Observations & Opinions

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Participant-Level Advice and Managed Accounts

Introduction

As part of their long-term strategic initiatives, many plan sponsors are considering offering a robust menu of services to participants in their defined contribution savings plans. The spectrum of choices continues to broaden from simple education and guidance, portfolio modeling and rebalancing techniques, and finally to advice and discretionary managed accounts. While plan sponsors and providers continue to emphasize traditional communication and education approaches, many sponsor fiduciaries are asking questions about advice and managed accounts. Investment advice delivers personalized asset allocation strategies and fund selection recommendations for participants. With managed accounts, participants delegate their investment decisions to a professional manager for a fee.

Plan sponsors' objectives in expanding the product array in the area of communication and education vary. For instance, plan sponsors may seek to offer one approach from a range of available services. Still, other plan sponsors may seek to offer a suite of services to ensure that participants have choice. Regardless of the intended role that education, guidance, advice, or managed accounts play in the overall communication and education strategy, the program must be based on procedural due diligence so as to recognize and help manage the plan sponsor's fiduciary responsibilities under ERISA.

Evolution of Advice Providers

The advice provider industry is relatively new and still evolving. The "pioneers" in the industry started offering investment advice and guidance six years ago. The Department of Labor (DOL) awarded a prohibited transaction exemption to Trust Company of the West in 1997, which served to move the industry past education to advice and counsel. The DOL also issued a ruling to SunAmerica, which helped the industry to move past advice and counsel to discretionary asset management. Many of the industry's current service offerings have been created and "brought to market" during the past two years.

The industry is relatively small and primarily has been driven by the defined contribution plan administrators and recordkeepers. The major recordkeepers provide plan sponsors and their participants with access to advice services. According to Cerulli Associates, the top 10 providers use a total of only four different advice providers (underlying models):

DC Services Provider	Advice Provider
Fidelity	Proprietary, Ibbotson
Hewitt Associates	Financial Engines, mPower/Morningstar
CitiStreet	Financial Engines
Vanguard	Financial Engines
Merrill Lynch	Ibbotson
Mellon	Financial Engines, mPower/Morningstar
Putnam	Financial Engines, mPower/Morningstar
T. Rowe Price	Financial Engines, mPower/Morningstar
Wells Fargo	MPower/Morningstar
Principal	Financial Engines

Options in Adopting Advice and Managed Accounts

Most plan sponsors who offer participants access to an investment advice service provider have tended to rely on the offering of their plan administrator and recordkeeper. It wasn't too long ago when virtually all plan sponsors shied away from offering any type of investment advice service—perhaps for reasons having to do with expected fiduciary liabilities. "Turning on" the advice service offered by the recordkeeper has been a popular choice among many plan sponsors. With the advent of discretionary asset management, some plan sponsors during the past year or two have retained a second provider in addition to the service offered by their recordkeeper.

Currently, the industry has non-standard fee models, thereby making it difficult to compare costs. Some have participant (i.e., usage) charges, and some charge a flat

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CAI

SAN FRANCISCO
MORRISTOWN
CHICAGO
ATLANTA
DENVER

101 CALIFORNIA ST.
SUITE 3500
SAN FRANCISCO
CALIFORNIA 94111
415.974.5060
FAX 415.274.3049
www.callan.com

dollar fee regardless of the number of participants who enroll. One firm will aggregate managed-account assets across all participant accounts so individuals benefit by a marginally reduced fee; other firms do not aggregate assets for fee purposes. Some offer multiple service levels with fee options within each level, and others offer a single service level with a single fee.

A Process to Evaluate Advice and Managed Account Providers

We believe it is important for plan fiduciaries to conduct their own analysis of advice and managed account providers. Certainly, recordkeepers with preferred relationships should share their due diligence documentation with plan sponsors. This would serve to augment the plan sponsor's independent review of the alternatives. To help plan sponsors get started, below are five key questions that should be incorporated into the RFP process.

1. Address the compensation arrangements with mutual fund providers/families, other investment management firms, and administrative/recordkeeping providers. Ask the provider to explain how they would propose to provide unbiased managed account services to plan participants.

2. If the provider also offers an online investment advice service, was the managed account methodology and system created based on the provider's investment advice calculation engine? Also, please describe what happens in the absence of participant input?

3. Is the advice or managed account provider able to utilize the investment funds currently offered in the defined contribution plan, or does the provider require the fund lineup to be expanded? Would the plan sponsor be required to utilize a self-directed brokerage account in order to use the managed account service?

4. Ask the provider to explain what they consider to be a successful managed account program in terms of participant utilization. Is the provider willing to offer managed account services as an automatic election in the defined contribution plan in order to reach "reluctant" investors who might not otherwise be induced to take advantage of the service? Does the provider currently have any clients who use an automatic election approach?

5. Ask the provider the degree to which they are willing to be a named fiduciary. Under what circumstances will the provider organization take a delegation of fiduciary responsibility from the plan sponsor or from the participant?

How to select an advice provider?

Step 1: Establish objectives for offering advice or managed accounts to participants. This strategy discussion will also help define the criteria used to evaluate each firm's services. One key area to address is the extent to which the provider will assume fiduciary responsibility.

Step 2: Prepare a "profile" to share with the providers. The profile typically contains pertinent information about the savings plan (such as number of participants, market value of plan assets, etc.). Also, plan sponsors should attempt to articulate the features and benefits sought in the ideal product. These two documents help establish the evaluation process and will demonstrate the development and implementation of a sound, fiduciary process.

Step 3: Identify the candidate organizations for consideration. Currently, the universe of advice providers and managed account providers is a relatively small group. However, the marketplace is developing quickly and new entities are entering the advice-provider field with ever-expanding capabilities.

Step 4: Prepare and send an RFP to address the following factors:

- Description of overall capabilities
- Number of existing plan sponsor clients and number of participants covered
- A detailed description of the "engine" under the asset-allocation hood (including the underlying assumptions)
- Ability to incorporate assets outside the defined contribution plan
- Access points (web, phone, paper, individual)
- User friendliness
- Fees (and who pays them)
- Operational and linkage considerations
- References
- Fiduciary status

Step 5: Analyze and score the RFP responses. The analysis may include a matrix comparison of the features and benefits of each program.

Step 6: Conduct Interviews. We believe it is important for plan sponsors to interview advice and managed account providers, just as is done when selecting a new recordkeeper or investment manager/fund.

For questions regarding the Callan Defined Contribution Investments Institute, please contact Deanne Christopulos at 415.974.5060 or email dci@callan.com.