

Part V The 401(k) Plan

Internal Revenue Code Section 401(k) was quietly slipped into the code by the Revenue Act of 1978, mainly to clear up a dispute over the taxation of profit-sharing plans. The section says, basically, that an employee savings plan can include a cash or deferred arrangement as long as the plan is designed to benefit low-paid as well as high-paid employees, among a few other requirements. Cash or deferred arrangements – CODAs – were deals in which employees had the choice of taking their profit-sharing bonuses in cash (and owing taxes on them that year) or putting them into their savings plans and postponing their tax bill.

A pension consultant, R. Theodore Benna saw the promise buried in the technical details of this Section. He had two key insights:

- He recognized that nothing in the law forbade an employer from applying CODAs to regular salary rather than just bonuses.
- He also saw that companies could chip in extra money to the plan to encourage employees to save, thus helping to ensure that the plan would serve all employees.

While Benna's inspiration complied with the letter of the law, it was so novel that no one could be sure it would win the approval of the Internal Revenue Service. As a test case, his company, Johnson Companies, set up a savings plan modeled on his idea. In November 1981 the IRS finally gave the design the green light.

Benna could not possibly have anticipated how his brainchild would flourish. According to estimates in the late 90s, more than 24 million employees at some 210,000 companies were eligible to participate in 401(k) plans. Three-quarters of those workers were taking advantage of the opportunity, and many of them have already racked up impressive savings. The average active employee in a plan has more than \$28,000 in his or her account. Nearly 10% of them have more than \$50,000.

To a cost-conscious corporate treasurer, 401(k) plans are the perfect retirement benefit. Compared to traditional pensions:

- they are less expensive to administer (about \$89 per employee in a small company, compared with as much as \$500 for a pension)
- they are easier for employees to understand and appreciate

- they absolve the employer of any responsibility to make sure that employees take any specific amount of money with them when they retire

In a 401(k) plan, it is up to the employee to make sure he or she has enough money when they retire. This aspect requires a radical change in thinking. The payoff that the employee gets from the company retirement plan depends first of all upon the employee. If he or she do not take the initiative to contribute to the plan, it will do nothing for them at all. If the employee does not invest wisely, the plan will never live up to its potential.

Basics of the 401(k)

More and more employees are investing in their futures through 401(k) plans. Employees who participate in 401(k) plans assume responsibility for their retirement income by contributing part of their salary and, in many instances, by directing their own investments.

Employees will need to consider the investment objectives, the risk and return characteristics, and the performance over time of each investment option offered by one's plan in order to make sound investment decisions. Fees and expenses are one of the factors that will affect one's investment returns and will impact his retirement income.

In a 401(k) plan, one's account balance will determine the amount of retirement income he will receive from the plan. While contributions to one's account and the earnings on his investments will increase his retirement income, fees and expenses paid by his plan may substantially reduce the growth in his account. The following example demonstrates how fees and expenses can impact one's account:

- Tom is an employee with 35 years until retirement and a current 401(k) account balance of \$25,000. If returns on investments in Tom's account over the next 35 years average 7 percent and fees and expenses reduce his average returns by 0.5 percent, his account balance will grow to \$227,000 at retirement, even if there are no further contributions to his account. If fees and expenses are 1.5 percent, however, his account balance will grow to only \$163,000. The 1 percent difference in fees and expenses would reduce his account balance at retirement by 28 percent.

In recent years, there has been a dramatic increase in the number of investment options typically offered under 401(k) plans as well as the level and types of services provided to participants. These changes give today's employees who direct their 401(k) investments greater opportunity than ever before to affect their retirement savings. The employee may

welcome the variety of investment alternatives and the additional services, but he may not be aware of their cost. As shown above, the cumulative effect of the fees and expenses on his retirement savings can be substantial.

Employer's Responsibility

An employee should be aware that his employer also has a specific obligation to consider the fees and expenses paid by the plan. ERISA requires employers to follow certain rules in managing 401(k) plans. Employers are held to a high standard of care and diligence and must discharge their duties solely in the interest of the plan participants and their beneficiaries. Among other things, this means that employers must:

- Establish a prudent process for selecting investment alternatives and service providers
- Ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of services provided
- Select investment alternatives that are prudent and adequately diversified
- Monitor investment alternatives and service providers once selected to see that they continue to be appropriate choices

Plan Fees

401(k) plan fees and expenses generally fall into three categories:

Plan Administration Fees

The day-to-day operation of a 401(k) plan involves expenses for basic administrative services (plan record keeping, accounting, legal and trustee services) that are necessary for administering the plan as a whole. Today a 401(k) plan also may offer a host of additional services, such as telephone voice response systems, access to a customer service representative, educational seminars, retirement planning software, investment advice, electronic access to plan information, daily valuation and on-line transactions.

In some instances, the costs of these administrative services will be covered by investment fees that are deducted directly from investment returns. Otherwise, if administrative costs are separately charged, they will be borne either by the employer or charged directly against the assets of the plan. When paid directly by the plan, administrative fees are either allocated among individual accounts in proportion to each account balance (i.e., participants with larger account balances pay more of the allocated expenses) or passed through as a flat fee

against each participant's account. Either way, generally the more services provided, the higher the fees.

Investment Fees

By far the largest component of 401(k) plan fees and expenses is associated with managing plan investments. Fees for investment management and other investment-related services generally are assessed as a percentage of assets invested. The employee should pay attention to these fees. They pay for them in the form of an indirect charge against the account because they are deducted directly from investment returns. The net total return is the return after these fees have been deducted. For this reason, these fees, which are not specifically identified on statements of investments, may not be immediately apparent.

Individual Service Fees

In addition to overall administrative expenses, there may be individual service fees associated with optional features offered under a 401(k) plan. Individual service fees are charged separately to the accounts of individuals who choose to take advantage of a particular plan feature. For example, individual service fees may be charged to a participant for taking a loan from the plan or for executing participant investment directions.

Investments and Services

401(k) plan investments and services may be provided through a variety of arrangements:

- Employers may directly provide, or separately negotiate for, some or all of the various services and investment alternatives offered under their 401(k) plans (sometimes referred to as an unbundled arrangement). The expenses of each provider (i.e., investment manager, trustee, record keeper, communications firm) are charged separately.
- In many plans, some or all of the various services and investment alternatives may be offered by one provider for a fee paid to that provider (sometimes referred to as a bundled arrangement). The provider will then pay out of that fee any other service providers that it may have contracted to provide the services.
- Some plans may use an arrangement that combines a single provider for certain services, such as administrative services, with a number of providers for investment options.

Investment Fees

Apart from fees charged for administration of the plan itself, there are three basic types of fees that may be charged in connection with investment alternatives in a 401(k) plan. These fees, which can be referred to by different terms, include:

Sales Charges (also known as loads or commissions)

These are basically transaction costs for the buying and selling of shares. They may be computed in different ways, depending upon the particular investment product.

Management Fees (also known as investment advisory fees or account maintenance fees)

These are ongoing charges for managing the assets of the investment fund. They are generally stated as a percentage of the amount of assets invested in the fund. Sometimes management fees may be used to cover administrative expenses. One should know that the level of management fees can vary widely, depending on the investment manager and the nature of the investment product. Investment products that require significant management, research and monitoring services generally will have higher fees.

Other Fees

This category covers services, such as record keeping, furnishing statements, toll-free telephone numbers and investment advice, involved in the day-to-day management of investment products. They may be stated either as a flat fee or as a percentage of the amount of assets invested in the fund.

Mechanics of the 401(k)

Most investments offered under 401(k) plans today pool the money of a large number of individual investors. Pooling money makes it possible for individual participants to diversify investments, to benefit from economies of scale and to lower their transaction costs. These funds may invest in stocks, bonds, real estate and other investments. Larger plans, by virtue of their size, are more likely to pool investments on their own -- for example, by using a separate account held with a financial institution. Smaller plans generally invest in commingled pooled investment vehicles offered by financial institutions, such as banks, insurance companies or mutual funds. Generally, investment-related fees (usually charged as a percentage of assets invested) are paid by the participant.

Common Investments

Mutual Funds

Mutual funds pool and invest the money of many people. Each investor owns shares in the mutual fund that represent a part of the mutual fund's holdings. The portfolio of securities held by a mutual fund is managed by a professional investment adviser following a specific investment policy. Some mutual funds assess sales charges. These charges may be paid:

- when one invests in a fund (known as a front-end load)
- when he sells shares (known as a back-end load, deferred sales charge or redemption fee)

A front-end load is deducted up front and, therefore, reduces the amount of one's initial investment. A back-end load is determined by how long one keeps his investment. There are various types of back-end loads, including some that decrease and eventually disappear over time. A back-end load is paid when the shares are sold (i.e., if one decides to sell a fund share when a back-end load is in effect, he will be charged the load).

Mutual funds also may charge what are known as Rule 12b-1 fees, which are ongoing fees paid out of fund assets. Rule 12b-1 fees may be used to pay commissions to brokers and other salespersons, to pay for advertising and other costs of promoting the fund to investors and to pay various service providers to a 401(k) plan pursuant to a bundled services arrangement. They are usually between 0.25 percent and 1.00 percent of assets annually. Some mutual funds may be advertised as "no load" funds. This can mean that there is no front- or back-end load. However, there may be a small 12b-1 fee.

Collective Investment Funds

A collective investment fund is a trust fund managed by a bank or trust company that pools investments of 401(k) plans and other similar investors. Each investor has a proportionate interest in the trust fund assets. For example, if a collective investment fund holds \$10 million in assets and one's investment in the fund is \$10,000, he or she has a 0.1 percent interest in the fund. Like mutual funds, collective investment funds may have different investment objectives. There are no front- or back-end fees associated with a collective investment fund, but there are investment management and administrative fees.

Variable Annuities

Insurance companies frequently offer a range of investment alternatives for 401(k) plans through a group variable annuity contract between an insurance company and an employer on behalf of a plan. The variable annuity contract "wraps" around investment alternatives,

often a number of mutual funds. Participants select from among the investment alternatives offered, and the returns to their individual accounts vary with their choice of investments. Variable annuities also include one or more insurance elements, which are not present in other investment alternatives. Generally, these elements include an annuity feature, interest and expense guarantees and any death benefit provided during the term of the contract. In addition to investment management fees and administration fees, one may find these fees:

- Insurance-related charges are associated with investment alternatives that include an insurance component. They include items such as sales expenses, mortality risk charges and the cost of issuing and administering contracts.
- Surrender and transfer charges are fees an insurance company may charge when an employer terminates a contract (in other words, withdraws the plan's investment) before the term of the contract expires or if one withdraws an amount from the contract. This fee may be imposed if these events occur before the expiration of a stated period and commonly decrease and disappear over time. It is similar to an early withdrawal penalty on a bank certificate of deposit or to a back-end load or redemption fee charged by some mutual funds.
- Pooled guaranteed investment contract (GIC) funds. A common fixed income investment option, a pooled GIC fund generally includes a number of contracts issued by an insurance company or bank paying an interest rate that blends the fixed interest rates of each of the GICs included in the pool. There are investment management and administrative fees associated with the pooled GIC fund.

Documents

If one's plan permits the employee to direct the investment of assets in their account, the plan administrator should provide copies of documents describing investment management and other fees associated with each of the investment alternatives available to the employee (i.e., a prospectus). The plan administrator should also provide a description of any transaction fees and expenses that will be charged against the account balance in connection with the investments that the employee directs.

Account Statement

The account statement will show the total assets in account, how they are invested and any increases (or decreases) in his investments during the period covered by the statement. It may also show administrative expenses charged to the account. Account statements will be provided once a year upon request, unless the plan document provides otherwise.

Summary Plan Description

One's 401(k) plan's summary plan description (SPD) will tell him what the plan provides and how it operates. It may tell him if administrative expenses are paid by his plan, rather than by his employer, and how those expenses are allocated among plan participants. A copy of the SPD is furnished to participants when they join a plan and every 5 years if there are material modifications or every 10 years if there is no modification.

Annual Report

The plan's annual report (Form 5500 series) contains information regarding the plan assets, liabilities, income and expenses and shows the aggregate administrative fees and other expenses paid by the plan. However, it will not show expenses deducted from investment results or fees and expenses paid by one's individual account. Fees paid by the employer also will not be shown. The summary annual report, which summarizes the annual report information, is distributed each year.

Fund Management

Funds that are **actively managed** (i.e., funds with an investment adviser who continually researches, monitors and actively trades the holdings of the fund to seek a higher return than the market) generally have higher fees. The higher fees are associated with the more active management provided and sales charges from the higher level of trading activity. While actively managed funds seek to provide higher returns than the market, neither active management nor higher fees necessarily guarantee higher returns.

Funds that are **passively managed** generally have lower management fees. Passively managed funds seek to obtain the investment results of an established market index, such as the Standard and Poor's 500, by duplicating the holdings included in the index. Thus, passively managed funds require little research or trading activity.

Employee Influence

Employees can make a difference when it comes to their retirement plan. There are seven ways in which employees can change their retirement plan if they want.

- Get Involved -- Although one's 401(k) may seem set in stone, the reality is that plans change fairly often. A study by the Investment Company Institute, a mutual fund trade group, found that about one in 10 companies with a 401(k) reported that it was likely to switch investment managers the following year. Almost one in every five

- companies expected to add new investment options. One's company may be contemplating just such a change, in which case it might be ripe for employee input. Experts in this field insist that employees should get involved. It is their plan. They need to ask for what they want.
- **Speak Up** -- letting oneself be heard is the first step toward convincing the company it has a problem with its retirement plan. Many employees are confused and unhappy, but are too intimidated to do anything at all. If one voices concerns about the plan, he or she may find out there's a solution they did not know about. Or, they may discover that their concerns are widespread, in which case they will find allies in the battle for change.
 - **Enlist the Benefits Director** -- The administrator in charge of one's company's benefit plans may seem like the enemy. But often, big decisions about the retirement plan are made higher up. Indeed, the benefits department may see as many holes in the plan as the employee does and can be highly supportive in the efforts to convince management there's a problem.
 - **Do One's Own Research** – If one wants to add a mutual fund, call the mutual fund company and get some information on management style and performance history. Build a case why that fund meets the needs of employees like oneself. Find out what some of one's firm's competitors do in matching funds. Currently, about 85% of plans match some or all of employee contributions, according to consulting firm KPMG. Forty percent of companies the firm surveyed match 50% of employee contributions, 16% match 25% of employee contributions and 13% match 100%. Of the plans that provide matching funds, the average limit on the amount of employee contributions eligible for matching was 6.5% of pay. Such information can help bolster an argument that the employee has that their company's retirement plan is non-competitive.
 - **Organize**-- If one has no success with the benefits department, the next step is to solicit help from a company-sponsored employee group. If they work in a union shop, one should talk to their union representative. If the company has an employee representative on its benefits committee, the worker should talk to that person. One can also begin a grassroots movement by organizing colleagues to write the benefits department or otherwise complain to those in administration.
 - **Go to the Top** -- As a last resort, one should go directly to the company president or the top executive in charge of benefits.

- **Be Patient** – It is important to remember that this process doesn't happen overnight. It could take as long as a year of persistent effort to get anybody to budge. And even if one's company does decide it wants to change, it might not be in exactly the way one wanted. It will likely also take time for the company to research the options for itself and cut the requisite deals to make the changes a reality. Altering one's retirement plan is not to be taken lightly -- but the payoff can last a long time.

Loans

Currently, about 82% of 401(k) plans have loan provisions. That means one can borrow money from their nest egg and pay it back to without incurring penalties. Typically one is allowed to borrow up to half of their vested account balance, but not more than \$50,000. They have five years to pay back the loan, usually at competitive interest rates, and sometimes they can take even longer if the money is going for the down payment on a primary residence.

Most companies do not restrict how one uses the money. There is no credit check since the funds in one's account serve as collateral and many of the bigger plans now are automated, so all the employee has to do is call in the loan request, and they will be sent a check in a few days.

One pays interest as well as the principal on the loan to themselves, usually through an automatic payroll deduction. Plans are required to charge a market rate (usually prime plus one or two percentage points), but funds go right back into the account.

Financial advisors do not recommend doing this unless the employee absolutely has to. The whole point of saving money in a 401(k) is to leave it invested so it will grow tax-free until one stops working. Yes, the employee is paying themselves interest instead of giving that money to a bank, but if the nest egg was left whole and invested in equities, they would likely be making much better returns and the income would compound tax-free. Moreover, if one runs into trouble, it is their retirement at risk. If they lose their job or leave for a better opportunity, the loan becomes due immediately. If they cannot pay it back, it is treated as an early withdrawal and penalties and taxes will eat up the savings. One should not even consider taking out a loan unless they are very sure they will be in the job for the term of the loan.

Financial planners note that a disturbingly large percentage of 401(k) loans are used for things like vacations and big-ticket purchases. If one is young and has the self-discipline to pay the loan back in five years, they probably won't damage their eventual nest egg that

much. But they do lose five years of compounding and often people overestimate how disciplined they are.

About 82% of workers with 401(k)s can borrow from their plans for whatever purpose they choose. And, thanks to huge gains in the stock market, that puts a lot of cash at one's fingertips. It certainly doesn't make sense to use this money for luxuries like a backyard swimming pool or a new car. But does it make sense to tap one's 401(k) to pay off a loan?

Typical plans allow one to borrow up to half of the vested balance, but not more than \$50,000. They must pay the money back, with interest, over five years. But, because the employee is paying the interest to themselves, it isn't an additional cost. Just think of it as forced savings. If one doesn't repay the loan, they will owe income tax and a 10% early withdrawal penalty.

There are three negatives to borrowing from a 401(k).

- One is giving up the tax-free compounding of the money they withdraw.
- Second, the worker is replacing pretax money with after-tax money. If they are in the 28% tax bracket, it will take \$1.39 in salary to replace the \$1 withdrawn from the 401(k) plan.
- If they leave their current employer, They will probably have to pay the loan back immediately.

Changing Jobs

Let's say Sam is making \$75,000 at his current job, and he contributes 10% of his salary to the firm's 401(k) large-cap fund option. The plan matches his \$7,500 with 50 cents on the dollar, or \$3,750. And since he saves \$2,325 in taxes every year, he has been able to put most or all of that away for his kid's education.

Then he gets a job offer from a startup firm with a 20% raise, bringing his salary to \$90,000. But there is no 401(k). So how much of a raise is Sam really getting?

Some of the disadvantages are immediately obvious. He will lose the \$3,750 in matching contributions. That means the raise is really only \$11,250. And then there's the tax savings. He can now open a deductible IRA, something he was not eligible for before because he was already covered by a plan, but there's a \$2,000 limit on that. That means he will have only \$620 in tax savings, \$1,705 less than he now has -- which shrinks his raise even further, to \$9,545.

But that is not all. He still wants to save for retirement and his kid's education. But now he will have to save more because he has lost the benefit of tax-free compounding. The after-tax rate of return each year on a taxable account can be more than one percentage point lower. After Sam adds everything up, he will discover that if he keeps his money invested for 20 years, \$7,964 of his new raise will go to replacing the cost of the 401(k) program he is giving up. That means the new position is really only a 9.4% improvement on his current job.

Finally, participants on employer-sponsored qualified retirement plans must be alert to their vesting schedule. Vesting refers to the employee's ownership of his own plan assets.

All recent plans, especially defined contribution plans, adhere to one of two approved vesting schedules. Older defined benefit plans may have different schedules.

With either schedule employees are always 100 per cent vested in their own contributions and any interest attributable to their own contributions.

One schedule is called 5-year cliff vesting. Under 5-year cliff vesting employees are not vested until they have been participants for 5 consecutive years, then they immediately become 100 per cent vested in all employer contributions (and the attributable interest). From then on they will always be 100 per cent vested in both their own and employer contributions and interest.

The alternative schedule is 7-year step vesting. Under this employees are not vested for the two years after they become participants and then vest at a rate of 20 per cent a year for the next five years until they are also 100 per cent vested. Again, from that point on they will always be 100 per cent vested in both their own and any employer contributions.

It is the employer's prerogative to elect a schedule, although it is very difficult and costly to change one. The IRS has determined that the two alternative schedules are substantially equal for the majority of taxpayers and employees, although not every taxpayer will be affected equally by both.

Top-heavy plans, those with a disproportionate participation by highly-compensated employees, have separate vesting rules—either 3-year cliff vesting, or 6-year step vesting. The IRS determines when a plan is top-heavy and this test is applied annually.

Unvested employer contributions left behind by departing participants are called plan forfeitures and must be allocated equitably among all remaining participants. Sometimes a plan's forfeitures will exceed its interest earnings for one year.

Employers must report the per cent of vesting to each plan participant at the end of each year.