan account holdings of mutual funds.<sup>31</sup> This report combines the results of these analyses in order to examine the fees and expenses that investors incur on mutual funds held in 401(k) accounts.<sup>32</sup> This analysis finds that:

- 401(k) plan participants tend to be invested in lower-cost mutual funds;

- at year-end 2009, 80 percent of mutual fund assets in 401(k) plans were held in no-load funds; and
- one-fifth of mutual fund assets in 401(k) plans were held in load funds, predominantly in fund shares that do not charge retirement plan participants a front-end load.

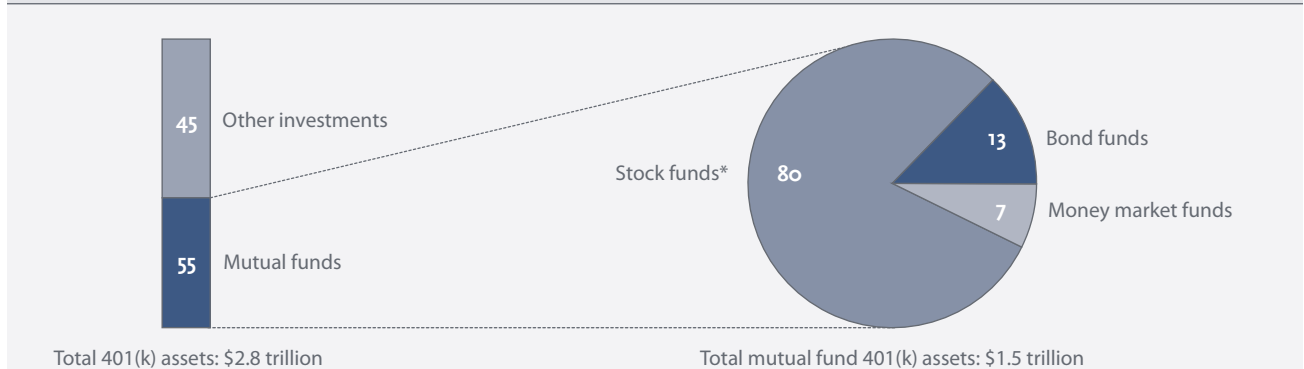
### Investors Pay Two Types of Mutual Fund Fees and Expenses

Investors in mutual funds potentially can incur two primary types of fees and expenses when purchasing and holding mutual fund shares: sales loads and mutual fund expenses. Sales loads are one-time fees paid either at the time of purchase (front-end loads) or, in some cases, when shares held less than a specified number of years are redeemed (back-end loads, also known as contingent deferred sales loads or CDSLs). Mutual fund expenses include ongoing charges for portfolio management, fund administration, and shareholder service, as well as fund distribution charges, also known as 12b-1 fees.<sup>33</sup>

FIGURE 5

### ABOUT HALF OF 401(k) PLAN ASSETS WERE INVESTED IN MUTUAL FUNDS

Percentage of assets, 2009



\*Stock funds include hybrid mutual funds, which account for 21 percent of total 401(k) mutual fund assets.

Sources: Investment Company Institute, Federal Reserve Board, and U.S. Department of Labor

## UNDERSTANDING FUND AND SHARE CLASS CATEGORIES

The Investment Company Institute categorizes funds or fund share classes that have a front-end or back-end load or that have a 12b-1 fee of greater than 0.25 percent, as *load funds*, including those that waive the front-end load for retirement plan investors (see Figures 6, A2, and A3). Funds or fund share classes without loads and with 12b-1 fees of 0.25 percent or less are categorized as *no-load funds*. The no-load funds are further classified as either *institutional* or *retail or general purpose*. The figure classifies a no-load fund as *institutional* if the fund's prospectus states that the fund or share class is designed to be sold primarily to institutional investors or institutional accounts. This includes investments by individuals in 401(k) accounts that are purchased by or through an institution such as an employer, trustee, or fiduciary on behalf of its employees, owners, or clients. The figure labels the remaining no-load funds and share classes as *retail or general purpose*.

Similar designations have long been used in common parlance in the mutual fund industry. To some extent, however, their original connotations have become less meaningful as the industry has evolved, including as applied to 401(k) plans. Participant-directed 401(k) plans have characteristics associated with both "retail" investors (because each plan often has many individual accounts that must be maintained and investors that must be served) and "institutional" investors (in cases when the plan brings larger total investments). Nevertheless, these definitions are useful for certain research purposes, including illustrating trends in 401(k) plan assets held in mutual funds—such as highlighting the fact that 401(k) plans may purchase shares through a range of funds and share classes.

These labels should not be used for certain other purposes, such as to make inferences about the expenses of a given fund or share class. The fact that ICI has labeled a particular fund or share class *institutional* does not guarantee that its expenses are lower than those of a *retail or general purpose* or *load fund* with a similar investment objective. For example, in 2009, the average expense ratio of no-load institutional funds or share classes of equity mutual funds offered for sale was 1.03 percent. But the asset-weighted average expense ratio incurred by 401(k) investors in no-load *retail or general purpose* equity mutual funds in 2009 was 0.70 percent—32 percent less.

**Mutual funds and fund share classes.** The combination of sales loads and 12b-1 fees that an individual investor might pay depends on the fund or fund share class. It is now commonplace for mutual funds to offer several different share classes,<sup>34</sup> all of which invest in the same portfolio (fund) while offering different services tailored to the service needs of different investors or, in the case of 401(k) plans, the group of participants in the plan.

*No-load funds: no-load institutional shares and no-load retail or general purpose shares.* A mutual fund may set up a multiclass share structure to pay for differing advice and shareholder services offered to different investors investing in the same portfolio, or fund. One type of fund or share class can be a *no-load fund*.

These funds or share classes charge no front-end load or CDSL and charge a 12b-1 fee of 25 basis points (0.25 percent; a basis point is one one-hundredth of a percentage point) or less. At year-end 2009, with 39 percent of 401(k) mutual fund assets, no-load retail or general purpose funds were the most common funds (Figure 6).<sup>35</sup> The second largest no-load fund type was institutional shares, which have gained share of 401(k) mutual fund assets over the past several years. At year-end 2009, no-load institutional funds or share classes accounted for 40 percent of 401(k) mutual fund assets, compared with 16 percent in 1996. Altogether, 80 percent of 401(k) plan mutual fund assets were invested in no-load funds at year-end 2009.

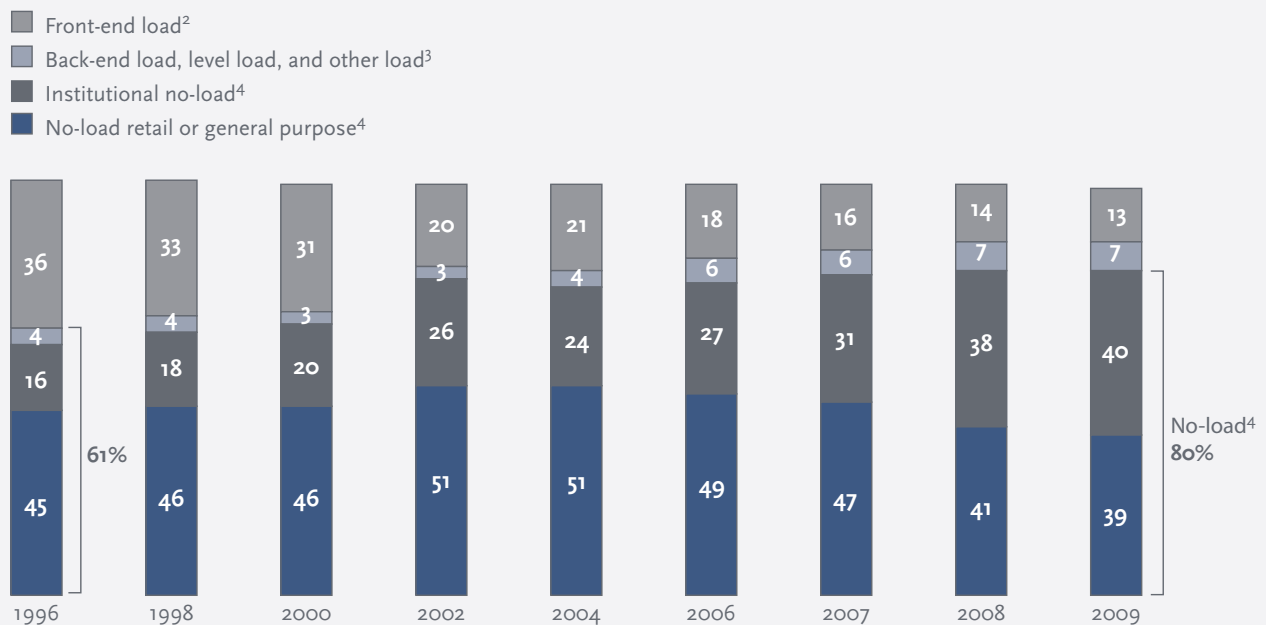
*Load funds: front-end load shares, back-end load shares, level load shares, and other load shares.* In 2009, the remaining 20 percent of mutual fund 401(k) assets were invested in *load funds*, but the actual loads are generally waived for retirement plan investors.

- Front-end load shares. For example, one type of load fund or share class carries a front-end load, which is a percentage of the fund's sale or offering price, and is normally charged at the time of purchase. Yet, 401(k) plan participants generally are not charged a front-end load on shares purchased through their plans.<sup>36</sup> Front-end load shares may have a 12b-1 fee, typically between 25 and 35 basis points. Thirteen percent of 401(k) mutual fund investments were held through front-end load shares in 2009 (Figure 6).

- Back-end load shares. Back-end load funds or shares are offered for sale at net asset value without a front-end load, but such share investors pay distribution expenses through a combination of an annual 12b-1 fee and a CDSL.<sup>37</sup> Back-end load shares represented a negligible percentage of mutual fund assets held in 401(k) plans.<sup>38</sup>
- Level load shares. Level load shares, which also use a combination of an annual 12b-1 fee and a CDSL,<sup>39</sup> represented a small share of 401(k) mutual fund assets.<sup>40</sup>

**FIGURE 6**  
**401(k) MUTUAL FUND ASSETS BY SHARE CLASS**

Percentage of assets,<sup>1</sup> selected years



<sup>1</sup> Percentages may not add to 100 percent because of rounding.

<sup>2</sup> Front-end load > 1 percent. Primarily includes A shares; includes assets where front-end loads are waived.

<sup>3</sup> Other load share classes include share classes not classified as front-end load or load retirement shares. The category includes back-end load classes (primarily B shares), level load classes (primarily C shares), and other load share classes. See Figure A2 for additional detail.

<sup>4</sup> No-load shares have front-end load = 0 percent, CDSL = 0 percent, and 12b-1 fee ≤ 0.25 percent.

Note: Figures exclude mutual funds available as investment choices in variable annuities and tax-exempt mutual funds.

Sources: Investment Company Institute and Lipper

**Mutual fund expenses.** Although 401(k) investors typically do not pay loads on the mutual funds they purchase through their 401(k) plans, they do incur the fund expenses of the mutual funds they are holding in their 401(k) accounts. Ongoing expenses are paid from fund assets, and investors thus pay these expenses indirectly. The total expense ratio, which reflects both the operating expense ratio—including portfolio management, fund administration and compliance, shareholder services, and other miscellaneous costs—and distribution charges (known as 12b-1 fees), is measured in this report as an asset-weighted average. Using the asset-weighted average to measure costs provides an aggregate estimate of what 401(k) participants actually pay to invest in mutual funds through their 401(k) plans. Under this approach, funds with larger shares of 401(k) mutual fund assets contribute proportionately more to the summary measure than do less widely held funds.

#### **401(k) Participants Hold Lower-Cost Mutual Funds**

**Stock funds.** Eighty percent of 401(k) plan assets invested in mutual funds were invested in stock funds at year-end 2009 (Figure 5).<sup>41, 42</sup> As also seen industrywide, average stock fund expense ratios edged up in 2009.<sup>43</sup> The asset-weighted average expenses paid by 401(k) investors on their stock funds rose 3 basis points, after having declined in the previous five years. This increase in mutual fund expense ratios was not unexpected. Certain fund costs (transfer agency fees, accounting and audit fees, director fees, and various other fees) tend to be relatively fixed in dollar amount. Thus, in times when market values push fund assets lower, these relatively fixed dollar fees contribute proportionally more to the expense ratio of the funds.<sup>44</sup>

In 2009, 401(k) investors continued to concentrate their stock fund assets in lower-cost stock funds. The average total expense ratio incurred by 401(k) investors in stock funds was 0.74 percent in 2009, half of the

1.48 percent simple average for all stock funds and lower than the industrywide asset-weighted average of 0.86 percent (Figure 7). 401(k) mutual fund investors not only incur lower average expense ratios in stock funds overall, but also in each broad type of stock fund: domestic stock funds, hybrid funds, and foreign stock funds (Figure 8).

Several factors contribute to the relatively low average expense ratios incurred by 401(k) plan participants investing in mutual funds. Both inside and outside the 401(k) plan market, mutual funds compete among themselves and with other financial products to offer shareholders service and performance.<sup>45</sup> Shareholders are sensitive to the fees and expenses that funds charge.<sup>46</sup> Indeed, new sales and assets tend to be concentrated in lower-cost funds, providing a market incentive for funds to offer their services at competitive prices.<sup>47</sup> In the 401(k) plan market, performance- and cost-conscious plan sponsors also impose market discipline. Plan sponsors regularly evaluate the performance of the plans' investments,<sup>48</sup> and performance reflects fees. In early 2009, more than half (62 percent) of plan sponsors indicated that they had replaced a fund in the past two years because of poor performance.<sup>49</sup>

The lower average expense ratios incurred by 401(k) participants also reflect other factors. Some plan sponsors choose to cover a portion of 401(k) plan costs, which allows them to select funds or share classes with less built-in servicing costs. Furthermore, many 401(k) plans have large average account balances, and such economies of scale help to reduce the fees and expenses of the funds offered in these plans.<sup>50</sup> Finally, unlike shareholders outside of 401(k) plans who typically pay for the assistance of a financial adviser when investing in mutual funds,<sup>51</sup> there is a more limited role for such financial adviser services inside these plans.

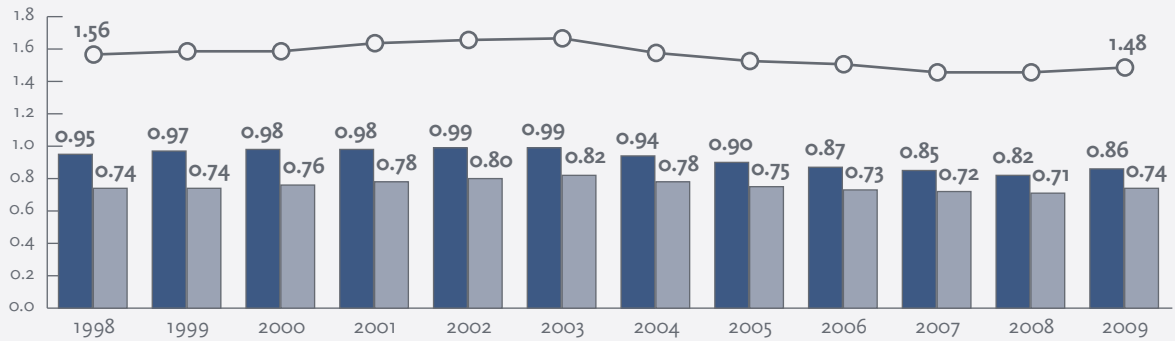
FIGURE 7

**401(k) MUTUAL FUND INVESTORS TEND TO PAY LOWER-THAN-AVERAGE EXPENSES**

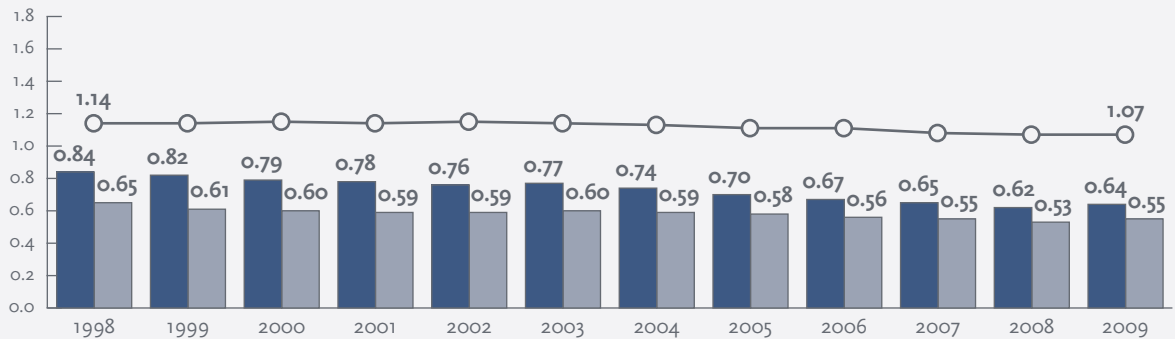
Percent, 1998–2009

- Industry average expense ratio<sup>1</sup>
- 401(k) average expense ratio<sup>2</sup>
- Industry simple average expense ratio

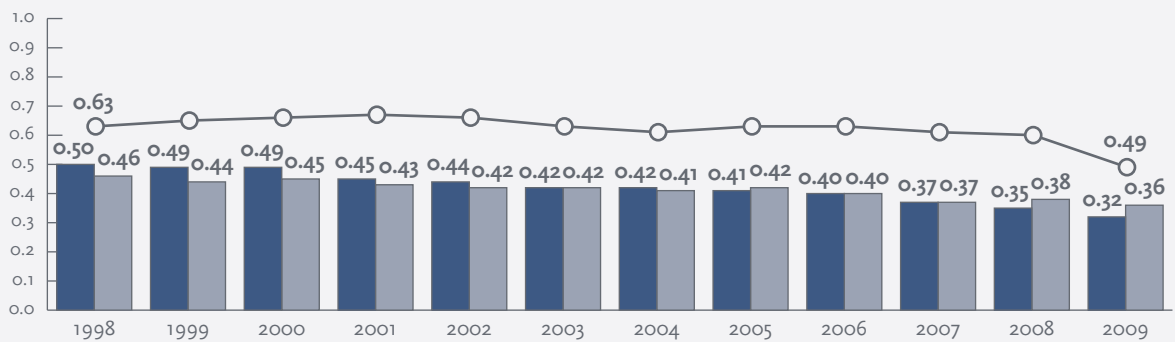
**STOCK FUNDS**



**BOND FUNDS**



**MONEY MARKET FUNDS**



<sup>1</sup>The industry average expense ratio is measured as an asset-weighted average.

<sup>2</sup>The 401(k) average expense ratio is measured as a 401(k) asset-weighted average.

Note: Figures exclude mutual funds available as investment choices in variable annuities and tax-exempt mutual funds.

Sources: Investment Company Institute and Lipper

FIGURE 8

**ASSET-WEIGHTED AVERAGE TOTAL MUTUAL FUND EXPENSE RATIOS**

Percent, 1996, 2006, 2008, and 2009

	1996		2006		2008		2009	
	Industry <sup>1</sup>	401(k) <sup>2</sup>	Industry <sup>1</sup>	401(k) <sup>2</sup>	Industry <sup>1</sup>	401(k) <sup>2</sup>	Industry <sup>1</sup>	401(k) <sup>2</sup>
<b>Stock funds</b>	1.03	0.84	0.87	0.73	0.82	0.71	0.86	0.74
Domestic stock	0.98	0.81	0.83	0.68	0.78	0.67	0.81	0.69
Foreign stock	1.32	1.14	1.04	0.96	0.97	0.91	1.01	0.90
Hybrid	0.96	0.79	0.80	0.65	0.79	0.62	0.85	0.67
<b>Bond funds</b>	0.89	0.65	0.67	0.56	0.62	0.53	0.64	0.55
High yield and world bond	1.16	1.03	0.94	0.84	0.88	0.85	0.90	0.87
Other bond	0.80	0.60	0.61	0.53	0.57	0.51	0.59	0.52
<b>Money market funds</b>	0.52	0.43	0.40	0.40	0.35	0.38	0.32	0.36

<sup>1</sup>The industry average expense ratio is measured as an asset-weighted average.

<sup>2</sup>The 401(k) average expense ratio is measured as a 401(k) asset-weighted average.

Note: Figures exclude mutual funds available as investment choices in variable annuities and tax-exempt mutual funds.

Sources: Investment Company Institute and Lipper

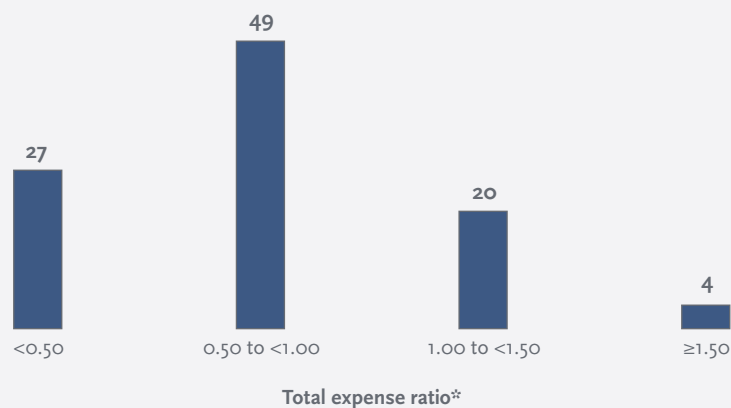
Although expense ratios vary among the mutual funds that 401(k) participants hold, 76 percent of 401(k) plan stock fund assets were invested in mutual funds with expense ratios less than 1 percent at year-end 2009 (Figure 9). Twenty-seven percent of 401(k) stock fund assets were in mutual funds with expense ratios less than 0.50 percent.<sup>52</sup>

**Bond funds.** Thirteen percent of 401(k) mutual fund assets were invested in bond funds at year-end 2009 (Figure 5), and 401(k) bond fund investors also have concentrated their assets in lower-cost bond funds. At year-end 2009, 401(k) bond fund investors paid an asset-weighted average expense ratio of 0.55 percent, about half the industrywide simple

FIGURE 9

**401(k) STOCK FUND ASSETS ARE CONCENTRATED IN LOWER COST FUNDS**

Percentage of 401(k) stock mutual fund assets, 2009



\*The total expense ratio, which is reported as a percentage of fund assets, includes fund operating expenses and 12b-1 fee.

Note: Figures exclude mutual funds available as investment choices in variable annuities. Stock funds include hybrid funds.

Sources: Investment Company Institute and Lipper

average (1.07 percent) and 14 percent less than the industrywide asset-weighted average of 0.64 percent (Figure 7). As with stock funds, the average expense ratio paid by 401(k) investors in bond funds is also lower in each of the broad subgroupings within bond funds (Figure 8). In addition, as also seen industrywide, average bond fund expense ratios edged up in 2009.<sup>53</sup> The asset-weighted average expense ratio paid by 401(k) investors on their bond funds in 2009 was 2 basis points higher compared with 2008, after having declined in the previous five years (Figure 7).

**Money market funds.** Seven percent of 401(k) mutual fund assets were invested in money market funds at year-end 2009 (Figure 5). For 401(k) participants holding money market funds, their total expense ratio was 0.36 percent of assets in 2009, compared with an industrywide simple average of 0.49 percent (Figure 7). In recent years, the 401(k) money market fund asset-weighted total expense ratio averages have been very close to the industrywide asset-weighted averages. Furthermore, the asset-weighted average expenses paid by 401(k) investors on their money market funds was 2 basis points lower in 2009 compared with 2008. The decline in money market fund fees in 2009 was due in part to individual funds reducing their fees in some cases as investment advisers waived advisory fees in the low interest rate environment.<sup>54</sup>

**A range of mutual fund fees is found across 401(k) plans.** Although as a group, mutual fund investors inside 401(k) plans own funds with below-average costs, some 401(k) plan participants pay more than these averages and other participants pay less. Thus, these averages do not necessarily reflect the reasonableness of the fees for any particular plan.

As noted earlier, in addition to the impact of the range and quality of services provided, a variety of factors affect the “all-in” fees of 401(k) plans. Furthermore, as with any other employee benefit, the costs associated with 401(k) plans are typically shared between the employer and plan participants.

Participants who work for employers that do not heavily subsidize their plans will incur higher fees on average. Plans that charge account-level fees will tend to have lower-cost investment options than plans without direct account-level charges. Participants in plans with a small amount of assets will tend to pay higher fees per dollar invested than plans with greater assets because of the relatively fixed costs that all plans must incur. Participants in plans that have many small accounts will typically pay higher fees per dollar invested than plans with fewer and larger accounts. Plans with more service features will tend to be more costly than more streamlined plans with fewer services for plan participants.

All of these factors influence the costs of the plan and the plan’s investment options, and must be considered when evaluating the reasonableness of a given plan’s costs.

### Other Costs Incurred by Mutual Fund Investors

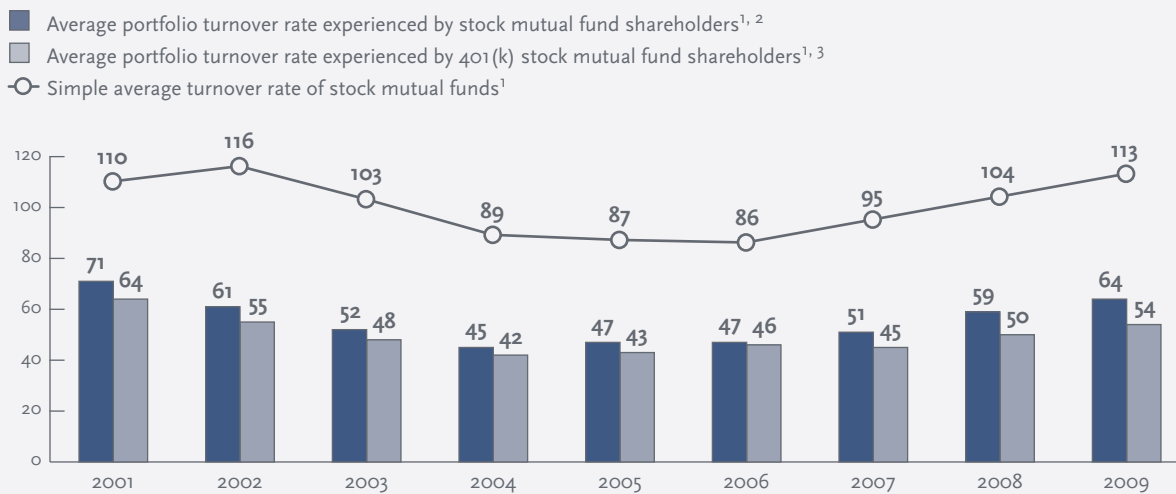
Another cost that mutual funds incur is the cost associated with buying and selling securities in the fund's portfolio. While these costs are not included in the fund's total expense ratio, they are reflected in the calculation of net return to the investor. To help shareholders evaluate the trading activity of a mutual fund, the Securities and Exchange Commission (SEC) requires each mutual fund to report its "turnover rate" in its annual shareholder report and in its prospectus.<sup>55</sup> Broadly speaking, the turnover rate is a measure of how rapidly a fund is trading the securities in its portfolio relative to total fund assets.<sup>56</sup> Although all pooled investments incur trading costs while managing their portfolios, only mutual funds are required to provide standardized information on portfolio turnover.

**Stock fund turnover rates.** 401(k) plan participants tend to own stock funds with relatively low turnover rates. The industrywide simple average turnover rate in stock funds was 113 percent in 2009 (Figure 10).<sup>57</sup> However, mutual fund shareholders tend to invest in stock funds with considerably lower turnover rates, as reflected in the lower industrywide asset-weighted average turnover rate of 64 percent.<sup>58</sup> The average turnover rate experienced in stock funds selected by 401(k) plan participants is similarly lower: the asset-weighted average turnover of stock funds held in 401(k) accounts was 54 percent in 2009.

FIGURE 10

### AVERAGE PORTFOLIO TURNOVER RATE OF STOCK FUNDS

Percentage of assets, 2001–2009



<sup>1</sup>The turnover rate for each fund is calculated by dividing the lesser of purchases or sales of portfolio securities for the reporting period by the monthly average value of the portfolio securities owned by the fund during the reporting period.

<sup>2</sup>Average portfolio turnover rate experienced by stock mutual fund shareholders is measured as an asset-weighted average annual turnover rate based on the assets held in each fund (reported as a percentage of fund assets).

<sup>3</sup>Average portfolio turnover rate experienced by 401(k) stock mutual fund shareholders is measured as an asset-weighted average annual turnover rate based on 401(k) plan assets held in each fund (reported as a percentage of 401(k) fund assets).

Note: Figures exclude mutual funds available as investment choices in variable annuities. Stock funds include hybrid funds.

Sources: Investment Company Institute and Strategic Insight Simfund



## CONCLUSION

401(k) plans are now the most common private-sector employer-sponsored retirement plan in the United States. Employers choose whether to offer these plans to employees as part of their total compensation packages; employees choose whether or not to participate. The creation and maintenance of a 401(k) plan involve a variety of services, and the costs of these services are generally shared by the plan sponsor and the plan participants.

401(k) plans provide many American workers with the opportunity to invest cost effectively in mutual funds. 401(k) participants primarily invest in stock funds, and the bulk of these stock fund assets is held in lower-cost mutual funds with low portfolio turnover. Numerous factors contribute to the relatively low expense ratios incurred by 401(k) plan participants investing in mutual funds. Among them are: (1) competition among mutual funds and other investment products to offer shareholders service and performance; (2) plan sponsors' decisions to cover a portion of the 401(k) plan costs, which allow them to select funds or share classes with less built-in servicing; (3) economies of scale that a large investor such as a 401(k) plan can achieve; (4) cost-conscious and performance-conscious decisionmaking by plan sponsors; and (5) the limited role of professional financial advisers in these plans.

## ADDITIONAL READING

**"Trends in the Fees and Expenses of Mutual Funds, 2009."** *Investment Company Institute Fundamentals*. Available at [www.ici.org/pdf/fm-v19n2.pdf](http://www.ici.org/pdf/fm-v19n2.pdf).

**Defined Contribution/401(k) Fee Study.** Investment Company Institute. Available at [www.ici.org/pdf/rpt\\_09\\_dc\\_401k\\_fee\\_study.pdf](http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf).

**"The U.S. Retirement Market, First Quarter 2010."** *Investment Company Institute Fundamentals*. Available at [www.ici.org/pdf/fm-v19n3-q1.pdf](http://www.ici.org/pdf/fm-v19n3-q1.pdf).

**ICI Resources on 401(k) Plans.** Investment Company Institute. Available at [www.ici.org/401k](http://www.ici.org/401k).

**ICI Resources on 12b-1 Fees.** Investment Company Institute. Available at [www.ici.org/rule12b1fees](http://www.ici.org/rule12b1fees).

## NOTES

- <sup>1</sup> See Brady, Holden, and Short 2010.
- <sup>2</sup> Section 401(k) of the IRC was added by Congress in 1978, to be effective beginning in 1980 (see Revenue Act of 1978, P.L. 95-600). However, companies generally did not begin to adopt 401(k) plans until the Department of Treasury and the IRS issued proposed regulations clarifying the scope of Section 401(k) on November 10, 1981 (see 46 Fed. Reg. 55544, November 10, 1981; Holden, Brady, and Hadley 2006).
- <sup>3</sup> The main advantages of a tax-qualified 401(k) plan are that employers are able to take an immediate deduction for contributions made by the employer, employees are able to defer taxation of contributions, and employees do not pay income tax on contributions or earnings until the monies are distributed. In exchange for this special tax treatment, the IRC imposes numerous conditions, many of which are designed to ensure that participants in all income ranges attain the benefits of the plan. For additional discussion, see, for example, Allen et al. 1997. Since 2006, employers can offer a Roth 401(k) option, which, like Roth IRAs, allows employees to contribute on an after-tax basis but receive distributions tax free. Like Roth IRAs, earnings are subject to income tax if the employee distributes them within five years of first contributing to the Roth 401(k) or before reaching age 59½.
- <sup>4</sup> ERISA requires that the plan sponsor appoint a “named” fiduciary or fiduciaries to administer the plan. See ERISA § 402. A plan sponsor may, and often does, name itself as the plan administrator. In its role as the plan administrator, the employer assumes fiduciary responsibility to select and monitor service providers and investment options for the plan. Most employers appoint a retirement committee consisting of senior human resource or other employees to oversee the administration of the plan. In their role acting for the employer as plan administrator, the members of the committee assume fiduciary responsibility to administer the plan solely in the interest of plan participants and beneficiaries. For convenience, this report often refers to “employer” and “plan sponsor” to mean the fiduciary or fiduciaries appointed to administer the plan.
- <sup>5</sup> Department of Labor Reg. § 2550.404c-1.
- <sup>6</sup> Hewitt Associates 2006 reported that nearly all of the 130 large DC plans covered in their report offered daily transfers. Profit Sharing/401k Council of America 2009 indicated that nearly 95 percent of the 908 profit-sharing and 401(k) plans surveyed offer to participants the ability to initiate daily fund transfers.
- <sup>7</sup> To protect the 401(k) plan’s assets, ERISA Section 403 requires that pension plan assets be held in a trust or invested in insurance contracts.
- <sup>8</sup> Profit Sharing/401k Council of America 2009 reported the array of educational resources used by plan sponsors, which include enrollment kits, newsletters, fund performance sheets, Internet/intranet sites, webinars, podcasts, seminars, workshops, paycheck stuffers, retirement gap calculators, posters, and individually targeted communication. The most commonly cited primary purpose for plan education is increasing participation (32.5 percent of plans).
- <sup>9</sup> Where participants are given the control of the investment of their accounts, which is common in 401(k) plans, the selection of the investment options available is usually designed to meet the requirements of Section 404(c) of ERISA. This section provides liability relief for plan sponsors and other plan fiduciaries from losses in plan accounts resulting from employees’ exercise of investment control. The DOL regulations under ERISA Section 404(c) are designed to ensure that participants have control over their assets and have adequate opportunity to diversify their holdings. Plans must offer at least three diversified investment options with materially different risk and return characteristics. (Although company stock or any individual stock can be offered in 401(k) plans, they would not qualify as one of the three core options.) Plans generally must allow transfers among the diversified investment options at least quarterly. Hewitt Associates 2007 indicated 90 percent of the 292 plans surveyed in the spring of 2007 considered themselves compliant with ERISA Section 404(c). Profit Sharing/401k Council of America 2009 indicated that in 2008, the average number of investment fund options available for participant contributions was 18; Hewitt Associates 2009 indicated an average number of investment options of 18 in 2008. Deloitte Consulting LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists 2009 reported that the average number of funds offered by the 606 401(k) plan sponsors in their survey was 20 in early 2009.
- <sup>10</sup> The IRC includes a number of flat annual dollar contribution limits. In addition, several sections of the IRC provide a framework for nondiscrimination testing, which limits contributions to 401(k) plans to ensure that employees in all income ranges benefit from the plan. For example, the actual deferral percentage (ADP) nondiscrimination test essentially requires that the before-tax contributions of highly compensated employees (as a percentage of their eligible compensation) do not exceed the contributions of non-highly compensated employees (as a percentage of their eligible compensation) by more than a specified amount.
- <sup>11</sup> Plans file their annual reports on Form 5500, which is a joint form of the DOL, the IRS, and the Pension Benefit Guaranty Corporation (PBGC).

- <sup>12</sup> For example, plans may incur costs responding to requests for information pursuant to Securities and Exchange Commission (SEC) Rule 22c-2, under which mutual funds may obtain trading information necessary to ensure compliance with the fund's short-term trading policies. In addition, 401(k) plans that allow participants to invest in the employer's stock must register with the SEC on Form S-8. ERISA preempts most state laws that relate to employee benefit plans, but plans may still need to comply with state tax laws relating to withholding and information filing. The Bureau of Consumer Financial Protection created by the Wall Street Reform and Consumer Protection Act of 2010 potentially has the ability to regulate service providers to 401(k) plans, but only with respect to specific regulatory areas approved by the DOL and the Department of the Treasury.
- <sup>13</sup> See U.S. Department of Labor, Employee Benefits Security Administration, "Understanding Retirement Plan Fees and Expenses." Some commentators, however, have argued that the core standard under ERISA that governs plan fiduciaries—the duty of prudence—requires that fiduciaries engage in a prudent process in evaluating a plan's investments and services and does not require a particular result. See Vine 2010.
- <sup>14</sup> See 75 Fed. Reg. 41600 (July 16, 2010). These regulations were released on an "interim" final basis, meaning the DOL could amend them in response to comments prior to the rules becoming effective in July 2011. A number of proposals to enhance the disclosure of 401(k) fees have also been introduced in Congress.
- <sup>15</sup> See U.S. Department of Labor, Employee Benefits Security Administration, "U.S. Labor Department Issues Interim Final Rule on Disclosure of Fees and Conflicts of Interest Affecting 401(k) and Other Retirement Plans."
- <sup>16</sup> See U.S. Department of Labor, Employee Benefits Security Administration, "Understanding Retirement Plan Fees and Expenses" and "A Look at 401(k) Plan Fees." See also U.S. Securities and Exchange Commission, "Calculating Mutual Fund Fees and Expenses."
- <sup>17</sup> Plan sponsors use a variety of arrangements to obtain services for their 401(k) plans. When multiple service providers are used, it is an "unbundled" arrangement, and the expenses of each provider (e.g., trustee, recordkeeper, communications firm, investment manager) are charged separately to the plan. Alternatively, the plan sponsor can select one provider that provides a number of services (sometimes referred to as a "bundled" arrangement). The single provider interacts with the plan and then pays for the other bundled services out of the fees it collects from the plan. Some plans use a combination of these approaches, such as selecting a single provider for administrative/participant services and one or more providers for investment options. In this case, the administrative expenses can be included in the fees collected by the investment products, rather than a separate charge being added. In the case of mutual funds, fees can be netted from fund assets to compensate the service provider for the services it provides to the fund.
- <sup>18</sup> U.S. Department of Labor Opinion Letters 97-03A (January 23, 1997) and 2001-01A (January 18, 2001).
- <sup>19</sup> For the most part, 401(k) plan assets are held in individual accounts established for each participant. However, the costs of running a 401(k) plan also may be partly defrayed through employee "forfeitures." Employees who terminate employment without fully vesting (that is, earning full ownership of account assets) forfeit matching or other employer contributions (participants are always 100 percent vested in their own contributions). These forfeitures are typically used to offset fees or pay for additional employer contributions. Deloitte Consulting LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists 2009 reported that 72 percent of plans that had matching contributions used those matching contribution forfeitures to reduce employer contributions; 27 percent used these funds to offset fees; 12 percent reallocated the forfeitures to participants; and 6 percent did something else ("other"). (Plans can indicate more than one use of these funds.) Profit Sharing/401k Council of America 2009 reported that 64 percent of 401(k) plans allocate forfeitures to reduce company contributions; 13 percent of 401(k) plans allocate the forfeitures among participants (based on account balances, 3 percent; based on participant contributions, 3 percent; or based on participant's share of company contributions, 7 percent); 20 percent of plans applied forfeitures to reduce plan expenses; and 3 percent of plans did something else ("other"). The IRC and ERISA determine the maximum vesting schedule for 401(k) plans and require that employer contributions made to the 401(k) plan not be removed from the plan. In addition, plans may charge fees for certain transactions, such as taking a loan or making a withdrawal, and participants typically pay those fees in full when engaging in the specific activity.
- <sup>20</sup> See Deloitte Consulting LLP and Investment Company Institute 2009a and 2009b for full results from the survey.
- <sup>21</sup> For the regression analysis of the fee data, see Deloitte Consulting LLP and Investment Company Institute 2009b.

- <sup>22</sup> For example, plan sponsors that also had a defined benefit plan or health and welfare plan with their DC plan retirement service provider tended to have a lower “all-in” fee. Leveraging an existing relationship could reduce start-up and ongoing costs, for example, if the service provider already works with payroll data for another purpose. See Deloitte LLP and Investment Company Institute 2009a and 2009b.
- <sup>23</sup> Generally, when more of the plan costs are subsidized by the employer, the costs paid by plan participants are lower. Consider, for example, the variety of ways the costs of administrative services are paid. Deloitte Consulting LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists 2009 reported that 30 percent of 477 401(k) plan sponsors surveyed indicated that the company (plan sponsor) paid for all administrative and recordkeeping expenses (see Figure A1 in the appendix). In contrast, 59 percent of plans surveyed indicated participants pay for recordkeeping and administrative services: 10 percent of plans charged participants directly and 49 percent of plans indicated participants pay through fees and expenses included in the particular investment products. For example, in the case of mutual funds, these costs are included in the fund’s total expense ratio (as they are for all mutual fund investors). Similarly, insurance fees or fees associated with other pooled investments are paid by participants as part of the cost of those investments.
- <sup>24</sup> In addition, Profit Sharing/401k Council of America 2009 reported that 47 percent of plan sponsors surveyed paid the plan recordkeeping expenses; participants paid for recordkeeping in 42 percent of plans; and 11 percent of plans indicated both the plan sponsor and participants shared the costs of recordkeeping.
- <sup>25</sup> The DOL provides information to help employees learn about fees associated with their 401(k) plans. See U.S. Department of Labor, Employee Benefits Security Administration, “A Look at 401(k) Plan Fees.” The SEC also provides investor education at [www.sec.gov/investor.shtml](http://www.sec.gov/investor.shtml). Plans designed to meet the requirements of Section 404(c) of ERISA (see note 9) are required to provide to participants, either directly or upon request, a description of the annual operating expenses, which reduce the rate of return and the aggregate amount of those expenses expressed as a percentage of average net assets for each available investment option. In addition, participants must receive a prospectus for any investment alternative, such as a mutual fund, that is subject to the Securities Act of 1933 (Department of Labor Reg. § 2550.404c-1(b)(2)(i)(B)). The disclosure requirements would change somewhat under a DOL proposal. Under the proposal, all participant-directed plans would provide participants, upon enrollment, fee and other investment information for each investment option available in the plan. For collective investment products—such as mutual funds, bank collective trusts, and insurance company separate accounts—annual fees would be disclosed as a total expense ratio. See 73 Fed. Reg. 43014 (July 23, 2008). The U.S. Government Accountability Office 2006 suggested Congress consider amending ERISA to require plan sponsors to disclose fee information of 401(k) investment options to participants in a way that facilitates comparison among the options. A number of bills introduced in Congress would create new requirements for plans to disclose fee and other information to participants.
- <sup>26</sup> GICs are insurance company products that promise a specific rate of return on invested capital over the life of a contract. A similar investment option is a synthetic GIC, which consists of a portfolio of fixed-income securities “wrapped” with a guarantee (typically by an insurance company or bank) to provide benefit payments according to the terms of the plan at book value. For additional discussion of these investment options and 401(k) plan participants’ asset allocations, see Holden, VanDerhei, and Alonso 2009.
- <sup>27</sup> Company stock is the stock of the plan sponsor (employer). See Holden, VanDerhei, and Alonso 2009 for additional discussion of 401(k) participant investment in company stock in 401(k) plans.
- <sup>28</sup> Profit Sharing/401k Council of America 2009 indicated that 15.5 percent of 401(k) plans offer a self-directed brokerage window for participant contributions; 8.3 percent of plans offer a mutual fund window.
- <sup>29</sup> For additional information on mutual funds and the U.S. retirement market, see Brady, Holden, and Short 2010.
- <sup>30</sup> See Reid and Rea 2003; Investment Company Institute 2004, 2005, and 2010; and Collins 2010.
- <sup>31</sup> See Brady, Holden, and Short 2010.
- <sup>32</sup> Additional servicing fees not reflected in the mutual fund total expense ratios are not captured in this analysis, nor is the cost of holding other types of investments in 401(k) plans. See Deloitte Consulting LLP and Investment Company Institute 2009a for a survey of 130 plans that explores the factors that impact 401(k) plan fees.

<sup>33</sup> Financial advisers, retirement plan recordkeepers, discount brokerages, and other financial intermediaries provide an array of important and valuable services to mutual fund shareholders. In the context of 401(k) plans, these services can include recordkeeping, transaction processing, participant communication, education and advice, and regulatory and compliance services (Figure 2). Mutual funds and their investment advisers use a variety of arrangements to compensate plan service providers for these services. Under one arrangement, a mutual fund's board of directors may adopt a plan pursuant to Rule 12b-1 under the Investment Company Act of 1940. As explained in U.S. Securities and Exchange Commission, "Mutual Fund Fees and Expenses," Rule 12b-1 allows mutual funds to use fund assets to cover distribution expenses and shareholder service expenses. "Distribution fees" include fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares and paying for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. Under Financial Industry Regulatory Authority (FINRA, formerly the National Association of Securities Dealers [NASD]) rules, 12b-1 fees that are used to pay marketing and distribution expenses (as opposed to shareholder services) cannot exceed 75 basis points (NASD Conduct Rule 2830(d)). "Shareholder service" fees are fees paid to respond to investor inquiries and provide investors with information about their investments. A mutual fund may pay shareholder service fees without adopting a 12b-1 plan. FINRA imposes an annual 25 basis point cap on shareholder service fees (regardless of whether these fees are authorized as part of a 12b-1 plan). The SEC has proposed significant changes to Rule 12b-1. See 75 Fed. Reg. 47064 (Aug. 4, 2010). For more discussion of 12b-1 fees and how funds use them, see Investment Company Institute 2005 and "ICI Resources on 12b-1 Fees," available at [www.ici.org/rule12b1fees](http://www.ici.org/rule12b1fees).

At year-end 2009, 71 percent of mutual fund assets held in 401(k) plans were invested in funds that had no 12b-1 fee; another 19 percent of 401(k) plan mutual fund assets were invested in funds with 12b-1 fees of 0.25 percent or less (see Figure A6). Figures A5 through A7 in the appendix report average 12b-1 fees as well as distribution of 401(k) mutual fund assets across funds by the amount of the 12b-1 fee.

Funds also may pay service providers for sub-transfer agency services or administrative services out of fund assets (this is reflected in the fund's total expense ratio in the "Other Expense" category). The fund's adviser (or a related entity) also may compensate the service provider(s) out of the profits earned from the advisory fee collected from the fund.

<sup>34</sup> In 2009, 27 percent of mutual funds holding 17 percent of assets were stand-alone funds; 73 percent of funds holding 83 percent of assets were multiclass funds. At year-end 2009, there were more than 7,500 funds with total assets of \$11,120 billion. See Investment Company Institute 2010.

<sup>35</sup> See Figure A2 in the appendix for additional detail and historical data. In addition, see Figure A3 in the appendix for mutual fund assets by share class by type of mutual fund (stock funds, bond funds, and money market funds).

<sup>36</sup> See Reid and Rea 2003.

<sup>37</sup> Back-end load shares, which are primarily Class B shares, typically have an annual 12b-1 fee of 100 basis points and a CDSL set at 5 percent in the first year the shares are held; then the CDSL falls in units of 1 percentage point per year, reaching 0 percent in the sixth or seventh year in which the shares are held. Back-end load shares that are transferred or exchanged within a fund family are not subject to the CDSL. Generally, after six to eight years, Class B shares convert to Class A shares, which lowers the level of the 12b-1 fee from 100 basis points to that of Class A shares. For additional details, see Investment Company Institute 2010 and Reid and Rea 2003.

<sup>38</sup> See Figure A2 in the appendix for additional detail.

<sup>39</sup> Level load shares, which include Class C shares, typically have an annual 12b-1 fee of 100 basis points and a CDSL set at 1 percent in the first year the shares are held. After the first year, no CDSL is charged on redemptions. These shares usually do not convert to Class A shares. For additional details, see Investment Company Institute 2010 and Reid and Rea 2003.

<sup>40</sup> See Figure A2 in the appendix for additional detail.

<sup>41</sup> Stock mutual funds include domestic stock funds (44 percent of total 401(k) mutual fund assets at year-end 2009), foreign stock funds (15 percent), and hybrid funds (21 percent). Lifestyle and lifecycle funds are generally included in the hybrid fund category. See Brady, Holden, and Short 2010 for details.

<sup>42</sup> Expense information is not available for mutual funds held as investment choices in variable annuities (often referred to as VA mutual funds).

<sup>43</sup> For additional discussion, see Collins and Roth 2009 and Collins 2010.

<sup>44</sup> For additional discussion, see Collins and Roth 2009 and Collins 2010.

- <sup>45</sup> For a more detailed discussion of competition in the mutual fund industry, see Coates and Hubbard 2006, Stevens 2006, Reid 2006, and Investment Company Institute 2010.
- <sup>46</sup> In February 2006, ICI conducted an in-home survey of 737 randomly selected fund owners who had purchased shares of stock, bond, or hybrid mutual funds outside workplace retirement plans in the preceding five years (see Investment Company Institute 2006). On average, recent mutual fund investors considered nine distinct items of information about a fund before purchasing shares, five of which they considered “very important” to making the final decision to invest in a fund. Seventy-four percent of recent fund investors wanted to know about a fund’s fees and expenses before purchasing shares; 69 percent reviewed or asked questions about the fund’s historical performance.
- <sup>47</sup> For example, see Investment Company Institute 2010 and Collins 2005.
- <sup>48</sup> Profit Sharing/401k Council of America 2009 found that 62 percent of plans monitor plan investments on a quarterly basis; 18 percent annually; 14 percent semiannually; 4 percent monthly; and 2 percent at some other frequency (in 2008). Deloitte Consulting LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists 2009 reported that 60 percent of the plans they surveyed evaluated and benchmarked the performance of plan investments on a quarterly basis; 16 percent annually; 18 percent semiannually; 5 percent on no formal schedule; and 1 percent at some other frequency (in early 2009).
- <sup>49</sup> Deloitte Consulting LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists 2009 found that 39 percent of plans had replaced a fund due to poor performance within the last year; 23 percent had replaced a fund one year to less than two years ago; 20 percent had replaced a fund two years to less than five years ago; 5 percent had last replaced a fund five or more years ago; and 13 percent had never replaced a fund.
- <sup>50</sup> The size of the plan, in terms of assets and participants, and the average account balance are key factors in the pricing of services. As stated in the text, however, a variety of factors influence the total fees of a plan and all of these factors must be considered when evaluating the reasonableness of a given plan’s cost. In addition, the reasonableness of fees paid by a particular plan is different from the question of whether a plan fiduciary engaged in a prudent process under ERISA in selecting and monitoring plan services and investments (see note 13).
- <sup>51</sup> Investment Company Institute 2010 reported that among mutual fund shareholders owning funds outside of employer-sponsored retirement plans, 80 percent owned fund shares through professional financial advisers in 2009. Financial advisers provide a range of services to investors: they generally help investors to identify financial goals and recommend funds to meet those goals, conduct transactions, maintain financial records, and coordinate the distribution of prospectuses, financial reports, and proxy statements (see Leonard-Chambers and Bogdan 2007).
- <sup>52</sup> For the distribution of expense ratios of mutual funds in 401(k) plans by more detailed investment objective, see Figure A4 in the appendix.
- <sup>53</sup> For additional information, see Collins 2010.
- <sup>54</sup> The average expense ratio of money market funds industrywide declined in 2009 both as a result of a decline in expense ratios among individual funds, as well as an increase in the market share of institutional money market funds. See Collins 2010 for additional detail.
- <sup>55</sup> The SEC has adopted modifications to its prospectus rules that make the turnover rate more prominent by moving the turnover rate to the summary section at the beginning of the prospectus. See 74 Fed. Reg. 4546 (Jan. 26, 2009).
- <sup>56</sup> The SEC requires that the turnover rate be calculated by dividing the lesser of purchases or sales of portfolio securities for the reporting period by the monthly average of the value of the portfolio securities owned by the fund during the same reporting period.
- <sup>57</sup> For a more detailed discussion of portfolio turnover, see Reid and Millar 2004.
- <sup>58</sup> The average portfolio turnover rate experienced by stock mutual fund shareholders increased slightly in 2009, placing it somewhat above the average experience of the past 36 years (the average of 1974–2009 was 58 percent). See Investment Company Institute 2010.



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## APPENDIX

**FIGURE A1**

### WHO PAYS ANNUAL 401(k) RECORDKEEPING/ADMINISTRATIVE FEES?

Percentage of plans surveyed,<sup>1</sup> early 2009

	Percent
<b>Plan sponsor</b>	28
<b>Participant</b>	59
Via investment product fees and expenses <sup>2</sup>	43
Via additional reduction to investment returns <sup>2</sup>	6
Via direct charge	10
Pro rata based on account balances	6
Equal dollar to all participants	4
<b>Direct fees paid by both plan sponsor and participants</b>	8
<b>Other</b>	5

<sup>1</sup>The survey covers 606 401(k) plan sponsors. This figure includes the 477 plan sponsors that responded to this question.

<sup>2</sup>These are additional administrative or recordkeeping fees in the form of a wrap fee or added basis point charge.

Sources: Investment Company Institute tabulation of data from Deloitte Consulting LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists, 401(k) Benchmarking Survey: 2009 Edition

**FIGURE A2**

### 401(k) MUTUAL FUND ASSETS BY SHARE CLASS

Percentage of assets,<sup>1</sup> 1996–2009

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>Load</b>	39	39	37	36	33	32	23	25	25	24	24	23	21	20
Front-end load <sup>2</sup>	36	35	33	33	31	29	20	21	21	19	18	16	14	13
Back-end load <sup>3</sup>	3	3	3	2	2	2	2	2	1	1	1	(*)	(*)	(*)
Level load <sup>4</sup>	1	(*)	1	1	1	1	1	1	1	1	1	1	1	1
Other load <sup>5</sup>	(*)	(*)	(*)	(*)	(*)	(*)	(*)	1	2	4	4	5	6	6
<b>No-load<sup>6</sup></b>	61	61	63	64	67	68	77	75	75	76	76	77	79	80
Institutional	16	16	18	18	20	23	26	25	24	26	27	31	38	40
Retail or general purpose	45	45	46	46	46	45	51	50	51	50	49	47	41	39
<b>Total</b>	100	100	100	100	100	100	100	100	100	100	100	100	100	100

<sup>1</sup>Components may not add to the total because of rounding.

<sup>2</sup>Front-end load > 1 percent. Primarily includes A shares; includes assets where front-end loads are waived.

<sup>3</sup>Front-end load = 0 percent, CDSL > 2 percent. Primarily includes B shares.

<sup>4</sup>Front-end load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fee > 0.25 percent. Primarily includes C shares; excludes institutional share classes.

<sup>5</sup>All other load share classes not classified as front-end load, back-end load, or level load.

<sup>6</sup>Front-end load = 0 percent, CDSL = 0 percent, and 12b-1 fee ≤ 0.25 percent.

(\*) = less than 0.5 percent

Note: Figures exclude mutual funds available as investment choices in variable annuities and tax-exempt mutual funds.

Sources: Investment Company Institute and Lipper

FIGURE A3

**401(k) MUTUAL FUND ASSETS BY SHARE CLASS**Percentage of assets,<sup>1</sup> 1996, 2006, 2008, and 2009**Stock funds**

	1996	2006	2008	2009
<b>Load</b>	46	26	25	23
Front-end load <sup>2</sup>	42	20	17	15
Back-end load <sup>3</sup>	3	1	(*)	(*)
Level load <sup>4</sup>	1	1	1	1
Other load <sup>5</sup>	(*)	5	7	7
<b>No-load<sup>6</sup></b>	54	74	75	77
Institutional	10	21	29	34
Retail or general purpose	44	52	46	43
<b>Total</b>	100	100	100	100

**Bond funds**

	1996	2006	2007	2008
<b>Load</b>	29	16	15	15
Front-end load <sup>2</sup>	22	12	10	11
Back-end load <sup>3</sup>	4	1	(*)	(*)
Level load <sup>4</sup>	1	1	1	1
Other load <sup>5</sup>	2	2	3	3
<b>No-load<sup>6</sup></b>	71	84	85	85
Institutional	32	56	59	57
Retail or general purpose	39	27	26	28
<b>Total</b>	100	100	100	100

**Money market funds**

	1996	2006	2007	2008
<b>Load</b>	1	4	5	7
Front-end load <sup>2</sup>	(*)	(*)	(*)	(*)
Back-end load <sup>3</sup>	(*)	(*)	(*)	(*)
Level load <sup>4</sup>	(*)	2	1	1
Other load <sup>5</sup>	(*)	2	3	6
<b>No-load<sup>6</sup></b>	99	96	95	93
Institutional	45	60	62	62
Retail or general purpose	54	36	34	30
<b>Total</b>	100	100	100	100

<sup>1</sup> Components may not add to the total because of rounding.<sup>2</sup> Front-end load > 1 percent. Primarily includes A shares; includes assets where front-end loads are waived.<sup>3</sup> Front-end load = 0 percent, CDSL > 2 percent. Primarily includes B shares.<sup>4</sup> Front-end load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 fee > 0.25 percent. Primarily includes C shares; excludes institutional share classes.<sup>5</sup> All other load share classes not classified as front-end load, back-end load, or level load.<sup>6</sup> Front-end load = 0 percent, CDSL = 0 percent, and 12b-1 fee ≤ 0.25 percent.

(\*) = less than 0.5 percent

Note: Figures exclude mutual funds available as investment choices in variable annuities and tax-exempt mutual funds.

Sources: Investment Company Institute and Lipper

**FIGURE A4**

**401(k) MUTUAL FUND ASSETS BY INVESTMENT OBJECTIVE AND TOTAL EXPENSE RATIO**

Percentage of assets,<sup>1</sup> 2009

	Total expense ratio <sup>2</sup>			
	<0.50	0.50 to <1.00	1.00 to <1.50	≥1.50
<b>Total</b>	37	45	16	3
<b>Stock funds</b>	27	49	20	4
Domestic stock	33	45	19	3
Foreign stock	8	58	28	7
Hybrid	30	57	10	3
<b>Bond funds</b>	55	39	5	1
High yield and world bond	3	74	19	5
Other bond	60	36	3	1
<b>Money market funds</b>	85	14	1	(*)

<sup>1</sup>Row percentages may not add to 100 percent because of rounding.

<sup>2</sup>The total expense ratio, which is reported as a percentage of fund assets, includes fund operating expenses and 12b-1 fee.

(\*) = less than 0.5 percent

Note: Figures exclude mutual funds available as investment choices in variable annuities and tax-exempt mutual funds.

Sources: Investment Company Institute and Lipper

FIGURE A5

**401(k) MUTUAL FUND INVESTORS TEND TO PAY LOWER-THAN-AVERAGE 12b-1 FEES**

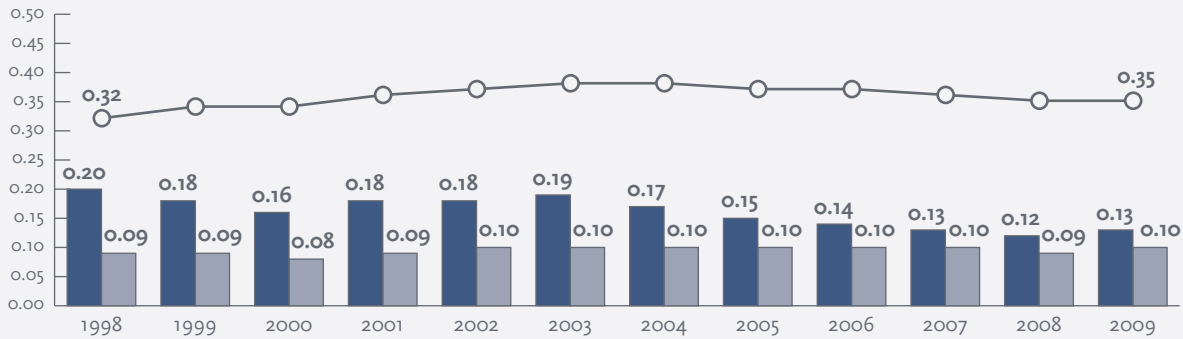
Percent, 1998–2009

- Industry average 12b-1 fee<sup>1</sup>
- 401(k) average 12b-1 fee<sup>2</sup>
- Industry simple average 12b-1 fee

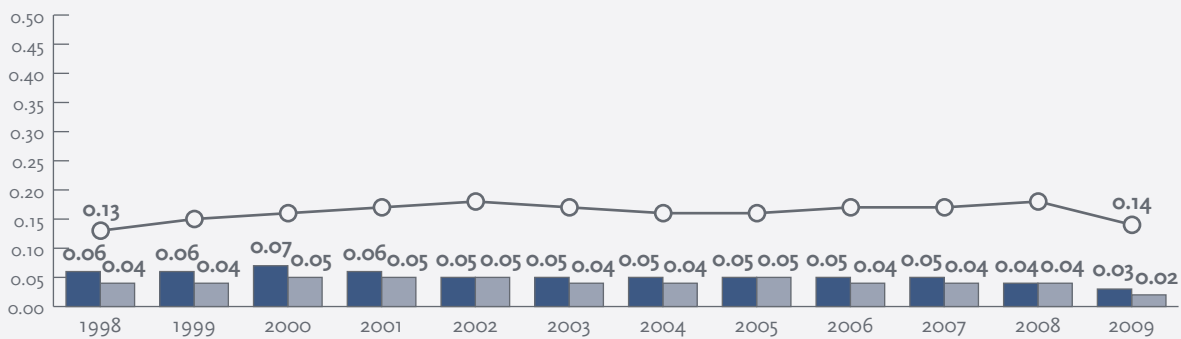
**STOCK FUNDS**



**BOND FUNDS**



**MONEY MARKET FUNDS**



<sup>1</sup>The industry average 12b-1 fee is measured as an asset-weighted average.

<sup>2</sup>The 401(k) average 12b-1 fee is measured as a 401(k) asset-weighted average.

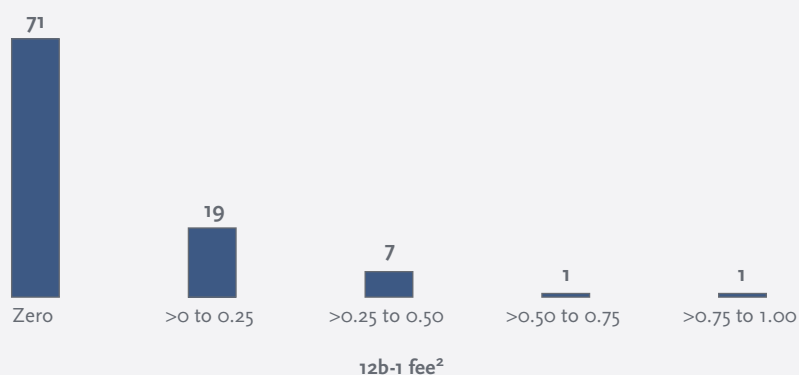
Note: Figures exclude mutual funds available as investment choices in variable annuities and tax-exempt mutual funds. Figures include mutual funds without 12b-1 fees.

Sources: Investment Company Institute and Lipper

**FIGURE A6**

**401(k) STOCK FUND ASSETS BY 12b-1 FEE**

Percentage of 401(k) stock mutual fund assets,<sup>1</sup> 2009



<sup>1</sup>Percentages do not add to 100 percent because of rounding.

<sup>2</sup>The 12b-1 fee is reported as a percentage of mutual fund assets.

Note: Figures exclude mutual funds available as investment choices in variable annuities. Stock mutual funds include hybrid funds.

Sources: Investment Company Institute and Lipper

**FIGURE A7**

**401(k) MUTUAL FUND ASSETS BY INVESTMENT OBJECTIVE AND 12b-1 FEE**

Percentage of assets,<sup>1</sup> 2009

	12b-1 fee <sup>2</sup>				
	Zero	>0 to 0.25	>0.25 to 0.50	>0.50 to 0.75	>0.75 to 1.00
<b>Total</b>	73	19	6	1	1
<b>Stock funds</b>	71	19	7	1	1
Domestic stock	73	18	7	1	1
Foreign stock	64	23	9	2	1
Hybrid	75	14	6	2	2
<b>Bond funds</b>	68	26	3	1	1
High yield and world bond	59	28	7	3	2
Other bond	69	26	3	1	1
<b>Money market funds</b>	91	8	1	(*)	(*)

<sup>1</sup>Row percentages may not add to 100 percent because of rounding.

<sup>2</sup>The 12b-1 fee is reported as a percentage of mutual fund assets.

(\*) = less than 0.5 percent

Note: Figures exclude mutual funds available as investment choices in variable annuities and tax-exempt mutual funds.

Sources: Investment Company Institute and Lipper

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