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What Is "Fair"?

Five years ago, during the bottom of the market “correction,” the average profitability of providers servicing 401(k) plans was 0.5% (or one half of 1%). That same year, three-fourths of all providers made less than 10% margins, a level no shareholder would consider as meeting minimum acceptable standards. In 2004, average 401(k) profitability rose to a six-year record of 11%. In this environment, any attack on any fee source that is not carefully constructed has the potential for serious damage.

Today, one-fourth of the providers in our study (of the top 75 providers of defined contribution services) operate at slim or negative margins. Removing the “revenue share” would raise this number to more than 60%, or 27 of 45 providers. Of more importance, these 27 providers share the following key characteristics:

• Lower total fees

• More “open” architecture

• Focus on smaller plans.

Today's world of retirement services is a complex web of interactive parts (services and revenue) with one major systemic issue: a complete mismatch between revenue generated (primarily from investment fees) and costs incurred (primarily from participant services). The reasons for this are historic. Years ago, most defined contribution plan sponsors (and their consultants) were satisfied if they received “free” recordkeeping services from a bundled provider that offered a good investment menu. Historically, fees from investment management activities grew as assets grew, and most plans were profitable to bundled providers.

Unfortunately, our industry is full of examples of well-meant ideas conceived as improvements turning into expensive luxuries, or having unforeseen and undesirable consequences. For example, while it may sound unfair for participants with high balances to pay investment fees that significantly outstrip unit costs, one benefit of today’s common practice is that high-balance accounts pay for the services that new or lower-paid participants need to ensure their retirement security. Specifically, they allow new participants to afford services that currently outstrip their individual ability or willingness to pay. Capping, rebating, and otherwise eliminating fees scaled to investments easily could result in defined contribution plans becoming unattractive to new employees and individuals with smaller balances, thereby hurting precisely the population defined contribution plans were designed to help.

Diligence in obtaining the best value in defined contribution services is not only desirable but also one of the cornerstones of exercising fiduciary responsibility. However, hunting for cheaper fees without regard for consequences is taking the easy way out. Targeting what is arguably the smallest component of fees for special attention risks tilting the playing field instead of leveling it. Potentially, only large-scale providers with a built-in stake in internally managed investments will remain viable, with the likely consequence that costs (and fees) will go up for everyone.

- **Peter J. Demmer**

Peter J. Demmer, chairman and CEO of Sterling Resources Inc., has executive management responsibility for the firm’s strategic consulting practice, which specializes in retirement services in the US and international markets. His strategic and business analysis of the roles that investment firms play in supporting domestic and global retirement programs has been quoted extensively. He holds a BS degree in Industrial Engineering and an MS in Operations Research and Economics from New York University.