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What can your 401(k) do for you?

By **David Blanchett**
Columnist: Your Finances

In general, people are not good savers and are not good investors. While we may prefer to think otherwise, academic studies have shown that people aren't saving enough money for retirement and that they tend to overestimate their abilities when it comes to investing. In the past, employees did not generally have to concern themselves with retirement savings and investment decisions, since these decisions were made primarily by their employer (and the government). However, over the last decade, there has been a dramatic shift in the retirement plan industry away from defined benefit plans (where the employer is responsible for providing benefits at retirement) towards defined contribution plans (commonly referred to as 401(k) plans, where each employee or participant is responsible for ensuring their own retirement success).

401(k)s have come a long way since their introduction 25 years ago. There are currently around $3 trillion in 401(k) assets. Technically, a 401(k) is a profit-sharing plan where participants are allowed to make deferrals. The name 401(k) comes from the section of the Internal Revenue Code that defines the program, section 401(k). Additional savings programs do exist, such as 403(b)s or 457s, which are very similar to 401(k)s, but these are less common since they can only be used by certain types of employers, such as schools and non-profit organizations. As 401(k)s have grown in scope and importance, Congress has taken increasing notice of them, especially recently. Recent Congressional hearings have been held discussing 401(k)s, most notably 401(k) plan fees.

A popular saying in economics is "there's no such thing as a free lunch." The reasoning behind the statement is simple: nothing's free. Everything must cost someone something (even if it's just time, which still has an economic value). In the past, 401(k)s have been perceived as "free" savings vehicles to both employees and employers since the costs of the program were not disclosed to employees or the 401(k) plan participants. Remember, though, there's no such thing as a free lunch. 401(k) fees have always existed; they've just been hidden or transferred among providers in such a way that they appear invisible to participants. While it's not unreasonable to be paid for a good or service, it is important to ensure that the fee is worth the services being provided. It's impossible to determine relative value without knowing what you're paying.

It is a duty under ERISA, which is a federal statute enacted in 1974 to protect the interests of employee benefit plan participants, that the employer (more specifically, the plan fiduciary) be aware of the costs of the 401(k) plan. Understanding and benchmarking 401(k) plan fees and expenses are important because doing so ensures that they are reasonable and well spent. While most employers have a 401(k) plan, there are considerable differences in the quality of 401(k) providers, something that can be said of any service industry in this country. The long-term performance of a well run, high-quality 401(k) plan, though, can be dramatically different than a poorly run, low-quality 401(k) plan.

The difference in a high-quality plan isn't going to just the explicit fees associated with the provider and the investments; there are implicit fees as well. The implicit fees relate to the opportunity costs associated with the poor management of the 401(k) plan. Some examples would be a poor overall savings rate, bad participant asset allocations, and below-average investment options. Properly addressing each of these components is vital to the long-term success of a retirement plan, since even a slight improvement in performance can have a dramatic impact on plan participants. For example, an investment return of 8 percent, over the span of 30 years, will lead to an

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account balance that is approximately 30 percent greater than an investment return of 7 percent. If you increase the return to 9 percent, you create an account balance that is 75 percent greater than an investment return of 7 percent.

The ideal 401(k) plan minimizes both explicit and implicit fees. By being aware of the explicit fees, it is possible to quantify, and therefore benchmark, the costs of the plan. By addressing the implicit fees, it is possible to increase the investing success of plan participants. Remember, if you're going to pay for the lunch, you might as well get one you're going to enjoy!

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