Volume 7, No. 11

Senior Consultant
The Voice of the Investment Management Consultant

The Defined Contribution Market Is Going Through Big Changes – For the Better

Richard M. Todd, CIMC, Principal, Innovest Portfolio Solutions

The defined contribution world has never been more competitive. Retirement plan providers are fighting aggressively to keep existing clients as pricing has come down dramatically, services have improved and more importantly, provider disclosures are significantly better.

The Securities and Exchange Commission ("SEC") is finally scrutinizing revenue-sharing agreements between mutual funds and retirement plan providers to gain a better understanding of the industry's "pay to play" shell game. The SEC recently sent out detailed questionnaires to a number of the largest retirement plan providers, asking about their revenue-sharing practices. At almost the same time, the Department of Labor ("DOL") has focused its attention on the fiduciary oversight of retirement plans. "The time has come to move the focus of pension-plan governance out of the human resources department and beyond compliance with tax laws", said Secretary of Labor Elaine Chao in a recent speech to the Yale School of Management. "The executive-level suite needs to focus on pension-plan governance itself, especially the responsibility and liability of pension plan fiduciaries."

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> **– Elaine Chao**
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Doing a thorough review and benchmarking of a plan's retirement plan provider has never been more prudent – or more rewarding. Historically, many providers sold "free" retirement plans to plan sponsors as mutual funds sent "soft dollars" to providers, making it difficult for plan sponsors to grasp total costs. In other words, participants were and still are bearing mutual fund expenses that are being rebated back to the provider without full disclosure to the plan or participants. The SEC is questioning providers on whether the revenue-sharing entitled some funds better access to plans than others. In many cases, we believe that payment to providers is excessive and at the expense of participants in the form of higher mutual fund expenses. By renegotiating with the existing provider or by taking a plan out to bid, it is not unusual to save a plan and participants tens of thousands, if not hundreds of thousands, of dollars per year. In reality, excess revenue-sharing should come back to either the plan to cover other plan expenses such as legal, consulting and audit costs, and/or to the participants. With better markets and constant contributions into plans, the mostly asset-based rebates to providers have skyrocketed in many plans over the years.

More good news is that providers that previously had only proprietary products are opening their investment universes to virtually any fund that can provide daily pricing. This enables trustees and investment committee members to offer participants a more fiduciarily sound "best of breed" approach to the investment menu made available to plan participants. No longer do plan trustees need to be stuck with ill-performing products, whether proprietary or not, and trustees can simply unplug and replace when prudence calls for change.

Other services in the participant education arena are vastly improved as well. From tools and research to one on participant advice, these educational services have become much more specialized and customized.

We believe the best approach to analyze the current arrangement is for a plan sponsor to take a step back from their current situation and design the "perfect plan." Next, go to the existing provider and negotiate a more favorable arrangement and/or take the plan to the marketplace and ask for the sponsor's perfect plan. In many cases, the plan sponsor and trustees may be only familiar with the current plan arrangement and may need some education as to the possibilities and solutions that exist within the marketplace. Consultants can be very helpful in assisting the trustees and investment committees through this endeavor. Further, they can be very adept at benchmarking the current situation and in taking the plan to bid through the Request for Proposal (RFP) process. Consultants can have significant pricing power in the marketplace and generally recognize that every vendor, good or bad, can put their product in excellent light. A quality consultant's experience with a vast number of providers can keep a plan from jumping from the frying pan into the fire.

Choosing A Consultant

Make sure they are conflict free! Fee-only consultants are a must. Using an insurance or securities broker who receives any compensation from a provider corrupts advice. If the provider has created room to pay a broker, then the consultant should carve it out for the benefit of the plan. Typically if the "consultant" has a series 6 or 7 securities license, they are selling products and are conflicted.

In addition, some consulting firms have other departments or related companies that provide services to managers (typically marketing consulting), are money managers or mutual funds, or have other businesses that negatively impact integrity. Sales stories are frequently told about "firewalls" keeping the businesses separate because of the conflict. However, experienced professionals are frequently shareholders or partners in the parent firm and receive bonuses, distributions and equity, based on the success of the other businesses. That is a conflict! Further, some consulting firms that have these conflicts of interest have been asked recently to reduce expenses or even lay-off employees to compensate for the misdeeds on the other side of the firewall (often involving the mutual fund scandals).

Experience, Experience, Experience!

The retirement vendor marketplace must be thoroughly understood, and the only way to grasp the idiosyncrasies of the market is to have a multitude of experiences with existing clients. Lack of expertise, time and history can lead to poor solutions and poor contracts with providers. In addition, actual client experiences with providers will mean much more than a provider's professional proposal or presentation. At times, we've seen great proposals from these vendors that were in the process of being terminated with another client for poor performance. Furthermore, the consultant has clout in negotiations, as the provider often will be more flexible with a consultant with a book of clients than any one particular client. We have paid for our consulting services many times over through favorable fee negotiations.

Approach to Investments

We believe many consulting firms are mistaken in their approach when analyzing proposed investments for plan sponsors. Typically, they ask the provider to recommend their best menu, and then the consultant evaluates the quality of the proposed investment array. The key to evaluating the investments for a prospective relationship is the size of the universe, the quality of the universe (many low cost institutional products and share classes) and true flexibility of the universe, if a future fund change is warranted. Since the provider is conflicted with revenue-sharing from the mutual fund, a quality, conflict-free consultant will be the most objective. Investments cannot be evaluated in a vacuum, and investments will change over time.

Investment Expertise Is Critical

Anybody can crunch numbers, and consultants and other advisors are too enamored with looking at historical data. Too little time is spent by investors and advisors as to understanding "why" performance happened – good or bad. A deep team of analysts is crucial. The strategies of each product, the people involved in building the track record, the culture of the organization, the compensation structure of the managers (e.g., are they owners with a strong financial interest in being successful?), and the "edge" in the strategy "looking forward" are important to understand and document. Ultimately, we believe that identifying quality products and managers comes from only experience and hard work. Data crunching gets you less than part way to truly understanding an investment.

This is an ideal time to re-evaluate your provider relationship to not only enhance a major benefit to participants but to also protect the plan sponsor and fiduciaries. A quality consultant can easily pay for their services and expertise through fee negotiation and can make a very complicated process much less taxing on the plan sponsor. The rewards can be astronomical – not only today, but for years to come. ■

About the Author

Richard M. Todd, CIMC is a consultant and principal of Innovest Portfolio Solutions (http://www.innovestinc.com) in Greenwood Village, Colorado. He can be reached at 303-694-1900 or richt@innovestinc.com.

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