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Squeeze Play
As Returns Sag, Employers Turn Up Heat on 401(k) Fees

Switching Fund Providers, Or Threatening to Do So, Can Mean Big Savings

Paying the Broker \$100,000

By KEN BROWN and CHRISTOPHER OSTER
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Earlier this year New York law firm Schulte Roth & Zabel LLP did something unexpected for its employees. It persuaded Wachovia Corp. to slash the fees charged by the bank to run Schulte Roth's retirement plan.

Many of Schulte Roth's employees never even realized they were paying fees for their retirement plan. But the reduction will save some employees hundreds of dollars every year, potentially ballooning into tens of thousands of dollars by the time they retire.

The incident highlights a little known truth about one of the most widely held retirement plans, known as the 401(k). Employees with money in many of these plans are paying steep and largely invisible fees that are eating into their quarterly returns and their eventual retirement payout.

By law, employers are supposed to make sure their retirement plans don't overcharge employees. But until recently, few employers took this responsibility seriously. That has changed in the wake of mutual fund scandals, government pressure and the three-year bear market that has eroded many retirement accounts. A growing number of employers are demanding -- and very often winning -- lower management fees.

"If you haven't squeezed your retirement plan provider on fees, chances are they probably are making a little more juice than they need to," says David Bauer, a consultant with Casey, Quirk & Acito LLC, which advises money managers. (See [related article](#).)

First introduced in the early 1980s, 401(k) plans, named for a section of the tax code, allow employers to help their workers build up a nest egg for retirement with big tax advantages. Usually both the employer and employee contribute money to the plan, and each worker decides how to invest the money. While investment choices vary, the majority of plans offer mutual funds -- which tend to charge high fees. The firm running the plan often owns most of the mutual funds it offers, but sometimes it offers funds that are owned by other financial firms.

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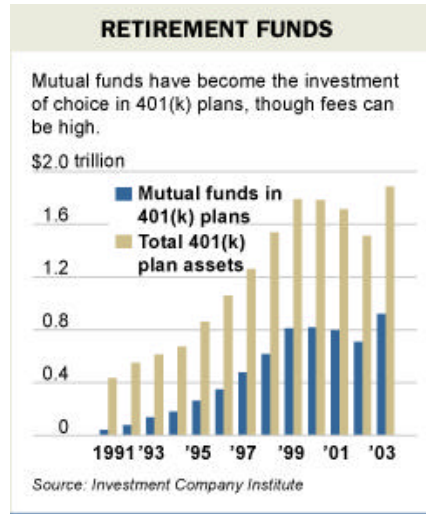


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More than 42 million Americans now have a total of nearly \$1.9 trillion in investment plans, and almost half of that money is in mutual funds.

Investors in 401(k) plans can figure out how much they're paying in fees by arithmetic. Fees are usually a percentage of money invested, a figure that usually ranges from 0.5% to 2%. Plan managers have to disclose this rate in the information booklet prospectuses, sent out to investors when they sign up for a 401(k) plan. So this so-called expense ratio on quarterly statements mailed to investors but not the number of dollars charged that quarter.



Instead, the quarterly statements show how much money their 401(k) made or lost each quarter calculated after the fees are deducted. A quarterly statement shows a gain of 7% before the fees were deducted.

In the absence of pressure from employees, 401(k) plan managers have raked in big profits. Some are earning as high as 80% from the fees they're charging. Tom Gladding, who used to sell 401(k) plans for Fidelity Lynch & Co. and is now a consultant, says plan managers are willing to accept fee cuts if their margins drop to 25% or 30% if an employer threatens to take its retirees elsewhere.

About 27,000 employers are currently looking to replace their plan manager last year, according to a survey done by Fred Barstein, who runs a Web site at 401kexchange.com. More than 400,000 employers offer 401(k) plans.

A weaker stock market has helped make employers more willing to squeeze plan managers. During the long bull market of the 1990s, while 401(k) plans were earning double-digit returns, few investors worried about the expenses at their plan.

This shift coincided with big losses suffered by employees at WorldCom Inc. and Enron Corp., two companies bankrupted by massive accounting scandals, where employees were stuffed with company stock. In the wake of those scandals, the Department of Labor, which regulates 401(k) plans, launched an education campaign in May dubbed "Right," to remind companies that they can get into trouble if they don't stay on top of employees' retirement plans.

The mutual fund scandals of the past year also emboldened companies to challenge the fees that funds charge. Several big fund companies were investigated and fined for improper trading practices, soiling the fund industry's once pristine reputation. In settlements with regulators, several fund companies agreed to reduce fees, further putting the squeeze on the fees they were charging 401(k) plans.

Employers including amusement-park operator Cedar Fair LP, building materials supplier Hughes Supply Inc. and Schulte Roth have cut their 401(k) plan fees either by switching managers or threatening to switch and getting better deals from their current managers.

These employers have used different tactics to negotiate lower fees. They are cutting the money going to brokers who market 401(k) plans. Another tactic focuses on convincing plan managers to pocket for putting independently operated funds into their

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lineup. The Securities and Exchange Commission is separately investigating whether this practice leads plan managers to favor some funds over others. But some employers have found that they can get lower fees by pushing their plan manager to share some of this extra money.

"It was really an eye-opener for us," says Cedar Fair's Chief Financial Officer Bruce A. Jackson. The Sandusky, Ohio-based company was able to save \$300,000 in costs at its \$50 million 401(k) plan after hiring Amvescap PLC to replace its plan manager, KeyCorp, which left the business. Amvescap was willing to share in fees it collected from outside funds.

"We had been at Key Bank for years and we had paid a lot of fees to them and we were not aware they were not only collecting from us, but from the funds," Mr. Jackson adds. Most of the savings will go to the plan's 600 participants. A KeyCorp spokesman said KeyCorp's fees were high because its business strategy was to provide high levels of service.

Schulte Roth was also able to cut the fees for its plan after discovering Wachovia was getting money from some of the outside funds offered in Schulte Roth's plan. The law firm hired Mr. Glading, of Glading Group, to review the plan's costs.

After analyzing the financial details of Schulte Roth's \$58 million plan, Mr. Glading concluded that the law firm could get a better deal. In talks with the bank, however, Wachovia insisted it was barely making any money on the plan. "It's the response I always get," says Mr. Glading. "It's the response I always gave," he adds, when he sat on the other side of the table while working for Merrill.

Schulte Roth put its plan out for bid. The bids that came in from Wachovia's rivals confirmed Mr. Glading's view that the firm could get lower fees elsewhere. It also pushed Wachovia to compromise.

"It's all negotiation -- and these guys are just printing money on some of these plans," Mr. Glading says, although he declined to comment specifically on the Schulte Roth case. Wachovia offered to take an annual pay cut of roughly \$200,000, agreeing to give the law firm some of the money it had been collecting from outside funds included in the plan. Of that money, Schulte is giving about \$100,000 back to employees through lower fees and the law firm is cutting its own plan expenses by \$100,000 to zero.

Fees for the 954 participants in Schulte Roth's plan will drop by different amounts, depending on the size of each employee's retirement account. "This was clearly a benefit to the employees," said Gary Fiebert, the law firm's executive director.

A Wachovia spokeswoman said the bank cut its fees by only about \$100,000 in total and adds that it cut some services as a result. The spokeswoman also disputes that Wachovia's profits had been too high.

When 401(k) plans were first introduced, employers divided up the management functions between different institutions. Employers generally hired an administrator to keep the records, send out statements and educate employees. They separately hired money managers to invest the funds. Fees were paid mainly by employers, who negotiated to keep them low.

In the late 1980s, mutual-fund firms began offering to handle both the money-management and the administrative functions. Not only was this a simpler arrangement for employers, it also appeared to be cheaper: The financial firms offered to take on the work without charging employers. Instead the fund firms began quietly billing employees by taking money out of their 401(k) accounts.

The problem with this arrangement is that it makes it difficult for companies to figure out how

much their plans are paying, and where the money is going. Hughes Supply brought in a consultant, Steven Gissiner of Clark Consulting, to analyze its plan. Mr. Gissiner says the plan's manager had Hughes paying a broker more than \$100,000 a year -- for little more than attending four one-hour meetings with the company every year. Hughes' plan serves 5,000 employees and has \$135 million in it.

Richard Tunno, Hughes's compensation director, fired the broker. "He would show up once a quarter for an hour, dash in and dash out," Mr. Tunno says.

Hughes had less success getting its plan manager, Putnam Investments, to cut its fees. Mr. Gissiner estimated Hughes's plan was paying Putnam the same rates as individuals with just a few thousand dollars to invest, compared with the lower rates reserved for institutions that invest millions of dollars at a time. If Hughes's plan paid the same as big institutions, its fees would come down as much as 25% on its funds, or more than \$100,000, Mr. Gissiner says. But when Mr. Tunno met with Putnam executives in Boston last month, Putnam convinced Mr. Tunno it wasn't overcharging his company's plan.

Joseph Craven, director of institutional retirement services at Putnam, says Putnam doesn't discuss client relationships.

The 401(k) business has gotten so competitive that even company plans that pay low fees can get a break. The Hanford Site Savings Plan runs the 401(k) for workers from private companies carrying out the cleanup effort at the U.S. Department of Energy's nuclear site. It was paying an average of just 0.41% of the money in its \$800 million plan. The plan, which covers about 10,000 current and retired workers, was able to cut its fees earlier this year to an average of 0.32% by putting it out for bid. "The participants don't see these fees, except through a reduced investment return," said Mike Hradec, the plan administrator.

The plan switched over to Vanguard Group in April, but not before squeezing the fund manager, which is known for its low fees. Vanguard had wanted to charge participants when they borrowed from their accounts. "We took that off the table," Mr. Hradec said. Vanguard had also proposed charging more for one type of fund than the plan had been paying before but backed down. "A lot of companies would be surprised at how much money is on the table," he said.

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