Monday, May 24, 2021

Understanding and Evaluating Retirement Plan Fees | Part Two: Benchmarking Investment Fees

Benchmarking investment fees is essential to fulfilling a retirement plan sponsor's fiduciary obligation. However, it can be a complicated task. In part two of our Understanding and Evaluating Retirement Plan Fees series, we share the importance of accurately benchmarking investment fees and how to overcome some common plan sponsor pitfalls.

When it comes to fee benchmarking, most advisors and plan sponsors tend to think of recordkeeping and other vendor costs. But investment fees are also an important component of retirement plan fees. Retirement plan sponsors need to benchmark their plans' investment fees to meet their fiduciary obligations. However, evaluating investment costs is complicated. If fact, we've encountered some common pitfalls. Here are a few.

Benchmarking only the total expense ratio of the fund. A fund's total expense ratio may not take into consideration all the components that comprise that fund's true cost. This is particularly true for those funds with revenue sharing. Plan sponsors may inadvertently benchmark only the expense ratio. However, what should be compared to other investment managers of that same asset class or category is expense ratio minus revenue sharing.

Revenue sharing consists of fees built into the expense ratios of the plan investments. These fees are often used to offset plan expenses, like recordkeeping and administration. The amount of revenue sharing present within a fund's expense ratio is a function of how the plan sponsor opts to pay for plan expenses. It is not directly tied to how much an asset manager charges to manage the fund. Recordkeeping and administrative fees are typically benchmarked separately by the plan sponsor.

Comparing the overall fund expense ratio without isolating the net investment fee component can result in a misinterpretation of benchmark results. Figure One below demonstrates this concept.

Figure One: Understanding Total and Net Investment Costs

Fund	Total Expense Ratio	Revenue Sharing	Net Investment Cost
ABC Small-Cap Growth Fund	0.95%	0.25%	0.70%
XYZ Small-Cap Growth Fund	0.75%	0%	0.75%
Small-Cap Growth Category Average	0.80%	-	0.80%

Source: CAPTRUST Research

In the example above, ABC Fund has a higher total expense ratio than the category average and the XYZ Fund. One could erroneously conclude that its investment fees are high when compared to both. However, incorporating revenue sharing into the equation results in a net investment cost lower than both the category average and the XYZ Fund.

Fund's fees benchmarked to a peer group that is not applicable or apples-to-apples. Funds are often compared to peer groups without considering the net investment fees of the funds within the peer group. In this scenario, a fund's total expense ratio is compared to a category average, for example, small-cap growth. The category peer group includes all share classes of funds in that asset class. This includes those with varying degrees of revenue sharing and those with no revenue sharing. Thus, it is difficult to make an apples-to-apples comparison of the fund's net investment fees relative to this peer group.

Funds are also often compared to a peer group that includes both actively and passively managed funds. This will always result in the passively managed funds appearing less expensive than the category average, regardless of how they stack up relative to other passively managed investments in that same category. Including passively managed investments in the category average also results in a lower overall category average, making it harder for actively managed funds in that category to appear reasonable.

Ideally, when comparing the investment cost of funds in a lineup, only the net investment cost of each fund would be compared to a peer group that excludes funds with revenue sharing. This can be a difficult and manual analysis to perform. Additionally, the peer group should only compare the fund to other funds managed in a similar fashion—either actively or passively.

Not considering investment fees in conjunction with overall investment performance of the fund. It's important to evaluate investment costs in conjunction with fund performance. The Employee Retirement Income Security Act (ERISA) requirement for plan sponsors to determine that plan fees are reasonable is in consideration of the services received. In the case of a fund, the service received can be considered the fund's performance relative to standards set by the plan sponsor. That's why actively managed funds typically charge more than passively managed investments.

When funds are benchmarked, costs are typically evaluated before performance standards. It is important to remember that the lowest fee is not always the best value. The fund's investment fees may be reasonable if, net of all fees, the fund is meeting performance standards set by the plan. This is even if its net investment fee is higher than the appropriate category average. That determination should be made by the plan sponsor.

Benchmarking investment fees can be complicated and it’s not always clear whether a fee is reasonable. It can be difficult to make an accurate comparison. Like other plan fees, investment fees should be reviewed on a periodic basis. Plan sponsors should understand how the investment fees for their plan compare to alternatives in the market and in consideration of the services received.

In our next series installment, we dive into the revenue sharing portion of a fund’s expense ratio and how share class selection can impact the method by which plan sponsors pay for plan expenses.

Author(s)

John Leissner, ARPS, CFS®

https://www.captrust.com/people/john-leissner/

Jennifer Doss, CRPS®, QKA

https://www.captrust.com/people/jennifer-doss/

Legal Notice