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Be sure to understand the costs of your 401(k) plan

401(k) ADVISER
MICHAEL J. FRANCIS

Understanding the costs you incur when you participate in your employer's 401(k) plan is important for two reasons. First, while you're working and saving for retirement, understanding your plan's costs will make you a smarter and hopefully wealthier investor. Second, when it comes time to retire, understanding your plan's costs will allow you to more effectively compare it with your rollover options.

Despite recent efforts to make 401(k) fees easier to decipher, it typically takes some detective work to truly understand your plan's costs. In general, the fees you pay can be separated into two categories: fees that are reported directly on your quarterly statement and fees you have to calculate yourself. Allow me to elaborate.

Fees you see: In 2012, rules went into effect requiring employers to itemize fees that are deducted directly from your account on your quarterly statement.

These fees typically cover costs for plan administrative services such as record-keeping, custody of plan assets, website operation, statements, consulting, compliance, and participant education and advice.

Fees you don't see: The second type of fee you pay is critically important to understand because it is the largest fee you pay. It is deducted from your account by your plan's fund managers, but you never see the charge. They simply reduce your funds' reported rate of return.

Each fund has a published "expense ratio," which is required to be readily available. If that was all there was to it, this would be simple, but unfortunately, it gets a little complicated because most plans use a portion of this fee to cover some of the plan's administrative expenses.

"Revenue sharing" is an industry term that describes a payment negotiated between a mutual fund and a record-keeping organization that administers 401(k) plans. These payments involve a mutual fund paying some of its expense ratio back to the plan's record keeper to cover administrative costs.

To obtain the amount of revenue sharing payments made by each fund in your plan, contact your human resources department. Plan record keepers are required to provide this information to your employer but generally don't give it to participants. It's also important to ask how these revenue sharing dollars are used.

If your HR department responds that all revenue sharing payments are returned to participant accounts from which they were deducted, the administrative charges published on your quarterly statement are complete.

If your HR department responds that all revenue sharing payments are used to cover plan administrative costs, then you need to multiply these revenue sharing amounts by the amount of assets you have invested in each fund and add that to any fees published on your quarterly statement to understand your total plan administrative costs.

Here's an example. The published expense ratio of the Dodge & Cox Stock Fund (DODGX) is 0.52%. This fund pays 0.10% in revenue sharing back to the record keeper. That means of the $52 deducted every year for every $10,000 you have invested in this fund, $42 is retained by the fund and $10 goes to cover plan administrative costs.

At this point, you should have what you need to calculate how much you pay in investment management and plan administration expenses. Now the most important question: What do I do with this information?

All else equal, I recommend you select funds that pay as little revenue sharing as possible — ideally none. In my experience, mutual funds with administrative service fees built into their expense ratio tend to overcharge for these services.

If you have quit your job and are considering rolling your 401(k) savings into an IRA or new employer's plan, make sure you use the net investment management expense ratio when you compare your current investment management costs with the investment cost of the alternatives you are considering.

Understanding your 401(k) plan's fees is an important first step in controlling them.

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