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Why Fees Matter—The Coming "Retirement Plan Sticker Shock"

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Most Americans either do not know what they are paying within their retirement plan or, even worse, make the completely erroneous assumption that they aren't paying anything at all. In the coming years, due to new required fee disclosures starting for some in 2012, this will abruptly change. Many of you will be faced with "**Retirement Plan Sticker Shock**." That retirement plan with the nice match from your employer that has previously been erroneously perceived by you to cost you "nothing" (due to the lack of ethics of the product and advice vendors hiding their fees) will suddenly show you a statement with annual costs TO YOU that may be $1,000, $3,000, or even $10,000 or more EVERY YEAR!

I am confident that these new fee disclosures are going to take many people by surprise (including many employers and trustees), so that the coming years will have many retirement plans taking action to fix all of the needless expenses that are being scooped from participants' retirement savings. I'd like to think the first version of this book and my various media appearances had something to do with getting these disclosures in the hands of participants. Keeping participants in the dark about costs was the strategy of many product vendors and advisors which left most participants not knowing what, if anything, they were paying. The first version of this book walked those motivated enough to work through the

maze to uncover the craftily hidden expenses. I sent the first version of the book to every member of the Senate and Congress and then the media picked up on this message of hidden expenses. I was interviewed in numerous newspaper stories and on several radio shows. I even was interviewed on CNN and Fox Business, and 60 Minutes did a story on hidden retirement plan expenses.

Now, disclosures and more transparency are coming and the unethical vendors that have been hiding their needless fees are going to have a day of reckoning. If they had originally ethically disclosed their costs to participants and employers and charged an honest price for only necessary services instead of trying to use every trick in the book to hide their repeated skimming of retirement assets, they would have nothing to fear now because the participants and employers would have known what was going on. But now, after intentionally misleading their clients for years, they are going to face not only a revolt, but also I suspect numerous lawsuits too. It serves them right!

What's a Little Fee Between Friends?

Why should you worry about fees? Does the difference of say 0.41 percent a year really impact your life much? After all, if you have $100,000, that's "only" $410 a year. How could that make much of a difference to your life now, or in the future?

Product vendors often will discount the impact of such a "small" fee in their presentations to your employer . . . and you if you confront them. They will say it is a small price to pay for their "superior service" (which will not really be measurable) and for the "strength of their firm" which in all likelihood has no material impact that really protects you. Yet, all else being equal, this seemingly small fee differential has a real price to your lifestyle.

Take for example a 35 year old that earns $60,000 a year and has accumulated $75,000 so far in her retirement account. The difference between total expenses of 1.10 percent annually, versus 0.69 percent annually (a difference of 0.41 percent) does have some significant impact to her lifestyle. At least, I think she would think it is significant.

To make up for this seemingly "small" difference, she would have to work two extra years to age 67 instead of retiring at age 65.

IS WORKING TWO EXTRA YEARS JUST TO PAY NEEDLESS FEES TO A VENDOR SOMETHING YOU WOULD CONSIDER A SMALL PRICE TO PAY?

Of course, she doesn't have to work longer to make up for the difference in the needless expenses. Alternatively, since she will have accumulated less money with the higher fee by age 65, she might just opt to spend less in retirement. That "small" fee difference would force her to reduce her retirement spending for the rest of her life by $4,200 a year. Without the excess fee she could have confidently planned on a retirement income of $36,000 a year for the rest of her life, but with just an extra 0.41 percent headwind of excess expenses, to have the same confidence she would have to reduce her retirement income by 12 percent to $31,800.

DO YOU THINK YOU COULD FIND SOMETHING TO DO IN RETIREMENT WITH AN EXTRA $4,200 A YEAR FOR LIFE? IS THAT A "SMALL" PRICE?

That extra expense of 0.41 percent right now in dollars is only $308 based on her current retirement plan balance of $75,000. Maybe she could just increase her savings to make up for this "small" difference, still retire at 65 and still plan on spending $36,000 a year. That seems less painful than working two more years, or cutting her retirement income by $4,200 a year. The only problem with this is that as her account grows with contributions (and hopefully some market growth), so will the impact of that fee differential. So, the amount she would need to increase her savings by for the next 30 years until retirement is $1,500 a year . . . 30 percent more than she would otherwise have to save ($5,000 versus $6,500) and the equivalent of about a $25,000 mortgage at 4 3/8 percent interest.

IS INCREASING YOUR SAVINGS BY 30 PERCENT A YEAR FOR 30 YEARS A "SMALL" PRICE TO PAY? WOULD AN EXTRA $1,500 A YEAR FOR 30 YEARS IMPROVE SOME ASPECTS OF YOUR LIFE? THINK ABOUT HOW THAT COULD IMPACT YOUR HOLIDAY GIFTS OR VACATIONS!

Figure 1.1 demonstrates these impacts of such a "small" difference in fees in terms that might be more meaningful to you than what the product vendor or advisor will cavalierly discount in his answer to you about fees.

I would like to think that the worst plans out there are over charging for services by "only" this "small" amount. Unfortunately, that is not what I have witnessed. For example, after releasing the first version of this book, I heard from a police officer about his union-backed 457 retirement plan for a large city's police force.

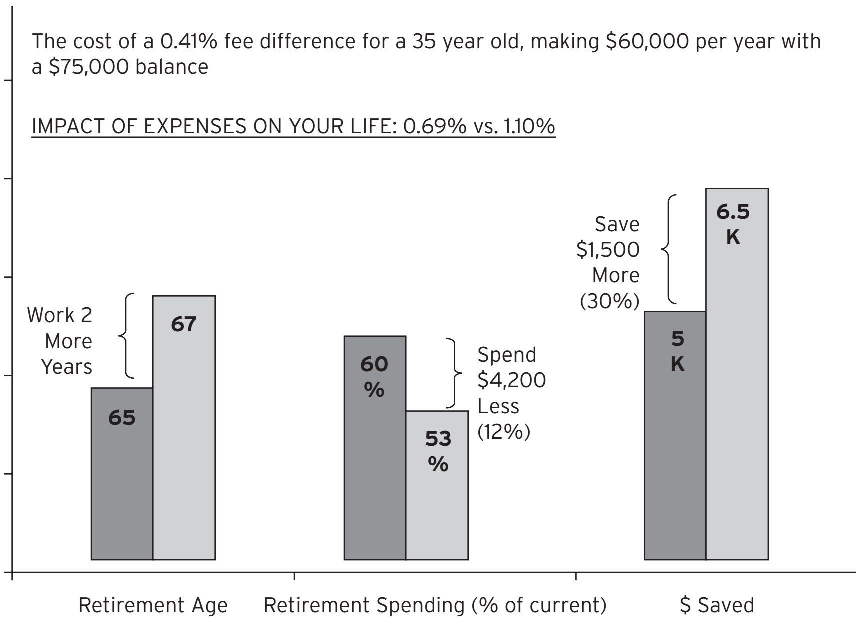


Figure 1.1 Cost to the Employee–Quality of Life

The officer was actually credentialed in finance and analyzed the costs that were coming from the plan. The plan was large (more than $1 billion) and should have had the negotiating power to get the lowest fees to enable the police officers to get a good deal so they could have a comfortable retirement after serving and protecting citizens over their careers. Unfortunately, it appears that the union that controlled the decision chose a vendor for some other purpose than serving their members, because the costs of this huge plan were nearly 2 percent a year.

Another example came from an objective advisor who contacted me about a State 403(b) plan where teachers and administrators didn't know their retirement assets were being skimmed to the tune of 0.50 percent by the union in the form of kickbacks, unless they read the fine print deeply buried in half-inch-thick documents. There will be more on this in Chapter 10 which is dedicated to those plans which still will not receive the fee disclosures.

Over the years since the release of the first version of my book, I have witnessed many plans with similar problems. I've seen multimillion dollar plans for several medical practices with expenses of 2 to 3 percent a year or even more. I've seen a complacent law

firm that should know better with multiple tens of millions, needlessly having their lawyers' retirement assets skimmed by an extra 0.50 percent a year.

Perhaps most seriously as a violation of ERISA, I've seen multiple occasions where trustees of a corporate or non-profit retirement plan selected an expensive vendor (a bank) because they thought they could get more favorable loan and other banking terms. THIS IS A PROHIBITED TRANSACTION under the Employee Retirement Income Security Act of 1974 (ERISA) yet it happens every day, even though the trustees of the plan face *personal liability* for this action, if and when they are discovered.

You saw the impact to one's lifestyle of just a 0.41 percent additional needless expense. For some of these plans, with an excess cost of 1.5 percent to more than 2 percent, it gets even more extreme.

Do You Have an Extra $1 Million You Could Spare?

Probably not, but that could very well be the price tag you are paying over your life if your retirement plan has excess costs of 1.5 percent annually. Take an example of a diligent 25 year old that has been taught to save for retirement. Graduating from college and landing a good promotion after working for a few years, she is in a position to start saving for retirement and she starts saving $7,500 a year in her retirement plan ($625 a month) and adjusts that each year for 3 percent inflation.

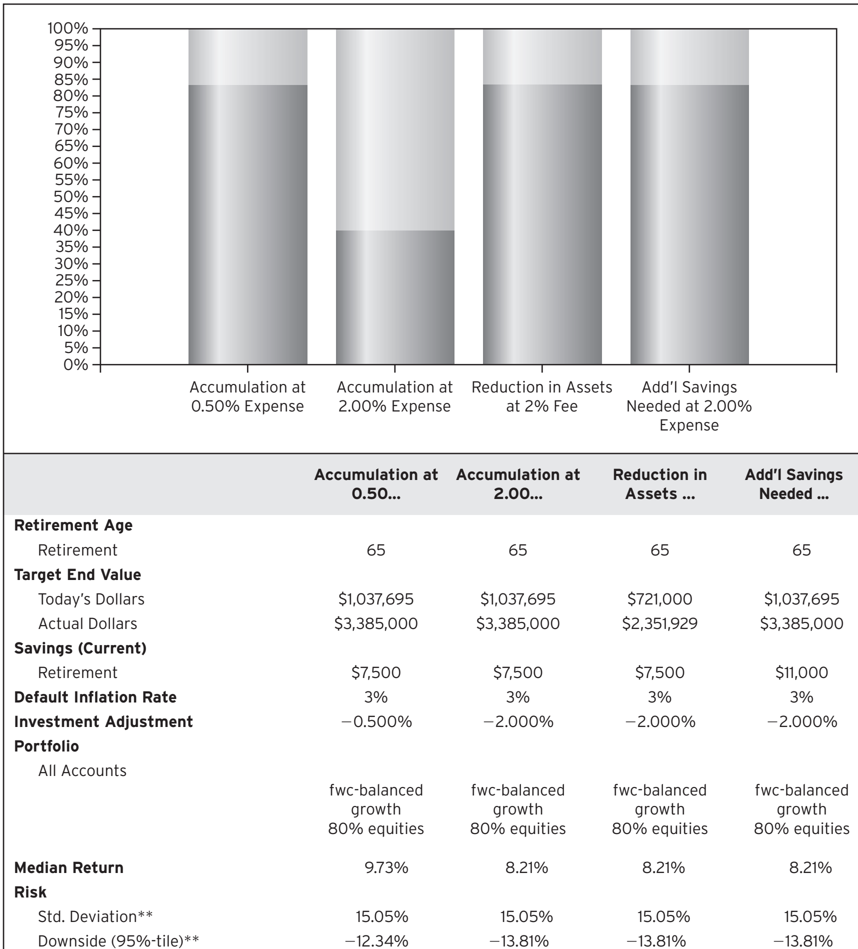
Over 40 years, with an expense of only 0.50 percent, and a simple investment allocation of 80 percent domestic stocks, and 20 percent in 7- to 10-year Treasury bonds, in 83 percent of the 541 historical 40-year periods back to 1926, she would have accumulated an amazing $3,385,000. (The worst historical 40-year period for her, starting in the Great Depression and ending in the 1974 bear market, would have her accumulate "only" $2,343,000.) Unfortunately, due to the impact of inflation, the spending power of the nearly $3.4 million would be only a bit more than $1,000,000.

However, if her fees were 1.5 percent higher (2.0 percent versus 0.50 percent), and all other things being equal, instead of an 83 percent historical chance of exceeding $3.4 million, she would have only a 40 percent chance. Think about this. **The effect of the excessive 1.5 percent fee cuts her odds of accumulating $3.4 million in half!**

It gets worse as you probe into the analysis. With the drain of the excessive 1.5 percent cost, her retirement assets at age 65 at the same 83 percentile as the lower-cost plan would be more than $1 million less ($2,351,929 versus $3,385,000). Remember *the worst* outcome of 541 historical 40-year periods with a 0.50 percent expense was $2,343,000, about the same amount as the eighty-third percentile with a 2.00 percent fee.

To make up for this in additional savings, instead of saving an inflation-adjusted $7,500 a year, she would have to save an inflation-adjusted $11,000 a year. That's a 46 percent increase in the amount she'd need to save ($3,500) every year for the next 40 years, just to make up the difference in fees.

The following figures summarize these comparisons.



	Accumulation at 0.50...	Accumulation at 2.00...	Reduction in Assets ...	Add'l Savings Needed ...
Retirement Age				
Retirement	65	65	65	65
Target End Value				
Today's Dollars	$1,037,695	$1,037,695	$721,000	$1,037,695
Actual Dollars	$3,385,000	$3,385,000	$2,351,929	$3,385,000
Savings (Current)				
Retirement	$7,500	$7,500	$7,500	$11,000
Default Inflation Rate	3%	3%	3%	3%
Investment Adjustment	−0.500%	−2.000%	−2.000%	−2.000%
Portfolio				
All Accounts	fwc-balanced growth 80% equities	fwc-balanced growth 80% equities	fwc-balanced growth 80% equities	fwc-balanced growth 80% equities
Median Return	9.73%	8.21%	8.21%	8.21%
Risk				
Std. Deviation**	15.05%	15.05%	15.05%	15.05%
Downside (95%-tile)**	−12.34%	−13.81%	−13.81%	−13.81%

	Plan Name	Over Target	< Target	Less than $0
1	**Accumulation at 0.50% Expense**	83%	17%	0%
	We evaluated 541 40-year periods of market returns from 1926 to 2010. Your portfolio met your goals and had a targeted ending value of at least $1,037, 695 at age 65 in 450 of these periods, or 83%. The first 40 year period used market returns from January 1926 to December 1965. The second period used returns from February 1926 to January 1966 and so on until the last period which used returns from January 1971 to December 2010. Your plan never ran out of money.			
2	**Accumulation at 2.00% Expense**	40%	60%	0%
	We evaluated 541 40-year periods of market returns from 1926 to 2010. Your portfolio met your goals and had a targeted ending value of at least $1,037, 695 at age 65 in 215 of these periods, or 40%. The first 40 year period used market returns from January 1926 to December 1965. The second period used returns from February 1926 to January 1966 and so on until the last period which used returns from January 1971 to December 2010. Your plan never ran out of money.			
3	**Reduction in Assets at 2% Fee**	83%	17%	0%
	We evaluated 541 40-year periods of market returns from 1926 to 2010. Your portfolio met your goals and had a targeted ending value of at least $721,000 at age 65 in 449 of these periods, or 83%. The first 40 year period used market returns from January 1926 to December 1965. The second period used returns from February 1926 to January 1966 and so on until the last period which used returns from January 1971 to December 2010. Your plan never ran out of money.			
4	**Add'l Savings Needed at 2.00% Expense**	83%	17%	0%
	We evaluated 541 40-year periods of market returns from 1926 to 2010. Your portfolio met your goals and had a targeted ending value of at least $1,037,695 at age 65 in 451 of these periods, or 83%. The first 40 year period used market returns from January 1926 to December 1965. The second period used returns from February 1926 to January 1966 and so on until the last period which used returns from January 1971 to December 2010. Your plan never ran out of money.			

Think of Your Retirement Plan Savings and Expenses Like a Mortgage

Most people, if they qualify for good terms and have sufficient equity in their homes, would refinance if it would make a significant difference in their mortgage payment.

When you shop for a mortgage, you obviously pay some attention to the interest rate and the resulting payment amount. This is completely analogous to your retirement savings. *In a mortgage, you are financing the purchase of a home. In retirement planning, you are financing the purchase of a retirement income.* In a mortgage, the interest rate you pay will impact the cost of your monthly payments and your total interest cost over the life of the loan. In a retirement plan, the expenses you pay will impact the cost of the savings needed to fund your retirement and the total amount you will be able to accumulate. It is all just simple math.

Take the example of our diligent 25 year old saving $7,500 a year ($625 a month) until retirement at age 65. That equates to the principal and interest payments for a 30 year mortgage at 4.5 percent of $121,350. To make up for the 2 percent fee instead

of a 0.50 percent fee, she'd have to save $3,500 more a year. **This is the equivalent of a mortgage rate of 8.13 percent for that same $121,350!** Alternatively, at 4.5 percent interest it is the equivalent of a $180,914 mortgage, instead of $121,350. The only difference between these mortgage examples and the retirement savings examples for our diligent 25 year old is that the savings are inflation adjusted instead of being fixed, and that instead of 30 years for the mortgage the higher retirement savings lasts for 40 years.

Would you be indifferent about paying 8.13 percent interest on your mortgage if you could easily get a mortgage at 4.5 percent? Of course not. Then why would you be indifferent about the cost to finance your retirement?

It may just be time to refinance your retirement planning.

Not All Fees Are Bad

When this book was originally released, I received a lot of hate mail from financial advisors and retirement plan product vendors. There were two things they were upset about. First, most did not appreciate me exposing how they were hiding their expenses and empowering the public to discover them. The new disclosures will eventually solve this problem for most participants, so they can blame the regulators instead of me on this point. The other thing they were upset about was "denying them a living." This came mostly from financial advisors that cried they "work hard" for their "meager" earnings, and suggesting that retirement plans should have expenses that are more reasonable, in the 0.50 percent to 0.75 percent range would eliminate their income. What the advisors did not realize is that THEY are being victimized by the product vendors too!

For most corporate retirement plans that have more than just a few million dollars, many advisors are lucky to earn 0.25 percent to 0.60 percent on the plan. For this they do enrollment meetings, select and monitor the funds that are available, and replace funds that "go bad" (meaning underperform). Some advisors even do one on one personal consultations with participants to help them select an "appropriate" allocation based on the participants' "risk tolerance" and help them select the funds or portfolios. In some rare circumstances, advisors actually meet individually with participants on an ongoing basis, offering some form of continuous "advice."

The advisors that provide these services believe that they are worth the 0.25 percent to 0.60 percent they receive. Unfortunately, the way the product vendors have them fooled, there is usually an additional cost THE ADVISOR DOES NOT RECEIVE that often equals an additional 0.50 percent to 1.5 percent, depending on the products used. Advisors have been trained to think those additional product expenses are helpful and necessary to participants for the management of funds or the insurance "features" that are part of these products.

But, go back and look at our diligent 25-year-old saver and the historical analysis we did. The worst historical outcome (a 1-in-541 historical chance) with a 0.50 percent total expense had her accumulating at least $2.34 million. This would have been the result if she simply indexed domestic equities and 7- to 10-year treasuries in an 80 percent stock and 20 percent bond portfolio. There are index funds available to even smaller plans with less than $1 million that could construct this portfolio for about 0.11 percent. This would leave the advisor at least 0.39 percent for the fees for his services and keep the total expenses at 0.50 percent. For most advisors, if the plan had total expenses of 0.50 percent, they would be lucky to earn 0.10 percent to 0.20 percent, so the PRODUCT vendors (that the advisors naively believe are their "partners") are costing them somewhere between half to three quarters of their income! Instead, they blame me.

For plans with total expenses of 0.75 percent, the advisor would normally be lucky to earn 0.25 percent to 0.35 percent, because of the expense of their product vendor "partners." But, if they objectively used the lower-cost 0.11 percent expense portfolio, they could earn 0.64 percent, increasing THEIR income by 80 percent to 156 percent. Yet, they blame me . . . and here is why.

The Biggest Expenses Have the Least Value

Just as the vendors have been misleading participants and employers about how much is being scooped out of retirement plans in fees, the product vendors have misled advisors into believing their fees are worthwhile for their "professional management" or insurance "features."

Many advisors believe that the source of their value is based on their attempt to out-perform the markets and that if they play that game, then they won't be employed at all and would not be entitled

to any fee. The product vendors and their firms train them in this mistaken belief.

Going back to our diligent 25-year-old saver, remember that if she simply indexed her portfolio and rebalanced annually, in the worst of 541 historical 40-year periods she would have accumulated $2.34 million. In 83 percent of the historical periods, she would have accumulated more than $3.38 million. This presumes that she indexed and **underperformed the markets every year** by the expenses of 0.50 percent AND NO MORE.

The markets cannot underperform themselves, and EVERY active (aka expensive) manager risks potentially underperforming. This is not knowable in advance, and past records have been academically demonstrated not to be indicative of future results despite the industry's efforts to try to mislead us about this reality.

Take Morningstar for example. They know, and have admitted in their own research papers, that the biggest predictor of relative performance is fees. Their star ratings have little if any predictive power. And it isn't hard to see this. As of this writing, Morningstar ranks the indexed exchange traded fund (ETF) iShares S&P500 Growth (symbol IVW) as being in the top 1 percent of their "Large Growth Peer Group" for the last decade. This means this index fund outperformed 99 percent of all large growth funds, according to Morningstar. This holds true for iShares Russell 3000 Value ETF as well. Morningstar ranks this fund in the top 1 percent of all large value "peers" for the last decade.

Passive pundits will argue this is why you should index. I won't, because that would be misleading. The S&P500 SPDR (symbol SPY) fell where it should over the last decade, at the 50th percentile based on total return. And, somewhat ironically, the iShares S&P500 Large Cap Value ETF fell at the one-hundredth percentile of its supposed "peers" over the last decade.

So which is it? Some index funds fall at the top 1 percent, some in the middle, and some at the bottom 100th percentile. What does it mean? It means only one thing. Morningstar peer rankings (and thus **star ratings**) are comparing apples to oranges and **are thus completely meaningless**. There is effectively no statistical chance that an index fund would out-perform 99 percent of all active funds over a decade. There is likewise effectively no statistical chance that every active manager would outperform the index fund over a decade. **All it shows is that star rankings and "peer groups" are**

nothing more than a misleading shell game. You, and the advisors that believe and regurgitate this sham, are the victims. The product vendors (and Morningstar, or Lipper for that matter) that convince you and the advisors otherwise are laughing all the way to the bank.

Fees are a 100 percent certainty. Future performance is uncertain. Past performance already occurred and you cannot go back in time to capture something that has already occurred. Active management has two things going against it that makes it a statistically stupid endeavor. First, there is a 100 percent certain additional cost that you could avoid. Second, along with the hope of outperformance, which does have SOME chance to occur (choose your odds . . . 50 percent? 40 percent? 25 percent?), there is also a RISK of potential material underperformance, something you can avoid with near certainty by indexing (the market cannot underperform itself).

Advisors that think they are earning their fees by being croupiers in this game have been misled by the product vendors (and their firms) that are likely getting paid more than the advisor that is actually showing up and doing work for the plan.

If you have paid attention to how this game plays out over time in your retirement plan, you may have noticed that top performers are rarely if ever swapped out. After all, why would you replace a fund that is performing excellently? Okay. So when do you replace a fund? Usually, this occurs after the performance is terrible for a few years. Advisors think this is their value. Think about the absurdity in this.

What they say:

> "*We apply diligent research and help you select some of the top-performing funds for your plan, then we closely monitor their performance and replace them with better funds if their performance deteriorates.*"

Sounds pretty good doesn't it? Well, think through logically what this actually means. Would you pay for the reality of what they do? Try this on for size because this is what typically happens in reality, and even the advisors don't realize this is what they are actually doing:

"We pick funds that performed well for others, yet have no idea whether or not they will outperform in the future or not. If they do perform well for you, we will keep them in your plan. If they underperform one year, we will in all likelihood give them

the benefit of the doubt and keep them in place. If they underperform a second year, we will probably put them on a "watch list." If they underperform again for a third year, we will probably replace them with a fund we didn't originally pick for you but did well for others and we will lock in the three years of poor performance for all of your participants. For this, I deserve to be paid well."

By the time you have the 100 percent certain additional cost to overcome, and, the locking in of poor performance for invariably a number of the funds over the years, it is very unlikely that the winners that are picked (either by "skill" or luck) will be able to make up the difference. And, in many cases, the investments may materially underperform, something that an index fund doesn't risk.

For any retirement plan covering a number of employees, there is no reason that the plan for Dick's Cabinet Shop needs to offer different or "custom" selected funds for their plan relative to Sarah's Catering Company. Every employee (regardless of their employer) should have access to low-cost, diversified funds across broad asset classes like domestic stocks, foreign stocks, Treasury bonds, and cash equivalents. From these simple alternatives you can design an array of efficient allocations that accommodate anyone's desire for balancing return and risk, and often pre-designed efficient portfolios can be offered as well. For example, we have six model allocations that range from 30 percent stocks up to 100 percent stocks, and the blended expense ratios for these globally diversified portfolios are around 0.11 percent to 0.13 percent. Add another 0.20 percent to 0.30 percent (depending on the size of the plan) for the responsibility of selecting the funds and keeping the portfolios in balance, and you have total expenses of 0.31 percent to 0.43 percent. A brokerage window (a discount brokerage account) offering just about any investment vehicle rounds out the investment options in case any participant has some peculiar need that the standard offerings don't accommodate for some reason, or, if a participant has a personal advisor that can help them with tax location management across all of their assets.

With this sort of structure, you get the market performance that you probably would get with any other plan at a far lower cost. You'd get participant education meetings in person, online Webinars, recorded Webinars, do-it-yourself risk-assessment kits, daily online Web access with performance reporting for each participant, and so on. Custody and administration costs (more on

these in the next chapter) would be no more than 0.06 percent on assets and $35 dollars a year per participant.

The Missing Link

There is one VERY, VERY valid complaint that I have heard from financial advisors about my focus on fees. That is, most retirement-plan participants don't know whether they should increase their savings, decrease their savings, or whether they can afford to stop contributing to their retirement plan completely. They don't know whether they can comfortably plan on an early retirement at age 59 or whether they should plan to work until they are 68. They don't know whether they can afford to have a very low-risk portfolio (with, say, just 30 percent stocks), or whether the better choice for their goals might be a portfolio with 60 percent or more in stocks. They don't know whether they can comfortably plan on a $35,000 retirement income or $50,000. Lowering the fees won't tell them the answers to these questions. The advisors are right about this. You probably don't know the answers to these questions.

The problem I have with this though is that MOST advisors (not all) don't answer these questions individually for you as a participant in a retirement plan, and, even on the rare occasion when they do, they don't regularly review and change the advice as your goals, priorities, and the markets change your confidence level in exceeding your goals. So while they argue that an advisor is usually needed to help a participant figure this out for their personal situation, in most cases, advisors are not delivering that sort of advice.

Advice about these things is valuable though, because it enables you to make the most of your life based on what you personally value. You may enjoy your job and not want to retire early, so your willingness to work longer can buy you a lower annual savings amount, or less investment risk for example. Conversely, you might prioritize early retirement and be willing to compromise the retirement income from your portfolio from $45,000 to $41,000 if that enables you to retire two years earlier. These goals and priorities are clearly likely to change over time, are completely personal, and cannot be answered in "group education meetings" (that are generally sale pitches more than education) and continuous ongoing advice is the only way to make the most of the one life you have.

This type of advice is not usually offered in a retirement plan. It is personal and custom, and it isn't cheap. It might raise your total costs to 0.85 percent, or maybe even 0.90 percent. But, if it enables you to retire two years sooner, or reduce how much you are saving each year, or spend more in retirement (when you wouldn't have known you could do any of these things) it might be worth it to you to pay the extra price for the service . . . if YOU value it.

That's the problem I have with the advisor's complaints about reducing fees. I don't have a problem with someone individually choosing to pay a fee for something they value. I have a problem with the fee if it is mandated, unnecessary, based on irrational bets, and is positioned in a one-sided misleading presentation. Does the extra 0.50 percent to 1.50 percent you might pay to Putnam, American Funds, or Hartford buy you any of these goals? It might. It might not. It is unknown. If you put a value on making the gamble, you are free to do so in the brokerage window. I just don't think EVERY participant should be forced into playing the same game. Do these companies even know what your goals are and which ones you value more than others? Of course not! What are THEY doing for the fees they are taking out of your retirement plan, and maybe from the advisor's pocket too?

So, my argument with advisors that defend the products as their "source of income" as the argument they use to justify their existence is that the valued advice does not exist in their world either. Their focus is on returns, not wealth and personal goals and priorities. They confuse the two. Instead, if they really wanted to be valuable they should give the sort of continuous advice that participants want, and are willing to individually pay for instead of being a croupier hoping to outperform and locking in underperformance that could have been avoided by indexing.