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401(k) ADVISER
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If you want to be a successful 401(k) investor, be an educated consumer. Know what you're investing in and how much it's costing you.

The mutual funds in your retirement plan pay management and operational expenses, which cut into profit. By understanding these expenses, and how to compare costs across funds, you can make better investment choices for your retirement savings.

To understand the expenses, it's important to realize that funds are organized as stand-alone corporations. So, like any company, a mutual fund has several types of expenses.

Generally, a fund's biggest expense is its "investment management fee," which is used to pay the pros who research securities and make buy-and-sell decisions for the fund. A highly skilled investment management team, with a great track record for outperforming peers, can command a handsome price. On the other hand, if a fund is passively managed to mirror a benchmark (an index fund), there is significantly less skill required. The typical investment management fee accounts for one-third to one-tenth of the cost to manage the fund.

Another significant expense is trading costs. The amount of this cost is determined by how actively the fund buys and sells securities. These so-called portfolio turnover rates range from 20% if the average security is held for five years to 300% if the average investment is held only four months.

This cost isn't disclosed in the fund's prospectus but is available in the fund's "statement of additional information." While harder to uncover, trading costs can be significant and, in some cases, double a fund's published expense ratio. So it behooves you to investigate a fund's portfolio turnover.

Since their fixed expenses are spread over a larger asset base, bigger funds benefit from economies of scale. This doesn't imply that bigger is always better. In fact, larger funds can become unwieldy and difficult to manage.

Finally, a fund pays expenses to market itself to the investing public. Funds that communicate directly with investors pay advertising expenses, while other funds pay advisers a fee for recommending them.

Marketing fees paid to advisers are known as 12b-1 fees, named after the section of the securities law that provides for them. These fees are disclosed in a fund's prospectus and are included in its expense ratio.

All of the expenses to run a fund company are deducted from the fund's assets, typically on a daily basis. Most of these costs are summarized and published as the fund's expense ratio, which is expressed as a percentage of fund assets. Remember, however, a fund isn't required to report all expenses as part of its expense ratio. For this reason, you need to do a little investigating if you want to know the total expenses being deducted from your investment.

Because you'll never see a bill for your fund's expenses, you need to identify and understand them. Mutual fund expenses are charged as a percentage of the fund's total assets. Even a seemingly small increase in the percentage of these expenses could have a big impact on the growth of your account. For example, if your 401(k) balance is $50,000, the difference in cost of paying 1.25% a year on assets invested vs. 0.75% over a 20-year period could exceed $30,000. As you can see, these costs are real, and you need to consider them carefully when evaluating your fund choices.

When 401(k) plans were introduced more than two decades ago, there was a real hope that these plans would lower the cost of investing for American workers by allowing them to buy investment products in bulk. Industry professionals assumed that lower costs for investment management would be negotiated by pooling the retirement assets of many employees.

Investors can be their own advocates, taking advantage of these cost benefits. By understanding what's involved in mutual fund expenses, you can make better investment decisions for your own account. Better still, you can be a positive agent for change if your employer's plan has yet to take advantage of the increasingly competitive investment management fees being offered.

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