



Bautis Financial

Secure Your Castle. Achieve Your Dreams

Does it make sense to Rollover your 401k to an IRA?

By Marc Bautis, June 2011

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. Taking this approach may bring tax consequences, penalties, and a risk to your retirement where this is usually not the best choice.

This whitepaper will detail why most of the time it makes sense to go with option number 3 (Rolling your 401k into an IRA). The biggest advantage of a 401k plan is the company match (if your company has one). When you leave the company you will no longer get a match on your contributions. We will look at the fees and expenses associated with the 401k plan itself and also at the fact that they are usually filled with poor investment choices.

- 401k plans are expensive to administer and most of the time those administration fees are passed on to the plan participants
- Fake diversification: The choices to invest in a 401k plan are limited and many asset classes that are needed to make a diversified portfolio are not included
- The choices to invest in most 401k plans are not quality (expensive and poor performing)

Background of the 401k

The 401k plan was created nearly 30 years ago as a perk allowing executives another option on dodging 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. After you and the company part ways, you have to make a decision as to what you should do with your 401k plan? The good thing is that you have some options;

Your Options

1. **Leave it in the existing plan** – Once you leave your company the employer you will not be able to make additional contributions to your 401k plan and subsequently if you were receiving matches on your contributions they would also stop as well. 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, this option almost never makes sense. Not only will you have to pay taxes on your distribution, but you would have to pay a 10% penalty because your withdrawal is treated as an early-age withdrawal. On top of the penalty taking money out of your 401k plan could seriously derail your retirement.
3. **Transfer your old 401k plan to your new company's 401k plan** – once you join the new company you can take the funds from your old 401k plan and roll them into your new plan. The problem we will see with this approach is that your new 401k plan may not be any good either.
4. **Rollover your 401k to an IRA** – This option almost always makes the most sense. With an IRA you usually have access to better investments at less of a cost. In the section below we will go into more detail on why investment choices and fees are important to determining what to do with your 401k account

Why Rollover?

In the section above I talked about the following problems with 401k plans. In this section we are going to look at each of the three areas in more detail

- *high administrative costs,*
- *fake diversification,*
- *and poor investment choices.*

401(k) providers like any other company are in the business of making money. They don't actually care how they make money, just as long as they make a tidy profit. The providers can make money by:

- 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're simply shifting the cost to their employees. Let's look at these fees and expenses in more detail

1. 401k plans are expensive to Administer

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 fees you pay from you. Surprisingly they are legally allowed to do this.

Because a 401k does not send out a monthly or quarterly bill, it's 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. Fees and expenses can be broken up into four classes: Let's take a look at the myriad of fees associated with a 401k plan are (*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

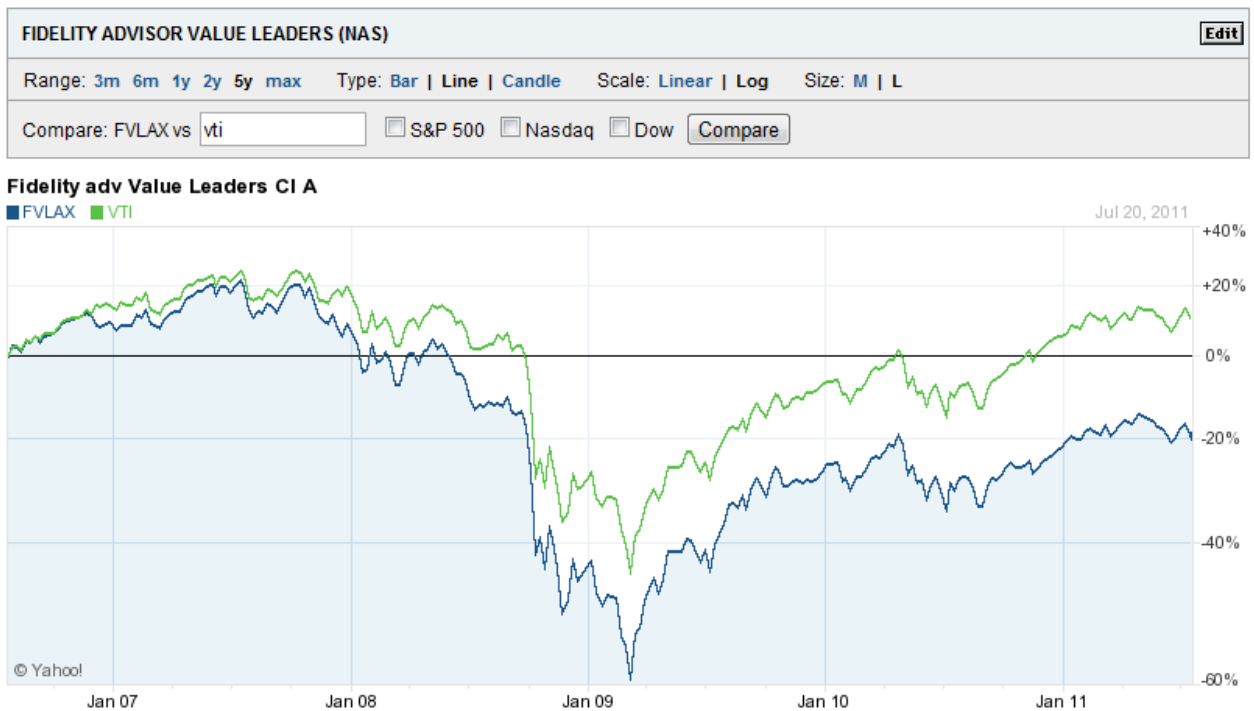
Example of a fund that may be included in your 401k plan:

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 the same 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 change 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. You can translate that into commissions even though you may not have talked to an Advisor when setting up the investments in your plan. 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 on the fund that makes the 1.22% look cheap.

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

Hopefully your 401k plan does not include sales commissions on top of the obscene annual expenses.

- 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.

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- 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) – payments that occur between investment companies and their service providers. These are very tough to asset 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. 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

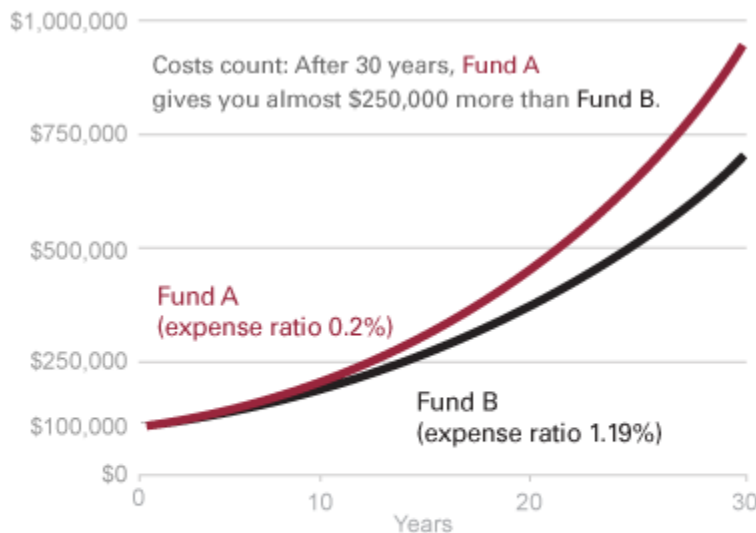
- Start-Up or Conversion Expenses – Many Record Keepers and Third Party Administrators will charge one-time fees for a start-up plan or to convert a plan from another provider
- Administrative Fees – Individually paid for by participants for things like initiating a loan, to process a distribution, or 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:
 - o Fiduciary Governance Consulting
 - o 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 understated. Costs matter. A great graph from Vanguard showing what higher fees could mean over a long period of time is:



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. Also if you lucky 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. Two to three bond funds that are the same and that's it. Gone are the days where you can build a portfolio with those few asset classes.

I repeatedly see the following missing 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
 - o Inflation protected securities
 - o Energy
 - o Real Estate
 - o Precious Metals (Silver and Gold)
 - o Commodities
 - o 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.