IS IT TIME TO OUTSOURCE YOUR DC PLAN?

If you are an investment committee member for a defined contribution retirement plan, you may feel the weight of responsibility for making decisions about tens or hundreds of millions of dollars of other people's money.

In my experience, (and I first started meeting with investment committees of defined contribution plans in 1985) many committee members are uncomfortable when asked to make investment decisions. The main reason is that this is not their area of expertise, and they know it.

Gaining sound investment expertise is not easy. Not only is the amount of money more significant today, but also the investment landscape has changed dramatically. Thirty years ago, investments consisted primarily of stocks, bonds and cash. The stocks were mainly U.S. domestic and, almost exclusively, large cap companies. Bonds consisted of U.S. government securities and high-grade corporate bonds. High yield was just a gleam in Michael Milken's eye. Asset-backed securities, mortgage bonds, liquid alts, emerging markets, target date**...** well, you get the idea; they did not exist either.

Today, globalization and the sheer number of investments available to both retail and institutional accounts can be overwhelming for even the most knowledgeable committee member. The parallel development of complex investment analytics and risk measures can make the job that much more difficult. Add to this mix, increased government regulation, fiduciary complexity and the potential for litigation.

It is unsurprising that investment committee members may be out of their comfort zone when faced with decisions that industry professionals have to consider. Even if committee members have sufficient knowledge, the time required to deal with these decisions may problematic.

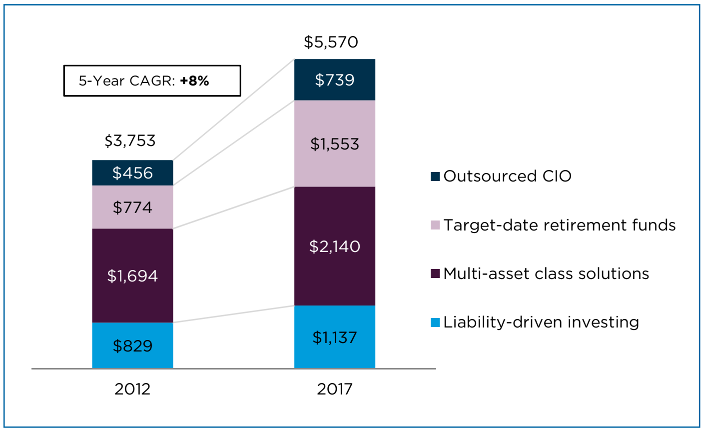
How do we address this issue? The best approach may be to share the burden with others.

Outsourcing takes off

Investment committee members for defined benefit plans, foundations and endowments began recognizing the need to share their responsibilities a few years ago. Many decided to turn over or outsource the selection of managers and the related monitoring to industry professionals for either all or a portion of their portfolios. Based on the continued growth in outsourcing these functions, committees appear to be happy with their choices. A recently updated study predicts that institutional outsourcing of investments will reach $739 billion in the next three years.[1]

This trend is expanding now to the defined contribution (DC) world. With DC plans becoming the primary and often only retirement plan offered to employees, the stakes for fiduciaries are higher than ever. While outsourcing will not be appropriate for every organization, many committees may find this to be the right choice for them and their plan participants. In a recent survey, 36% of plan sponsors indicated they either already outsource the investment decisions for their DC plan or are considering doing so.[2]

Global Revenue Opportunity ($M)[1]



How it works

In the retirement world, there are two approaches that committees can take in using a fiduciary consultant. They can have their consultant be a fiduciary by making recommendations under ERISA 3(21)(a) and reserve decision-making to the committee, or they can outsource or delegate the investment decision-making process by giving the consultant discretion to manage, buy and sell plan assets

[1] Exhibit 9, page 11 of The Complete Firm 2013: Competing for the 21st Century Investor, Casey Quirk, February 2013.

under ERISA Section 3(38). An ERISA 3(38) manager takes discretion for investment decisions such as retaining or firing investment managers or funds available through the plan. In addition, the consultant will negotiate investment manager agreements, where needed, and oversee the transfer of monies from one investment manager to another to ensure accuracy and timeliness. If desired, the consultant can create manager-of-manager structure[3] that simplify decision-making for participants. These manager-of-manager structures often are better diversified than portfolios created by the typical participant.

ERISA specifically allows a plan sponsor to delegate or outsource the selection, monitoring and replacement of investment managers or funds to another party. A key point committees will want to consider is whether to hire a firm that uses their own proprietary products and/or managers or one that is not conflicted and uses only non-affiliated investment managers.

Legally, the party chosen to be a 3(38) manager must be a bank, insurance company or registered investment advisor (RIA). Once the decision on which party to use is made, the 3(38) manager is legally responsible and *assumes the liability for decisions regarding the investments in the plan.*

In fact, if you are on an investment committee for a retirement plan, you may already outsource much of the investment work and allow for discretion. The managers of the mutual funds or commingled trusts you use in your 401(k) or 403(b) plans are responsible for buying and selling securities in their portfolios on a discretionary basis. They don't make recommendations to your committee or ask permission to buy or sell securities. By engaging them, you have given them the authority to do these things. However, it should be noted that mutual fund managers are not fiduciaries to your plan and will not serve in an ERISA 3(38) capacity.

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Now many committees are looking to hire someone, often their existing consultant, to choose investment managers/funds on a discretionary basis. In many ways, this is the next logical step in the institutionalization of DC plans. Hiring a consultant as a 3(38) manager allows the consultant to make decisions rather than recommendations. The consultant periodically reports back to the committee. Reporting may look very similar to, or the same as, what is provided to the committee today.

Why outsource?

For some committees whose members are comfortable with investments and have the time to review and consider the plan investments, there may be no reason to outsource the decision-making to another party. However, for committees who lack the time, struggle to make decisions or simply accept their consultant's recommendations, outsourcing may make sense. Some of the potential benefits include:

- mitigating liability for the committee (but not eliminating it);
- freeing the committee to address other issues such as participant outcomes, or spending less time in meetings;
- allowing for more efficient decision-making and quicker manager replacement when warranted;
- lowering overall plan costs; and
- improving participant outcomes.

Not all or nothing

Some committees may not want to give up their entire decision-making responsibility for plan investments. For example, the committee may be comfortable with the routine investment decisions of choosing or replacing a large growth manager, but it may be uncomfortable with complex decisions involving esoteric asset classes or dynamic asset allocation such as target date. In that instance, the committee may decide:

- to outsource advice on a specialized asset class where the committee does not have expertise, such as real estate or emerging markets;
- to outsource the creation of a glide path and/or hire managers for custom target date funds;
- to outsource the Qualified Default Investment Alternative (QDIA), where participants are placed into an investment strategy by default if they do not actively make an election and where much of the plan assets is concentrated; and
- to outsource a multi-manager structure such as fixed income that incorporates multiple sub-asset classes (sovereign debt, corporates, high yield, TIPs, etc.) using multiple managers as part of one fund or investment option.

Fees

Plan sponsors should review the proposed fees when considering outsourcing the investment decisions, just as they would for any other service. As might be expected, fees are usually higher for 3(38) managers than for managers serving in a purely advisory capacity. The extent and complexity of what is outsourced will impact the fee, as well. Creating custom investment structures can represent substantial additional work, with a commensurate fee. However, plan sponsors may

[2] 2014 Defined Contribution Survey, Towers Watson.

[3] For example, the creation of a single equity fund that is diversified across investment styles and managers.

be surprised to find that the additional fees charged for a typical 3(38) relationship represent a small premium to what they are already paying their consultant.

Other considerations

Hiring a 3(38) manager requires a prudent selection and monitoring process. While it is possible to mitigate liability, the committee and its members will still be fiduciaries and liability cannot be eliminated altogether. Generally, the process for monitoring a discretionary manager is straightforward. The committee will want to ensure that the 3(38) manager is:

- following the plan's Investment Policy Statement (IPS);
- has a process that is reasonable; and
- is a bank, insurance company or registered investment advisor.

It is advisable at the beginning of the relationship for the parties to agree on clear guidelines that the discretionary manager will follow, some of which may not be addressed in the IPS. These might include asset class restrictions or address how investment fees will be charged.

There are operational considerations as well and the committee will want to be careful in negotiating the agreement with the 3(38) manager so that it is clear what responsibility it is taking for trading oversight, pricing, notices to participants and other communications such as fact sheets. The committee may choose to approach the process over a period of time, by first hiring the consultant in the more limited 3(21)(a) fiduciary role, and later in the more expanded 3(38) role once the committee is comfortable with the consultant's approach.

Conclusion

Outsourcing investment decisions in DC plans can be seen as part of a continuing trend to institutionalize 401(k), 403(b) and other DC plans. It is a logical next step in shifting complex decisions to full-time professionals to protect the interests of participants and reduce risk for sponsors of retirement plans. After all, it wasn't all that long ago that many plans did their own record keeping in-house. Who would do that now?

If you would like to find out more about this emerging trend and whether it is right for your plan, please contact us at 312-214-1500.

About the author

Donald Stone
Director, DC Strategy and Product Development & Senior Consultant

With 30 years of industry experience, Mr. Stone leads Pavilion's defined contribution strategy. In this capacity Mr. Stone is responsible for plan governance consulting, income replacement and managed account solutions in plans. Mr. Stone is co-founder of Plan Sponsor Advisors, a DC consultancy acquired by Pavilion Advisory Group Inc. in 2014.

As a recognized industry leader, Mr. Stone has consulted with numerous major financial services firms on retirement plan design and disclosure issues. He spearheaded an early effort for open investment architecture when proprietary funds were still the norm, and raised the issue of fee disclosure in 1996.

Mr. Stone is an informed spokesperson on retirement plan issues and is frequently quoted in publications such as *Bloomberg*, *The Wall Street Journal*, *Treasury & Risk*, *Workforce Management* and *Pensions & Investment*. He currently serves on the Executive Committee of the Defined Contribution Institutional Investment Association (DCIIA), an industry advocate for better participant outcomes, and is a member of the Plan Sponsor Council of America (PSCA).