Unloading the fees on retirement accounts

BY DAVID F. ROYER

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If you have retired prospects who own mutual funds or who still have their 401(k) in mutual funds, finding the hidden costs can help you capture new clients and make your annuity practice grow.

A recent article in the Wall Street Journal ("The hidden costs of mutual funds") pointed out that the cost of doing business on Wall Street can be significantly higher than most investors understand. The average expense ratio for mutual funds, according to the article, is 1.31 percent, but is that the total cost for owning a mutual fund? The hidden costs can be as much or, in some cases, greater than the advertised cost. The buying and selling of securities in a portfolio can add from an additional 1 percent to as much as 3 percent of undisclosed commission expenses to the owner. The SEC doesn't require commissions to be factored into the expense ratio so the average fund owner who thinks they are paying 1-2 percent may actually be paying 3 percent or more to own a particular fund.

In 2008, California Congressman George Miller, chairman of the Education and Labor committee, proposed legislation that would require full disclosure of hidden fees and loads in 401(k) plans. Wall Street, according to Congressman Miller, opposed the proposed legislation with ferocity.

According to the Investment Company Institute, at the end of the third quarter of 2009, 46 percent of retirement savings was invested in mutual funds and 36 percent in other securities. That means that 82 percent of American's retirement savings are at risk to market fluctuation and the high fees charged by Wall Street's middle men. In March of 2009 when the Dow dropped under 7,000, the lowest close in 11 years, all eyes were focused on Wall Street's instability.

After close to a trillion dollars of taxpayers' bailout money was unleashed, on April 12, 2010, the Dow broke through 11,000 and IRAs and 401(k) plans saw months of much-awaited growth. It is estimated that retirement savings in America is in the $14 trillion range and over $11.5 trillion (82 percent) is in mutual funds and other securities. Assuming an average of only 2 percent combined fees and loads, Wall Street will pocket a whopping $230 billion annually of money intended for Americans' retirement years.

Fees and loads are out of the compounding formula forever

Assume your client is age 50 and doesn't expect to need to tap retirement savings until age 65. That will provide him with 15 years of potential growth. Let's start out with $300,000 and estimate he will earn an average rate of return of 5 percent. $300,000 times 5 percent for 15 years will compound to $623,678.

Now let's see what would happen if the same client earned 5 percent in a mutual fund but was charged 2 percent in fees and loads.

The same $300,000 earning an average rate of 5 percent (minus the 2 percent load) would produce $467,390 in his retirement account at age 65. That represents a difference of $156,288 less savings at retirement time. If the total cost of owning the fund averaged 3 percent to 4 percent, the negative financial impact at retirement time would have grown exponentially.

It doesn't end there!

Now that your client has reached age 65 and has already lost $156,288 of savings, it's time to begin the distribution phase. The game plan is to transform what's left into a reliable stream of retirement income. Here is where the lack of compounding compounds the retiree's frustration. As long as his savings remains in the 401(k) or mutual funds, the fees and loads continue.

If your client needs only 5 percent annually from his account balance, he will still be paying Wall Street their 2 percent. That will generate a drain of 7 percent when he only needed 5 percent to maintain his lifestyle in his retirement years. The extra drain due to the cost of doing business with Wall Street is 40 percent more than the owner/ participant needed to reduce his nest egg.

The more the mutual fund owner makes, the more they pay

If your prospect owns a fund with a current value of $500,000 and the total cost of owning that fund is 3 percent, their annual cost is $15,000. This money is unceremoniously removed from his account each year. Ask your prospect to visualize someone reaching into their retirement savings and removing $15,000 or more each year. Next ask him to imagine that same person using that money to take a lavish vacation or buy an expensive watch. At this point your prospect might react by saying, "They can't do that!"
Unfortunately they can do just that, and that's exactly what they are doing.

The end result

Some of your prospects may be comfortable with the cost of owning a particular fund while others may go into shock. The key issue is, if you properly and accurately address the fees and loads with your prospects, they can make better informed decision about positioning their retirement assets.

Annuities also pay commissions that are not generally discussed with annuity buyers. The reason is simple. Annuity commissions are paid by the insurance company and are not taken out of your clients' account balances, consequently 100 percent of their annuity deposit is working for them. Annuities can also provide your prospects a guaranteed stream of retirement income that cannot be outlived.

The current turbulence on Wall Street and the high cost of investing in mutual funds has created an ideal opportunity for any advisor to grow their practice and provide a valuable service for their prospects and clients.