RVKuhns
& ASSOCIATES, INC.

Fee Study of 457 Plans

Prepared by R.V. Kuhns & Associates, Inc.

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PURPOSE

The purpose of this study is to identify the different fee structures available to and utilized by 457 Deferred Compensation Plans, in order to present alternatives to similar plan sponsors as well as to educate plan sponsors on market trends and best practices. This study compiles data from a peer group study conducted by R.V. Kuhns & Associates in February 2005 as well as various industry sources as cited throughout the report.

TYPES OF EXPENSES

Before analyzing the total costs of a plan versus its peers and considering alternative fee structures, it is important to identify and understand the various types of fees incurred by 457 plans. Plan fees and expenses generally fall into four categories:

- Plan Administration Fees: The day-to-day operation of a plan involves expenses for basic services, such as plan recordkeeping, accounting, and legal services that are necessary for administering the plan as a whole. The plan may also offer a host of additional services, such as education seminars, retirement planning software, investment advice, telephone voice response systems, and electronic access to plan information. Generally, the provision of more services results in higher fee levels. In some instances, the costs of administrative services will be covered by investment fees that are deducted directly from investment returns. Otherwise, administrative costs are allocated among individual accounts, typically as a percentage of individual assets or as a flat fee for each participant.
- Trustee Fees: Trustee fees are typically the smallest component of the total set of expenses and involve a payment to a provider for the holding and safeguarding plan assets. Trustee services are often offered at no additional separate charge when

the provider's funds are purchased by the plan. In other instances, trustee fees may be a percentage of total plan assets or a flat fee.

- **Individual Service Fees:** In addition to overall administrative expenses, there may be individual service fees associated with optional features offered by a retirement plan. Individual service fees are charged separately to the accounts of individuals who choose to take advantage of particular plan features. For example, individual service fees may be charged to a participant for taking a loan from the plan or for executing participant investment directions.

- **Investment Fees:** The largest component of plan fees and expenses is associated with the management of plan investments. Fees for investment management and other investment-related services are generally assessed as a percentage of assets invested and are paid by the participant. For mutual funds, these fees are implicit, meaning that participants pay for them in the form of a charge against their account balances. These fees directly reduce investment returns. For this reason, investment fees, which are not specifically identified on statements of investments, may not be immediately apparent. Investment fees consist primarily of management or advisory fees and administrative or operating expenses. These fees are ongoing charges for managing the asset of the investment option. Investment products that require significant management, research, and monitoring services will generally have higher fees. However, other fees charged in connection with investment options include transaction costs, sales charges, and 12b-1 fees.

  - *Transaction Costs* reflect commissions and spreads on trades. These costs are not usually separately identified, but rather they are netted with the investment return and are often overlooked. Investment options with higher levels of portfolio turnover will increase the transaction costs of the fund.

  - *Sales Charges*, known as loads or commissions, represent transaction costs for buying and selling funds.

  - *12b-1 Fees* are ongoing fees paid out of fund assets for advertising and other costs of promoting the fund to investors. 12b-1 fees, however, also may be used to pay various service providers, pursuant to revenue sharing arrangements.

Revenue sharing is the transfer of soft dollars between mutual funds and the administrative service providers who support 401(k) and other defined-contribution plans. 12b-1 fees are often the source of additional revenues used in the revenue sharing process. For instance, 12b-1 fees may be charged to participants or plan sponsors in a DC plan and then rebated back to the recordkeeping

provider to cover the cost of their services. Revenue sharing arrangements usually are implicit and charged directly against plan assets. 12b-1 fees are embedded in the expense ratio of mutual fund shares. It is important for plan sponsors to understand built-in revenue sharing relationships and consider these expenses when analyzing and comparing the plan's overall fee structure.

FEE STRUCTURES

Even after recognizing the various types of fees potentially incurred by plans, comparing plan expenses is not a straightforward task because there are a wide variety of payment arrangements. Generally, plan investments and services are provided through one of the following arrangements:

- Unbundled : Plan sponsors may directly provide, or separately negotiate for, some or all of the various services and investment alternatives offered under their plan. The expenses of each provider (e.g., investment manager, trustee, record keeper) are charged separately.
- Bundled: In many plans, some or all of the various services and investment options may be offered by one provider for a fee paid to that provider. The provider will then pay any other service providers with which it may have contracted to provide those services.
- Other: Some plans may use an arrangement that combines a single provider for certain services, such as administrative services, with a number of providers for investment options.

FACTORS AFFECTING FEES

When analyzing and comparing a plan's fee structure it is important to recognize the factors that can affect vendor pricing. What may look like a bad price may only be a reflection of a complex plan. Some considerations include plan size, plan design and features, and participant characteristics and behavior.

- **Plan Size:** Factors such as the number of plan participants and average account balances can have a significant impact on pricing. There are certain fixed costs of providing services to a plan that are highly insensitive to the number of plan participants. Thus, the fewer the participants, the higher the per-capita expenses.

- **Plan Design and Features:** Decisions by the plan sponsor have a considerable influence on the magnitude of fees and expenses charged. For instance, offering participants features such as the ability to change their investments daily or access to investment advice may add incremental costs.

- **Participant Characteristics and Behavior:** The characteristics of each plan's participants can also affect the pricing of vendor services. For instance, plan participants who don't speak fluent English, have lesser investment knowledge, or have a lower level of computer skills may require a higher level of individual service from the vendor, which can make the plan more difficult and expensive to administer. Participant behavior directly affects transaction costs. Plans typically charge additional fees for transactions such as withdrawals and loans. Further, the overall cost of investment management fees depends heavily on participant behavior. Participants' selection of actively managed versus passively managed investments or the proportion of equity versus fixed income investments will have an affect on total fees incurred.

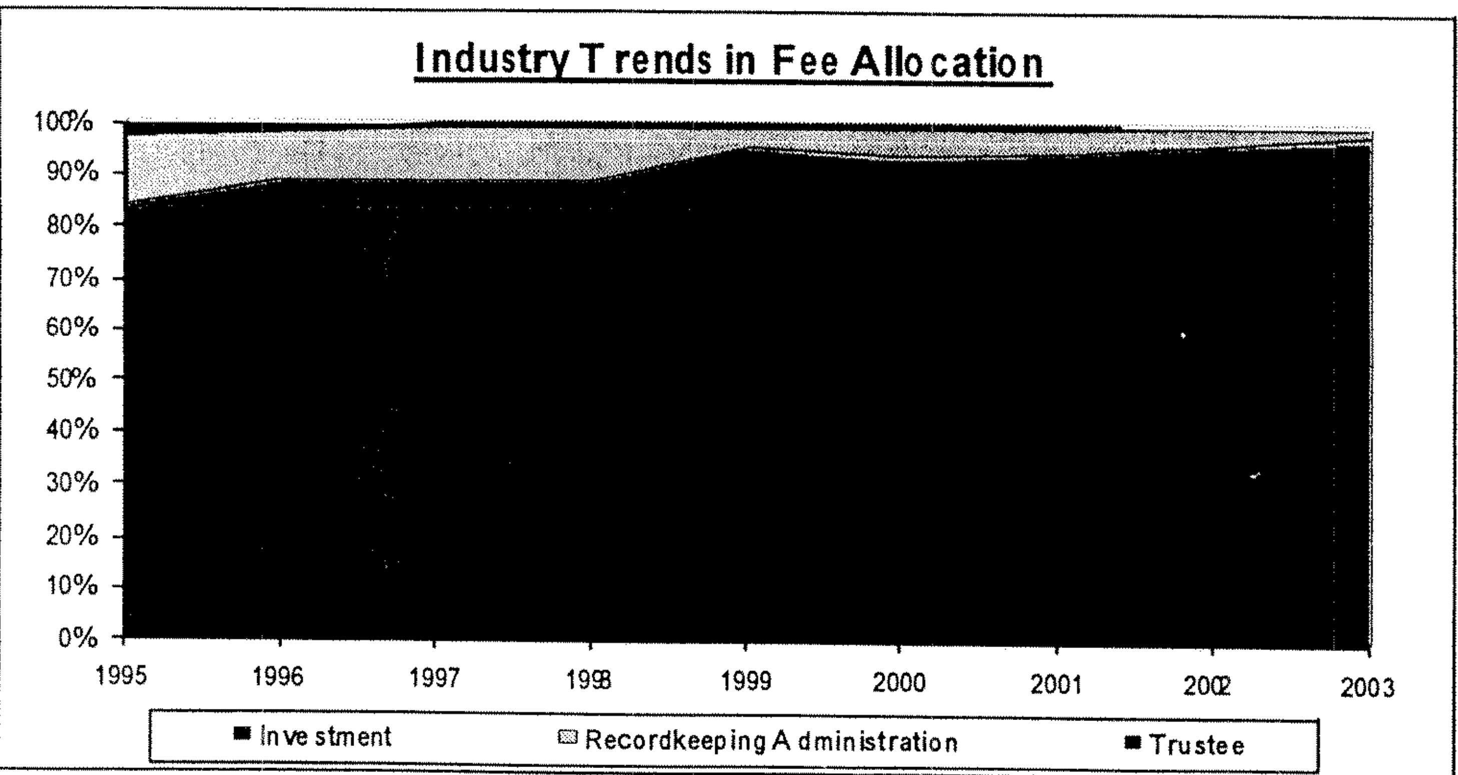
INDUSTRY STATISTICS AND COMPARISON

A number of factors, as discussed in the previous section, can make fee comparisons among plans difficult. Correspondingly, industry sources of data are limited. The best way to ensure proper pricing of a plan is to periodically test the market with competitive bids. However, comparing providers' fees against industry data and other peers can be helpful and is an important step for plan sponsors in fulfilling their fiduciary responsibilities. Because industry data is limited, most data available relates directly to 401k plans as opposed to 457 plans. We reference such data in the next section. Although some important distinctions between them exist, the services provided to both types of plans are largely similar.

Industry Trends

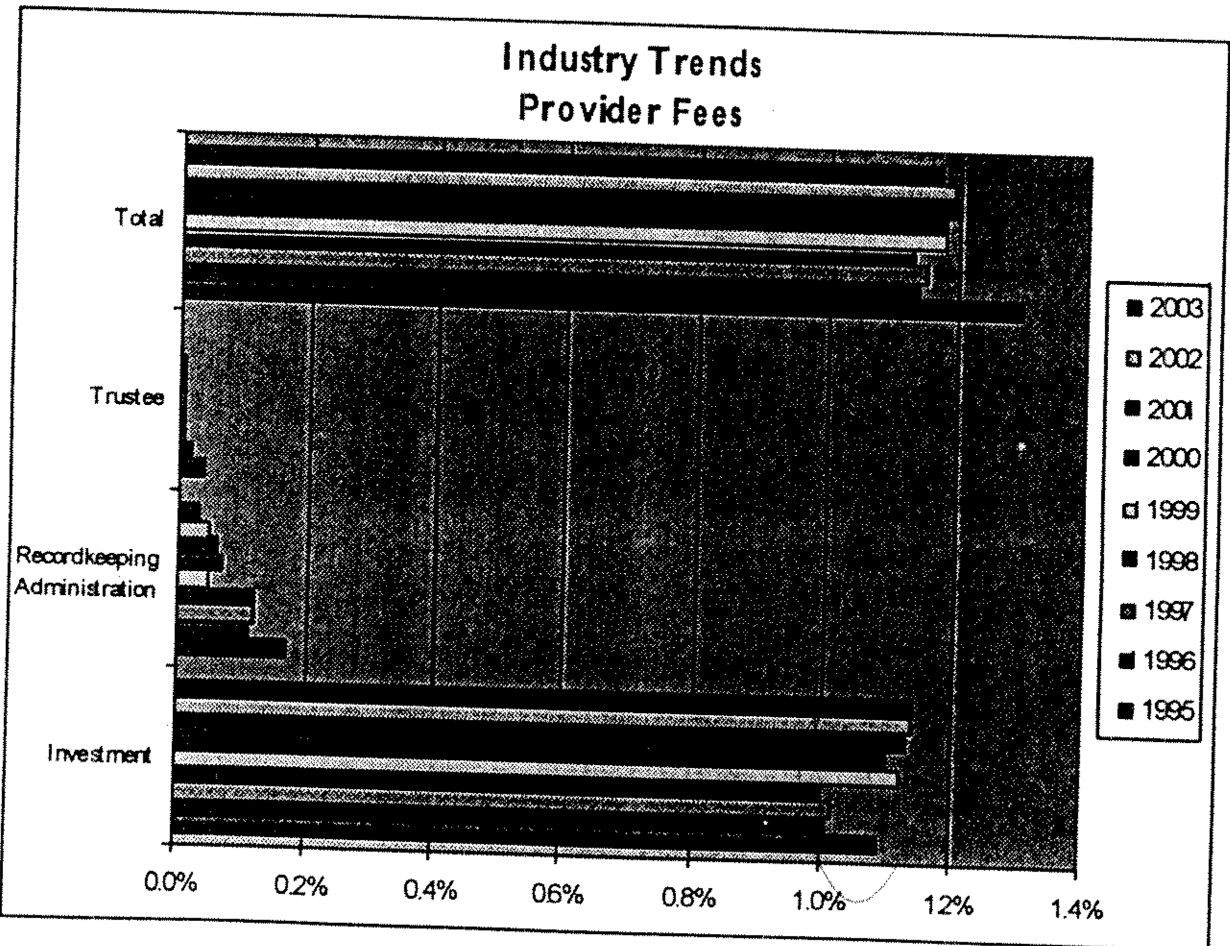
Industry trends are an important primer for comparing plan fees. They can show the direction of the overall market in terms of pricing and structure. The retirement plan industry is a dynamic environment. It is continually changing in response to market conditions, participant and plan sponsor demands, and industry regulations. According to the Deloitte Consulting 2004 Annual 401(k)

Benchmarking Survey, 86% of plans reported no change in their recordkeeping/administration fees from last year, while 10% of respondents claimed that their fees had decreased. The chart below indicates a trend in the allocation of total plan fees. Investment-related fees have become an even more dominant portion of total fees as recordkeeping and administrative fees comprise a smaller portion of total fees than they have historically.



Source: HR Investment Consultants' 401k Averages Book, 7th edition *Average Plan Cost as a Percentage of Assets (5,000 participant plan with $200 Million in assets)*

The next chart indicates the same trend, in absolute terms, and also illustrates a reduction in the total costs of defined-contribution retirement plans with greater than $200 million in assets, from 1.30% in 1995 to 1.17% in 2003.



Source: HR Investment Consultants' 401k Averages Book, 7th edition *Average Plan Cost as a Percentage of Assets (5,000 participant plans with at least $200 Million in assets)*

According to the Deloitte Consulting 2004 Annual 401(k) Benchmarking Survey, the average expense ratio of fund options offered in a plan is between 50-85 basis points. The survey results are summarized in the following table:

Plan's Average Expense Ratio	Survey Response
Up to 0.50%	19%
0.51% to 0.85%	35%
0.86% to 1.25%	26%
More than 1.25%	1%
Don't know	19%

Source: Deloitte Consulting 2004 Annual 401(k) Benchmarking Survey

R.V. KUHNS' PEER STUDY METHODOLOGY

A peer universe of 32 state, county, and municipal 457 Plans with assets ranging from $100-$400 million was identified. An introductory letter, explaining the purpose and process of the study, was sent to the plan sponsors in December 2004. In January 2005, staff from R.V. Kuhns made contact with each plan sponsor to gauge their interest in participating in the study. Of the initial 32 plan sponsors selected for the survey, RVK received responses from 16 plans, for a response rate of 50%.

Brief conference calls were scheduled with each of the 16 plans to discuss their fee structures. Before each call was conducted, a short outline of intended discussion topics was provided to the plan sponsor to guide the call. Each conference call lasted approximately 10-20 minutes. The first portion of each call was spent collecting general statistical information about each plan, such as current asset size, type of plan (state, county or municipal), and number of participants.

During each call, plan sponsors were asked general questions pertaining to the fee structure of their plan, their current service provider(s), their internal resources and budget. Specifically, plan sponsors were asked to discuss the fees that the plan is charged by their service provider(s) and what fees are charged to the plan's participants. Plan sponsors were asked to distinguish whether fees

charged to participants are explicit (fees which are fully disclosed to participants, such as a flat fee or a percentage of asset-based fee), implicit (fees which are not fully disclosed to participants, such as revenue sharing and internal fund management fees), or some combination of both. Additionally, plan sponsors were asked to elaborate on their process for collecting and paying fees, whether the record keeper(s) collect participant fees directly, how the plan covers its internal budget, and whether or not a surplus account is maintained for periodic plan costs.

PARTICIPANTS IN PEER STUDY

The following 16 457 plans participated in the peer group study:

- City of Kansas City, MO
- City of Long Beach, CA
- City of Milwaukee, WI
- City of Philadelphia, PA
- City of San Jose, CA
- City & County of Honolulu, HI
- Kern County, CA
- King County, WA
- Municipality of Anchorage, AK
- Oakland County, MI
- State of Oklahoma
- San Bernardino County, CA
- State of Colorado
- State of Delaware
- State of Nevada
- State of New Mexico

SUMMARY OF PEER STUDY RESULTS

- Nine of the 16 plans in this peer group study collect all fees implicitly via revenue sharing agreements or subsidize fees with the use of proprietary investment products.
- Only two of the 16 plans collect all fees explicitly, while five of the plans utilize a combination of revenue sharing and flat or percentage-of -asset fees to cover plan costs.
- Twelve of the 16 plans have their service providers pass back a portion of revenue-sharing fees collected to cover the plan's internal budget. The other four plans either have no internal budget or have other sources of funding.
- Six of the plans charge participants a flat fee and three plans charge their participants a percentage-of-assets fee (two plans charge both).

- Three of the plans referenced an account for excess fees collected, used for safekeeping or to pay for periodic plan costs such as Provider or Consultant RFPs and plan audits.
- Three of the plans offer participants more than one service provider platform.
- Twelve of the 16 plans currently utilize (or are searching for) an outside Investment Consultant for ongoing monitoring of the plan.

CONCLUSIONS FROM PEER STUDY

- From this study, revenue sharing and internal fund management fees seem to be the most common method of passing the plan sponsor's costs of administering of the plan along to participants.
- The plans that charged explicit participant fees, either flat or as a percentage of assets, reiterated the importance of fully understanding the full cost of the plan, as well as the transparency of plan costs to participants.
- Some plans feel that holding reserve accounts for excess plan fees collected is an acceptable, even necessary, method of covering periodic plan costs such as Provider and Consultant searches and plan audits. Other plans felt that stockpiling participants' fees was inappropriate and often they annually adjusted the basis point or flat fee charged to ensure that participants were charged only enough to cover plan costs and no excess.
- The majority of the plans feel that utilizing multiple service providers was not advantageous, because bargaining leverage with a plan provider diminishes with the amount of assets managed. As few plans, however, consider that the competitiveness of two providers vying for market share increased the level of client service offered and drove pricing lower when negotiating contracts and investment options.
- The majority of the plans referenced the importance of an outside investment consultant to help monitor the plan, select the best possible investment line-up, and to help the plan understand the implicit costs charged to participants.

REGULATORY CONSIDERATIONS

While our peer group survey and industry statistics still show a predominate number of bundled as opposed to unbundled plans, inquiries by plan sponsors, participants, and regulators indicate a shift in this trend on the horizon. The mutual fund scandals involving late trading and market timing have challenged most plan sponsors to take a closer look at their retirement programs and their fiduciary responsibilities. Fees are an area that has caught sponsors, participants, and even regulators' attention.

Deloitte Consulting's 2004 Annual 401(k) Benchmarking Survey showed that while close to 90% of respondents indicated that they have a good understanding of their plan's fees, fewer than 60% understand the revenue sharing arrangements in place with mutual fund companies and the actual cost for their provider to administer their plan. This gap in understanding will likely prompt further questions and analysis on the part of plan sponsors as they try to fulfill their fiduciary responsibilities.

There is certainly an ongoing effort by regulators to understand 401(k) fees, as evidenced by the following regulatory actions:

- The Securities and Exchange Commission (SEC) and the Department of Labor are both actively reviewing mutual fund fee structures, but so far both have focused more on trading issues.
- The broad Mutual Fund Reform Act of 2004 (MFRA) seeks to prevent future trading abuses while also improving fee disclosures.
- In July 2004, the SEC began broadly seeking information about payments by funds and their advisors to DC plans, their consultants, and recordkeepers.

Investment-related expenses are of particular interest to plan fiduciaries and regulators, because they are the largest component of DC plan fees. Further, the indirect nature in which investment management fees are generally charged makes them less transparent. Excess revenue sharing received by plan administrators from mutual fund 12b-1 fees is being scrutinized as it represents money that could go back to participants. One potential outcome of the SEC inquiry is a ban on 12b-1 fees. Even such a ban does not occur, the inherent conflicts of interest uncovered are expected to accelerate the trend toward fee-based retirement services and the need for greater fee transparency.