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# Exploring the Expanding Universe of Investment Products

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## Agenda

1. Drivers of Product Evolution
2. Impacts on the Product Universes and Advisor Operations
3. How Advisors can Adapt to the Changing Product Landscape
4. Summary
5. Questions and answers

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## Drivers of Product Evolution

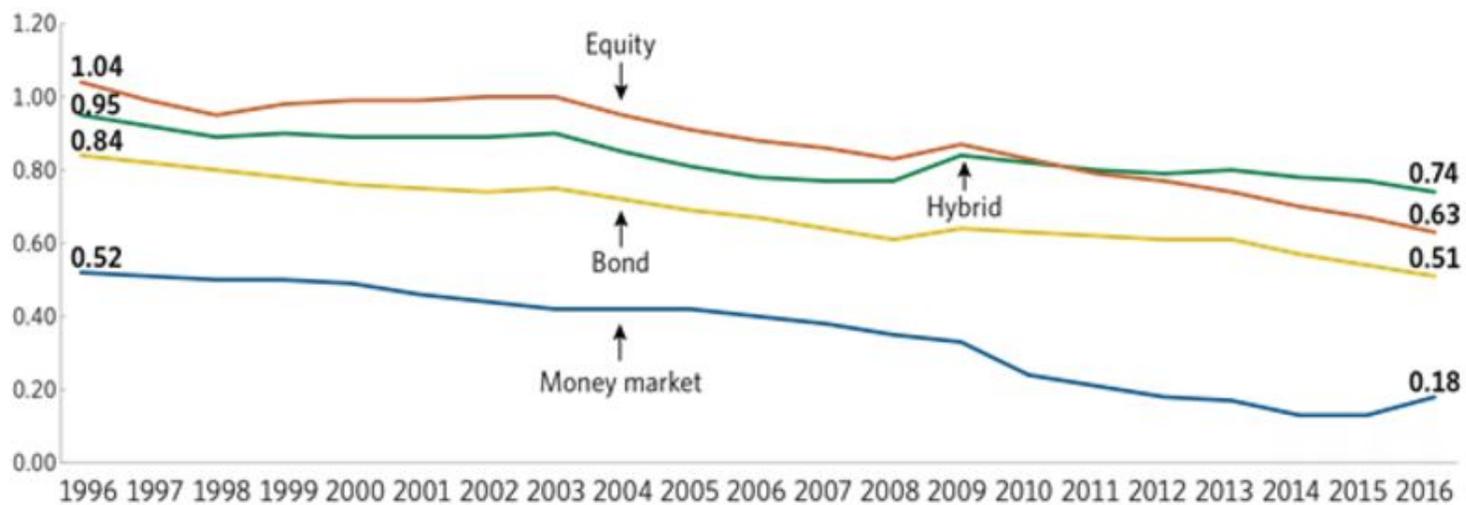
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## Drivers of Product Evolution

1. Costs – Increasing transparency and price sensitivity lead to cost compression
2. Conflicts – The more conflicts you have, the harder it is to mitigate them
3. Competition – Consumer awareness and needs are changing

## Cost Compression Hits All Asset Classes

**Mutual Fund Expense Ratios Have Declined Substantially Since 1996**  
*Percent, 1996–2016*



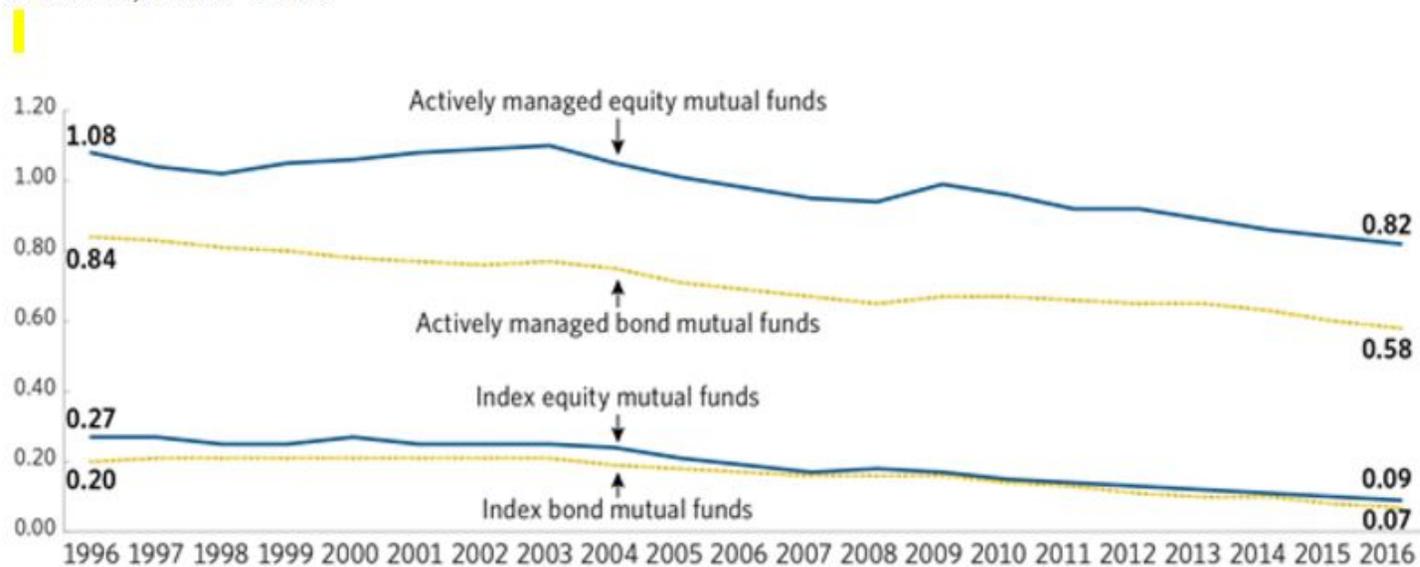
Data from Investment Company Institute (ICI)

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## Cost Compression Hits Both Active and Passive Management

### Expense Ratios of Actively Managed and Index Mutual Funds

Percent, 1996–2016



Data from Investment Company Institute (ICI)

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## Managing Conflicts Through New Mutual Fund Share Classes

- Getting paid is a conflict; getting variable compensation compounds the conflict
- Class T shares have lower sales load than other existing classes and generally have 12b-1 and servicing fees; permit each intermediary to set the sales load (which must be the same for each intermediary)
- Clean shares allow brokers, rather than mutual funds, to set fund commission rates (subject to conditions)
  - Broker acts on an agency basis as seller of clean shares
  - No distribution-related payments to the broker
  - Prospectus disclosure that investor may have to pay a commission and other share classes may be available
  - Broker sets the commission
  - Purchases and redemptions will be made at net asset value established by the fund (before commission)
- Some back-tracking on T shares pending probable further delay in implementing the DOL's Fiduciary Rule

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## Overarching Fiduciary Concepts Governing Costs And Conflicts

- Costs must be fair and reasonable given the services provided
  - Competitive; not unconscionable
  - Justified based upon sound due diligence
- Conflicts must be avoided or managed to serve the investor's best interest; advice must be
  - Prudent
  - Individualized
  - In conformity with the fiduciary duty of loyalty
- Disclosure is necessary, but not sufficient, to adhere to the fiduciary duties of loyalty and care

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## **Competition – Consumer Awareness and Needs Are Changing**

- Rising demand for reconfigured guaranteed retirement income options
- Falling demand for some previously popular products
- Rising demand for some novel investment alternatives in the fund space



## Interest in Guaranteed Income from DC Plan Sponsors catching-up with Participants

- April 17, 2013 Transamerica survey– According to a survey of defined contribution plan participants by Transamerica Retirement Solutions, 65 percent of participants age 50 or older are interested in having a guaranteed income option in their defined contribution (DC) plan; and 43 percent said if they had the choice, they would invest in one now.
- “Of 212 companies surveyed in 2016, 85% agreed that the “core purpose” of workplace retirement plans should be to serve as a source of retirement income. That’s way up from only 9% in 2012, according to two studies conducted for MetLife.” <sup>1</sup>

<sup>1</sup> EMPLOYERS ARE TRYING TO SOLVE THEIR WORKERS' RETIREMENT INCOME PROBLEM, MARKETWATCH.COM MARCH 2017

## Regulatory Guidance on Guaranteed Income Products as Default Options

- IRS Notice 2014-66 allows TDFs to allow participants in designated age-bands to invest in annuities
- October 23, 2014 DOL Information Letter to Treasury's Deputy Assistant Secretary for Retirement and Health Policy describes when unallocated deferred annuity contracts can be used in a QDIA
- August 2015 GAO report, *401(K) Plans – Clearer Regulations Could Help Plan Sponsors Choose Investments for Participants*, calls upon the DOL to clarify use of lifetime income solutions in QDIAs
- December 22, 2016 DOL Information Letter to TIAA clarifies when annuities can be used as default options when they don't meet the requirements of a QDIA and supports lifetime income options

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## Winners And Losers In The Annuity Arena Under The DOL Fiduciary Rule

- Winner: Fixed-rate deferred annuities with income riders
- Winner: Fee-based indexed and variable annuities
- Losers: Traditional indexed and variable annuities with non-level compensation
- Caution: The future is foggy for requirements for annuities under the DOL Fiduciary Rule

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## **Biggest Loser To Date: Non-traded REITs – Exhibiting The Formula For Disaster**

- Transparency problems: Not traded and unreliable pricing
- Sky-high and variable distribution costs
- Poor performance
- No clear path forward

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**Impacts on the Product  
Universes and Advisor Operations**



## Morningstar US Open-End Mutual Fund Data as of August 31, 2017

<b>Total Share-Classes</b>	<b>27,317</b>		
Those with less than Three Years of History	5,802	21.2%	
Those with less than Three Years of History that are Extensions of Existing Funds	4,550		78.4%
<b>Total Target Date Fund Share-Classes</b>	<b>2,578</b>		
Those with less than Three Years of History	870	33.7%	
Those with less than Three Years of History that are Extensions of Existing Funds	660		75.9%



## Morningstar US Open-End Mutual Fund Data as of August 31, 2017

Total Share-Classes	<b>27,317</b>	
Those with less than Three Years of History	<b>5,802</b>	<b>21.2%</b>
<u>Those with less than Three Years of History that are Extensions of Existing Funds</u>	<b>4,550</b>	<b>78.4%</b>
Those with less than Three Years of History Associated with New Funds	<b>1,252</b>	<b>21.6%</b>

<i>Biggest Percentage Increases in Fund Types</i>	Total	'New Fund' Share-Classes	<u>New % of Total</u>
	<u>Share-Classes</u>	<u>Last Three Years</u>	
Long/Short	468	81	<b>17.3%</b>
Alternatives	675	75	<b>11.1%</b>
Target Date	2,578	210	<b>8.1%</b>
Emerging Markets	1,218	82	<b>6.7%</b>

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## Morningstar Collective Investment Trust Fund Data as of August 31, 2017

Total Share-Classes	<b>5,318</b>	
Those with less than Three Years of History	<b>1,602</b>	<b>30.1%</b>

Total Target Date Fund Share-Classes	<b>1,831</b>	
Those with less than Three Years of History	<b>695</b>	<b>38.0%</b>

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## Exchange Traded Funds

- In 2016, 85% of asset inflows from mutual fund into ETFs were in assets with expense ratios of nine basis points or less.<sup>1</sup>
- Multi-factor ETFs led new issuances in 2016.<sup>1</sup>
- Vanguard filed to issue actively managed ETFs.

<b>Universe</b>	<b>Total Investments<sup>2</sup></b>
Retail Variable Annuities	130,003
Open-end Mutual Funds	27,317
Collective Investment Trusts	5,318
ETFs	2,041

<sup>1</sup> Implications of the Escalating ETF Fee Wars, Sam Bourgi, May 11, 2017

<sup>2</sup> Morningstar Direct, data as of 8.31.2017

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## **How Advisors Can Adapt to the Changing Landscape**



## **Determining whether New Investments Warrant Consideration**

Factors that should be considered in determining whether a new investment warrants consideration for a fiduciary account include:

1. Uniqueness and strength of benefits relative other, readily available investments
2. Alignment of any unique benefits with the goals and needs of the specific account for which it's being considered
3. Availability of alternative prudent selection criteria robust enough to make a prudent evaluation
4. Experience and skill of the individual or team, and expected successors, evaluating the alternative criteria
5. Persistence in the availability of alternative criteria to facilitate ongoing monitoring

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**Example:  
Lower Cost Share Class of Existing Fund**

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## Due Diligence on New Share-Classes of Existing Funds

1. Where available, leverage 'extended performance' (earlier fund performance linked to new share class)
2. Utilize fact-sheets/data associated with older share-classes
  - a. When possible, utilize materials from share-classes that are "at least" as expensive as the new share-class
  - b. Disclose any "transitive" due diligence processes to clients

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**Example:  
Due Diligence on DC Annuity Solutions**



## Annuity Safe Harbor Requirements

Under the annuity selection safe harbor, the selection of an annuity provider and contract for benefit distributions from an individual account plan satisfies the requirements of section 404(a)(1)(B) of ERISA if the fiduciary:

1. Engages in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities;
2. Appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under the annuity contract ;
3. Appropriately considers the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract;
4. Appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract; and
5. If necessary, consults with an appropriate expert or experts for purposes of meeting these conditions.

Ongoing requirement to review selections.

Focus on the process, not the results, and information available at the time decisions made.

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## Safe Harbor Interpretation

While the Department of Labor (“DOL”) has provided a safe harbor regulation under ERISA for the selection of annuity providers, it does not provide a true roadmap for fiduciaries to follow. (The DOL has indicated that the steps described in the regulation are not the exclusive means of engaging in a prudent selection process.) **It appears, however, that if a fiduciary selects a well regarded company from among the available candidates that others have chosen in the past** – especially one that has a well-known reputation, a significant volume of annuity business and a history of managing that business, high ratings from the ratings agencies that are consistent across all the agencies and over a long period, and is well financed – **it is not necessary to engage in the exact steps described in the regulation.**<sup>1</sup>

<sup>1</sup>LIFETIME INCOME IN DEFINED CONTRIBUTION PLANS: A FIDUCIARY APPROACH A WHITE PAPER BY FRED REISH, BRUCE ASHTON AND JOSEPH FAUCHER



## DC Annuity Due Diligence Approach

Based on plan demographics/participant needs, identify the appropriate income options for the plan.

Once the option type is selected, evaluate using an objective, thorough, analytic process for selection:

### Sample Checklist

- Strength and Stability<sup>1</sup>
- Ratings<sup>1</sup>
- Track Record<sup>1</sup>
- Costs<sup>1</sup>
- Transparency<sup>1</sup>
- State Guarantees<sup>1</sup>
- Recordkeeper availability
- Portability

<sup>1</sup>LIFETIME INCOME IN DEFINED CONTRIBUTION PLANS: A FIDUCIARY APPROACH A WHITE PAPER BY FRED REISH, BRUCE ASHTON AND JOSEPH FAUCHER

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## Summary

1. Costs, Conflicts, and Competition driving Investment Expansion
2. ETFs Posing Increasing Challenge to Open End Mutual Funds
  - Low cost
  - Clean Shares
  - Multi-factor and active strategies growing
3. The expanded investment set offers great opportunities, but requires discipline and prudence
  - New, lower fee, share-classes deserve immediate attention
  - Innovative investments should only be considered if:
    - Prudent selection criteria are readily available
    - Those responsible for selection and review have the required expertise
    - Unique benefits align with the specific client/account needs



## Questions

Additional information on fiduciary trends can be found at

Fi360 Fiduciary Talk Podcast

[www.fi360.com/fiduciarytalk](http://www.fi360.com/fiduciarytalk)

Also available on iTunes

and

Fi360 Blog

[www.fi360.com/blog](http://www.fi360.com/blog)

Additional questions can be directed to [support@fi360.com](mailto:support@fi360.com)