FEATURE

Cleaning Up

How to help sponsors think about the use of R6 shares.

BY JUDY WARD

The rapid growth of clean shares in the 401(k) plan market isn't likely to slow down soon.

Just look at the results of an industry survey by Ignites Research, which asked both plan advisors and DCIOs about likely retirement plan investment changes as a result of the U.S. Department of Labor's fiduciary rule. Both advisors and DCIOs expect the greatest growth to come in use of share classes that carry no loads and no 12b-1 fees, commonly called R6 shares, says Loren Fox, New York-based Ignites' director of research. Ignites did the research, surveying 281 of the *Financial Times* "Top 401 Retirement Advisers" and 23 DCIO managers, in the summer of 2016.

"Forty-three percent of the advisors expect to boost their use of R6 shares in plans, and 96% of DCIO firms see more opportunities in this share class," Fox says. The expectation of new fiduciary rules, along with the drives to increase fee transparency and levelize 401(k) participants' administrative fees, have fed robust growth in R6 shares in the past several years. "In the next couple, of years we'll at least see the same pace of growth, if not a pickup in the growth rate," he predicts.

The Current R6 Market

Asset managers have been adding clean shares rapidly. "I count about 1,600 R6 shares," says Paul Ellenbogen, head of global regulatory solutions at Morningstar. "Of those, half launched in the past three years" (though not every asset manager calls its revenue-free share an R6, he says, pointing out that Fidelity calls it a "Class K" share).

The growing sponsor interest in clean shares also works for asset managers, Ellenbogen says. "Asset managers are tired of doing what they view as essentially subsidizing the industry," he explains. "Asset managers are launching clean shares because they want to be out of the administration-subsidization business, and to compete head to head with ETFs (exchange-traded funds) on managing money."

Offering R6 shares has not yet become universal among asset managers, however. "There are still firms that haven't entered the R6 market, although they probably will as it becomes a must-have in the 401(k) market," Fox says. "I would not be surprised if some asset managers are still holding off on R6 shares because they're not sure of the final form that the new fiduciary rules will take. It depends in part on how much plan sponsors and recordkeepers feel that institutional shares, or load-waived A shares, can still fit the bill in the new fiduciary environment."

Typically, asset managers have started out by offering an R6 in their more popular asset classes among 401(k) plans, like large-cap equity, core growth, and small-cap equity, says Jamie McAllister, senior vice president and defined contribution consultant at Callan Associates Inc. "Definitely they are doing it in equities, and we see it in fixed income as well, although we are not seeing it offered as much on the smaller, specialty funds. We also haven't seen it as much in alternatives, but many alternatives used by 401(k) plans are in CIT (collective investment trust) vehicles anyway."

Asset managers offering R6 shares typically do it for almost all their options available to 401(k) plans, although they're being somewhat selective, Ellenbogen says. "Fund firms realize that not all of their funds are winners," he says, "so they realize that throwing an R6 share class on a mediocre fund is not the answer to their distribution problem."

Usage of R6 shares appears to be picking up briskly. As of July 2017, asset managers reported $615 billion of retirement assets in zero-revenue shares, versus $432 billion of retirement assets in shares that pay revenue, says Chris Brown, founder and principal at Newton, New Hampshire-based Sway Research LLC, which focuses on the defined contribution investment-only (DCIO) market.

Compare those numbers to the last time Sway Research looked at R6 adoption, in August 2016. Just 11 months earlier, the market was split nearly evenly between zero-revenue shares (with $411 billion in assets) and revenue-paying shares (with $410 billion in assets). "But now, zero-revenue shares hold nearly 60% of the assets," Brown says. "Essentially, all of the growth since the end of August has been in zero-revenue shares, which makes sense given the demand for low-fee solutions in DC menus, which has been exacerbated by the DOL fiduciary rule." And nearly 300 mutual funds added a zero-revenue share class over the same period, Sway Research finds.

But some sponsors interested in R6 shares could find that their plans lack enough assets to get into these shares. Asked whether this share class typically has asset thresholds, Ellenbogen says, "Asset managers tend to be very cagey about that. If you try to nail that down and ask them, 'What is the threshold for the R6?' it gets really squishy. They say, 'Let me ask my manager.'" The answer seems to depend on factors including how much in assets a plan has overall with a manager, he says.

Portfolio Evaluations, Inc., a Warren, New Jersey-based advisory firm, sees the most current interest in R6 shares from sponsors of large plans, says Gary Pallatta, senior consultant, retirement plans consulting group. "There is a drive by sponsors to bring down costs for all participants," he says. "The industry has taken steps to reduce fees, and this is just a further part of that trend.'"

Analyzing the Net Fee

Investment menus in most 401(k) plans still incorporate some revenue sharing, McAllister finds. "Many sponsors are trying to get as many no-revenue funds as they can on the menu," she says, "but the majority still have a few funds that pay revenue."

When helping a sponsor evaluate a migration to R6 shares, pay close attention to the net participant cost, recommends Jim Phillips, president of Peabody, Massachusetts-based Retirement Resources and a member of the NAPA Leadership Council. A move to revenue-free shares, with an explicit administrative fee for participants, can sometimes increase participants' net cost compared to utilizing revenue sharing to pay administrative fees, he says.

"If you look at the expense ratio of the zero-revenue share class of many funds, you will see that there is not a direct, proportional reduction in the expense ratio by taking out the revenue sharing," Phillips says. Say that a fund has a share class with a 100-basis-point expense ratio, which includes 65 basis points of revenue sharing, and then it introduces an R6 share. "If you take out the revenue sharing, you'd think that the R6 share would cost 35 basis points. What you find, when you look, is that's not necessarily the case. The cost may be 40 basis points, or 45."

"Sometimes it is a matter of having to amortize fund costs over a smaller R6 asset base. The fund companies tell us that they are aware of the issue, and they expect that as the R6 asset base increases, that (cost difference) will disappear over time," Phillips continues. "But for now, what looks like a nice, simple, participant-friendly move may not be. It's important to be very deliberate until share pricing rationalizes."

A fee analysis done for a plan sponsor may find that using a revenue-paying share class actually costs participants less than an R6, McAllister says. "Let's say a fund manager has an R4 share and an R6 share. The R4 share has been around for years and has a significant asset base, while the R6 share is relatively new, so the investment-management component of the fee could actually be cheaper for the R4 share than the R6," she says. "In that case, if the plan is able to rebate the revenue sharing paid by the R4 shares back to participants invested in those shares, the R4 is actually less expensive." Before making the decision between the R4 and R6 share class, she adds, the plan sponsor should understand the rebating capabilities of the recordkeeper for that plan.

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> — *Paul Ellenbogen, Morningstar*

Some revenue-free shares may never cost exactly the same amount less than the revenue-sharing reduction, Brown says. "There's always a little 'noise' in the management fee," he says. "There could be other, distribution-related expenses in there that asset managers are trying to partially cover with the fee. I don't think that we will ever necessarily see it completely 'clean.' Asset managers are always looking for different ways to cover some of their costs."

Sponsors can go with the option to use some R6 shares and leave other revenue-paying funds on the menu, but have their plan's recordkeeper rebate the revenue sharing fully to participants invested in those funds, Phillips says. "Not all recordkeepers can do that, but some already have the capability and others are building it now," he says. "Some other recordkeepers probably say it is not worth it to build out that capability, because they think that in the future, it will be of no use if plans just migrate to investments with no revenue sharing."

Recordkeepers increasingly are developing sophisticated operational capabilities to rebate revenue sharing back to participants, McAllister says. Historically when a sponsor wanted revenue sharing rebated, she says, recordkeepers simply took the revenue sharing amount and spread out the refunded money to all of a plan's participants. Now, she says, more recordkeepers can rebate revenue sharing just to participants invested in the revenue-paying funds. "Some are able to even accrue that rebate on a daily basis, so if a participant was only invested in a revenue-generating fund for three days, for example, that participant will get a rebate proportionate to the three-day period," she adds.

Sponsors also have the option to move to a full R6 investment menu, so that no potential exists for disparity in participants' administrative cost sharing, Phillips says. "Really, I think when sponsors talk about migrating to 'clean' shares, they want to do it for fee equalization for participants," he says. "You can't achieve that equalization if you go halfway, and use R6 shares for only part of the menu. If half of the plan's menu has to generate enough revenue to cover all the administrative costs, then the costs are borne in an unequal fashion by participants."

Removing all revenue sharing means converting to an explicit administrative fee for participants, if a sponsor does not decide to pay the administrative fee itself. So, many participants will see an explicit administrative fee on their quarterly statements for the first time. "That's certainly one of the challenges," Pallatta says. Making that change without upsetting employees "is all about doing the proper communications," he says. "You have to go out to participants and clearly explain why you are doing this, and what the benefit is to them."

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