

Attacking the Wrong Target - Revenue share on "placed" funds

Attacking revenue share received by both bundled and unbundled defined contribution providers indiscriminately is one more example of our industry zealously targeting the wrong practice and, potentially, the wrong providers. While we applaud fee disclosure and transparency, our "message" is simple. If plan sponsors want fewer providers, fewer investment choices, and less competition, then revenue sharing should be eradicated. If they want more competition and more investment (and provider) choices, care should be taken in singling out this one component of fees without paying sufficient attention to other elements. Results from the past three years of our Profit 2000™ defined contribution industry benchmark study (of 45 providers with more than 60% of all defined contribution plans) demonstrate these points.

"In-House" Managed Assets—The Primary Source of Revenue Investment management fees account for more than two-thirds of all fees paid to defined contribution providers. They vary extensively based on plan size and on the types of investments managed by the specific provider. The chart on page 105 shows investment fees and revenue sharing, calculated in basis points, on managed assets earned by 33 full service providers representing more than 50% of all US defined contribution assets. The investment fees garnered vary from a low of 20 basis points (on 10% of plan assets managed by a large plan provider) to slightly more than 200 basis points (for special asset classes and for providers specializing in "start-up" plans with little or no assets).

While the chart data is impressive (78 basis points earned on \$50,000 in participant assets would result in per-participant revenue of \$390 per year), the real "earnings" of bundled providers are much lower. "Unbundling" and "open investment architecture" have cut the proportion of investments managed by bundled providers every year since 1999.

Today, less than 50% of total assets in the defined contribution industry are managed by the same provider that delivers recordkeeping and plan services. The use of self-directed assets, broker windows, and company stock (no management fees) has further reduced both the percentage of funds managed by bundled providers and associated fees.

Providers increasingly are concerned about a new trend among consultants to recapture "excess" management fees from plans with high average participant balances. This trend caps the upside potential for profits from plan services and ignores the fact that most providers do not expect to make money on newly created plans or "takeover" plans won in competitive bids, at least in the first few years.

Combining the information of the two earlier charts shows that a transfer of assets from "in-house" managed to "revenue-shared" results in a loss of more than two-thirds of the total revenue (from 78 to 23 basis points on average). Many providers have seen "in-house" managed assets shrink by as much as two-thirds as assets "escape" through their open funds platform—just five years ago, the average provider managed more than 60% of plan assets. Thus, reliance on revenue share from outside providers has become increasingly important. Meanwhile, providers have taken significant steps to counteract this drain on revenue. In the past five years, unit costs and provider fees have declined by more than 20% on an asset basis, despite increased regulatory/legal costs, costs of the "open" platform, increased demands for education, an average of 50 new "features" added to defined contribution product technology, and significant increases in the costs of acquiring new business (in part due to increased "due diligence" from sponsors and consultants).

- Peter J. Demmer

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