Are 401(k)s Too Complex?

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On the surface, employer-provided 401(k) plans seem simple enough. Employees set aside pre-tax dollars that are invested through their workplace plans, employers often match some of these dollars, and then contract with professional investment management firms to run the plans, providing a range of investment choices, recordkeeping, and related administrative services.

Surveys have found that many employees think the plans are free to them and carry no fees. Of course, that's not true. There are numerous hidden 401(k) fees that are layered into a typical plan. There have been countless studies about how the lack of financial literacy by 401(k) investors can cost them enormous sums of money over the decades that they participate in the plans.

Most plans offer only modest efforts, if any, to educate employees about how 401(k)s work, and certainly don't tell participants much about the fees. In response to growing frustration over how hard it is to get access to fee information, the U.S. Labor Department will be implementing new 401(k) disclosure rules this summer. The new rules are an improvement, but hardly a consumer activist's dream come true.

Now, after an extensive study of 401(k) fees by the U.S. Government Accountability Office (GAO), employees are getting a bad rap for not understanding the plans. How can you understand something if it's never explained to you? In fact, the GAO found that the plans' often convoluted fee arrangements are so complicated that even many employer sponsors don't understand them well enough to provide guidance to their employees.

Private and government institutions know that consumers don't like to pay extra fees or taxes. Over the years, these institutions have become expert at hiding these charges so that it is very hard for consumers to know the exact charges or taxes they are paying. In the case of 401(k)s, there can be fees for investing funds, managing funds, administering employee 401(k) accounts, and even for offering the fund as an investment choice in the first place.

In fact, firms that administer the plans sometimes get paid by the funds that they offer as 401(k) investment choices. This is not considered a bribe, for reasons that escape me. Instead, it's an accepted part of the business. And the fees have been opaque to investors, even though they wind up paying them.

The GAO report goes into these matters in some detail. It also includes a very telling video that tries to explain how revenue-sharing works in 401(k) plans. I watched this video several times and can safely declare it to be impenetrable to anyone not schooled and skilled in the world of 401(k) fees. That would include employee participants and, it seems, their employers.

Here, by way of illustration, is part of the transcript of the video:

"Let's say Ms. Jones, President of Jones Inc., decides to start a 401(k) plan for the company's employees. As the plan sponsor, Ms. Jones selects a bundled service provider, BundleCo, which provides a full range of services, including offering investment options, recordkeeping and administrative services, legal advice, trustee services, and customer service. Ms. Jones agrees to pay BundleCo a fixed amount of $1,000 for annual services. BundleCo tells Ms. Jones that they contract with other companies to provide a full range of services to Jones Inc. The written contract between BundleCo and Jones Inc. specifies that some of BundleCo's services will be paid for by these other companies in exchange for services BundleCo provides them.

"For example, BundleCo contracts with a number of investment fund companies to offer funds to the plans BundleCo services. BundleCo has a contract with Fund Company A to sell Fund A. Fund Company A agrees to pay BundleCo a portion of the fees they collect for marketing and distributing their fund. These fees, known as 12(b)-1 fees, are part of Fund A's expense ratio, which is the fund's total annual operating expenses, including management and other fees, expressed as a percentage of assets. Fund Company A agrees to pay BundleCo an annualized rate of 0.25 percent of plan assets. BundleCo also offers Fund B. In addition to 12(b)-1 fees, Fund Company B also includes subtransfer agent fees, also known as subTA fees, in their expense ratio. SubTA fees are used to reimburse BundleCo for performing recordkeeping services—services BundleCo is performing for Fund Company B, but not for Fund Company A. Fund Company B agrees to pay BundleCo an annualized rate of 0.50 percent of plan assets. BundleCo also offers Fund C. However, Fund Company C does not include 12(b)-1 or subTA fees in their fund's expense ratio, and therefore will not pay BundleCo to offer Fund C. BundleCo agrees because this is a low-cost fund that many plans are interested in."