FEATURE

Rumble in the Jungle

As the DC market matures, a power struggle is emerging between record keepers and advisors.

BY FRED BARSTEIN

IT WASN'T THAT LONG AGO THAT 90% OF DC PLANS WERE SOLD BY BLIND SQUIRREL ADVISORS PAID THROUGH 12B-1 COMMISSIONS. HOW THE WORLD HAS CHANGED, RIGHT? NOT EXACTLY. WHILE AN ESTIMATED 50% OF NEW PLAN SALES AND A GREATER PERCENTAGE OF ASSETS ARE SOLD BY ADVISORS WITH FIVE OR MORE PLANS, THAT STILL LEAVES 75% OF PLANS WITH BLIND SQUIRRELS, MANY COMMISSIONED BASED. LESS THAN 10% OF PLANS ARE WITH THE SO CALLED "ELITE" PLAN ADVISORS — THOSE WITH MORE THAN $100 MILLION OF DC AUM. BUT THE WORLD IS MOVING TOWARD FEE-BASED, FIDUCIARY PLAN ADVISORS WHO ARE FORMING TEAMS.

Some providers are adjusting, while others are stuck in pre-recession world even as all signs point to a new paradigm where power is shifting to advisors facilitated by DCIO firms.

Consolidation

As we move away from a post-recession mentality to a new world where workers, companies and the government are placing an ever-increasing importance on participant-directed corporate retirement plans, there are signs of dramatic change. The Putnam merger, followed quickly by the acquisition of JP Morgan's large market record keeper by Great-West earlier this year herald a world where there will be four to five dominant providers in each of the three major markets:

- mega plans, or those over $500 million;
- advisor sold, or those with $1 million-$500 million; and
- micro plans dominated by blind squirrels and payroll vendors.

Sure, there will be other players, most attached to large insurance companies, but will they matter? Smaller, independent, open architecture record keepers using innovative technology will thrive while buying up smaller rivals. In this new world, record keepers will have to decide which sandbox they want to play in.

DCIOs, who had seemed immune to the consolidation bug because margins were so high, are starting to feel the pinch. As the cost of distribution and value added tools soar, more firms are rethinking their strategies for the DC market. Jim Brockelman, head of mid-market sales for John Hancock and formerly national sales manager for Putnam's DC efforts, quipped, "There's a big question about the distribution model of DCIOs. Mutual funds had a record sales year but revenue was down because of the cost of distribution." As a result, look for more deals like TIAA-CREF's purchase of Nuveen and the merger of Victory and Munder, with other firms pulling back from the traditional DCIO model, like Lord Abbett, who is relying more on retail wholesalers eschewing a dedicated DCIO field staff.

Meanwhile, broker dealers are consolidating, with RCAP buying five IBDs including Cetera and creating an entity with almost 9,000 advisors promising to provide enterprise scale and clout rivaling LPL. Likewise, more advisor teams are forming as advisors struggle with fee compression, sophisticated buyers and more experienced competition. "It's difficult not to be part of a team as margins shrink forcing advisors to service more plans. Advisors need the efficiencies that a larger team offers," says Jim Hageney, a principal at Centurion Group outside Philadelphia with 13 advisors and $9 billion in DC assets.

Fee Compression

There seems to be an obsession with fees, driven by fee disclosure rules and the press, but as LPL advisor Jim Sampson notes, "Fees are only high in the absence of value." Until the industry, especially advisors, can show improved outcomes or "DC Alpha," we will be stuck focused on inputs, which can be easily commod-

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itized. Similarly, there is a prodigious move to index funds as costs are lower and many active managers, especially in certain asset classes like large cap value, struggle to beat their benchmarks. Dave Reich at LPL's home office uses the dreaded airline analogy for record keepers, noting, "Airlines struggled after deregulation as prices dropped below infrastructure costs for what was considered to be a commodity. Record keepers, like airlines, have to find new profit pools as old ones dry up, like the arlines charging for bags, food and premium seats."

So with a smaller pie to fight over, what's the proper allocation between record keeping, advisory services and money management? Should that change when one group provides the other's services like record keepers managing money or advisors providing more administrative services? Should record keepers charge the same for plans sold and serviced by elite advisors part of a team who do not need the same sales support or some client services?

Record keepers struggle with this question, notes Troy Hammond, CEO and founder of PensionMark. "We're subsidizing record keeper costs for plans sold by blind squirrels. Our attempts to get record keepers to provide different pricing have not gone well." On the other hand, while CAPTRUST's Fielding Miller wants to be treated differently, he is not looking for better pricing. Says Miller, "I need record keepers to share data so I can integrate with my systems and processes to better serve clients. Record keepers are acting differently with us in that regard."

So where's the greatest value created? Some would say that the advisor, especially the elite ones, provides the most value and therefore should get the greatest share of the revenue. Merrill Lynch's Bruce Gsell claims, "There is going to be a shift in splitting revenue, especially for advisors that do employee education, workshops and one-on-one meetings." So if record keepers are reluctant to give up their share, some will look to the money managers using more low-cost index solutions, like Jim O'Shaunessy is doing at Sheridan Road. "Historically, brokers couldn't sell index funds because there were no 12b-1 fees. Now, we are regularly reducing fund costs by over 80% while charging a flat fee for our services and saving the client money," says O'Shaunessy.

Customization

Will the DC world ever catch up with technology that knows where you are, what you like to buy and makes recommendations based on what your peers are doing? Does one glide path for all people born within five years for all companies regardless of size or industry really make sense? According to the DC industry, the answer is a resounding yes. And it seems like the choice can be mostly based on who the record keeper is. There's plenty of data on record keeping systems that can determine which type of managed investment a participant should use based on salary, age, account balance, deferral rates and whether there's a DB plan. So why use off-the-shelf, proprietary TDFs where the advisor has no input on not only which funds should be used but also which strategies, never mind the allocation? Isn't the advisor at risk for recommending funds or strategies with which they are not comfortable?

More and more advisors are moving to customized managed investments, whether it's through managed accounts, collective trusts (CITs) or customized glide paths where funds and strategies can be switched out. Fielding Miller's CAPTRUST bought Freedom One, which provides record keeping services, but, perhaps more importantly, has a 10-year track record on almost a $1 billion of CITs. Centurion has $500 million of CITs managed by a separate division using their own glide path but is also looking at using third parties like BlackRock or Legg Mason if the conflict becomes too significant.

Though PensionMark is shying away from creating and managing their own investments due to fiduciary concerns, they are looking to work with larger independent firms like BlackRock, which gives PensionMark an advantage with prospects. Worried that off-the-shelf TDFs use assumptions that are too broad, Hammond said, "We are rolling out customized investments to better serve participants with the message about the assumptions we are making. We then ask participants to contact us if these assumptions are not accurate and we are getting a good response." Customization follows guidance by the DOL which seemed to favor the movement encouraging the market to look beyond current TDFs.

But not everyone is looking at customized investments concerned about conflicts, costs and complexity. SageView's Randy Long is evaluating, noting "We are early in our evaluation of CITs and 3(38) solutions but we're concerned for a number of reasons. If we're the portfolio manager, who's evaluating us? And what happens if our investments have relatively poor performance. Do we fire ourselves?" Ralph Haberli at BlackRock asks, "Where should advisors spend their complexity budget? Some start with customized solutions and end with off-the-shelf funds depending on the client or market. You have to determine if the payoff is worth the cost."

Outcome-based Solutions

There's a race going on among record keepers and advisors over who can claim to improve outcomes. Those that can will not only be able to charge more, but will win more (or lose fewer) clients. But before we get too excited, there are a few fundamental questions. First, do our clients really care as much about outcomes as we think? Of course, some do, depending on their culture and size, but not at the expense of increased cost, liability and work. The HR department cares about people and outcomes but the finance group is concerned about costs — whether out-of-pocket or staff — and the CEO at a smaller firm cares about risk. So if you get clients comfortable that you are not raising costs, liability or work, then — and only then — can you have discussions about outcomes.

Secondly, how do you measure outcomes, which may be as simple as income replacement rates? Measuring participation and deferral rates as well as asset allocation is good for effort, but the real question is: How much income is being replaced by DC plans? What's the benchmark? Should it be for firms of the same size and industry? Should advisors just show increases made when they take over a plan but then, how much is good? Do we need 80% replacement from our plans – what about Social Security and outside assets? Is 40% or even 50% more reasonable? What percentage did DB plans really replace?

And who has the greatest impact on outcomes? Record keepers don't really need advisors to design the ultimate auto-plan with auto-enrollment at 6% escalating to over 10% using a stretch match and managed investments as the QDIA. But advisors can customize, educate, advise and get those numbers even higher. And remember who sold the plan to begin with.

Power Shift

So does anyone doubt that the power is shifting from record keepers to advisors? The question is when, where and how. As long as there are blind squirrels, the record keeper will reign over those plans.

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Morgan Stanley's Ed O'Connor does necessarily believe that there will be a power shift, noting, "I don't believe that this is a zero sum game. Expert advisors like our CRDs have taken a more active role managing client relationships in partnership with record keepers." O'Connor's biggest concern is not sharing power with record keepers. "My biggest concern is what the government will do, specifically a takeover of DC plans," he says.

So as teams grow and more plans move to elite advisors and focused BDs, all of whom will control more of the assets and plans, how will the inevitable power shift take place? Whether it's through custom glide paths, CITs or 3(38) services, advisors are taking a more active role in managing the money and asset allocation, which is where most of the returns lie.

Helping participants stay the course is also an important role played by advisors. As Fielding Miller notes, "It's not about being a fiduciary or picking the best funds. It's about helping participants whose average return is 2% while their investments return an average of 8%."

So will record keepers adjust and be willing to take more of a back seat, share data and provide rational pricing for elite advisors and teams? The answer to that question will determine which markets they want to participate in. Blind squirrel plans might cost more to service and sell and might be more at risk, but they also enjoy more attractive pricing because the buyer is not so savvy. In fact, many elite advisors said they have just two or three firms they use regularly, though they will show four or five firms at finals. The successful record keeper might have two-tiered pricing and service models to effectively court the elite advisors while serving the blind squirrels.

While some advisors like Fielding Miller think the record keepers are much more important to his operation, others, like PensionMark's Hammond, differ: "DCIOs are adding more value that record keeping wholesalers enabling us through value added tools and services." Matt Gannon, formerly an executive at MFS and now with Cohen and Steers, notes that, "When MFS exited the record keeping business in 2008, we focused on record keepers to generate sales but eventually shifted to teams and experienced advisors. At the beginning, 70% of sales came from record keepers, but that shifted entirely as advisors took a more active role in selecting the funds and managing the plans."

More advisors are looking to their DCIO partners to enable and guide them while keeping out of the limelight, something that many record keepers have a hard time doing. For example, BlackRock has set their focus on teams looking to enable them leveraging their institutional risk management systems that has $14 trillion either under management or advisement. Says BlackRock's Haberli, "We are comfortable being the partner behind the scenes for both the record keepers and the advisors segmenting our services based on their core value proposition realizing that each may be different."

For those that are able to show increased DC Alpha, consolidation, price pressure and navigating the power shift will be not be problems — they will be opportunities to separate themselves. Until then, there will continue to be a somewhat cordial but combative dance among advisors, record keepers and broker dealers, with the DCIOs playing the music and the record keepers writing the lyrics as long as they keep tight control over the data.