Testimony Before the ERISA Advisory Council

"Pros and Cons on 401(k) Rollovers"

John A. Turner
Pension Policy Center

Bruce W. Klein
Pension Policy Center

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Good morning. My name is John Turner. I am Director of the Pension Policy Center. I am presenting testimony prepared by myself and Bruce W. Klein, who is a Senior Research Associate at the Pension Policy Center. We commend the ERISA Advisory Council for addressing the issue of 401(k) rollovers. This is an area where government policy can improve the retirement income security of American workers. We have written two papers on rollovers, one focusing on 401(k) rollovers and the other on rollovers from the Thrift Savings Plan. We have included those papers in the list of references at the end of this testimony. We commend the council for considering rollovers from the Thrift Savings Plan as well as 401(k) rollovers.

In this testimony, we discuss situations when a rollover would be desirable and when it would not be desirable. We also make an informal assessment of which situation is more commonly the case. While we do not discuss why rollovers are occurring, we note that the extent to which they occur is surprising when viewed from the perspective of behavioral economics, which has focused on the inertia of pension participants.

While we discuss a number of issues relating to rollovers, there are three main points we make. First, we conclude that generally a rollover of a substantial sum from a low-fee 401(k) plan is a mistake. Second, most participants are in large plans that generally have relatively low fees and a good selection of investment choices. Third, for the small minority of participants in small funds with high fees and poor investment choices, a rollover to another plan or an IRA is generally a good idea. We reject the argument that having a larger range of investment options in an IRA is an advantage because behavioral economics indicates that having too many options can make it difficult for many people to reach a decision.

We first discuss the importance of distinguishing between large and small 401(k) plans when considering rollovers. Next we discuss the pros and cons of rollovers. Lastly, we offer some concluding comments.

Large versus Small 401(k) Plans

In comparing 401(k) plans to IRAs, it is important to distinguish between large and small 401(k) plans. As seen below, large plans tend to be better in terms of investment options and fees. For this reason, it is important to note that most participants in defined contribution plans are in plans with 100 or more participants. In 2011, there were 77.4 million participants in plans with 100 or more participants, compared to 11.3 million participants in plans with fewer than 100 participants (U.S. Department of Labor 2013). Thus, 87 percent of participants are in plans with 100 or more participants. By contrast, that year there were 75,520 plans with 100 or more participants, compared to 563,070 plans with fewer than 100 participants. Thus, only 12 percent of the plans had more than 100 participants. For this reason, data that indicate that most 401(k) plans are worse than IRAs in some respect are misleading because what is relevant is the situation for most workers.

Pros and Cons of Rollovers to IRAs

This section discusses the pros and cons of rollovers from 401(k) plans to IRAs. While different issues will be important in different circumstances, the issue of fees is one that every participant should consider.

Fees. In comparing IRAs and 401(k) plans concerning fees, the question is not whether an IRA can be constructed that provides lower fees than 401(k) plans, Rather, the question is whether the IRAs that people have generally charge lower fees than the 401(k) plans people are participating in. Some workers changing jobs or retiring may be able to reduce the fees they pay by moving from a 401(k) plan to an IRA. A worker may be in a 401(k) plan with no low fee options. For example, the 401(k) plan for the nonprofit firm Demos in 2012 did not offer any investment options with an expense ratio less than 70 basis points (Hiltonsmith 2012). A worker may face higher fees if he has several small accounts than if he rolls over those accounts into a single account, such as an IRA or a subsequent employer's 401(k) plan. For example, some accounts charge fixed fees for small account balances.

Fees tend to be higher in smaller 401(k) plans than in larger ones. A study of 401(k) fees has found that, due to economies of scale, plans with more total assets and with more assets per participant tend to have lower fees (Investment Company Institute and Deloitte 2009). Thus, on the basis of fees, a roll over to an IRA is more likely to be beneficial from a 401(k) plan that has a small number of employees and has relatively small account balances.

Fees vary considerably across 401(k) plans. One study found that 10 percent of the 130 plans in the study had an "all-in" fee, which includes administrative fees, of 0.37 percent of assets or less, while ten percent had an "all-in" fee of 1.71 percent or more, with an average of 0.72 percent (Investment Company Institute and Deloitte 2009). In an update of that study, 10 percent of the 525 plans surveyed had an "all-in" fee of 0.28 percent of assets, while ten percent had an "all-in" fee of 1.38 percent of assets (Deloitte 2011). This compares to an average fee for equity mutual funds for retail investors of 0.79 percent (79 basis points) and 0.62 percent in bond funds (Investment Company Institute 2012a).[i]

For 401(k) participants in high-fee plans, rolling over their account to an IRA can easily result in lower fees. For many 401(k) participants, however, rolling over is a bad decision when judged from the perspective of fees. Typically IRA account holders pay higher fees than 401(k) plan participants—about 25 to 30 basis points a year higher (GAO 2011b), which presumably would result in their receiving lower benefits. These higher fees generally are not justified by higher levels of service or higher investment returns. In August of 2011, the Department of Labor released regulations on enhanced fee disclosure in 401(k) plans that appear to have resulted in reduced 401(k) fees, and thus would provide a further advantage to 401(k) plans relative to IRAs (Anderson 2012).

Some 401(k) plans offer very low fee options that are not available to participants in IRAs. For example, some plans provide options that are institutionally priced rather than retail priced. Institutional pricing is the reduced pricing that sponsors of defined benefit plans have, and that is sometimes extended for some options to participants in the 401(k) plan of the employer. For example, an institutionally priced equity index fund that a plan sponsor's defined benefit plan uses could charge as low as 6 basis points to 401(k) plan participants of that plan sponsor. In some 401(k) plans, the plan sponsor pays the administrative fees, while those fees are the individual's responsibility in an IRA. The consulting firm AonHewitt (2011) writes, "Within the defined contribution system, plan participants not only generally have access to high-quality investment options at reasonable prices (through lower-cost institutional fund products such as collective trusts and separate account vehicles), but also benefit from fiduciary protections. Workers cannot obtain these benefits individually in the retail market."

The plan sponsors of 401(k) plans have a fiduciary duty to pick a range of investment options with reasonable fees. Some 401(k) sponsors have been sued over the fees their plans charge, which provides evidence that not all sponsors are diligent in providing low fee options, but also suggests that going forward that unreasonable fees in 401(k) plans will less likely be a problem because of the attention received by these court cases (MacGillivray and Gladbach 2007, Morgenson 2014).

The fees for IRA users may also include fees for financial advice because many people are not financially sophisticated and feel like they need assistance in managing their accounts when faced with the large number of options available to IRA participants. One large provider of financial advice charges fees of 1.5 percent for advisory services for account balances up to $500,000 on top of the investment fees the mutual funds in the account charge (GAO 2013).

Number and Quality of Investment Options. Advertising and advice encouraging rollovers generally focuses on the greater number of investment options available to IRA participants. making this issue one of the most important to consider. However, it is not clear that having more investment options is an advantage. The optimal number of options depends on the ability of participants to make decisions when faced with numerous choices. It also depends on the relationship between the quantity and quality of options.

<u>Number of Options</u>. A 401(k) plan may only have six or eight options, compared to more options in mutual funds, but the number of options varies across plans, with some 401(k) plans having more options. For example, one large plan has 73 options (Black 2011). Not all IRAs, however,

have a broad range of options. For example, IRAs offered by mutual fund companies may be limited to the funds of that company (FINRA 2014b). One large IRA provider offers several small cap funds, but the one with the lowest fee charges 91 basis points.

Some advisers believe that participants should be able to invest in anything allowable. One advocate for rollovers to IRAs (Edelman 2014, p. 162) writes, “Other asset classes, such as commodities, real estate, oil and gas, natural resources and precious metals are also unavailable in many plans.”

While traditional economics views more choice as desirable, the paradox of choice refers to the negative effects of having too many choices. For some pension participants, having too many options may make investment decisions more difficult, which would cause the limited options in a 401(k) plan, and the presence of a default option in some plans, to be an advantage. Several studies have documented problems people have in making decisions when facing a large number of options (Iyengar and Lepper 2000, Carosa 2011). Research has documented that for psychological reasons of mental overload, fewer choices above a minimum level are better for many people when the selection of options is sufficient to allow diversification. A further study found that too many investment options in 401(k) plans lowered participation rates (Iyengar, Huberman and Jiang 2004), presumably because some people were deterred by the large number of investment choices. The idea that a good feature of IRAs is having unlimited choice is thus not supported by behavioral research.

Quality of Options. Another aspect of too much choice, in the context of 401(k) plans, is that there may be a tradeoff between quantity and quality of choice, with a larger number of choices including more options that are of poor quality (Goldreich and Halaburda 2011). For example, Deloitte (2011) finds that 401(k) plans with more investment options tend to charge higher average fees,

In 401(k) plans, where the choices have been preselected by financial experts, it would be expected that the average quality of choice would be better than for IRA participants who face a much larger range of choice, with limited elimination of poor quality choices.

Investigating the benefit to 401(k) participants of employer screening of investment choices, Sialm et al. (2014) find that 401(k) participants gain from plan sponsors dropping poorly performing funds from the investment menu and adding well performing funds. This process of screening the menu of investment options has the effect of moving participants’ assets out of poorly performing funds, even if the participants are unlikely to initiate changes on their own. It appears that, on average, plan sponsors are able to prevent plan participants from making bad decisions relative to future investment performance that are made by individual investments not in defined contribution plans.

Curtis and Ayres (2012) find that most 401(k) plans offer participants the opportunity to efficiently diversify their investments. However, smaller plans are more likely to offer poor quality investment choices than large plans. Curtis and Ayres (2012) find that including suboptimal investment choices in the investment menu results in a cost to plan participants who choose those options. By comparison, in IRAs there is essentially no plan menu, so the cost to participants through suboptimal choices presumably would be larger. Another study finds that workers tend to invest a higher percentage of the portfolio in actively managed funds if more of those funds are available (Brown, Liang, and Weisbenner 2007). Actively managed funds charge higher fees than passively managed funds.

One advocate for rollovers argues that most 401(k) plans do not offer Exchange-traded funds (ETFs), which tend to charge lower fees than mutual funds. However, one company that offers both indicates that, "Purchases and sales of ETFs trigger sales commissions and, possibly, other brokerage costs. When these fees are added to the total cost of the investment, no-load index funds, which have no sales charges, can become a less expensive alternative" (T. Rowe Price 2009).

Legal Protections. Workers have fiduciary protections under the Employee Retirement Income Security Act (ERISA) when they participate in 401(k) plans, but lose those protections when they transfer their assets to an IRA. Plan sponsors of 401(k) plans have fiduciary responsibilities under ERISA to act in the best interests of, and solely for the benefit of, the participants (US GAO 2011a). IRA providers have neither of these responsibilities. Loss of fiduciary protections can be particularly important at advanced older ages when the risk of cognitive impairment is greater (Barlyn 2010).

Lost Pensions. A young worker who changes jobs, and perhaps moves to a different city, may have difficulty decades later locating a 401(k) account from a former employer, particularly if it was a small employer. Employers themselves may change locations, change names, be bought out, declare bankruptcy, or simply go out of business, all creating difficulties for participants tracking down former 401(k) account balances. While the United Kingdom and Australia have lost pension registries maintained by government agencies to help with this problem, that assistance does not exist in the United States for 401(k) participants (Blake and Turner 2002). Thus, in particular for workers many years from retirement, it may be advantageous to roll over a 401(k) account either to the account of a new employer or to an IRA.

Control. According to a number of mutual fund websites, a presumed benefit of IRAs over 401(k) plans is that the account holder has more control over the IRA (e.g., Charles Schwab 2014). What this means is unclear, since in both cases the worker can choose the investments, but the choice of investments would be larger generally with the IRA, as just discussed, though that appears to cause difficulties for many participants.

Financial Engines, the financial advisory firm, has found that workers generally do not want control and would rather have investment choices be made for them by an investment professional. Financial Engines is a company that began by providing financial advice to 401(k) plan participants through employers sponsoring 401(k) plans. From its early experience it observed that often its clients did not take the steps necessary to follow its advice, so now it primarily manages 401(k) accounts.[ii] One advantage to participants of a managed 401(k) accounts is that Financial Engines accepts fiduciary responsibility (Financial Engines 2011). For a fee, individuals generally can have their money professionally managed, either within a 401(k) plan or an IRA, but in the IRA they will generally not have an adviser who accepts fiduciary responsibility.

Consolidating Accounts. Having several small 401(k) accounts with different former employers may be a nuisance to track. One website argues that a benefit of consolidating accounts is that the person can get a more complete picture of his investments (Vanguard 2014). Consolidating accounts may have the advantage of convenience. For workers age 70 ½ and older, consolidating accounts means that Required Minimum Distributions only need to be calculated for a single account. However, rolling over accounts can also mean that investment options that are available only with one employer, such as institutionally priced assets, are no longer available to the person. Consolidating small accounts can be done with an IRA, or it can be done by rolling over to a subsequent 401(k) plan.

"Early" Withdrawal Options. With an IRA, workers younger than age 59 ½ can make penalty free withdrawals for first time purchase of a home or for educational expenses (Fidelity 2014). Money can be accessed for these purposes from most 401(k) plans for active employees by taking a loan, which also preserves the participant's ability to maintain tax preferenced savings.

An advantage to keeping the money in a 401(k) for workers younger than 59 ½ is that it can be withdrawn at job change without penalty as early as age 55. If it is rolled over to an IRA, and then withdrawn before age 59 1/2, it is subject to a 10 percent early withdrawal penalty on top of income tax.

Conclusions

We have discussed the pros and cons of rollovers from 401(k) plans to IRAs. While we discuss a number of issues relating to rollovers, there are three main points we make. First, we conclude that generally a rollover of a substantial sum from a low-fee 401(k) plan is a mistake. Second, most participants are in large plans that generally have relatively low fees and a good selection of investment choices. Third, for the small minority of participants in small funds with high fees and poor investment choices, a rollover to another plan or an IRA is generally a good idea.
We reject the argument that having a larger range of investment options in an IRA is an advantage because behavioral economics indicates that having too many options can make it difficult for many people to reach a decision.

References

Turner, John A. and Klein, Bruce W. 2014a. "FINRA, the SEC, and the Standard for Financial Advice: The Case of TSP Rollovers." Pension Policy Center Working Paper.

Turner, John A. and Klein, Bruce W. 2014b. "Retirement Savings Flows and Financial Advice: Should You Roll Over Your 401(k) Plan?" *Benefits Quarterly* Summer 2014 (forthcoming).

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[i] The fees in the two studies are not directly comparable. The fees in the 401(k) plan study are plan averages, while the mutual fund fees are weighted by assets. Thus, the mutual funds study is overweighted for large accounts, compared to a participant based statistic, while the plan statistics are overweighted for small plans, compared to a participant based statistic.

[ii] This observation was made in a conversation with a representative of Financial Engines.