Secure Your Castle, Achieve Your Dreams

Top Reasons to Rollover a 401k

By Marc Bautis

Summary

After you change jobs where you were contributing to a 401k you are left with 3 options to do with that account. (1) You can keep your money in the existing plan at your old company (permitting the company lets you do this); (2) you can roll it into the plan at your new company, or (3) you can roll it over into an IRA. There is a fourth option of cashing out your 401k and taking it as a distribution however taking this approach may bring tax consequences, penalties, and a risk to your retirement, therefore this is usually not the best choice. This whitepaper will detail why most of the time it makes sense to go with option number three (3), rolling your 401k into an IRA.

The biggest advantage of a 401k plan is the company match, if in fact your company has one. Of course when you leave your company, you will no longer receive the benefit of the matching contributions from the company. We will evaluate the fees and expenses associated with a 401k plan. We will also evaluate the often poor investment choices that comprise most 401K plans.

- **Expensive, Hidden Administrative Fees**: 401k plans are costly to administer and with that, they are often passed onto the plan participants unknowingly
- **Deceiving diversification**: the investment choices available to 401k plan participants are limited and many asset classes, required to have a diverse portfolio, are not included
- **Investments of Poor Quality**: the funds available within most 401k plans are typically expensive and poor performing

Background of the 401k

The 401k plan was created nearly 30 years ago as a perk, allowing executives another way to dodge Uncle Sam by deferring taxes on the income they earned. It was never meant to supplant the employer-guaranteed pension fund as the cornerstone of our nation's retirement system, but propelled by a combination of companies looking to cut costs and consumers who wanted control of their retirement destiny, that is exactly what has happened.

What happens when you leave your company?

You worked for your company and for years you diligently socked money away in your 401k plan. If you were lucky, your company included a match of your contributions, be it a small or large percentage. After you and the company part ways, you are forced to make a decision as what you should do with your 401k plan? Not to fret, there are a few options:

Your Options

1. **Leave it in the existing plan –** Once you leave your company, two things occur with regards to your 401k: you are unable to make additional contributions to your 401k plan independently and, subsequently, your company matching contributions (you may have been receiving) will

also discontinue. Some plans do not allow you to keep your old plan open so this may not be an option depending on how your plan was setup.

2. **Take a distribution –** If you are younger than 59 ½, the option to cash out almost never makes sense. Not only will you have to pay taxes on your distribution, but you would also have to pay a 10% penalty because this action is treated as an early-age withdrawal. On top of the penalty for this cash out, you stand the severe risk of seriously derailing your retirement plans.
3. **Transfer your old 401k plan to your new company's 401k plan –** You can take the funds from your old 401k plan and roll them into your new company's new 401k plan. However the problem we probably will find with this approach is that your new company's 401k plan may not be any better than the last.
4. **Rollover your 401k to an IRA –** This option almost always makes the most sense because, with an IRA, you usually have access to better investments at lesser cost than a 401k plan. The section below will explore the specific details that are most important to determining what to do with your old 401k account as it related to diverse investment choices and fees.

Why Rollover?

We have already fleshed through the top line problems with most 401k plans. Now we will delve deeper into each of the three drawbacks to a 401k plan:

1. **Expensive, Hidden Administrative Fees**
2. **Fake diversification**
3. **Investments of Poor Quality**

401k plan administrators are in the business of making money, just like any other company. They do not actually care how they make money, just as long as they make a tidy profit. The plan providers can make money in a couple ways:

- Offering good choices to employees, but charging employers high administration fees.
- Charging low administration fees, but offering high-cost investment options to participants.

Smaller employers can't afford to pay high administrative fees, so they may opt for something cheaper, not realizing that they are simply shifting the cost from their company to their employees. The fees and expenses are scrutinized in more detail below.

1. **401k plans are expensive to administer**

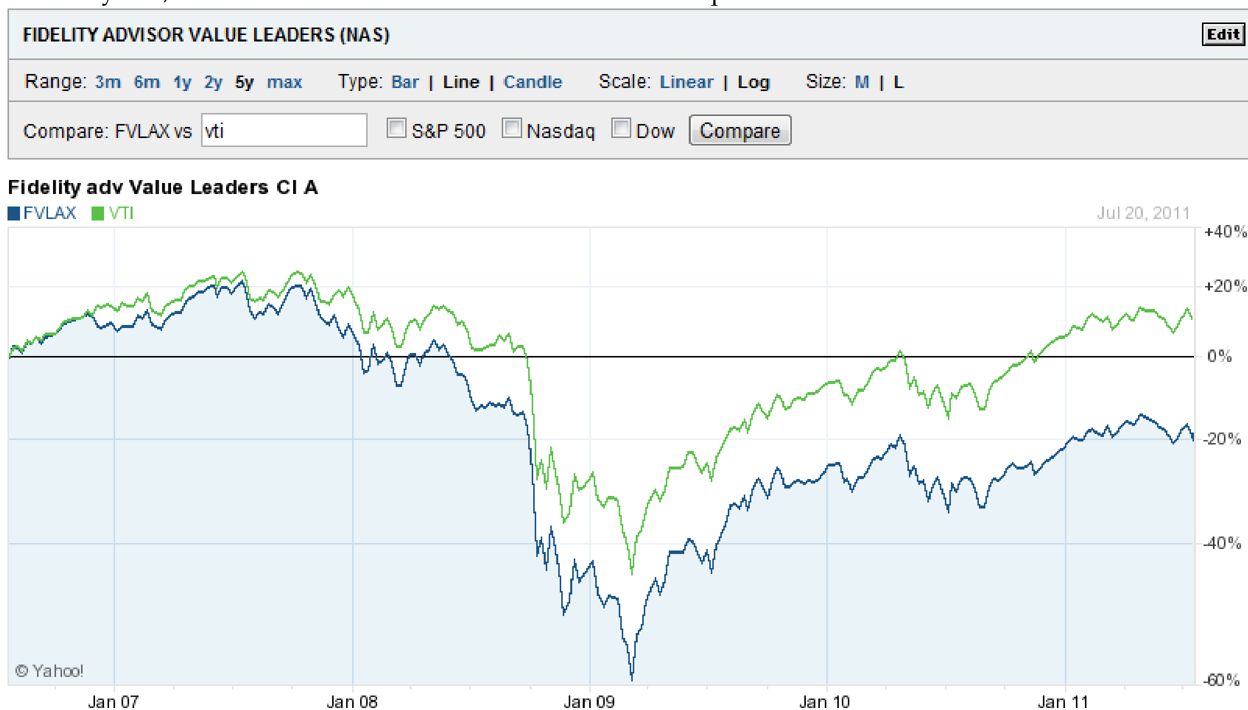
The law requires the creation of a plan document as part of the set-up of a plan as well as the submission of annual reports (Form 5500) that require extensive recordkeeping and preparation. The IRS also requires annual nondiscrimination testing to ensure that highly compensated employees do not contribute in excess of their ceiling. Also added to expenses are additional recordkeeping requirements that are required.

Most Americans either do not know what they are paying within their 401k or think that they aren't paying anything. This may seem absurd, but the typical 401k statement effectively hides the fees you pay from you. Surprisingly, they (the 401k plan providers) are legally allowed to do this.

Because a 401k plan provider does not send out a monthly or quarterly bill, it is easy to forget about the fact that these retirement accounts can cost plenty. Most employers absorb some of these costs, but many of them are passed on to employees in the form of higher expense ratios for the mutual funds in the plan. There are a myriad of fees associated with a 401k plan and can be broken up into four classes however not all of these may be applicable to your specific plan.

Asset-Based: implicit fees paid from plan assets and are usually expressed as a percentage of plan assets. These are the most favorite types of fees by 401k service providers because their revenues grow as the plan grows. Examples of these types of expenses include:

- Expense Ratios – the fees charged by mutual funds for investment management services. These fees are explicitly disclosed to investors in the fund prospectus or fact sheet and are automatically deducted from participant accounts. These expenses will still be present with the funds in an IRA, however with an IRA your investment choices are almost limitless which also means the ability to include funds with cheaper fees and expenses in your account
  Example of a fund that may be included in your 401k plan:
  Fidelity Advisor Value Leaders Class A (FVLAX) – This fund has an expense ratio of 1.22% per year.
  Example of a fund that you can include in your IRA which has a similar investment objective as FVLAX
  Vanguard Total Stock Market Index (VTI) – This fund has an expense ratio of 0.06%
  Both funds have an objective of investing in Large Cap Value stocks. If FVLAX was a good performing fund, you would mind paying the 1.22% per year in expenses but if we look at a 5 year performance charge for both funds we will see that VTI has been up 15% over the past 5 years, while FVLAX was down 20% over that same period.



- Share Classes – Mutual Fund companies have created different share classes for the same mutual fund they offer. The reason is so they can charge different fees and expenses and compensate brokers and Third Party Administrators (TPAs). You may see things after the mutual funds on your statement like CL A, Class A, or just the letter A. The letters represent different share classes and most likely involve commissions being taken off of your investment going to a salesperson. Going back to our example above of Fidelity Advisor Leaders Class A (FVLAX); not only does the fund have a whopping 1.22% annual expense ratio it also has a sales commission of as much as 5% on top of it.

Fees & Expenses		
Expense	FVLAX	Category Avg
Annual Report Expense Ratio (net):	1.21%	1.27%
Prospectus Net Expense Ratio:	1.22%	N/A
Prospectus Gross Expense Ratio:	1.22%	N/A
Max 12b1 Fee:	0.25%	N/A
Max Front End Sales Load:	5.75%	5.33%
Max Deferred Sales Load:	N/A	2.52%
3 Yr Expense Projection*:	940	575
5 Yr Expense Projection*:	1,207	889
10 Yr Expense Projection*:	1,967	1,763

* Per $10,000 invested

The following is another example of how important share classes are to expenses. A 401k plan that I have worked with has the following mutual fund as one of its options. **American Funds American Balanced R2 (RLBBX)**. The annual expense of this fund is **1.43%.** The share class is **R2**. Another version of the Balanced fund can be purchased outside the 401k plan. **American Funds American Balanced F-1 (BALFX)** is the same exact fund with respect to what investments it contains. The only difference is the share class, with this one being F-1. F-1 has an annual expense of **0.63%**

- 12b-1 fees – These fees are used to pay for sales, marketing and distribution costs and usually range from .25 to 1 percent. Someone has to pay for all of the Fidelity commercials you see on TV. The fee is paid directly to the broker and may not be disclosed to plan fiduciaries. How is this for a conflict of interest? Suppose a plan offers two similar large cap growth funds. Fund A has total expenses of 1.00 and pays the broker a .50 percent 12b-1 fee. Fund B has total fees of 1.50 percent and pays the broker a 1.00 percent 12b-1 fee. The broker has a vested interest to recommend Fund B because they stand to make twice the amount of compensation.

Fees & Expenses		
Expense	FVLAX	Category Avg
Annual Report Expense Ratio (net):	1.21%	1.27%
Prospectus Net Expense Ratio:	1.22%	N/A
Prospectus Gross Expense Ratio:	1.22%	N/A
Max 12b1 Fee:	0.25%	N/A
Max Front End Sales Load:	5.75%	5.33%
Max Deferred Sales Load:	N/A	2.52%
3 Yr Expense Projection*:	940	575
5 Yr Expense Projection*:	1,207	889
10 Yr Expense Projection*:	1,967	1,763

* Per $10,000 invested

- Wrap Fees – an all-inclusive annual fee imposed on the value of total assets in a 401k plan. These are typically charged by insurance providers, who provide a 401k plan in the form of a variable group annuity. Wrap fees typically include mortality and expense fees and distribution fees.

- Custodian Fees – a fee that is charged by a custodian for providing back-office functions such as cash receipt and disbursement functions, trading, and mutual fund settlement services. A separate custodian is usually necessary when utilizing an independent record-keeper.
- Section 28(e) Fees (Soft Dollars) – these are payments that occur between investment companies and their service providers. These are very tough to assess as they are embedded into other expenses within a mutual fund. For example if a mutual fund buys research from a brokerage firm with actual cash (hard dollars), these costs show up in the expense ratio of the fund. However, a mutual fund may be given these products and services by the brokerage firm in exchange for higher than reasonable commissions paid to the firm to execute trades for the fund. Another example is if a trade costs five cents per share to execute, the brokerage firm may charge the mutual fund ten cents per share and use the excess commission to offset the cost of the services given to the mutual fund
- Trading Costs – another tough fee to identify, because they are not clearly disclosed by mutual fund companies. Every time a mutual fund buys or sells securities within the portfolio it incurs trading costs (commissions, bid/ask spreads, market impact). These costs reduce market return. These costs will still be included in the mutual funds in an IRA portfolio; however more control could be added to limit trading costs in an IRA by adding things like Index Funds.

Per-Person: expenses based on the number of eligible employees or actual participants in the plan

- Administration Fee – Most 401k Third Party Administrators will charge a per-participant fee for administration, which is often in addition to a flat, base fee to administer the plan

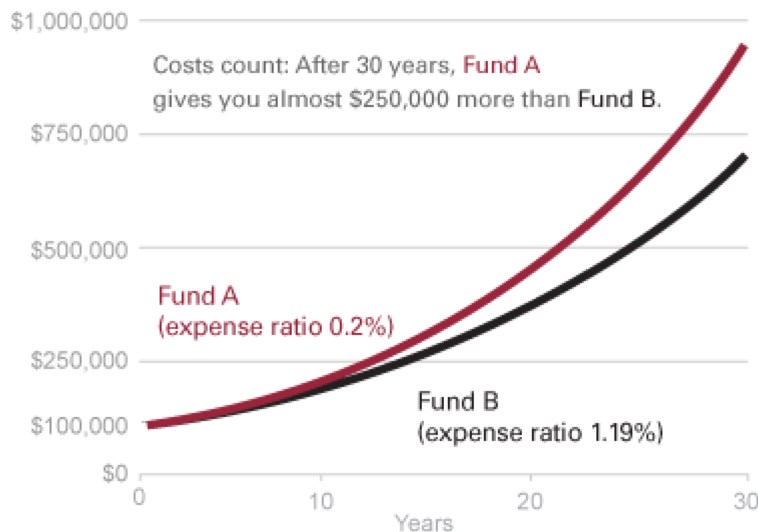
Transaction-Based: expenses based on the execution of a particular plan service or transaction

- Start-Up or Conversion Expenses – Many Record Keepers and Third Party Administrators will charge one-time fees for a start-up plan or to convert a plan from another provider
- Administrative Fees – Individually paid for by participants for things like initiating a loan, to process a distribution, or to mail participant statements
- Surrender Charges – these are mostly included in 401k plans group annuity contracts that are managed by Insurance companies. Insurance companies include these charges to protect their profitability since they often pay large upfront commissions to the brokers who sell these products

Flat Rate: fixed charge that does not change, regardless of the plan size.

- Base Administration Fee – Many TPAs charge a flat, base fee in addition to per participant charges for plan administration
- Consulting Fees – These are billed charges in the form of a flat fee or retainer charged by consulting firms for services such as:
    - Fiduciary Governance Consulting
    - Investment Policy Development
    - Investment Consulting, Selection, and Monitoring
    - Vendor Search and Selection
- Audit Fees – Federal law requires that all ERISA-covered plans with more than 100 participants be audited by an independent auditor.
- Attorney Fees – plans sometimes require the services of an ERISA attorney

The impact of these fees, especially on long term retirement savings, cannot be underestimated. It cannot be stressed enough that costs matter. A graph from Vanguard illustrates what higher fees can do to erode one's savings over a long period of time:



Source: Vanguard. This hypothetical illustration does not represent any particular investment, nor does it account for inflation. There may be other material differences between investment products that must be considered prior to investing. All investments are subject to risk.

Not all of the fees and expenses listed above may be included in your plan as you may be lucky enough that your company is paying some of the expenses. But one thing you can be assured of is that it will cost less overall in fees and expenses to have your retirement assets in an IRA rather than a 401k plan

2. **Fake Diversification - The choices to invest in a 401k plan are limited**

I have analyzed 401k plans that have as little as four investment options including company stock. Most of the plans I see have 10 -15 investment options. Usually you should be able to put together a diversified portfolio with 10 options except that a lot of the time 401k plans including overlapping options with their investment choices. There usually will be two or three large cap stock fund options. A couple of small cap stock fund options. Maybe there are two to three bond funds that are very similar. And that is usually it. This is a problem because gone are the days where you can build a truly diversified portfolio with those few asset classes.

I repeatedly see the following options missing from 401k plans.

- Small and Mid-Cap Company Stocks
- International and Emerging Market stocks (The 2000's were called "The Lost Decade" with respect to the S&P 500 Index ending the decade at the same point it started at. Emerging Market indexes returned about 15% a year in the 2000's.
- Inflation Advantaged Investments – Because of our governments propensity to spend money over the past couple of years and the emergence of global economies, there is a good chance that inflation is on the horizon. Sure, stocks are good hedge against inflation, but so are these other asset classes
    - Inflation protected securities
    - Energy
    - Real Estate
    - Precious Metals (Silver and Gold)
    - Commodities
    - Fixed Income – A lot of times I'll see an intermediate term bond fund included as an option. While this may be a good choice to add to your portfolio, there are also a lot of other fixed income choices that are missing. Things like (Preferred and Convertible

securities, International bonds which can hedge against a falling dollar, Floating Rate Bonds)

Why is diversification important? Because studies have shown that proper asset allocation (diversification and rebalancing) account for 95% of the gains in your portfolio. Only 5% can be attributed to market timing and investment selection. Proper diversification can also smooth out your returns and not cause a panic attack with market volatility that has become the norm over the past 5 years. My favorite graphic to show the importance of diversification is a table that Allianz Investors put together that displays how different asset classes performed over the past 10 years.
http://www.bautisfinancial.com/The_Importance_Of_Diversification_2011.pdf
With a 401k plan that has a limited choice of investments you are taking a big bet that could turn out good, or ruin your retirement.

3. **Poor Investment Choices**

Because of some of the conflicts of interest detailed in the Fees and Expenses section of this whitepaper sometimes sub-par quality investments are added as your investment options. There is often no incentive to including quality investments in your plan and sometimes the agenda is to put high fee choices in the plan which pays the broker or mutual fund company a high commission.

Conclusion

You contribute hard earned money to your 401k plan. With the diminishing role of pensions in people's retirement 401k plans are going to play an ever bigger role is funding your retirement and to prevent you from outliving your money. Making a smart move with how you invest your retirement assets can sometimes mean tens or even hundreds of thousands of dollars more in your pocket over your lifetime. When you take into account the expenses included in a 401k plan along with the limited investment choices that smart move usually means rolling over your 401k to an IRA.

About Marc

Marc is an Independent Financial Advisor located in Rutherford, NJ. Marc created The Retirement Fitness Challenge ™ program to help ensure that families and individuals are prepared for retirement. He offers a free initial consultation to anyone interested in finding out more about how financial planning can help them or them family and can be reached at 201-842-7655 or by emailing marc@bautisfinancial.com.