Hidden 401(k) Fees: The Great Retirement Plan Rip-Off

By Adam Wiederman, The Motley Fool

You've been advised to save for retirement using your company's 401(k) plan.

The benefits, after all, are significant:

1. Contributions are made with pre-tax dollars, lowering your taxable income each year you contribute.
2. The money you contribute, along with earnings, continues to grow tax-free until you begin to withdraw.
3. Most plans include a matching contribution from your employer, handing you free money as an incentive to save.

Yet despite all these perks, a new study by Demos, a nonpartisan public policy research and advocacy organization, alleges that your 401(k) plan may be ripping you off in ways you don't even recognize.

What's worse, the typical 401(k) will steal an average of nearly $155,000 from each worker over a lifetime of saving.

'Secret' Fees Savers Don't Know They're Paying

The reason for this massive loss of wealth over a lifetime of saving comes down to fees. And those fees are usually expressed in a way that disguises the true cost.

Most investors who purchase mutual funds have heard of fees like the "expense ratio," which averages more than 1% annually. Funds in 401(k)s are not exempt from such fees, which cover the cost of record keeping and compliance, the fund manager's salary, and (sometimes) marketing fees.

While the expense ratio is publicly shared, there are other fees that, Demos found, "are nearly completely hidden from retirement savers." We're talking about "trading fees."

Trading fees are costs incurred when a mutual fund buys or sells an investment, in the form of commissions and bid/ask spreads (the difference between the price the fund actually buys or sells it for versus its market value). And they vary based on how actively a mutual fund is trading.

But good luck trying to figure out how much you're actually paying for trading fees.

Obscure Reporting at Its Finest

The biggest problem facing 401(k) sleuths is that "reporting fees as a percentage of assets actually disguises their true cost," according to the Demos report.

Demos compares it to receiving a surcharge on a concert ticket purchase. Let's say you buy a ticket to a show. The ticket company bases its fee on the price of the ticket. So, for example, if the fee is 5%, you pay 5% of the price of the value of the good they're selling you.

Mutual funds, on the other hand, charge customers a fixed amount based on your account balance, not a percentage of the returns they earned on your money (which is the value they actually provided). It's akin to paying 5% of your bank account balance to the ticket seller in order to buy admission to the show.

In other words, mutual funds that employ this practice are paid even if they just hold onto your money. They don't have nearly as much incentive to actually earn returns on your money because *they get paid no matter what*.

You Only Think You're Paying 1.23% in Fees...

The study shares an example fund in which a $50,000 investment earned 4.65% net. Meaning after one year, the account was worth $52,325.

In reality, of course, the fund earned more on that initial $50,000. The stated expense ratio was 1.23%, so $615 in fees came out prior to that return. That means the fund actually made $2,930 gross, or 5.88% of the initial $50,000.

However, the study encourages us to look at this in another way -- by expressing fees as a percentage of the gross return. To do this, take the $615 in fees, and divide it by the gross return of $2,930. This equates to a startling 20.9% of its return in fees -- meaning an investor paid 20.9% for the value the fund added.

But this still doesn't take into consideration those obscure "trading fees" mentioned above. According to Demos, trading fees "often cost savers as much as or more than the explicit expense ratio," meaning this example fund probably had a "real expense ratio" of 2.46%.

Since trading fees come out of the gross returns, we can adjust the fund's gross (pre-fee) return to 7.11%. Meaning the fund actually earned $3,555 before fees. It gets worse.

... You're Actually Shelling Out More Than 30%

Combining the expense ratio and trading fees, this fund withdrew $1,230 in fees ($615 + $615). Dividing this by the gross return of $3,555, an investor in this fund paid a startling 34.6% in "true fees."

In other words, an investor paid a whopping $1,230 for $2,325 to be made on his money.

Add this up over a lifetime of saving and investing in a 401(k) plan and the average worker loses as much as $154,794, according to Demos. A higher-income household can expect to lose even more -- as much as $277,969.

As Demos' study sums up, "Considering that a significant portion of these fees goes to paying the high salaries and expenses of the investment professionals managing these funds, asking struggling American households to pay these prices to save for retirement is more than patently unfair, it's immoral."

Unfortunately, the options for investors who want to avoid the fee frenzy are limited.

Stuck With a Rigged System?

One way around the fee issue is to take charge of your saving yourself, investing in a self-directed brokerage account through your company's 401(k) plan. Or you could make use of IRAs or taxable accounts.

The trade-off is that you lose some of the biggest perks of a 401(k) -- either a company match, or tax-free growth. After all, it's necessary to save for your own retirement. And a 401(k) is still the most tax-efficient way to save for retirement.

But the system is clearly broken. So until the 401(k) system gets fixed, it's a lose-lose situation for all too many investors.

This article was written by Motley Fool analyst Adam J. Wiederman. Click here for Adam's free report on how to ensure a wealthy retirement.