GOSSELIN CONSULTING GROUP LLC

A World of Investment Opportunities

EVALUATING THE TRUE "NET COST" OF INVESTMENT OPTIONS

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In prior articles we've focused on plan administration pricing and financing options as a way to reduce potential fiduciary liability and mitigate the impacts of participant subsidization. Another way to ensure that participant fees are reasonable is to evaluate the true cost differences across vehicles and share classes for each investment option in the plan.

It remains common practice for today's plan sponsors to use revenue sharing as a way to offset plan administration fees. However, since most funds distribute varying amounts of revenue sharing, it's nearly impossible to arrive at the same amount for all funds in a plan line-up. While we are a proponent of eliminating revenue sharing from a plan's line-up in order to equally allocate administration costs across all participants, there may be certain instances where this approach doesn't make sense. To make this determination, it's imperative to analyze the true "net costs" across investment vehicle and share class alternatives.

First, let's briefly review the key component's of a fund's expenses. The prospectus gross expense ratio reflects the full cost of what it takes the investment manager to run the fund plus any 12(b)-1 and/or sub-TA fees. In the case of newer and/or smaller funds, this figure may be quite a bit higher than its stated net expense ratio. This difference represents a contractual fee waiver put in effect by the investment manager in order to make the fee paid by investors more reasonable and comparable to its asset class peer group. The prospectus net expense ratio is what is actually paid by investors of the fund and is reflected in the fund's performance. Embedded within the gross and net expense ratios are management fees, 12b-1 fees, and "other" fees passed through to investors for the management, operations, and marketing of the fund.

In addition to the prospectus net expense ratio discussed above, it's important to analyze the true "net cost" across share classes and investment vehicles offered by the same fund. Gosselin Consulting Group defines "net cost" as the prospectus net expense ratio minus any applicable fund offsets / revenue sharing used to offset non-investment-related plan expenses. Many funds offer multiple share classes as well as collective investment trusts (CIT's) that present different cost structures. This net cost takes into consideration the important effect of revenue sharing in order to arrive at the actual cost borne by the plan. Since revenue sharing directly offsets plan administration costs, those invested in a revenue-sharing fund pay more for plan expenses and also see a greater reduction from fund performance. Let's consider the following investment option alternatives:

Fund / Share Class (Mutual Fund or CIT)	Prospectus Net Expense Ratio	Revenue Sharing	Net Cost
ABC Large Cap Value Fund / **Class A** (MF)	1.05%	0.45%	0.60%
ABC Large Cap Value Fund / **Inv.** Class (MF)	0.80%	0.25%	0.55%
ABC Large Cap Value Fund / **Inst**. Class (MF)	0.68%	0.00%	0.68%
MyCo Foreign Equity Fund / **Inv**. Class (MF)	0.95%	0.15%	0.80%
MyCo Foreign Equity Fund / **Inst**. Class (MF)	0.83%	0.00%	0.83%
XYZ Total Return Bond Fund / **Inst**. Class (MF)	0.46%	0.00%	0.46%
XYZ Total Return Bond Fund / **N/A (CIT)**	0.40%	0.00%	0.40%

In the case of ABC Large Cap Value Fund, it offers three viable share class options for consideration. Upon first glance, the prospectus net expense ratio would indicate that the Institutional class is the cheapest of the three. However, when factoring in the effect of revenue sharing, we see that the Institutional class is actually the highest on a net cost basis. While the plan sponsor may be trying to strip out all revenue sharing, they may have a justifiable case to use the Investor share class at a net cost of .55%. While the delta between these two share classes is quite large and is rather uncommon, it can occur and provides reason to explore all alternatives. As long as the plan sponsor has used a prudent process to arrive at their decision to use the Investor class, and that decision is well documented, it may help to reduce fiduciary liability.

If we evaluate the MyCo Foreign Equity Fund, we see two share class alternatives. While the prospectus net expense ratio is lower on the Institutional class, we see the true net cost is actually .03%, or three basis points, higher than the Investor class. In this case, given that the delta is only three one-hundredth of a percent different, the plan sponsor would be justified to use the Institutional share class to eliminate the impact of revenue sharing. This holds even more weight if the fund in question is a sizable fund in the plan. Again, this decision should be based on a prudent process and well documented to satisfy the DoL.

Lastly, we have the XYZ Total Return Bond Fund which offers an Institutional class as well as a collective investment trust (CIT). In this case, both provide no revenue sharing, so it's important for the plan sponsor to a) be aware that a collective investment trust exists for the investment option, and b) confirm that they meet any requirements to use the fund. Plan sponsors may be unaware when CITs exist for a particular investment option, which may put them at risk especially when/if the plan experiences significant growth in plan assets. If the plan's policy is to not use CITs, or if it's a non-qualified plan that is ineligible to use CITs, the plan sponsor should document that information to show that the appropriate due diligence was conducted to identify all available options.

Periodically conducting this level of analysis for all investment options in the plan — including comparative analysis for plan investment options in similar asset classes (i.e. LCV vs LCG) — as well as for potential new and/or replacement investments will put the plan's fiduciaries in the best position to mitigate potential liability. Fund expenses are highly visible and plan participants are becoming more aware of the concept of revenue sharing. Therefore, a plan sponsor that follows a prudent process and documents its rationale behind key fee-related decisions will best fulfill its fiduciary responsibility.

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