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The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2006

Key Findings

- **401(k) plans are a complex employee benefit to maintain and administer, and 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 generally determines how the costs will be shared.
- **About half of the $2.7 trillion in 401(k) assets at year-end 2006 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 low-cost funds with below-average portfolio turnover.** Both characteristics help to keep down the costs of investing in mutual funds through 401(k) plans.

Why Employers Offer 401(k) Plans

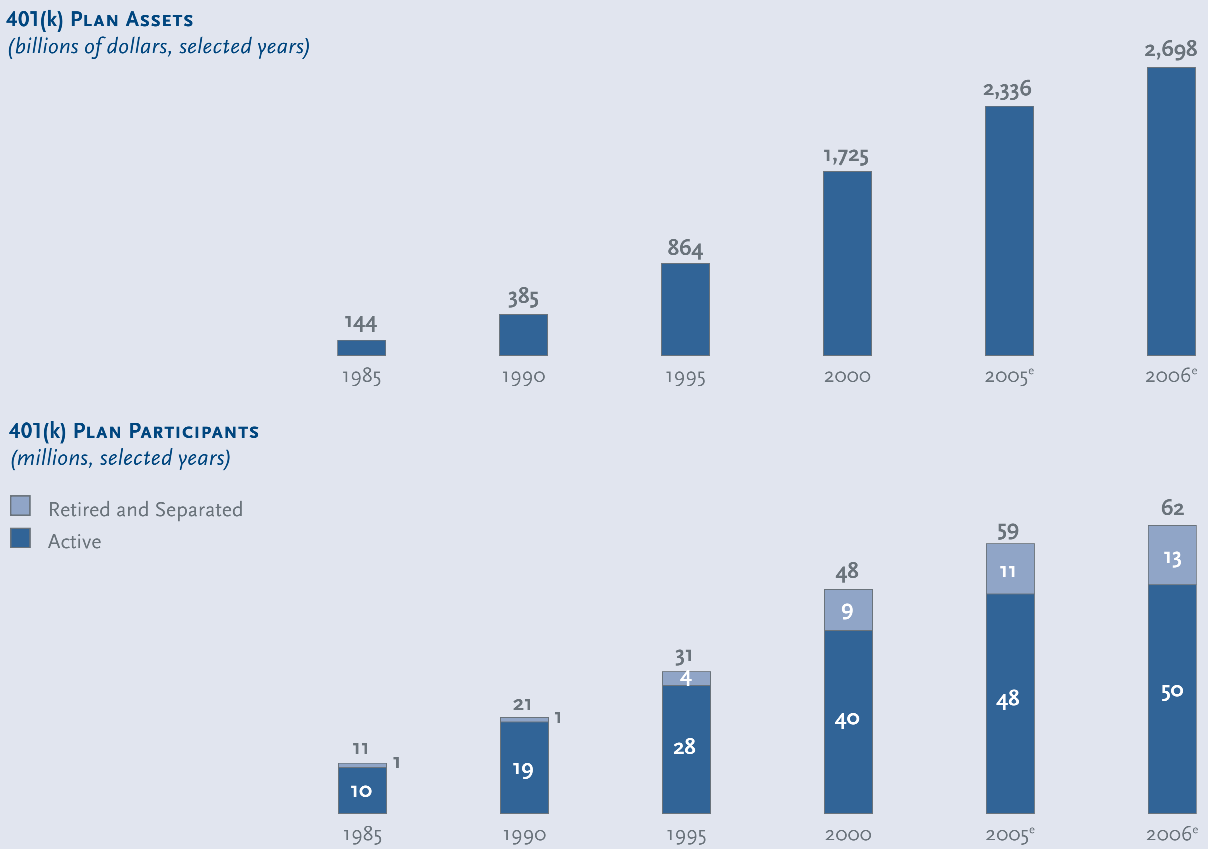
During the past two decades, 401(k) plans have become a popular workplace benefit, valued for their role in providing employees a means to set aside a portion of their compensation on a tax-favored basis. Indeed, 401(k) plans have become the most common defined contribution (DC) plan, serving 50 million active participants and holding $2.7 trillion in assets at year-end 2006 (Figure 1).[1] In just the last 16 years, 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 2006.

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 end 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 end products and services. Providing and maintaining 401(k) plans require employers 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.

Sarah Holden, ICI Senior Director, Retirement and Investor Research, and Michael Hadley, ICI Assistant Counsel, prepared this report.

Figure 1

401(k) Plan Assets and Participants



e = estimated

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

sources: Investment Company Institute, Federal Reserve Board, U.S. Department of Labor, and Cerulli Associates

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.[2] The Department of 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.[3] 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,[4] to oversee the administration of the 401(k) plan for the exclusive benefit of plan participants within legal requirements. The plan fiduciaries must arrange for the provision of the many services required to create and maintain a 401(k) plan.

Administrative Services. These services provide the framework necessary to maintain 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). Administrative service providers also process each and every participant transaction. DOL regulations require plans to allow participants to make changes to their investment elections at least quarterly,[5] but most 401(k) plan participants are permitted to make daily transactions in their plans.[6] In addition, plan fiduciaries must arrange for the provision of administrative services relating to setting up, converting, or terminating a plan, and trustee services.[7]

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).[8] In addition, the plan fiduciaries select a lineup of professionally managed investment options that cover a range of return and risk,[9] sometimes including a brokerage window through which participants may select individual securities. If a 401(k) plan sponsor chooses to permit loans, plan fiduciaries must arrange for loan processing services. In addition, plan sponsors may opt to provide participants with access to insurance and 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, which require administrative services; and

Trustee Services to provide 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; and

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; and

Processing of Domestic Relations Orders to ensure 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,[10] lengthy audited annual reports to the DOL,[11] and tax reporting to the IRS. Furthermore, plans may have additional compliance burdens under federal securities or state laws.[12] In addition, 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.

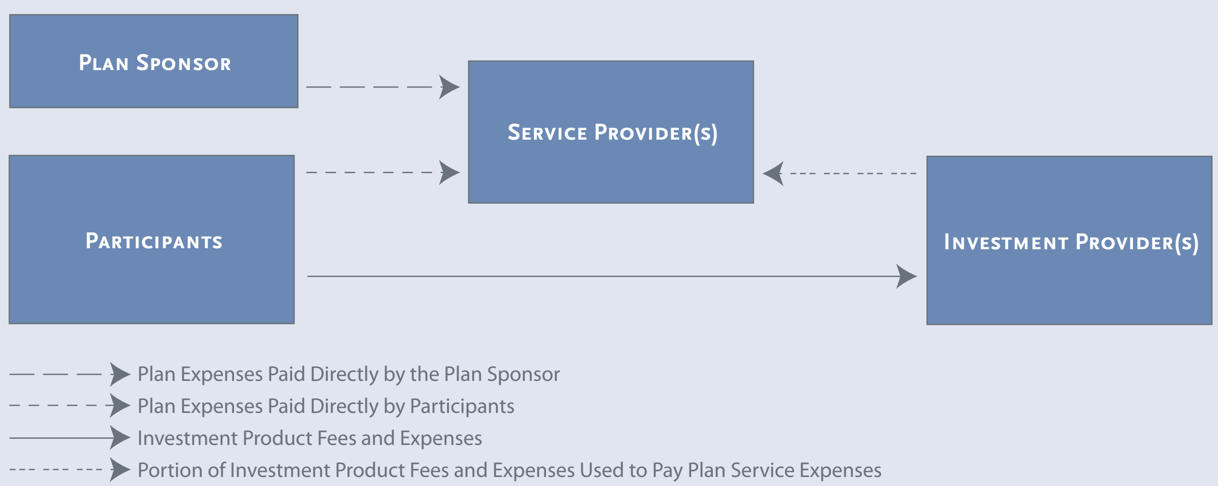
Plan Sponsors Must Ensure that Service Costs Are Reasonable

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."[13] To assist plan sponsors in this responsibility, the DOL makes a model fee disclosure form[14] available to plan sponsors, and offers a number of publications to help plan sponsors review the fees charged by current or potential service providers.[15] Because all services have costs, 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.[16]

Plan sponsors select the service providers and choose the investment alternatives offered in their 401(k) plans.[17] The costs of running a 401(k) plan generally are shared by the plan sponsor and participants, and the arrangements can vary widely. The DOL requires that the plan sponsor pay the costs associated with the initial design of the plan, as well as any design changes.[18] Beyond these design services, employers can share the costs of the plan services with their employees (Figure 3). However, many employers

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 to pay plan expenses.
source: Investment Company Institute

voluntarily cover some or all of 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.[19]

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. 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. More than one-third (37 percent) of plan sponsors surveyed indicated that the company (plan sponsor) paid for all administrative and recordkeeping expenses (Figure 4).[20] In contrast, 55 percent of plans surveyed indicated participants pay for recordkeeping and administrative services: 12 percent of plans charged participants directly and 43 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.[21]

Other Factors Affecting Participant Costs. When participants incur some or all of their 401(k) plan's costs, how they pay for these costs will affect the fees and expenses of the investment options in their plans. When 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.

Figure 4

Who Pays Annual 401(k) Recordkeeping/Administrative Fees?

Percent of plans surveyed,[1] 2005

	Percent
Plan Sponsor	37
Participant	55
via Investment Product Fees and Expenses[2]	38
via Additional Reduction to Investment Returns[2]	5
via Direct Charge	12
Pro rata based on account balances	8
Equal dollar to all participants	4
Direct Fees Paid by Both Plan Sponsor and Participants	4
Other	4

[1]*The survey covers 830 401(k) plan sponsors.*

[2]*Although reported separately in this survey, these two components are generally combined and included in the fees and expenses of the investment option.*

source: Investment Company Institute tabulation of data from Deloitte Consulting LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists, Annual 401(k) Benchmarking Survey 2005/2006 Edition

Plan characteristics also impact the costs that plan participants incur. Because there are some services that all plans must provide, plan size and average account size are important determinants of the cost of the plan relative to invested assets. For example, new plans with few assets likely will have higher costs per dollar invested than more mature plans with more assets and a larger average account size. Large employers' plans typically will be less costly per invested dollar than small employers' plans because plan costs that are relatively fixed can be spread across a larger pool of participants and assets.

Not only are there costs that all plans must incur, there are costs that each individual participant's account generates. Measured per dollar of invested assets, costs for plans with a small average account size will tend to be higher than similarly sized plans with a larger average account size.

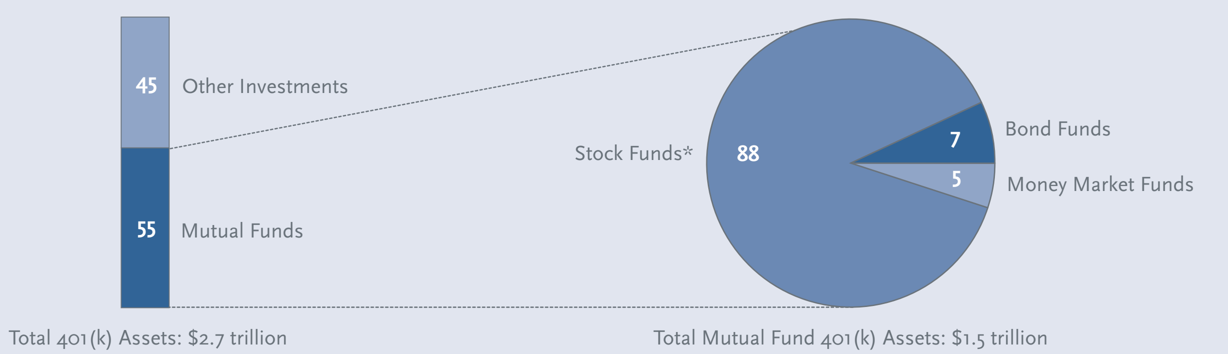
Looking at Fees and Expenses of Mutual Funds Held in 401(k) Accounts

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),[22] company stock,[23] or a brokerage window that provides participant access to direct investment in stocks, bonds, and other securities.[24] All told, about half (55 percent) of the $2.7 trillion in 401(k) plan assets at year-end 2006 was invested in mutual funds (Figure 5).[25]

Figure 5

About Half of 401(k) Plan Assets Are Invested in Mutual Funds

Percent of assets, 2006



**Stock funds include hybrid mutual funds, which account for 18 percent of total 401(k) mutual fund assets.*
sources: Investment Company Institute, Federal Reserve Board, and U.S. Department of Labor

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.[26] In addition, ICI separately tracks 401(k) plan account holdings of mutual funds.[27] 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.[28] This analysis finds that:

- 401(k) plan participants tend to be invested in low-cost mutual funds;
- at year-end 2006, three-quarters of mutual fund assets in 401(k) plans were held in "no-load" funds; and
- one-quarter of fund assets in 401(k) plans were held in load funds, predominantly in fund shares that do not charge retirement plan participants a front 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 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 (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.[29]

Share Classes. The combination of sales loads and 12b-1 fees that an individual investor might pay depends on the fund share class. It is now commonplace for mutual funds to offer several different share classes,[30] 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.

A mutual fund may set up a multi-class 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) or less. Seventy-five percent of 401(k) plan mutual fund assets were invested in no-load funds at year-end 2006 (Figure 6).

Another 25 percent of mutual fund 401(k) assets were invested in "load funds," but the actual loads are generally waived for retirement plan investors. For example, one load share class carries a front 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 load on shares purchased through their plans.[31] Front load shares have a 12b-1 fee, typically between 25 and 35 basis points. About one-fifth (19 percent) of 401(k) mutual fund investments were held through such front load shares in 2006 (Figure 6).

Back-end load shares are offered for sale at net asset value without a front load, but such share investors pay for some 401(k) plan services through a combination of an annual 12b-1 fee and a CDSL.[32] Back-end load shares represent a very small percentage of mutual fund assets held in 401(k) plans (Figure 6). *Level load shares,* which also use a combination of an annual 12b-1 fee and a CDSL,[33] represent a small share of 401(k) mutual fund assets as well.

Retirement shares, a share class specifically designed to meet the servicing needs of employer-sponsored plans, grew to represent 9 percent of 401(k) mutual fund assets in 2006 (Figure 6).[34] Virtually a non-existent pricing option in 1996, retirement shares are about equally split between load (4 percent of the total) and no-load funds (5 percent of the total).

Figure 6

401(k) Mutual Fund Assets by Share Class

Percent of assets,[1] 1996 and 2006

	1996	2006
Load	41	25
Front Load[2]	37	19
Back-End Load[3]	3	1
Level Load[4]	1	1
Retirement Shares	(*)	4
Other Load[5]	(*)	(*)
No-Load[6]	59	75
Institutional	14	18
Retail	45	52
Retirement Shares	(*)	5
Total	100	100

[1]Components may not add to the total because of rounding.

[2]Front load > 1 percent. Primarily includes A shares; includes assets where front loads are waived.

[3]Front load = 0 percent, CDSL > 2 percent. Primarily includes B shares.

[4]Front load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 > 0.25 percent. Primarily includes C shares; excludes institutional share classes.

[5]All other load share classes not classified as front load, back-end load, level load, or load retirement shares.

[6]Front load = 0 percent, CDSL = 0 percent, and 12b-1 ≤ 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; Lipper; Value Line Publishing, Inc.; CDA/Wiesenberger Investment Companies Service; © CRSP University of Chicago, used with permission, all rights reserved (312.263.6400/ www.crsp.com); Primary datasource; and Strategic Insight Simfund

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. The total expense ratio, which reflects both the operating expense ratio—including portfolio management, fund administration, shareholder service, and other miscellaneous costs—and 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 Low-Cost Mutual Funds

Stock Mutual Funds. Eighty-eight percent of 401(k) plan assets invested in mutual funds were invested in stock funds at year-end 2006 (Figure 5).[35, 36] The average total expense ratio incurred by 401(k) investors in stock funds was 0.74 percent in 2006, about half of the 1.50 percent simple average for all stock funds and lower than the industrywide asset-weighted average of 0.88 percent (Figure 7). 401(k) mutual fund investors not only incur low average expense ratios in stock mutual funds overall, but also in each broad type of stock fund: domestic stock funds, hybrid funds, and foreign stock funds (Figure 8).

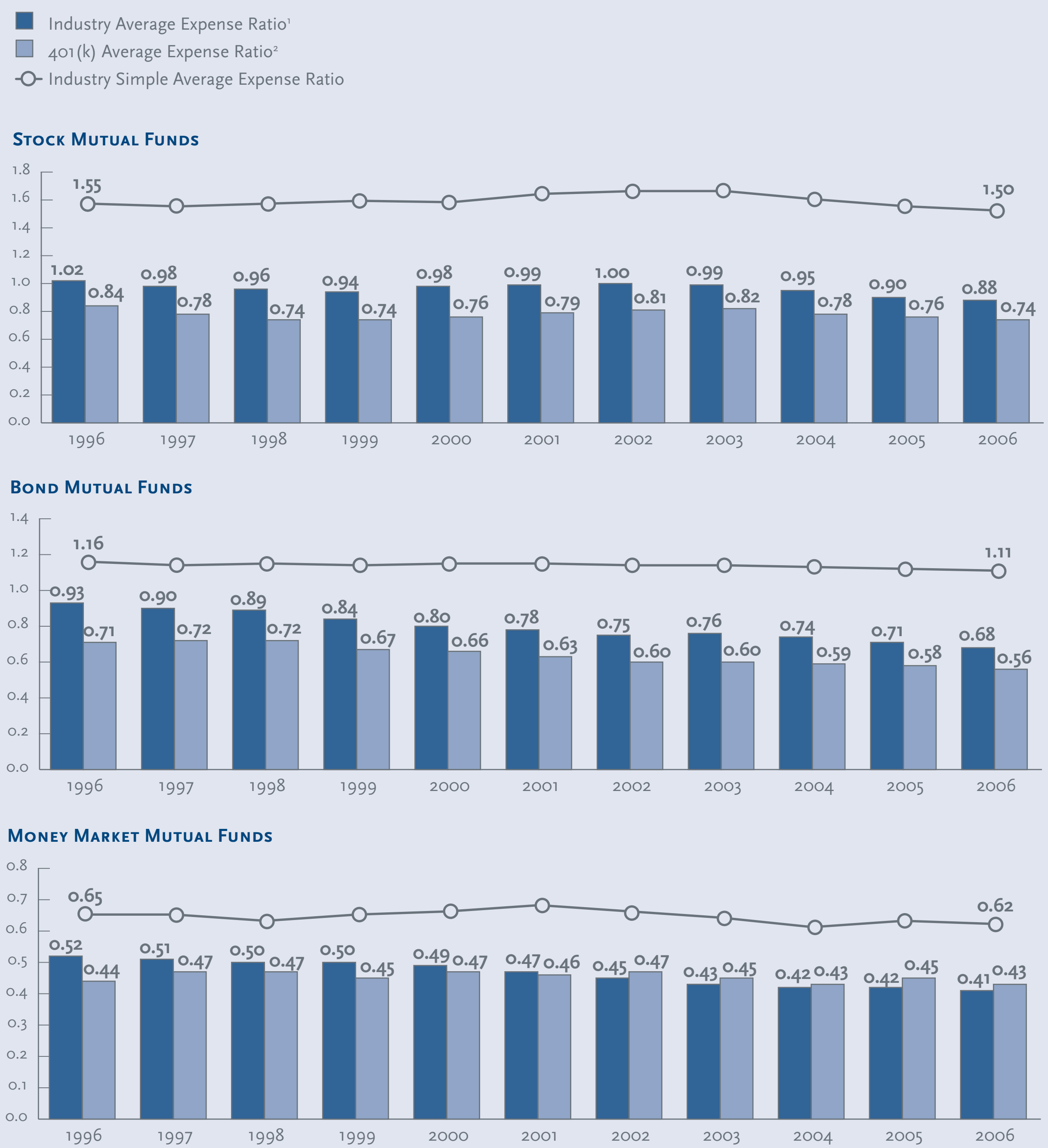
Several factors contribute to the relatively low average expense ratios incurred by 401(k) plan participants investing in mutual funds. Both inside and outside the 401(k) plan market, mutual funds compete among themselves and with other financial products to offer shareholders service and performance.[37] Shareholders are sensitive to the fees and expenses that funds charge.[38] 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.[39] 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,[40] and performance reflects fees. In 2005, more than half of plan sponsors indicated that they had replaced a fund in the last two years because of poor performance.[41]

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.[42] Finally, unlike shareholders outside of 401(k) plans who typically pay for the assistance of a financial adviser when investing in mutual funds,[43] 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 of assets, 1996–2006



[1]The industry average expense ratio is measured as an asset-weighted average.

[2]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; Lipper; Value Line Publishing, Inc.; CDA/Wiesenberger Investment Companies Service; © CRSP University of Chicago, used with permission, all rights reserved (312.263.6400/ www.crsp.com); Primary datasource; and Strategic Insight Simfund

Figure 8

Asset-Weighted Average Total Mutual Fund Expense Ratios

Percent of assets, 1996 and 2006

	1996		2006	
	401(k)[1]	Industry[2]	401(k)[1]	Industry[2]
Stock Mutual Funds	0.84	1.02	0.74	0.88
Domestic Stock	0.82	0.97	0.70	0.84
Foreign Stock	1.14	1.32	0.97	1.05
Hybrid	0.79	0.95	0.64	0.80
Bond Mutual Funds	0.71	0.93	0.56	0.68
High Yield and World Bond	1.07	1.17	0.86	0.95
Other Bond	0.64	0.82	0.53	0.62
Money Market Mutual Funds	0.44	0.52	0.43	0.41

[1]The 401(k) average expense ratio is measured as a 401(k) asset-weighted average.

[2]The industry average expense ratio is measured as an asset-weighted average.

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

sources: Investment Company Institute; Lipper; Value Line Publishing, Inc.; CDA/Wiesenberger Investment Companies Service; © CRSP University of Chicago, used with permission, all rights reserved (312.263.6400/www.crsp.com); Primary datasource; and Strategic Insight Simfund

Although expense ratios vary among the funds that 401(k) participants hold, more than three-quarters of 401(k) plan stock mutual fund assets were invested in funds with expense ratios less than 1 percent at year-end 2006 (Figure 9). More than one-fifth of 401(k) stock mutual fund assets were in funds with expense ratios less than 0.50 percent.[44]

Bond Mutual Funds. Seven percent of 401(k) mutual fund assets were invested in bond funds at year-end 2006 (Figure 5), and 401(k) bond fund investors also have concentrated their assets in low-cost bond funds. At year-end 2006, 401(k) bond fund investors paid total fees and expenses of 0.56 percent, about half the industrywide simple average (1.11 percent), and nearly one-fifth less than the industrywide asset-weighted average of 0.68 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 sub-groupings within bond mutual funds (Figure 8).

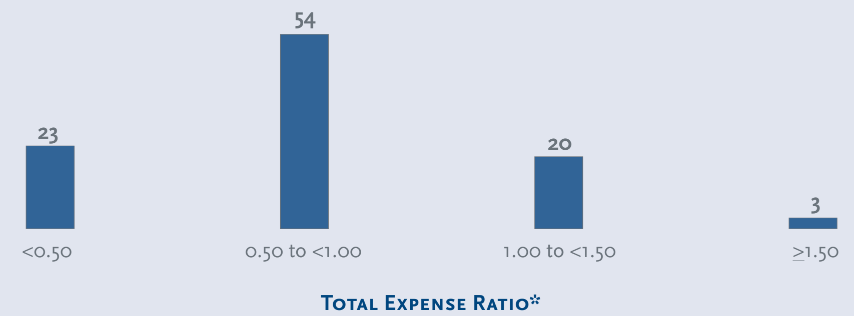
Money Market Mutual Funds. Five percent of 401(k) mutual fund assets were invested in money market funds at year-end 2006 (Figure 5). For 401(k) participants holding money market funds, their total expense ratio was 0.43 percent of assets, compared with an industrywide simple average of 0.62 percent (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.

Fee Comparisons Across Individual Plans Are Difficult. 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.

Figure 9

401(k) Stock Mutual Fund Assets Are Concentrated in Low-Cost Funds

Percent of 401(k) stock mutual fund assets, 2006



**The total expense ratio, which is reported as a percentage of fund assets, includes fund operating expenses and 12b-1 fees.*
note: Figures exclude mutual funds available as investment choices in variable annuities.
sources: Investment Company Institute and Lipper

As noted earlier, a variety of factors affect the fees and expenses paid by 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 pay higher fees 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

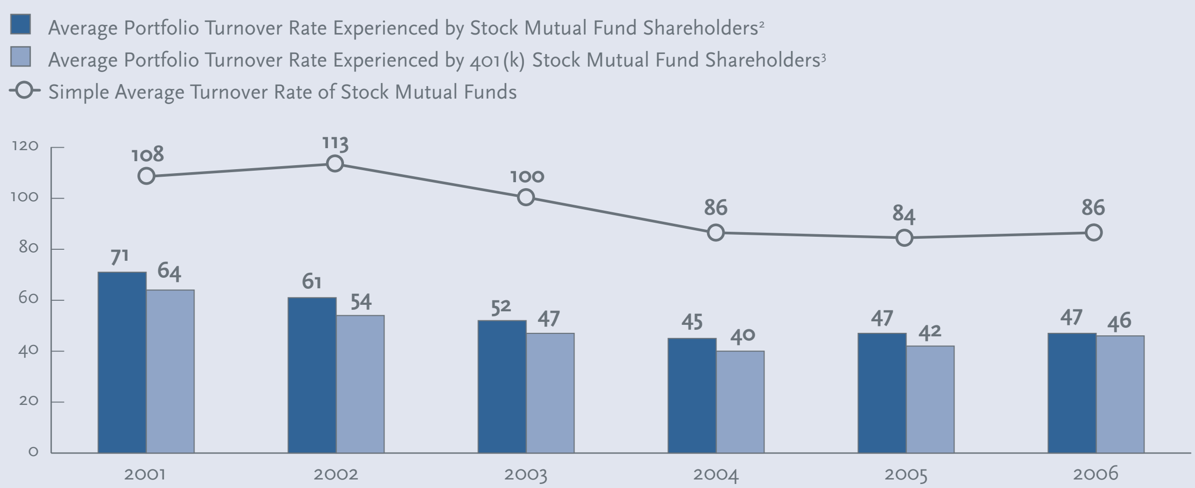
Another cost that mutual funds incur is the cost associated with buying and selling securities in the fund's portfolio. While these costs are not included in the fund's total expense ratio, they are reflected in the calculation of net return to the investor. To help shareholders evaluate the trading activity of a mutual fund, the Securities and Exchange Commission (SEC) requires each mutual fund to report its "turnover rate" in annual shareholder reports and in documents filed with the SEC. 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.[45]

Stock Fund Turnover Rates. 401(k) plan participants tend to own stock mutual funds with relatively low turnover rates. The industrywide simple average turnover rate in stock funds was 86 percent in 2006 (Figure 10).[46] However, mutual fund shareholders in general tend to invest in funds with considerably lower turnover rates, as reflected in the lower industrywide asset-weighted average turnover rate of 47 percent. The average turnover rate experienced in funds selected by 401(k) plan participants is similarly lower: the asset-weighted average turnover of stock mutual funds held in 401(k) accounts was 46 percent in 2006.

Figure 10

Average Portfolio Turnover Rate[1] of Stock Mutual Funds

Percent of assets, 2001–2006



[1]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 of the value of the portfolio securities owned by the fund during the reporting period.

[2]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).

[3]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 mutual funds include hybrid funds.

sources: Investment Company Institute and Strategic Insight Simfund

Conclusion

401(k) plans are now the most common 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 mutual funds, and the bulk of these stock fund assets is held in low-cost 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) performance- and cost-conscious decisionmaking by plan sponsors; and (5) the limited role of professional financial advisers in these plans.

Notes

1 See Brady and Holden (July 2007) for asset information; Cerulli Associates (2006) for participant information.

2 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 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 (November 2006)).

3 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 provides 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, Melone, Rosenbloom, and VanDerhei (1997).

4 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.

5 Department of Labor Reg. § 2550.404c-1.

6 Hewitt Associates (2006) reports that nearly all of the 130 large DC plans covered in their report offered daily transfers. Profit Sharing/401(k) Council of America (PSCA; 2006) indicates that more than 90 percent of the 1,106 profit-sharing and 401(k) plans surveyed offer to participants the ability to initiate daily fund transfers.

7 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.

8 PSCA (2006) reports 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 (36.3 percent of plans; see PSCA (2006)).

9 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 core options). Plans generally must allow transfers among the diversified investment options at least quarterly. Hewitt Associates (2005) indicates 85 percent of plans surveyed in 2004 considered themselves compliant with ERISA Section 404(c). PSCA (2006) indicates that in 2005 the average number of investment fund options available for participant contributions was 19; Hewitt Associates (2006) indicates an average number of investment options of 14 in 2005. Deloitte Consulting, LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists (2006) report that the average number of funds offered by the 830 401(k) plan sponsors in their survey was 17 in 2005.

10 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.

11 Plans file their annual reports on Form 5500, which is a joint form of the DOL, IRS, and the Pension Benefit Guaranty Corporation (PBGC).

12 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.

13 See U.S. Department of Labor, Employee Benefits Security Administration, "Understanding Retirement Plan Fees and Expenses." See also U.S. Department of Labor, Employee Benefits Security Administration, "Selecting and Monitoring Pension Consultants – Tips for Plan Fiduciaries" and "Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan."

14 This form was developed by the Investment Company Institute (ICI), along with the American Council of Life Insurers (ACLI) and the American Bankers Association (ABA), and is available online at U.S. Department of Labor, Employee Benefits Security Administration, ("ABC Plan 401(k) Plan Fee Disclosure Form for Services Provided by XYZ Company," www.dol.gov/ebsa/pdf/401kfefm.pdf). Furthermore, the PSCA has a similar worksheet, available at www.psca.org/pdfs/feeworksheet.pdf. The Institute, along with the American Benefits Council (ABC), ACLI, ABA, and the Securities Industry Association (SIA; now the Securities Industry and Financial Markets Association (SIFMA)), submitted to the DOL in July 2006 a list of fee and expense data elements that plan sponsors and service providers may want to discuss when entering into service arrangements (see www.ici.org/statements/cmltr/06_dol_fee_com.html).

15 The DOL has stated an intention to issue regulatory guidance on plan sponsors' responsibility to understand the fees being charged by service and investment providers. 72 Fed. Reg. 22828, 22845 (April 30, 2007). A report by the U.S. Government Accountability Office in November 2006 recommended DOL action in this area. See U.S. Government Accountability Office (November 2006).

16 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."

17 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.

18 Department of Labor Opinion Letters 97-03A (January 23, 1997) and 2001-01A (January 18, 2001).

19 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 (2006) report that 70 percent of plans used matching contribution forfeitures to reduce employer contributions; 27 percent used these funds to offset fees; 9 percent reallocated the forfeitures to participants, and 9 percent did something else ("other"). PSCA (2006) reports that 69 percent of 401(k) plans allocate forfeitures to reduce company contributions; 19 percent of 401(k) plans allocate the forfeitures among participants (based on account balances, 6 percent; based on participant contributions, 2 percent; or based on participant's share of company contributions, 10 percent); 12 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.

20 See Deloitte Consulting, LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists (2006). In addition, PSCA (2006) reports that 56 percent of plan sponsors surveyed paid the plan recordkeeping expenses; participants paid for recordkeeping in 35 percent of plans; and 10 percent of plans indicated both the plan sponsor and participants shared the costs of recordkeeping.

21 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. Plans designed to meet the requirements of Section 404(c) of ERISA (see endnote 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 DOL has announced its intention to issue further regulations defining the information that plan participants must receive regarding plan fees (72 Fed. Reg. 22828, 22845 (April 30, 2007)), and has solicited information from the public to assist in this effort (72 Fed. Reg. 20457 (April 25, 2007)). The U.S. Government Accountability Office (November 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.

22 GICs are insurance company products that guarantee 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 and VanDerhei (August 2007).

23 Company stock is the stock of the plan sponsor (employer). See Holden and VanDerhei (August 2007) for additional discussion of 401(k) participant investment in company stock in 401(k) plans.

24 PSCA (2006) indicates that 14.3 percent of 401(k) plans offer a self-directed brokerage window for participant contributions; 8.3 percent of plans offer a mutual fund window.

25 For additional information on mutual funds and the U.S. retirement market, see Brady and Holden (July 2007).

26 See Collins (June 2007); Investment Company Institute (October 2005, February 2005, and February 2004); and Reid and Rea (July 2003).

27 See Brady and Holden (July 2007 and July 2007—Appendix).

28 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.

29 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). For more discussion of 12b-1 fees and how funds use them, see Investment Company Institute (February 2005).

At year-end 2006, 65 percent of mutual fund assets held in 401(k) plans were invested in funds that have no 12b-1 fee; another 25 percent of 401(k) plan mutual fund assets were invested in funds with 12b-1 fees of 0.25 percent or less. Figures A3 through A5 in the Appendix report average 12b-1 fees as well as distribution of 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). Under another type of arrangement, the fund's adviser (or a related entity) compensates the service provider(s) out of the profits earned from the advisory fee collected from the fund.

30 In 2006, 32 percent of mutual funds holding 25 percent of assets were stand-alone funds; 68 percent of funds holding 75 percent of assets were multi-class funds. At year-end 2006, there were more than 8,000 funds with total assets of $10,414 billion. See Investment Company Institute (2007).

31 See Reid and Rea (July 2003).

32 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 falling 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 detail, see Collins (June 2007), Investment Company Institute (2007), and Reid and Rea (July 2003).

33 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 detail, see Collins (June 2007), Investment Company Institute (2007), and Reid and Rea (July 2003).

34 Retirement share classes can be load or no-load depending on the level of the 12b-1 fee and presence of a load or CDSL.

35 Stock mutual funds include domestic stock funds (56 percent of total 401(k) mutual fund assets), foreign stock funds (16 percent), and hybrid funds (16 percent). Lifestyle and lifecycle funds are generally included in the hybrid fund category. (See Brady and Holden (July 2007) for detail.)

36 Expense information is not available for mutual funds held as investment choices in variable annuities (often referred to as VA mutual funds).

37 For a more detailed discussion of competition in the mutual fund industry, see Stevens (March 15, 2006) and Reid (January 2006).

38 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.

39 For example, see Collins (June 2007), Investment Company Institute (2007), Investment Company Institute (October 2005), and Collins (August 2005).

40 PSCA (2006) indicates that 52 percent of plans monitor plan investments on a quarterly basis; 27 percent annually; 15 percent semiannually; 5 percent monthly; and 2 percent at some other frequency (in 2005). Deloitte Consulting, LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists (2006) report that 58 percent of the plans they surveyed evaluated and benchmarked the performance of plan investments on a quarterly basis; 22 percent annually; 14 percent semiannually; 5 percent on no formal schedule; and 1 percent at some other frequency (in 2005).

41 Deloitte Consulting, LLP, International Foundation, and the International Society of Certified Employee Benefit Specialists (2006) find that 37 percent of plans had replaced a fund due to poor performance within the last year; 20 percent had replaced a fund one year to less than two years ago; 19 percent had replaced a fund two years to less than five years ago; 5 percent had last replaced a fund more than five years ago; and 19 percent had never replaced a fund.

42 The size of the plan, in terms of assets and participants, and the average account balance, are key factors in the pricing of services.

43 Investment Company Institute (April 2005) reports that among mutual fund shareholders owning funds outside of defined contribution plans, more than 80 percent own fund shares through professional financial advisers. 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.

44 For the distribution of expense ratios of mutual funds in 401(k) plans by more detailed investment objective, see Appendix Figure A2.

45 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.

46 For a more detailed discussion of portfolio turnover, see Reid and Millar (November 17, 2004).

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Appendix

Figure A1

401(k) Mutual Fund Assets by Share Class

Percent of assets,[1] 1996 and 2006

Stock Mutual Funds

	1996	2006
Load	47	27
Front Load[2]	43	21
Back-End Load[3]	3	1
Level Load[4]	1	1
Retirement Shares	(*)	5
Other Load[5]	(*)	(*)
No-Load[6]	53	73
Institutional	9	13
Retail	44	54
Retirement Shares	(*)	6
Total	100	100

Bond Mutual Funds

	1996	2006
Load	36	18
Front Load[2]	27	14
Back-End Load[3]	6	1
Level Load[4]	1	1
Retirement Shares	(*)	3
Other Load[5]	2	(*)
No-Load[6]	64	82
Institutional	19	50
Retail	45	31
Retirement Shares	(*)	1
Total	100	100

Money Market Mutual Funds

	1996	2006
Load	1	6
Front Load[2]	(*)	(*)
Back-End Load[3]	(*)	2
Level Load[4]	(*)	2
Retirement Shares	(*)	2
Other Load[5]	(*)	(*)
No-Load[6]	99	94
Institutional	45	53
Retail	54	41
Retirement Shares	(*)	1
Total	100	100

[1]Components may not add to the total because of rounding.

[2]Front load > 1 percent. Primarily includes A shares; includes assets where front loads are waived.

[3]Front load = 0 percent, CDSL > 2 percent. Primarily includes B shares.

[4]Front load ≤ 1 percent, CDSL ≤ 2 percent, and 12b-1 > 0.25 percent. Primarily includes C shares; excludes institutional share classes.

[5]All other load share classes not classified as front load, back-end load, level load, or load retirement shares.

[6]Front load = 0 percent, CDSL = 0 percent, and 12b-1 ≤ 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; Lipper; Value Line Publishing, Inc.; CDA/Wiesenberger Investment Companies Service; © CRSP University of Chicago, used with permission, all rights reserved (312.263.6400/ www.crsp.com); Primary datasource; and Strategic Insight Simfund

Figure A2

401(k) Mutual Fund Assets by Investment Objective and Total Expense Ratio

Percent of assets,[1] 2006

	Total Expense Ratio[2]			
	<0.50	0.50 to <1.00	1.00 to <1.50	≥1.50
Total	28	51	18	3
Stock Mutual Funds	23	54	20	3
Domestic Stock	28	56	13	3
Foreign Stock	4	39	51	6
Hybrid	24	66	9	2
Bond Mutual Funds	49	44	6	1
High Yield and World Bond	5	69	21	5
Other Bond	54	41	4	1
Money Market Mutual Funds	75	20	4	(*)

[1]Rows may not add to 100 percent because of rounding.

[2]The total expense ratio, which is reported as a percentage of fund assets, includes fund operating expenses and 12b-1 fees.

(*)= less than 0.5 percent

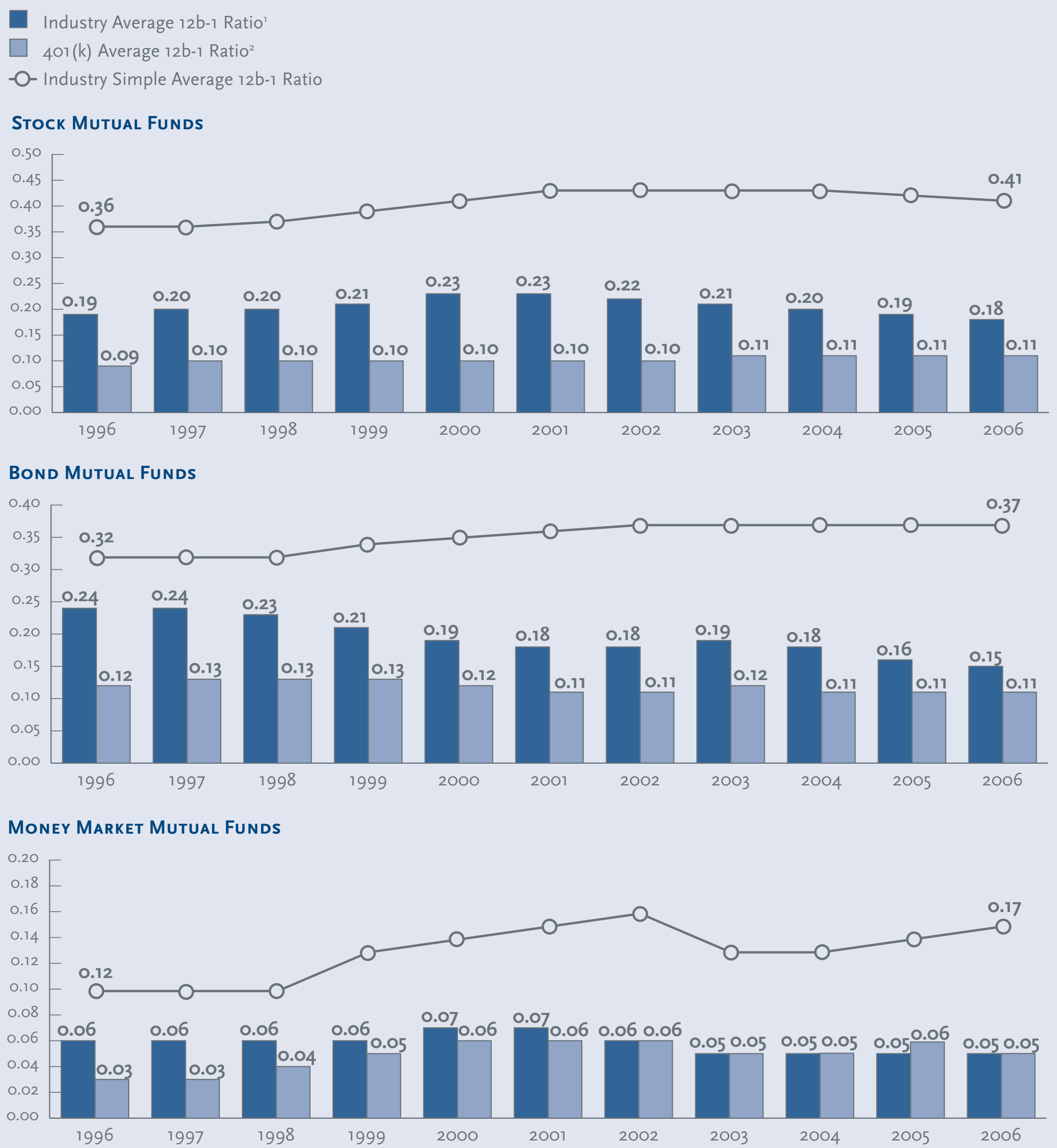
note: Figures exclude mutual funds available as investment choices in variable annuities and tax-exempt mutual funds.

sources: Investment Company Institute and Lipper

Figure A3

401(k) Mutual Fund Investors Tend to Pay Lower-Than-Average 12b-1 Fees

Percent of assets, 1996–2006



[1]The industry average 12b-1 ratio is measured as an asset-weighted average.

[2]The 401(k) average 12b-1 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. Figures include mutual funds without 12b-1 fees.

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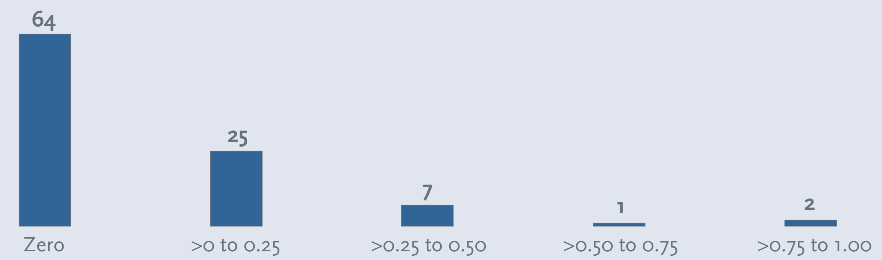
Figure A4

401(k) Stock Mutual Fund Assets by 12b-1 Fee

Percent of 401(k) stock mutual fund assets, 2006



note: Figures exclude mutual funds available as investment choices in variable annuities. Percentages do not add to 100 percent because of rounding.

sources: Investment Company Institute and Lipper

Figure A5

401(k) Mutual Fund Assets by Investment Objective and 12b-1 Fee

Percent of assets,[1] 2006

			12b-1 Fees		
	Zero	>0 to 0.25	>0.25 to 0.50	>0.50 to 0.75	>0.75 to 1.00
Total	65	25	7	1	2
Stock Mutual Funds	64	25	7	1	2
Domestic Stock	67	23	7	1	2
Foreign Stock	52	36	8	2	1
Hybrid	69	20	7	2	2
Bond Mutual Funds	59	34	4	1	1
High Yield and World Bond	55	30	9	2	5
Other Bond	60	34	4	1	1
Money Market Mutual Funds	81	15	2	2	(*)

[1] Rows may not add to 100 percent because of rounding.

(*)= 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

The ICI Research Department maintains a comprehensive program of research and statistical data collections on investment companies and their shareholders. The Research staff collects and disseminates industry statistics, and conducts research studies relating to issues of public policy, economic and market developments, and shareholder demographics.

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