



CATERPILLAR HAD A NIFTY idea for managing its employees' 401(k) assets. Instead of bringing in an outside investment firm, the bulldozer behemoth set up its own, the Preferred Group of Mutual Funds. Caterpillar then funneled \$1.3 billion into it, charging workers fees that were quite ample, if not out of line with averages in the mutual fund industry: 1.12% annually for a value fund, 1.54% for an international growth fund and so on.

After a decade and a half of this arrangement Caterpillar this year decided to dismantle the in-house shop; the assets will presumably wind up with a mainstream fund vendor. In September lawyers filed a class action against Caterpillar, charging that the company had used Preferred to profit illegally from its employees' retirement accounts, in violation of federal law requiring that 401(k) plans must solely benefit workers, not their companies. A Caterpillar spokesman denies wrongdoing and declines further comment.

The Caterpillar suit is one of several filed recently accusing big corporations, including Boeing, Kraft and International Paper, of failing to offer employees a fair shake in their 401(k) plans.

The accusations in many of these suits are of this nature: The plan fees are too high, or the fees are buried deep in disclosure doc-

Retirement Rip-Off

True or false: Your 401(k) plan is costing you more than \$1,000 a year. If you can't answer that question you're like a lot of Americans |

By Neil Weinberg

ALLISON SEIFER FOR FORBES

uments where they are all but impossible to tally or are not revealed at all, or the providers are tainted by conflicts of interest or even de facto pay-for-play kickbacks.

Such payments are at the center of a suit alleging that General Dynamics let its outside 401(k) administrators secretly move around assets to benefit themselves rather than employees. Northrop Grumman faces claims its workers were charged for active management despite investing in glorified index funds that should have cost them far less. Ten or so such suits, all filed by the same law firm in St. Louis, Mo., depict the fees as “complicated and confusing” or “excessive, undisclosed, and illegal.”

The legal assault has sent shivers through some parts of the corporate world. “These suits are a big deal because, potentially, they apply to every employer,” says Gregory Ash of law firm Spencer Fane Britt & Browne in Kansas City, Mo. He defends employers sued under federal ERISA (Employee Retirement Income Security Act) rules. The new cases “point out the fairly high degree of ignorance about 401(k) fees,” says Ash, who has received a sharp rise in calls from firms suddenly jittery about plan liability since the suits started popping up this year.

Roughly 40 million Americans, or two-thirds of the private-sector workforce participating in a retirement plan, have only a 401(k). In 1980 that was the case for only a fifth of workers. Some big companies get competitive bids for their 401(k) business, landing low-cost funds from Fidelity, Vanguard and other vendors. But subpar offerings are a common problem at small companies, where fees often gobble up 2% to 3% of assets each year. For a worker investing in a conservative blend of stocks and bonds, a 2.5% cost wipes out a significant fraction—perhaps half—of the real return that can be expected. “Costs in this industry are way out of line,” says Gregory Carpenter, chief executive of Employee Fiduciary, a firm that runs 401(k) plans at a fraction of the usual cost (see box, p. 138).

Small businesses sponsor the majority of the nation’s 650,000 401(k) plans; 97% of such plans have assets of less than

\$10 million. Because of high fees the returns on this country’s \$2.9 trillion of defined contribution assets lag behind returns on traditional pension plans by one percentage point a year, estimates the Center for Retirement Research at Boston College. That one-point difference equates to \$29 billion a year in fees that otherwise might have gone toward retirement savings.

Why don’t employers shop around for better deals? Partly because their own

plan sponsors [employers] have not calculated and do not know the actual cost of running the plan,” a U.S. Labor Department study group noted in 2004. “This ‘out of sight, out of mind’ mentality is particularly dangerous in asset-based fee arrangements, because as the account balances grow, so do the fees, regardless of whether additional services are provided.” Officials now are drafting rules to force administrators to reveal more about the fees.

The outfits vying to run 401(k) plans often do so by offering them at low or no cost to corporations, only 37% of which pay anything toward their upkeep, according to Deloitte Consulting. Plan administrators then make up the shortfall in two ways: by quietly deducting various fees from employees’ accounts; and by charging mutual funds for shelf space in the plan.

Marty P. VanDriel, general manager of TriVan Truck Body, a custom truckmaker in Ferndale, Wash., decided earlier this year to set up a 401(k) to help retain skilled welders and fabricators in a tight labor market. A

stockbroker presented him with a Principal Security Builder Retirement Program. Principal Financial is the largest operator of small-company 401(k) plans, with 30,000 under management.

Based on the glossy brochures presented to him, VanDriel assumed the total cost of the plan would be total employer fees of \$500 up front and \$1,500 a year. Only when he received a competing bid did he realize his employees also would pay top dollar for mutual funds under Principal’s plan. Among those listed was Alliance Capital’s Large-Cap Value fund at 2.29% a year—two and a half times what a cheaper share class costs.

One reason Principal’s 401(k) fees are so high is that, like many such plans, they include a 12b-1 commission for the salesman and a “sub-transfer agent” fee that fund firms pay to Principal. VanDriel says he didn’t understand that Principal gets paid by the fund

By the Numbers

Paying Retail

Even as 401(k) balances grow in size and importance, fees remain high and poorly disclosed.

\$2.9 trillion

Savings in 401(k)-type accounts.

1% Amount by which 401(k) fees are estimated to exceed those of traditional pension funds.

\$29 billion

Cost of those excess fees to 401(k) savers.

Source: Center for Retirement Research at Boston College.

money is not at stake. The company may pick up some recordkeeping costs, but the fees on the underlying funds are almost always borne by the workers. “Employers have a legal duty to oversee 401(k)s with the same care they do traditional pensions, but the incentive isn’t there because employees bear the brunt of the costs,” says Jerome Schlichter, whose firm, Schlichter, Bogard & Denton of St. Louis, is pushing the spate of recent suits.

And why don’t workers squawk—or, if given choices, go for the cheapest funds offered? “Fees in these plans are not transparent, and without transparency it’s hard for employers or participants to come up with low-fee options,” says Alicia Munnell, director of Boston College’s retirement research center.

Another problem: Mutual funds peg fees to account balances, which have tripled in a decade. “The vast majority of

firms whose mutual funds it recommends. He took a pass on its plan.

A Principal 401(k) proposal submitted to a builder in the Southeast with 40 employees was headlined by a \$1,000 setup fee and \$2,904 flat annual charge. In the small print on another page of 24 "Assumptions" was the fact that the plan proposal doesn't include investment management fees. Another assumption states "Compensation scale: Dep./asset 100/25 standard H." Translation: The selling broker will pocket 1% of the 401(k) assets invested as an upfront "kill fee"—lingo for bagging a new account—plus 0.25% a year for the life of the plan. Principal insists it adequately discloses its fees. "It is our policy to communicate the cost of operating retirement savings plans to our plan sponsor clients."

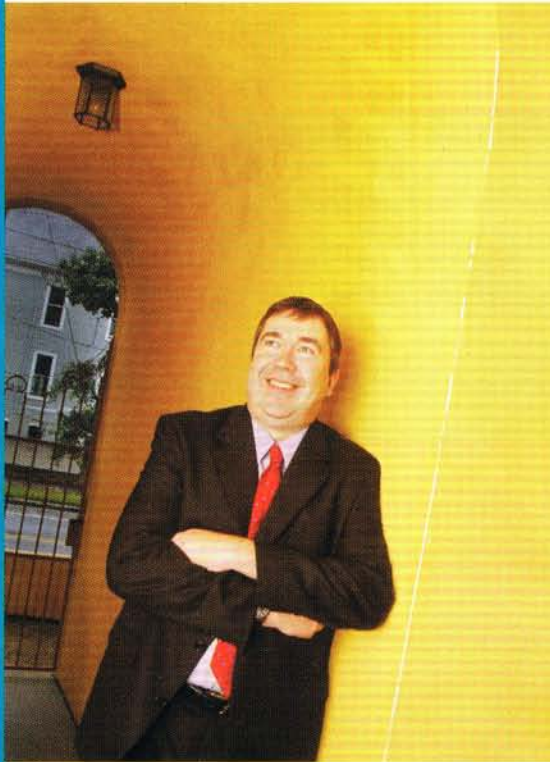
John Walton, who owns a highway construction outfit in Mobile, Ala., set up a 401(k) for a few dozen employees four years ago with a large insurer. Over time the firm withdrew outside investment choices, such as Janus and Oppenheimer, until only its own mutual funds remained in the plan. Walton eventually realized his workers were paying nearly 3% of assets a year in expenses and took his business elsewhere.

"With all the hidden fees inside what the mutual funds were charging, half our returns were going to expenses," he says.

Bisys, a 401(k) and fund administrator, was accused of misusing \$230 million in fees from mutual fund investors by overcharging for recordkeeping services and then kicking back some of the money to 27 fund advisers. In September its fund-services arm settled charges filed by the Securities & Exchange Commission, agreeing to pay \$21 million. Bisys and the SEC declined to name the fund advisers.

As it does with mutual funds outside of retirement plans, Bisys takes payments from most fund firms in the 401(k) plans it sells, although it won't say how much and doesn't spell out the payments in plan documents. Instead, Bisys tells employers whose 401(k) plans it runs that it "may receive fees from funds." Employees inquisitive enough to dig through Bisys' 401(k) prospectuses will find the potentially compromising fees lumped in with other administrative charges.

FIDUCIARY REVOLUTIONARY



Greg Carpenter: giving the little guys a break.

Employee Fiduciary has a dull-sounding name but a revolutionary business concept: namely, that the standard corporate 401(k) is a rip-off. This company aims to fix that.

In the small-company market, where insurers and so-called third-party administrators dominate, annual fees typically run to 2% to 3% of a retirement account's assets. At big employers, especially those with high per-worker balances, low-cost options are more common, although sometimes the worker has to hunt to find the really cheap funds.

Employee Fiduciary's twist is twofold. Instead

of charging asset-based fees, the three-year-old Mobile, Ala. firm charges employers \$25 per worker, with a \$1,500-a-year minimum to cover operating and regulatory costs. Then, instead of herding participants into investments it has a financial stake in touting, it lets employers create a menu from the entire universe of 36,000 funds and share classes. If they choose funds that pay so-called 12b-1 or other commissions to those who land them business, Employee Fiduciary passes those fees on to 401(k) savers, too. The company even accepts fiduciary responsibility for plans it runs—something most vendors shun.

The fact that it can do all this at a profit, the firm claims, is testament to the abysmal terms offered by most other 401(k) providers. "By selling on a cost-plus basis, instead of based on how much is invested, we can run these plans at a fraction of the usual cost and still make a nice profit," says Chief Executive Greg Carpenter.

Alexander Macaulay, a partner in Richmond, Va. law firm Macaulay & Burtch, had himself and about a dozen employees in a broker-sold MFS plan that was costing 2.1% of assets a year in fees. Macaulay cut that almost 90%, to 0.24%, by switching to Employee Fiduciary and low-cost index funds a year ago. "The fees for our old plan were hard to figure out but colossal," says Macaulay. "Until recently we didn't think we could do anything about it." —N.W.

Bisys is more explicit with sales agents. One sheet distributed to brokers who sell its *LinkinSight* 401(k) plan states that American Funds must make up at least 60% of investment options. "Each product manufacturer constructs its product to best position itself to be suc-

cessful in the marketplace and provide value to the plan sponsor and participants," Bisys explains in a written statement. Given that American Funds pays for play on Bisys' 401(k) menu, it is a safe bet that the arrangement provides plenty of value to Bisys, too.