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Why You Should Check Your 401(k) Plan's Fees

Expenses may be putting a bigger dent in your nest egg than you realize

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Like many investors, the kind of retirement you have may largely depend on how much money you stuff into your 401(k) plan and how well the funds in it perform.

If that's the case, though, you may want to take a closer look at what those investments are costing you.

The fees associated with 401(k) plans—one of the primary benefits employers offer their employees—can vary widely, and many investors don't understand just how damaging those expenses can be. Higher fees erode an investor's returns, putting a dent in a nest egg that gets bigger over time—sometimes significantly so. That means less money when you decide to leave the workforce for good.

Employees of small businesses are particularly vulnerable. While smaller 401(k) plans typically cost more to run, partly because they don't have economies of scale, a recent report from 401(k) researcher BrightScope expressed "shock" at just how much more expensive smaller plans can be.

According to the report, the average fee for smaller plans is between 1.5% and 2% annually, with many paying more than 2% a year in fees. That compares with less than 1% on average for larger plans, or those with more than $100 million in assets.

Same fund, different fees

Many mutual funds have multiple share classes with radically different fee structures, meaning different groups of investors pay different fees to invest in the same portfolio. Here's the problem: Even if your 401(k) plan contains otherwise solid funds, it may be offering you the share classes with the highest expense ratios.

For example, a target-date retirement fund for someone retiring in 10 years could have six retirement share classes with varying fees. That means the same fund with the same investments in it could cost 401(k) participants anywhere from 0.64% annually ($64 on $10,000 invested) to 1.39% ($139 on $10,000 invested).

While a fee discrepancy of a little less than one percentage point might seem small, its effects are dramatic over time. If an employee contributes $5,000 annually for 40 years to a fund that produces a 6% annualized return, the employee is left with around $770,000 at retirement. But if the employee's investment earns only 5.25% because of an extra 0.75% fee, the investor is left with around $640,000 at retirement, robbing him or her of well over $100,000.

Shouldering the burden

Why is there such a big difference in fees among share classes?

Fees for record-keeping (which involves keeping track of balances, contributions, withdrawals and loans) and payments to brokers constitute the difference between the cheapest and most-expensive share classes of retirement-class funds from the same family, which is why the 401(k) is arguably a poor mechanism for retirement savings.

What's in Your 401(k)?

As with other fund companies, the same fund here charges sharply different expenses for different classes, and then produces sharply different returns.

	Expense Ratio	Morningstar rating*	Five-year annualized return**
John Hancock Retirement Living Through 2025 Portfolio (Class R-1)	1.39%	★★★	7.44%
John Hancock Retirement Living Through 2025 Portfolio (Class R-2)	1.14	★★★	7.71
John Hancock Retirement Living Through 2025 Portfolio (Class R-3)	1.29	★★★	7.56
John Hancock Retirement Living Through 2025 Portfolio (Class R-4)	0.89	★★★	7.94
John Hancock Retirement Living Through 2025 Portfolio (Class R-5)	0.69	★★★★	8.20
John Hancock Retirement Living Through 2025 Portfolio (Class R-6)	0.64	★★★★	8.15***

*Based on performance adjusted for volatility against similar funds. Funds in the top 10% of a category get 5 stars. Funds in the next 22.5% get 4 stars. Also, 35% of the funds in a category are awarded 3 stars.

**Through October. ***Estimated.

Source: Morningstar

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Larger employers often foot the administrative costs associated with their retirement plans, allowing employees to benefit from cheaper share classes. For many small businesses, that may be a prohibitive expense. So if the lineup of funds in your 401(k) includes only the more expensive share classes, it could be an indication that your employer is relying on the asset manager or fund company to handle record-keeping in addition to the stock and bond picking, and dumping the extra costs on you by including only funds with higher expense ratios in its plan.

Record-keeping isn't the only thing that contributes to 401(k) costs. There also are legal documents associated with 401(k) plans that have to be drawn up by attorneys, filed with the Internal Revenue Service and rechecked periodically. This is usually handled by a third-party administrator, which is an additional expense not included in a fund's expense ratio.

A plan's expenses also may reflect how well the employer has negotiated with a broker on his or her fees. The problem is, small-business owners aren't always savvy about financial markets or negotiating asset-management fees.

When fund expenses push past 1% in what many observers expect to be a low-return environment, a 401(k) plan can become more a burden for employees than a benefit.

What you can do?

None of this necessarily speaks badly of the 401(k) providers that have multiple share classes of retirement funds. Many observers have argued that the 401(k) wasn't designed to be the major investment vehicle for most Americans, and requires policy overhaul.

But it is also true that fund companies with multiple share classes have stuck with an older distribution method, selling their products through full-cost brokers and advisers. Many businesses could probably save meaningfully on the broker fee by using discount brokerages such as Vanguard Group, Charles Schwab Corp. or Fidelity Investments, or by using one of the new robo advisers such as Wealthfront or Betterment.

Armed with this knowledge, here are a few things employees who think they might be stuck in poor plans should do.

Even if your 401(k) plan contains otherwise solid funds, it may be offering you the share classes with the highest expense ratios.

First, check the expense ratios of the funds in your plan and whether those funds are available in share classes that come with lower expense ratios. Much of this information can be found on fund-research websites.

An actively managed stock fund that charges more than 1% is expensive. The same goes for a bond fund charging more than 0.50% and a target-date fund above 0.75%.

If you find that your plan is expensive, consider initiating a discussion with HR or the person in charge of the 401(k) plan at work.

This can be a difficult situation. A business owner may have a long-standing relationship with a trusted broker, so employees in many instances need to proceed delicately.

But small businesses increasingly are getting the message that fees matter, and they have to shop for good plans that may truly be called "benefits" to their employees.

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