401(k) Fee Escape Artists

Here are five ways to avoid being gouged on your retirement account.

BY WILLIAM BALDWIN

WHAT'S YOUR 401(K)'S composite expense ratio? Higher than 0.1% a year? Then you should be looking for an escape hatch. It could save you a pile of money.

If the mere question about ratios leaves you flummoxed, you have company. Plenty of employees don't pay attention to what they are losing to fund fees. They should. The difference between high-cost funds and low-cost funds could easily add up over the course of a career to several hundred thousand dollars.

The operators of retirement plans and even employers do not necessarily mind the state of confusion that prevails. One way or another the considerable paperwork cost of a 401(k) must be paid, and the most common way to do that is to extract it via fund expense ratios. The plan may offer a few bargain funds, yet still depend for its economics on having most of the workers wander blindly into higher-fee options.

To get your costs down, you may have to be a bit creative. Consider these real-life cases.

X, 23, has just joined a fast-growing West Coast technology firm. The pay is high, but the 401(k) plan is bad. There's no employer match, and most of the funds on offer are expensive. Employees who sign up but neglect to make an investment choice are deposited into a balanced fund (a mix of stocks and bonds) that costs a rapacious 1.28% of assets annually.

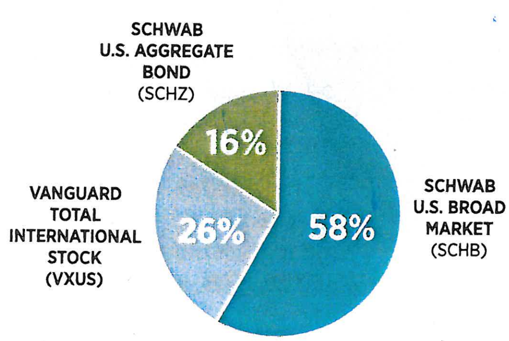
Not wanting to pass up the valuable tax deferral, X is contributing the maximum $17,500 a year. She wants a mix of stocks and bonds. There's one cheap stock fund available, an S&P 500 index fund at 0.09% a year. But the cheapest bond fund, American Century Ginnie Mae, costs 0.55%.

Solution: She will put her entire 401(k)

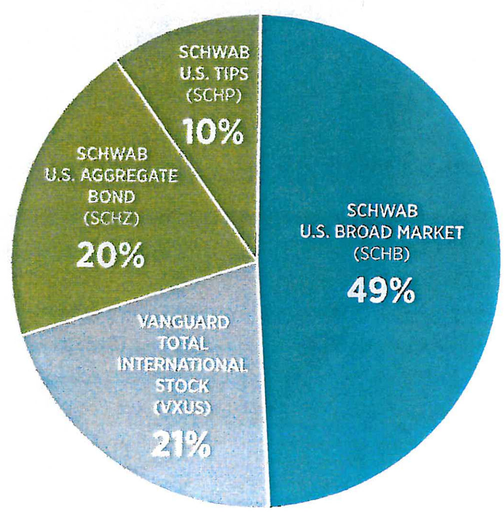
MODEL PORTFOLIOS FOR MODEL SAVERS

Someone with a $100,000 salary should have $100,000 in retirement accounts by age 35 and $800,000 at 65. These sample portfolios use exchange-traded funds with low expense ratios.

AGE 35
$100,000

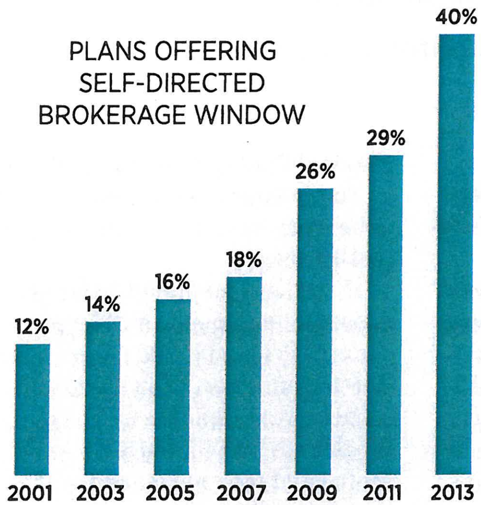


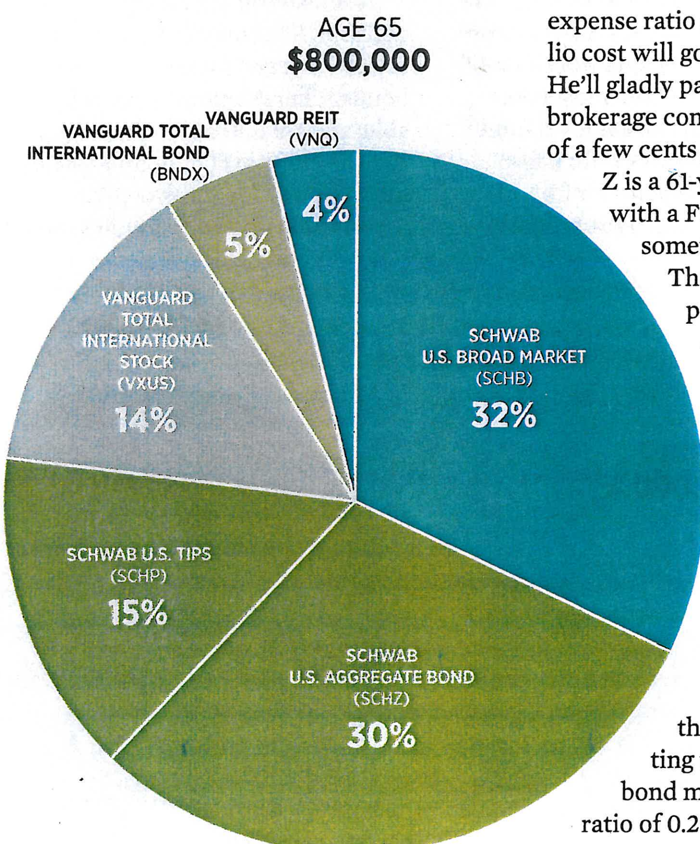
AGE 50
$400,000



OPEN WINDOWS

A survey of 401(k) plans by Aon Hewitt shows big employers are warming up to the "brokerage window," which lets savers buy funds (and sometimes securities) not on the main menu.





contribution into the stock index fund. Then she will restore her balance by adjusting other assets. She has an inherited IRA at low-cost Vanguard. She'll shift some of that money from stocks to bonds. With an investment of $10,000 or more, she is eligible for the bargain share class of the Vanguard Total Bond Market Index mutual fund. Annual cost: 0.08%.

Y, 37, is a new partner in a medical practice. There are all manner of compliance costs for retirement plans, and those costs must be recouped. The best the three docs could do was a menu drawn from the American Funds collection, priced at 0.58% to 1.13% a year.

The doctor's plan has an escape hatch. For a $100 transaction fee, a participant can use a "brokerage window" to buy just about any security. When his balance gets big enough, it will make sense for him to pay the fee and buy a dirt-cheap exchange-traded fund on the New York Stock Exchange. Schwab and Vanguard have ETFs costing as little as 0.05% a year.

Suppose Dr. Y moves $100,000 over to the Schwab U.S. Aggregate Bond ETF, with an expense ratio of 0.06%. His annual portfolio cost will go from $580 (or worse) to $60. He'll gladly pay the $100 transaction fee, a brokerage commission and a bid/ask spread of a few cents per ETF share.

Z is a 61-year-old manager at a nonprofit with a Fidelity-managed 403(b) plan, something very similar to a 401(k). The menu includes some low-expense stock index funds. But the cheapest fixed-income choice is the Fidelity Intermediate Bond Fund at 0.45% a year.

The $500 million plan has a brokerage window with a $75 fee. This window is opened just a crack: Z may not buy ETFs, and when he gets a Vanguard fund he is herded into the expensive share class.

Last year Z crawled through the window with $172,000, putting the money into the Vanguard bond market index fund at an expense ratio of 0.2%. His savings will run to $430 a year.

GO
CONSIDER
STOP

WALLY'S WORLD

Wally Weitz might not be the most famous value investor in Omaha, but his Value Fund has returned 11% a year since 1986, and his firm's assets under management have grown to over $5 billion. What's his outlook amid a choppy market?

LIBERTY MEDIA

"Grow, generate free cash flow, buy back stock and repeat: That's the John Malone model, and it works at all Liberty properties—Liberty Global and Liberty Interactive, too."

TRANSDIGM

"This maker of commercial and military aerospace components is a great business that continues to increase in value. But it's not cheap enough to buy right now."

HIGH-YIELD NO-GROWTH EQUITIES

"Beware stocks with these characteristics! Many are simply returning shareholders' capital and leaving little for the future, like some royalty trusts with limited life span."

RETIREMENT ON A BUDGET

For small firms there are three ways to shortcut the thicket of 401(k) regulations, says Brian R. Hogan, who oversees small-business retirement products at Fidelity Investments. Fees are minimal, although participants have to either meet investment minimums for the mutual funds they buy or else pay brokerage commissions (usually $8) to buy ETFs.

The **Simple IRA** is available to companies with no more than 100 workers. The employer must contribute at least 2% of each worker's pay; employees cannot contribute more than $12,000 ($14,500 if you're at least 50 years old). Annual administration fee: $25 per account.

The **Simplified Employee Pension** has no limit on the number of workers and no administration fee. The employer must contribute the same percentage of pay for all employees, so this choice makes sense if either all the employees are family members or the business owner is extremely generous. Employee contributions are not permitted.

The **Solo 401(k)** is best for a self-employed person with no other workers besides a spouse. The amount that can be set aside, determined by a complicated formula, is usually equal to $17,500 plus 18.6% of net income, with a $52,000 maximum. Older players can throw in another $5,500.

A survey by benefits consultants Aon Hewitt found that 76% of large employers have workers pick up all the costs of 401(k) administration. Among employers that push all or some of the costs onto employees, a rising minority (now 26%) assess account administration fees, such as $25 per account per year. The rest continue the tradition of burying costs in overpriced funds, a practice that helps youngsters with tiny balances but hurts workers who have been around long enough to accumulate respectable sums.

The game seems to be tilting to the older workers. Two in five large-company plans have the brokerage escape hatch *(see chart, p. 73)*.

Says David Gray, a vice president in Charles Schwab's retirement business: "We're seeing less and less of a tendency to subsidize 401(k) administration with fund fees and more and more transparency in costs."

That plays into his hands: Schwab manages the brokerage window for a lot of plans that use some other firm to administer the 401(k), and it sells low-fee ETFs. Gray says that among plans with both separately billed administration charges and index ETFs as the core of the investment menu, portfolio fees average no more than 0.1%.

What to do if you are trapped in a high-cost plan?

Complain. Oracle offers its employees a liberal low-cost brokerage account as well as mutual funds with fees as low as 0.02%. Why can't we get that?

Use the window. It will almost always save you money once your balance hits six figures. You'll find model portfolios for three different ages of employees on pages 72 and 73.

Counterbalance. Do what X did in the plan lacking affordable bond funds. Get whatever is cheap, and if that leaves you lopsided, fix the problem using assets outside the plan.

Make a withdrawal. Some plans allow some workers to take out some or all of their money while still employed. The restrictions may relate to your age and/or how much of the money came from company matches. Proceed cautiously, and arrange a custodian-to-custodian transfer so that you don't have tax problems.

Quit. When you change jobs, you can roll your account into an IRA that has no account administration charge. You can then buy any ETF you want.

Why do brokers have better deals for small IRAs than they do for 401(k) plans with thousands of participants? One reason is the plans have to prove that they are not discriminating against low-paid workers. Individual savers do not.

TRENDING

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PERSON
RICH KINDER
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COMPANY
SEAWORLD
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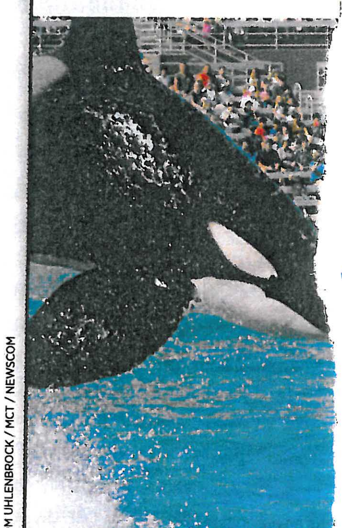
THEME
MARKET DIVERGENCE
Stocks trudge despite a mostly robust earnings season; revenue winners include the modern (Facebook, Under Armour) and the vintage (U.S. Steel).


TOM UHLENBROCK / MCT / NEWSCOM

FINAL THOUGHT

"Preparation for old age should begin not later than one's teens." —DWIGHT L. MOODY