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DC Perspectives

Man bites dog?

What's driving the fee discussion within the DC market

The cost of active investment options in 401(k) plans has been dropping for almost two decades. Competition among asset managers, the proliferation of indexed and passively managed ETFs in qualified plans, and a natural evolution in the industry to be more fee conscience across all investments, retirement and non-retirement alike. These natural market forces are, for the most part, good for the industry and for plan participants.

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For anyone in the industry, this has been an obvious, well-known reality. **So, why write this article?**

Fee compression is also being driven by forces outside the market, specifically the rash of fee litigation and settlements that have forced plan sponsors and fiduciaries to consider lower cost investment options. Complicating the question of asset management fees is the increasing pressure on recordkeepers to drive down administrative costs to plans...or potentially drive more suits.

Litigation tends to focus solely on cost, and not on what is received for that cost or what is appropriate for plan participants, be it asset fees or administrative costs. The lowest cost option is not always the best option...even the Employee Retirement Income Security Act of 1974 (ERISA) recognizes this tenet of retirement investing. Hence the title of this perspective.

Plan sponsors and fiduciaries are under a lot of pressure. They must balance their desire to provide plan participants with appropriate investment options while insulating themselves, or at least providing themselves some level of protection, from the threat of plan fee litigation. Collective Investments Trusts (CITs) can be an integral part of that strategy.

The compression background

According to the Investment Company Institute, the average equity mutual fund expense ratio incurred by 401(k) investors has been steadily dropping since 2002.[1] As of December 2018, equity fund fees for 401(k) investors had declined 47% to 0.41 percent compared to their 2000 levels.[2] During the same time periods, the fees for hybrid mutual funds dropped 32% to 0.49 percent and bond fund dropped 43% to 0.34 percent.[3] The decline is more pronounced the larger the size of the plan.

This fee compression has priced some asset managers out of the 401(k) market. As a result, some commentators have questioned whether advisers can continue to fulfill their fiduciary duties to 401(k) clients if they cull their available list of investment partners down too far.[4]

Why consider CITs

As active asset management fees continue to decline, combined with an industry shift to passive and other low-cost fund options, managers must adapt by adopting passive strategies or lower cost active strategies. CITs can provide the vehicle for asset managers to be competitively priced and allow plan sponsors and advisors to provide active management to plan participants in a fiduciarily complaint manner.

Once reserved for only the largest retirement plans, the use of CITs is on the rise in smaller plans. Efficiencies in tracking, trading and operations now allow CITs to break even for as little as $25 million in assets under management, which was unheard of just a few years ago.[5] This trend has helped CITs to become the fastest growing segment of the retirement market, with more than 6,100 CITs now being tracked in Morningstar's public database, and

1 See, Investment Company Institute, The Economics of Providing 401(k) Plans: Services, Fees, and Expenses 2018, ICI Research Perspective, Vol. 25, No. 4 (July 2019).
2 Id.
3 Id.
4 Id.
5 See, Desai and Dauwen, Collective Investment Trusts – A Perfect Storm, A DST White Paper (March 2017).

total CIT assets estimated to be $3.1 trillion as of 2018.[6] In addition, target-date CITs now comprise over a third of the $1.7 trillion in "target-date" strategies within the DC market (the majority still being target date mutual funds).

And, it's no wonder. CITs are a versatile, cost-efficient and competitive alternative to mutual funds for DC plans that offer the following benefits:

- **Low cost and transparency** – CITs generally cost less than mutual funds
- **Operational efficiency** – CITs are just as easy to manage as mutual funds
- **Customizable** – customize target date funds (TDFs) and managed accounts in CITs to move away from a "one size fits all" mentality
- **Easy access to information** – Plan sponsors and participants can access daily information about a strategy's pricing and performance
- **Style Purity** – CITs are used exclusively by retirement plans, which means that they don't suffer from the day-to-day inflows and outflows to the same degree as mutual funds and can keep more of a fund's assets fully invested.

6 Id.

The low cost of CITs provides a fiduciary advantage. CIT fees are negotiated with the plan sponsor, and the relative cost savings of CITs over mutual funds can be between 10 and 30 basis points due to lower compliance, administrative, advertising and marketing costs, as well as their lack of revenue sharing and ability to stay fully invested.[7] In addition, the customizable nature of CITs allows them to be tailored to a specific plan which allows fiduciaries to demonstrate that they did not try to fit a square TDF into a round retirement plan. Participants are all different, and TDF allocations and rebalancing inside CITs can be customized for specific plan participants.

Finally, CITs are better equipped to meet the needs of a broader section of plan participants because they have greater flexibility to hold alternative and illiquid assets than their mutual fund counterparts.

The wildcard here: innovation. More and more asset managers are looking at ways to provide distinctive strategies to meet the growing demand from plans and their participants for things like ESG-cognizant strategies, post-retirement income capabilities, and risk-managed strategies in the run-up to retirement age. In our view, CITs are much better suited to help asset managers provide the right strategy for each plan's needs.

7 Id.

Conclusion

Retirement plan sponsors and fiduciaries cannot fully insulate themselves from lawsuits, and in today's environment of plan litigation the larger you are the better chance there is that you will be targeted by the plaintiff's bar. Your best defense is a sound process for selecting service providers and asset managers, including a clear understanding of the fees that you are paying for each. At the same time, you want to provide participants with viable investment options for them to grow their retirement dollars. Plan sponsors can potentially do both through the use of CITs as a replacement for traditional '40 Act mutual funds, or, at a minimum, adding CITs as a complement to your plan's fund lineup.

Their low cost, flexibility and customization just might make them man's best friend.

About the author

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Deb is Head of US Defined Contribution at Schroders.

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