Fees Take Huge Toll on 403(b) Plans

By Leslie Haggin Geary • Bankrate.com   Posted May 1st, 2007

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You may have read news stories lately about excessive 401(k) plan fees, but less well-known are the pitfalls of 403(b) plans -- the retirement savings vehicles for America's teachers and people who work in the nonprofit sector.

403(b) plan basics

Because of their similar features, the 403(b) often is mistaken for a nonprofit replica of the 401(k). That's understandable. As is true of both types of plans, contributions are made with pretax dollars and earnings grow tax-deferred until they're withdrawn. Participants can stash up to $15,500 in 2007 and individuals age 50 or older can save an additional $5,000. There's generally, though not always, a 10 percent early withdrawal penalty for those who take money out before age 59½.

That's where similarities end and stark differences emerge. For example, employers in the private sector often make contributions into a 401(k) plan on behalf of their workers, but these so-called "matching funds" are not common among 403(b) plans, particularly those for public school workers. That means it's up to participants to fund 403(b)s themselves.

Management of the plans also is different. For example, 401(k) participants are steered by their benefits department toward a single provider -- usually a mutual fund company -- that's responsible for running the company's retirement plan. But in a nonprofit, such as a school, various providers may be on a list of approved vendors who are able to run plans for employees. So it's up to 403(b) participants to figure out which providers are available, then pick those with which they want to invest.

Big-name firms -- such as insurance giants TIAA-CREF and AIG Valic and mutual-fund giant Fidelity Investments -- together control about two-thirds of the $652 billion invested in 403(b)s. Beyond that, there's a vast universe of companies competing for 403(b) business, too.

"It's not unusual to have 25 choices (of providers) in the public schools," says Gerry O'Connor, director of Spectrem Group, a Chicago-based research firm that conducts annual studies of the 403(b) marketplace.

"There are a lot of people who built nice retirement nest eggs using a 403(b)," he says. "Could they have made more money using a different kind of structure? It's quite possible."

A universe of choices

Perhaps it's not surprising that individuals feel overwhelmed and ill-informed.

One recent study by Fidelity Investments found that 45 percent of individuals in the tax-exempt sector don't know how many 403(b) providers they can choose from in their retirement plans. And more than one-quarter of savers didn't know how many sub-accounts (the 403(b)'s equivalent of mutual funds) or other investment options they own.

"Unlike the corporate environment, where plan sponsors (retirement plan providers) choose one record keeper to serve all of their participants, in the tax-exempt market there are many vendors participating in a plan," says John Begley, executive vice president with Fidelity Employer Services Co. "Often the plan sponsor doesn't have all the information about those providers in an easily accessible way. So someone can be overwhelmed by their choices."

Moreover, employees in the private sector may frequently have access to various kinds of investing assistance, including access to free advice from their 401(k) providers, automatic enrollment and the ability to invest in a variety of equity-based funds, including life-cycle or target-date funds tailored to help them meet retirement savings goals.

By comparison, when it comes to picking 403(b) providers, tax-exempt employees tend to be given a slew of sales brochures and other documents from various companies that are permitted by a school or other institution to run 403(b) plans for their employees.

Besides the confusion with basic information, participants mostly have insurance products to choose from, which generally are much more expensive than mutual fund offerings from investment management firms. "The plans were started in 1958, and until 1974 they could only be invested in annuity products, so the insurance industry got the head start with them," says Dan Otter, a former teacher and author of "Teach and Retire Rich."

Pricey pitfalls: fees and charges

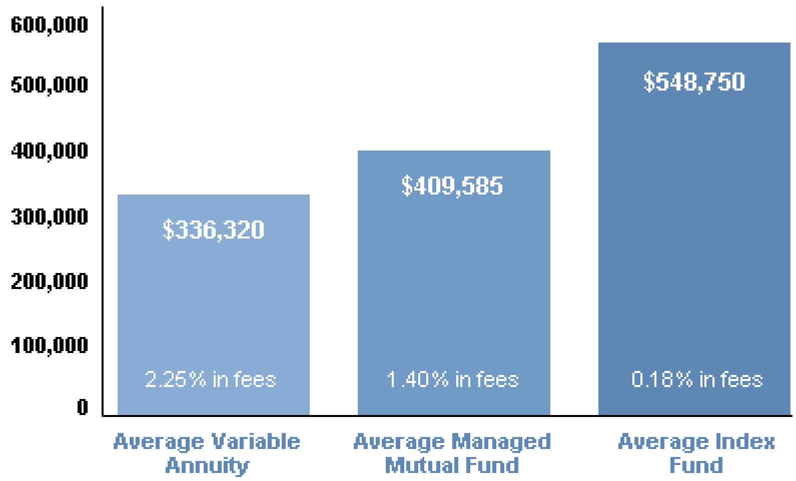
Today, the insurance roots of the plans continue to run deep. Of the $652 billion currently invested in 403(b) plans, a beefy 79 percent of assets are invested in variable or fixed annuities, the Spectrem Group reports.

Because annuities generally come with higher fees and additional charges, they can take a huge bite out of retirement savings, says Otter, who also founded the Web site 403bwise.com, which is dedicated to educating individuals about these retirement plans.

"It doesn't take a math teacher to realize that paying 0.5 percent in fees for a mutual fund versus paying 2.25 percent for a variable annuity can mean tens of thousands -- even hundreds of thousands -- more dollars in retirement," says Otter. "After choosing to participate in a 403(b) and selecting a vendor and investments, a participant can control exactly one thing: how much they pay for investments. I urge people to choose carefully."

How fees impact return

Value after 35 years, assuming $250 contributed monthly with an 8 percent average annual return.



Source: Meridian Wealth Management

Consider as an example the difference in the growth of two investments, one with fees of 2.25 percent and the other with fees of 1.4 percent. Contributions of $250 a month are made for 35 years, and the annualized rate of return is 8 percent in both cases. The account with the higher fees would amount to $336,320 after 35 years, while the one with lower fees would add up to $409,585 -- a difference of more than $73,000.

There are two types of annuities to choose from: fixed and variable. Fixed annuities guarantee individuals a rate of return for a specific length of time. Currently, that's about 6 percent annually, says O'Connor. By comparison, stocks have historically gained 10.4 percent a year, Ibbotson Associates says.

The values of variable annuities, which currently make up about 34 percent of 403(b) holdings, fluctuate because they depend on the performance of underlying investments. These typically include funds invested in stocks, bonds, money market products or some combination of these choices. The total cost of annuities depends on the vendor, but there are several fees to watch out for.

Types of fees

Mortality and expense risk fees: These are fees participants pay each year to the insurer to offset risk of investment loss plus fees involved to pay financial professionals for selling the annuity. So-called "M&E" charges are set as a certain percentage of an account's value -- generally 1.25 percent annually, the Securities and Exchange Commission says. That's $250 per year on a $20,000 account.

Administrative fees: These can be flat fees of, say, $25 a year, or a percentage of someone's account. Typically that's 0.15 percent -- or $30 for a $20,000 account.

Initiation fees: These are one-time start-up fees that may be waived. Prices vary but can run about $60.

Sales loads: These are nothing more than sales commissions that you pay when you buy (front-end load) or sell (back-end load) a fund. For example, a 7 percent front-end load on a $10,000 investment would cost you $700 for what effectively amounts to a sales charge. That money could be invested instead in a no-load fund.

Death benefit charges: These are used to pay for the so-called death benefit, an extra annuity feature that guarantees your heirs will get a certain amount, such as the total account value at a certain date in time or, alternatively, the value of the payments you've made minus any withdrawals. Other fees for special features include guaranteed minimum benefit charges and long-term care insurance benefit fees.

Surrender charges: These apply when you sell an annuity within a certain period of time, know as the surrender period, which can last up to 15 years, says Otter. The charge is a percentage of the amount you withdraw or transfer and depends on how long you've had your money in place. For example, if you have a seven-year surrender period, and you withdraw money early -- say, in the first year -- you might pay a 7 percent surrender charge. The surrender charge typically decreases by 1 percentage point each year until the surrender period finally expires in the seventh year. Some funds allow you to take a certain percentage of your money out -- say, up to 10 percent annually -- during the surrender period without paying the fee.

Stephen Schullo, an elementary school teacher in the Los Angeles Unified School District, found out about surrender charges the hard way. In the mid-1990s he discovered the fees and charges he was paying insurers as he tried to move his 403(b) assets to a mutual fund instead.

"At first I was told I couldn't do it. Then I was told I could. Then I was told about surrender charges," says Schullo. "Then it still took about six months to get the money out. The whole time insurance companies were sending me warning letters. When I finally got the money, I had to pay about $6,000 in surrender charges. It was horrific."

But Schullo paid the tab, figuring he was then young enough to "make up the difference" by moving his money into a lower-cost 403(b)(7), basically a 403(b) that's run by mutual fund firms, not insurers. He also formed 403(b) Aware, an advocacy group that's worked to get better 403(b) investments in his school district and to educate teachers about them.

He isn't upbeat about the future, however. The charges he paid, and the trials he went through to move his money "are still going on today. We've all been through the same sequence."

Invest in a 403(b): lock your money up for good?

Bruce McNutt, a math teacher in Wayne, N.J., was so incensed with the way fees ate into his 403(b) that he asked his school district to include Vanguard, the mutual fund giant, in the retirement program. When he was rebuffed, McNutt started hosting presentations in lunchrooms and teachers' lounges throughout his district, showing colleagues how fees affect their 403(b) savings.

"I'd go through a prospectus and pull up the numbers and say 'let's say you go to Company A. The M&E fee is 1.25 percent. And you pay that every year," says McNutt. "Then I'd explain management fees, which vary. I'd tell them 'take a copy of this presentation and ask your 403(b) rep what you're paying. Don't take my word for it.' One lady, she'd been teaching for 30 years, was so furious. She called her insurance guy and he wouldn't answer half her questions."

Eventually, McNutt got 50 other colleagues to lobby for Vanguard, which was finally added to the district's list of 403(b) plan providers in September 2006.

"You see a little kid getting beaten up; do you walk by or help the kid? In my mind, I have saved teachers of Wayne millions in retirement," says McNutt.

But victory still has its limitations. McNutt also is waiting until he no longer has to pay surrender charges to move his initial 403(b) savings to Vanguard.

How to Avoid 403(b) Pitfalls

By Leslie Haggin Geary • Bankrate.com

The good news: Pending federal regulations should make it easier for individuals to wisely invest in 403(b) retirement plans in the coming year.

The U.S. Treasury Department has proposed regulations that would, for the first time, require employers to keep documentation and have better administrative oversight of the providers running 403(b) plans. Experts say this should have two effects.

One, it should make it easier for employees to obtain information about their investment options and the companies and insurers that offer them.

Two, this new administrative burden on employers will most likely compel them to reduce the number of vendors running their 403(b) plans from as many as a couple dozen to a handful.

"So it might become easier for people to manage and choose if there are just three or four choices," says Gerry O'Connor, director of Spectrem Group.

What you can do now

What can you do to maximize your 403(b) today? Your first duty: Read the fine print. When a 403(b) provider makes a pitch, look at the prospectus and ask questions. Make a list of the fees charged, review performance history and compare these with your other choices.

If you have access to no-load funds that don't charge commissions, favor them over funds that do.

A Web site run by the state of California for its teachers, www.403bcompare.com, can help make research easier. It lists vendors managing 403(b) plans in that state's education system and provides details about the investments each company offers, including the fees charged.

"Because the state (California) is so big, a teacher in Connecticut or somewhere else will probably find the product on the site," says Dan Otter, a former teacher and author of "Teach and Retire Rich."

Become an activist

If you don't like the vendors already in your 403(b) plan, you can lobby your employer to add one you prefer, as McNutt did with other teachers in Wayne, N.J. Depending on your employer, this may be easy or difficult. You may need to get other colleagues to petition for additional choices, or you could get a green light to open a 403(b)(7) through a mutual fund company.

If this doesn't work, consider a so-called 90-24 transfer, which lets you move 403(b) assets to a financial institution of your choice. But be careful. You don't want to trigger surrender charges by moving money too early, so be sure assets have been invested past the surrender penalty phase before making the swap.

Otter recommends steering around surrender-charge pitfalls by stashing savings into a money market offered by one of the 403(b) vendors sponsored by your employer, because money markets rarely come with surrender fees. (Check first.) If so, you can then make the transfer.

Invest independently

Another option? Consider opening an IRA instead. You can't invest as much -- up to $4,000 (or $5,000 for someone 50 or older) in 2007. However, if you open a Roth IRA with after-tax dollars, you'll never owe the IRS again because earnings grow tax-free forever. If you make too much money to open a Roth, consider a non-deductible IRA. In 2010, the conversion restrictions will be lifted and anyone -- regardless of income -- will be allowed to transfer traditional IRA assets into a Roth, says Ed Slott, founder and editor of www.irahelp.com.

That's a route Stephen Schullo, an elementary school teacher in Los Angeles, advises fellow teachers to take if they don't have access to good, low-cost 403(b) providers. "The consensus is if you're paying more than 1.5 percent a year in fees, it isn't worth going with the tax-deferred route [of a 403(b)]. Plus, with a Roth you have tax-free growth and you can go with any company you want. You aren't restricted."