Fiduciary Corner

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Understanding Fee Methodologies

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"Fee Levelization" is a process designed to help eliminate disparity in paying for plan administration from plan assets

The issue of fees and expenses related to the operation of a 401(k) plan continues to draw great attention. For the past several years, the Department of Labor has required record keepers, custodians, consultants, advisors, and investment managers to provide additional fee disclosures to both plan sponsors and participants. Theoretically, this disclosure provides greater transparency and opportunities to compare fees from different vendors.

While Plan Sponsors inherently know that recordkeeping fees and other costs associated with managing the plan can have a significant impact on retirement outcomes, many of them continue to operate plans that have revenue sharing imbalances. Our experience has led us to believe that employers don't usually intend to charge fees unfairly, and many times are surprised to know that fees are structured inequitably. Fee equalization embeds fundamental fairness into the plan by allocating administrative fees across all plan participants.

We are confident in saying that most retirement plans include mutual funds or insurance company separate accounts that engage in revenue sharing. Revenue sharing is the practice of utilizing a portion of the expense ratios (or asset charges in separate accounts) paid by participants to subsidize the administrative expenses of the plan. On the surface, this practice doesn't seem unreasonable, but unfortunately, using revenue sharing to pay plan expenses can produce a wide variety of administrative fee outcomes for participants.

Let's take a look at why. Listed below is a 401(k) investment line-up structure used by many plan sponsors:

1. offers either a set of target-date funds or pre-mixed asset allocation funds
2. offers from one to three index funds
3. offers anywhere from 8-10 actively managed funds

In this line-up arrangement, the target-date or asset allocation funds have a higher expense ratio, commensurate with the increased active management of the funds.

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Institutional funds or collective trust funds may provide an alternative solution due to their lack of revenue sharing "credits"

The most popular actively managed target date funds generally have anywhere from 10 to 75 basis points that can be used as a revenue sharing "credit", which will be used to pay the plan's administrative costs. The index funds, on the other hand, generally do not have any revenue sharing "credits" or will have a much smaller amount available (i.e. 5 to 10 basis points) associated with them. The 8-10 actively managed funds available, in most cases, will vary in revenue sharing "credit" amounts anywhere between 10 and 75 basis points.

The typical result is that participants who invest in the target-date, asset allocation or core actively managed funds end up paying virtually all the plan's administrative expenses, while participants who build a portfolio from the line-up of index funds pay little or no administrative expenses. Unfortunately, participants who choose to invest in funds that have revenue sharing end up paying a greater share (or the entire share) of the plan's administrative expenses versus those participants who choose non-revenue sharing funds. Participants often have no way of knowing which funds pay revenue sharing and which funds do not, nor do they necessarily understand the difference, since revenue sharing agreements vary by provider and generally are not explained to plan participants. At best, revenue sharing is just a footnote in the wilderness of their fee disclosure materials.

The solution to this fee "credit" disparity is not a straightforward one; there are many factors to consider. **The first steps you can take to begin the process of equalizing your plan's fees include:**

1. **Evaluate how the administrative expenses are currently covered in your plan**. Do the funds available to plan participants engage in revenue sharing? If so, do the funds' have an "institutional" or no revenue sharing fee class available to your plan? Not all funds or fund families, however, offer share classes that do not include revenue sharing in the expense ratio.
2. **Examine whether there are any disparities caused by the way the fees are structured.** If you find that a disparity exists, consider how to restore balance to participant fees. A seasoned retirement plan consultant would be able to outline alternative methods of charging for administrative expenses that fairly distributes the cost across the participant base.
3. **Re-examine fees charged for funds to ensure participants are receiving a good value for the fees they are paying.** Understand how bundled fees are being used to pay for different services, such as investments and record keeping. Look for ways to use your scale to benefit your participants.

If you are interested in learning how Comperio has assisted clients in dealing with this issue, please call either Jim or Scott to schedule a meeting.

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