Comment on CRSB Proposed Plan Structure and Costs

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Beyond Diversification: The Pervasive Problem of Excessive Fees and "Dominated Funds" in 401(k) Plans

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Data

- Scraped from 2009 Form 5500 a
  - Plan level fees
  - Aggregate investor holdings
- ~3,500 plans with $120 billion in assets
  - only public mutual fund shares
  - Match on CRSP and Morningstar
  - Selection issues

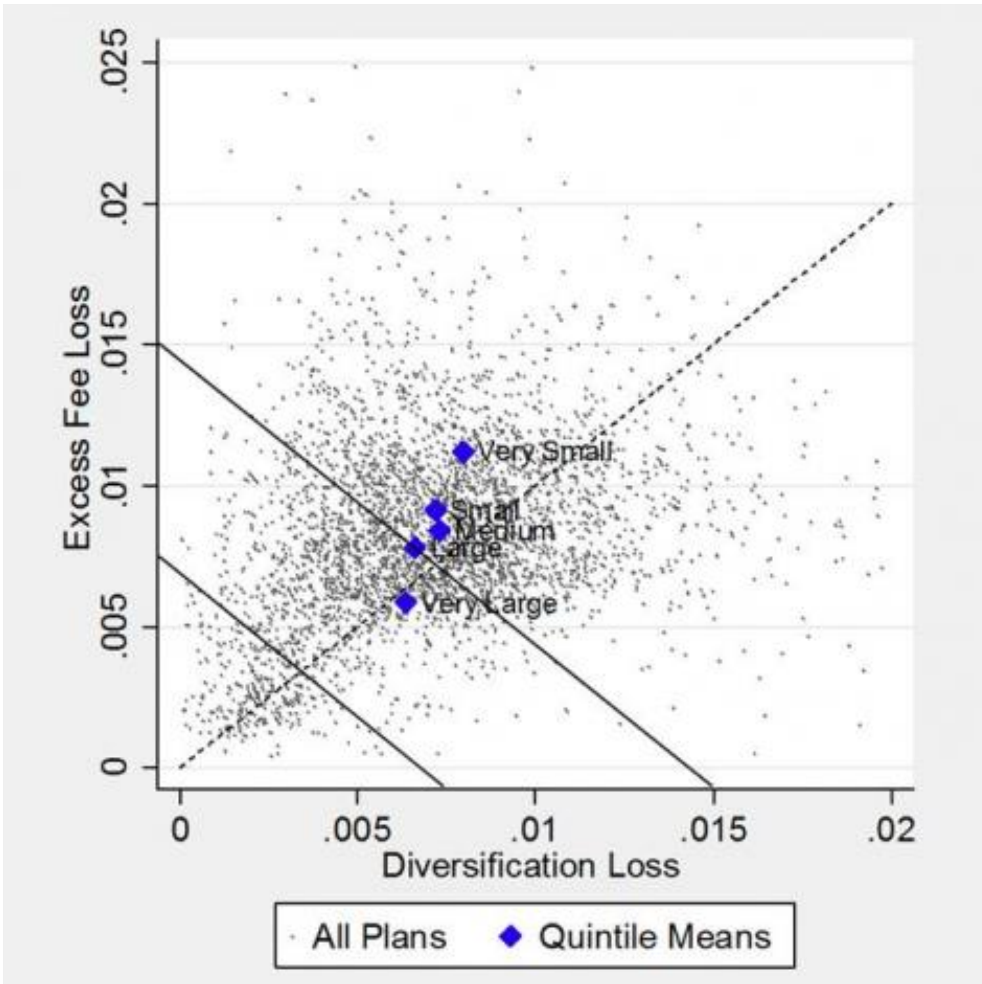
Excess Fees and Diversification Losses

Fees in the market

Vanguard Target Retirement 2050 Fund: 0.18%

Employee Fiduciary LLP: $30 per employee plus 0.08% of plan assets for administrative services for small plans.

Comparing Fee and Allocation Loss



Two ways of Dividing Losses

	Mean Loss	% of Total Mean Loss
Menu Diversification Loss	$\boxed{0.06\%}$	3.8%
Menu Excess Expense Loss	0.43%	27.6%
Total Fiduciary Loss	0.50%	32.1%
Investor Diversification Loss	0.65%	41.7%
Investor Excess Expense Loss	0.49%	31.4%
Total Investor Loss	1.06%	67.9%
Total Excess Expense Loss	$\boxed{0.85\%}$	54.5%
Total Diversification Loss	$\boxed{0.71\%}$	45.5%
Total Loss	1.56%	100.0%

Fees are so high:

For plans with company stock, 48% the co. stock option reduces fiduciary loss

With 16% of Plans, young investors would be better off foregoing tax benefit and investing in stand alone funds

Several Plans offer mutual funds with negative guaranteed interest rate

Do Services Justify Fees ?

Within industry, higher fees associated with:

Lower Participation

Lower Contributions

Poorer Investor Diversification

Dominated Fund

a fund no reasonable (informed) person
would invest in

Dominated Fund Estimates

52% of plans offering at least 1

hold 11.5% of plan assets

underperformed menu alternative
by > 60 basis points

Excess Fee Proposals

1) Dominated Fund proposal
2) Enhanced Default (50bp) proposal
3) High-cost designation (100 bp) proposal
4) Sophistication test proposal

Dominated Fund Reform

Design Defect

Don’t Offer

Enhanced Default Proposal

Enhanced default
Three investor mistakes
diversification,
risk-suitability,
low cost

Default should be < 50 basis points

Example: Western New England University

“High-Cost” Designation proposal

Inspired by “High Cost” Mortgages

Publicize as **"high-cost" plans** of major CT employers with average plan and fund level costs that exceed 100 basis points

Pop-Quiz

Suppose you had $100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow: more than $102, exactly $102, less than $102?

Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, would you be able to buy more than, exactly the same as, or less than today with the money in this account?

Do you think that the following statement is true or false? "Buying a single company stock usually provides a safer return than a stock mutual fund."[124]

Sophistication Test Proposal

Test for awareness of 3 potential mistakes regarding:

Diversification

Risk-Return Suitability

Excess Fees

Sophistication Test Proposal

Participants must pass a sophistication test before being allowed to invest in high cost or esoteric funds

Conclusions

- ERISA has succeed in giving participants opportunity to diversify systemic risk.
- But Excess Fees, Dominated Fund, and Investor Diversification losses remain a problem
- A CT Pub. Retirement Plan can address these problems if it guides employees away from high cost plans and assures that the CT fund options are low cost and well diversified.