

Understanding the costs of your §403(b) & §457(b) investments

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IMPORTANT NOTE: Effective January 1, 2007 MCPS defined contribution vendors were no longer permitted to direct employee contributions to load mutual funds or annuity products with “rolling surrender charges”, a contingent deferred sales charge applied to each bi-weekly purchase

The Montgomery County Public Schools currently offers all employees the opportunity to make pre-tax contributions into both a §403(b) Tax Sheltered Savings Plan and a §457(b) Deferred Compensation Plan. Both plans offer employees the opportunity to help accumulate savings towards retirement. Employee assets in the two plans exceed \$950 million. A majority of employees contribute to one or both plans.

A question employees should be asking is “What am I paying for these investments?” To understand what the different investments cost, it is necessary to understand the available investments options.

1. Fixed Annuities

are contracts with insurance companies that guarantee earnings at a minimum rate of interest during the time that an account is open.

2. Variable Annuities

are contracts with insurance companies in which the employee directs investments into a range of investment options, typically mutual funds. As with mutual funds, the value of the account will vary, depending on the performance of the chosen investment options. Also, similar to mutual funds, each fund has different investment objectives and is subject to different risks, fees, and expenses.

3. Mutual Funds

are companies that combine money from many investors and invest the money in stocks, bonds, money market instruments, and other securities. Each fund has different investment objectives and is subject to different risks, fees, and expenses.

This short introduction on investment fees should assist employees on how to become more informed investment consumers.

- Fixed annuities offer the safety of principal and income guarantees, meaning your investment is not expected to lose money, at the expense of lower returns. It is very important to know the underlying financial stability of the insurance company providing the guarantee. Credit rating agencies such as Moody’s and Fitch rate insurance companies and a representative should provide the information upon request. Insurance companies profit from the amounts they earn while managing this account. The difference between what the company earns versus what it credits to your account is the company’s profit. Companies typically do not disclose their profit and it will vary based

on the company you choose to invest with. The most important thing to remember is that there is a cost for investments directed to a fixed annuity just as there are costs to all investments.

- Variable annuity investments will have several charges:
 - Mortality & Expense Risk Charge is a percentage of the account value. This charge compensates the insurance company for insurance risks it assumes under the annuity contract. The primary feature of a variable annuity is the death benefit. Simply stated, if you pass away, the person selected as the beneficiary will receive the greater of (1) all the money in the account, or (2) some guaranteed minimum. Funds invested in variable annuities are also commonly subjected to contingent deferred sales charges (CDSC). The CDSC is a fee that would apply if you were to withdraw or transfer your money out of the annuity contract to another firm. CDSCs are in effect for up to ten years (the surrender period will differ with each company). CDSCs typically have a declining fee schedule whereby each year the fee is reduced by one percentage point until ultimately reaching zero. Check with the representative to find out more about CDSCs that may apply to the contract.
 - Underlying mutual fund expenses are also paid. Each investment option offered has a separate fee (expense ratio) associated with the fund. This fee will typically be deducted from the total return of the fund before you receive any earnings.

Mutual Funds cover costs by charging a fee (expense ratio) as a percentage of the amount you have invested. These costs include:

- Management Fees are the costs paid to the investment advisor for selecting and monitoring the investments
- Administrative/Service fees are those costs associated with recordkeeping, mailing statements, legal fees, tax reporting, and staffing call centers etc.
- Distribution or sales fees, also known as 12(b)-1 fees that are paid by the fund to compensate brokers and others who sell the funds

Mutual funds sold by brokers typically charge a fee to investors known as “sales load,” that is paid to the selling broker. These types of loads can be at purchase, (“front-end load”) or sale, (“back-end load.”)

Front-end loads reduce the amount available for purchase. For example, if you contribute \$100 per pay period to a fund that charges a 5 percent front-end load (typically known as A shares) your investment would only be \$95. The extra \$5 would be split between the selling broker and his company.

Back-end loads refer to charges incurred at the time of sale (CDSC). When an investor purchases shares that are subject to a back-end load (typically B shares), all of the money is invested at the time of purchase. The fee is only incurred when the investor sells shares. Similar to the CDSC of a variable annuity, back-end loads typically are in effect for many years and decline over time. An example would be the back-end load starting at 7 percent in year one and declining to zero after year 6.

It is important to note the expense ratio difference between A and B share classes. As illustrated below, Class A shares tend to have lower ongoing expense ratios (0.57%) versus Class B shares (1.35%). The broker is compensated for selling Class A shares via the 5.75% front-end load. The broker selling a Class B share fund is compensated from the 12(b)-1 that is higher than what is charged for the Class A share via the CDSC, if you sell the fund shares within a certain period.

Fund	Expense Ratio	12(b)-1 Fee ^(*)	Front-End Load	Back-End Load Yr. 1	Back-End Load Yrs 2 & 3	Back-End Load Yr 4	Back-End Load Yr 5	Back-End Load Yr 6
Class A	0.57%	0.23%	5.75%	-	-	-	-	-
Class B	1.35%	1.00%	-	5.0%	4.0%	3.0%	2.0%	1.0%

^(*) 12(b)-1 fee is part of the Expense Ratio

Mutual funds offered directly to participants from the fund company are referred to as no-load funds. If a participant chooses to invest directly with a no-load mutual fund family he/she would incur no front-end or back-end loads and the overall expense ratios tend to be lower than broker sold funds.

As you might expect, fees and expense vary from investment option to the next. An investment with high fees must perform better than a low-cost investment to generate the same return for you. Even small differences in fees can translate into large differences in returns over time.

What questions should you ask about your investment choices?

The best tip is to ask as many questions as you require to understand the process and what is involved financially! No question is a “stupid” question if you are unsure.

1. Will I have to pay any penalties if I change my investment choices? If so, how much? When do the penalties decrease?

The answer will primarily depend on the type of product initially chosen and when the product was purchased for your account. For example, if money is withdrawn from a variable annuity or a Mutual Fund B share within a certain period after purchase; the annuity or mutual fund company will usually assess a surrender charge (CDSC). The CDSC is a percentage of the amount sold or exchanged, and will decline gradually over a period of time.

2. What annual fees will I pay?

As you might expect, fees and expenses vary from product to product – and they can take a huge amount from your returns. For mutual funds and annuities, information on costs and fees are available in the prospectuses. For fixed annuities, refer to the sales literature or the contract. If you do not understand the sales literature or contract, ask your representative for additional information.

3. Does my financial professional make more money by selling one product over another?

Regardless of how much you trust your financial professional, it is always legitimate to ask how – and how much – he or she receives for selling a particular product. For example, you could ask the following:

- Do you receive a commission for selling Product X to me? If so, how much?
- Do you receive any other type of compensation for selling Product X? If so, what do you receive?
- Do you receive more for selling Product X over Product Y?
- Are there any other products that can meet my financial objectives at a lower cost to me (even if you do not personally sell those products?)

Fees are important, but should not serve as the primary factor in determining the suitability of an investment. While you cannot control the market, you can control how much you pay for investments. Factors such as personalized service, breadth of investment options, and investment performance are all important considerations. Educating yourself and asking the right questions will ultimately make you a better consumer and more confident in your investment selections.