



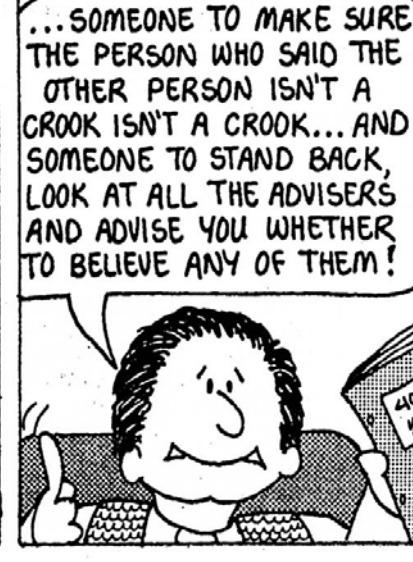
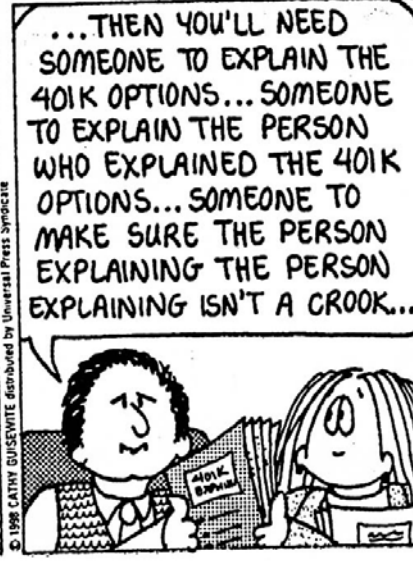
401(k) Plan Investments

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One View of the Problem

CATHY Cathy Guisewite



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Common Investment Problems in the Corporate 401(k) Market

- Excessive focus on employer paid expenses
- Poor understanding of investment design fundamentals
- Limited disclosure of revenue sharing arrangements
- Consultant conflicts of interest
- Brokers positioned as “consultants”
- Proliferation of new mutual fund share classes
- Inappropriate use of insurance products
- Bundled providers delivering investment “advice”
- Inattention to mapping strategies at transitions

Focus on Employer Paid Expenses

- In bundled market, 401(k) administration is often “free”
 - Cost of administration approximately \$100/participant
 - Average balance approximately \$40,000
 - Typical revenue share at least 0.25% (\$100/participant)
- Bundled vendors focus on minimizing explicit (employer paid) costs, maximizing revenues from funds
- “Open architecture” programs (e.g., TPA, trust company) also focus on revenue sharing to remain price competitive
- Limited focus on minimizing cost of underlying funds
 - Fund companies find increasing revenue share payout drives asset growth faster than reducing expense ratio
 - Participants bear cost of funds, but don’t participate in fund selection

Investment Design Fundamentals

- Plan should offer broad range of investment options
 - Funds should represent different asset classes
 - Style, size, geographic segmentation among equity funds
 - Term, quality segmentation among fixed income funds
 - Funds representing other asset classes (e.g., real estate)
- Quantitative methods for determining diversification
 - Fund classification (e.g. Morningstar, Lipper category)
 - Correlation matrix
 - Returns-based style analysis
- Number/range of funds based on plan demographics
- Sector funds generally inappropriate

Correlation Matrix for Recent New Client

- Morningstar defines values of 0.7 or greater as "highly correlated"

	Growth Company	Independence	Janus Twenty	Growth & Income	U.S. Equity Index	Equity-Income	Low-Priced Stock
Growth Company	1.0000						
Independence	0.9176	1.0000					
Janus Twenty	0.7873	0.7857	1.0000				
Growth & Income	0.6210	0.6530	0.7405	1.0000			
U.S. Equity Index	0.6975	0.6892	0.8029	0.9648	1.0000		
Equity-Income	0.3779	0.3685	0.4519	0.8720	0.8574	1.0000	
Low-Priced Stock	0.6021	0.6063	0.4240	0.6816	0.7316	0.7278	1.0000

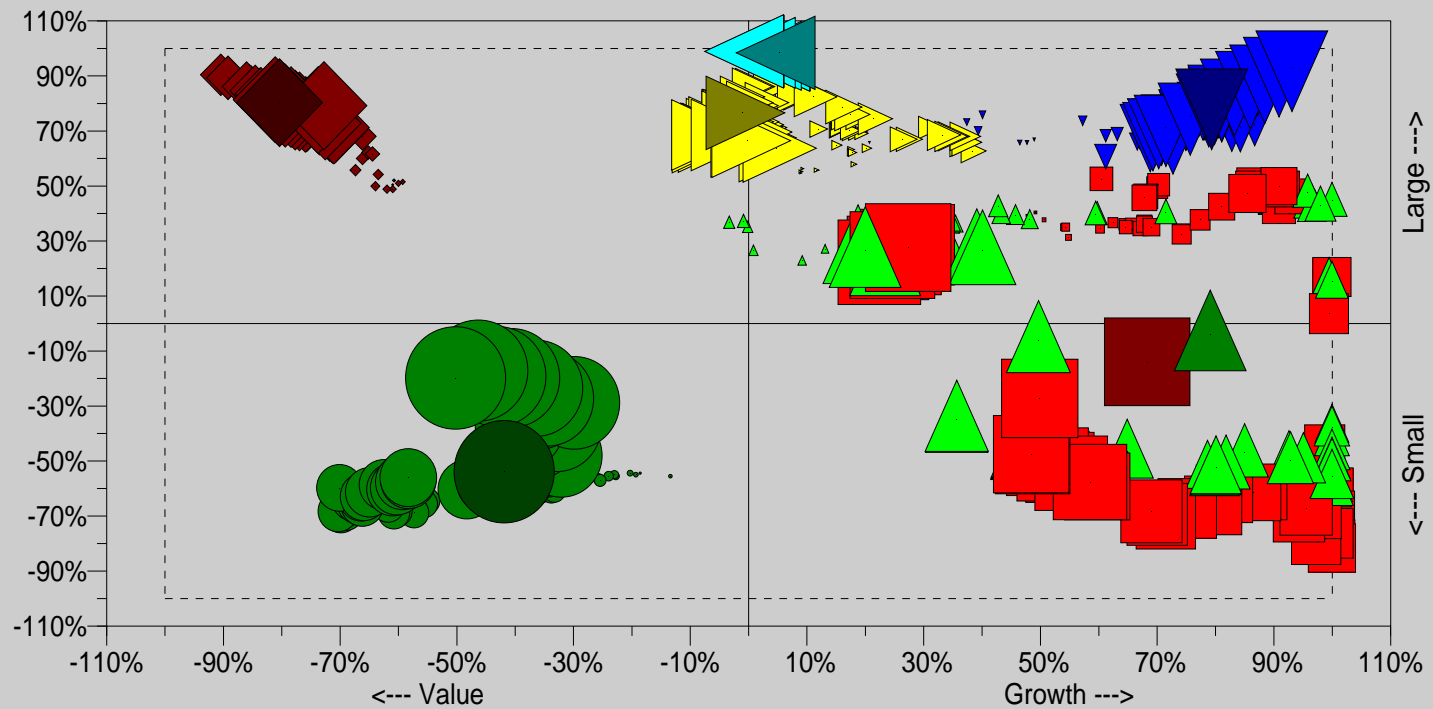
Regression Based Style Analysis

Overall Style
Jan 1994 - Dec 2003



Regression Based Style Analysis

Rolling Style
Jan 1994 - Dec 2003



- Fidelity Growth Company
- ▼ Janus Twenty
- ▲ Fidelity Spartan U.S. Equity Index
- Fidelity Low-Priced Stock
- ▲ Fidelity Independence
- ▲ Fidelity Growth & Income
- ◆ Fidelity Equity-Income

Revenue Sharing Disclosure

- Types of revenue sharing elements
 - Payment of 12b-1 fee
 - Revenue share from management fee
 - Sub-transfer agent fee
 - Finders fee
 - Additional override/volume considerations
- Typical disclosure
 - Existence of revenue sharing on outside funds
 - General range of arrangements (in basis points)
- Necessary disclosure
 - Specific arrangements with recommended funds
 - Implicit revenue sharing on proprietary funds
 - Arrangements with funds that were not recommended
 - Dollar amount of revenue sharing payments (projected/actual)

Consultant Conflicts of Interest

- Consultants serve both plan sponsors and investment product vendors
 - Plan sponsor engages consultant to conduct vendor search
 - Consultant favors vendors that are also clients
 - Consultant uses search to develop more vendor business
- Vendors pay consultants for “services” including:
 - Conference sponsorships
 - Due diligence studies
 - Database management
 - Process review/recommendations
- Current disclosure rules are ineffective
 - Possibility for conflict generally disclosed
 - Revenue from vendors generally not disclosed (amount/percent)
 - Identity of consultant’s vendor clients generally not disclosed

Brokers Positioned as “Consultants”

- Broker offers independent review of 401(k) program
 - “No cost/low cost”
 - Vendor to pay for service
- Broker recommends proposals for new plan vendor
 - Proposals skewed towards commissionable programs
 - Broker counsels against no-load programs
 - Demands finder fee from any no-load programs considered
- Commission payment often significantly larger than fee-for-service vendor search
- Poor disclosure of commission arrangement
- Broker’s primary duty: to client or to vendor?

Share Class Proliferation

- Mutual fund expense ratios insufficient to support demands for revenue share, brokerage commissions
- Fund companies are introducing new, higher cost share classes
- Designations include "R", "K", "Adv", "Admin", etc.
- Examples:

American Funds EuroPacific Growth

<u>Class</u>	<u>Expense Ratio</u>	<u>12b-1 Fee</u>
A (original)	0.90%	0.25%
R1	1.73%	1.00%
R2	1.70%	0.75%
R3	1.31%	0.50%
R4	0.96%	0.25%
R5	0.63%	0.00%

T. Rowe Price Equity Income

<u>Class</u>	<u>Expense Ratio</u>	<u>12b-1 Fee</u>
(Original)	0.79%	0.00%
Adv	0.94%	0.25%
R	1.08%	0.50%

Use of Insurance Products

- Mutual funds regulated by SEC through '40 Act
 - Prospectus disclosure
 - Uniform, inflexible fee structure
- Insurance products offer greater flexibility
 - Limited disclosure requirements
 - Flexibility in fee structure
- Sub-accounts/variable annuities invest in recognized “brand name” mutual funds
 - Program offers appeal of mutual funds
 - Fee arrangements customized based on perceived sensitivity
- Potential issues with 404(c) protection?

Providers Delivering Investment Advice

- Bundled providers can't offer plan sponsors advice on fund selection due to prohibited transaction concerns
- Consultants reduce bundled providers' revenues by recommending low cost, low revenue sharing funds
- Bundled providers counter with "near-advice"
 - Services include investment review, performance monitoring, gap analysis, investment consultation, fund screening, etc.
 - Sponsors can't distinguish between "advice" and "near-advice"
 - Sponsor reliance on provider "advice" may increase plan cost
- Contractual terms indicate provider not offering advice

Mapping Strategies

- Mapping required at vendor transition, plan merger, fund replacement, etc.
- We see vendors providing mapping recommendations
- Objective techniques for determining preferred map:
 - Correlation
 - Style analysis
 - Holdings analysis
- Many vendors rely on simplistic techniques
 - Fund classification
 - Name similarity
- Revenue concerns appear to play key role in vendors' mapping recommendations