

WORKPLACE BENEFITS

Do you know if your pension plan is overpaying for investment services?

For many sponsors of defined benefit pension plans,¹ investment fees can be a complicated subject. The Employee Retirement Income Security Act of 1974 (ERISA) requires that plan fiduciaries ensure fees paid to service providers are reasonable, but this isn't always straightforward. Investment services may be difficult to price and even harder to compare.

Service offerings can vary significantly, and fee schedules typically aren't publicly available. ERISA Section 408(b)(2) fee disclosures were created to help provide transparency to plan fiduciaries regarding the fees charged by various plan service providers, but they may not be easily understood by plan fiduciaries.

This paper is intended to help plan fiduciaries understand their obligations regarding investment fees. In support, it provides descriptions of different types of investment arrangements, ways fiduciaries can assess the investment-related fees being paid, and a detailed case study.¹

Why does it matter?

A fiduciary for a pension plan is required by ERISA to make sure that the plan's fees are reasonable. Even if a sponsor has hired an outside advisor to serve as a co-fiduciary, the duty to ensure that fees are reasonable under ERISA remains the responsibility of the plan sponsor.

Additionally, fees act as a drag against asset growth, which can impede plan goals. As a general best practice, plan fiduciaries should consider plan asset performance after deducting fees associated with the fund(s), manager(s) and/or advisor(s).

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First things first

Plan fiduciaries have an obligation to consider the fees associated with plan services. However, when choosing a service provider, the decision should not be based solely on cost considerations. Rather, the goal is to ensure that investment fees are reasonable within the context of the plan's investment strategy. Asset fees can vary significantly by asset class, investment style and implementation type. For example, passively managed funds generally cost less than actively managed funds, but that does not imply that a pension plan should only invest in passive indices. The goals and objectives of a plan should dictate the investment strategy—and by extension, the asset classes that the plan should generally invest in. From there, it is the responsibility of the plan fiduciaries to ensure that the fees associated with those investments are reasonable.

Background on types of investment fees

It's difficult to determine if investment fees are reasonable without having a firm grasp on what the plan actually pays. This can be challenging given the wide array of investment fees that exist. Aggregating the various fees being paid by a plan can help a plan fiduciary understand the total costs.

Most plans are likely to pay expenses at three different levels: program, manager and fund. Allocating the plan's fees to each of these categories helps create a clearer picture of a plan's costs.

Program level fees

Fees charged by advisors or consultants who provide services across asset classes. Examples include fees paid to an Outsourced Chief Investment Officer (OCIO)³ provider, fees paid to a consultant who provides quarterly market commentary and fees associated with access to an investment platform.

Manager level fees

Fees charged by asset managers who are responsible for individual strategies or accounts. Examples include fees paid for separately managed accounts (SMAs)⁴ and fees associated with private funds.

Fund level fees

Fees paid to a fund or trust. Examples include expense ratios, fund operating expenses and trustee fees. Fees for both actively managed and passively managed funds should be included.

To aggregate these various types of fees, they should first be expressed in a consistent form, either in dollars or basis points. Converting to dollar-terms conveys a tangible value. However, dollar-term fees are dependent on the value of the assets. Converting to basis points makes it easier to compare across asset values, but may feel less material. Either form is appropriate, and the form plan fiduciaries favor will come down to personal preference.

Potential conflicts of interest

Commissions, revenue sharing, soft dollar agreements and many other types of fee arrangements all exist in the investment world. These types of fee arrangements are not disallowed under ERISA, although plan fiduciaries should exercise caution regarding arrangements that could create potential conflicts of interest.

Section 408(b)(2) of ERISA was enhanced to require the disclosure of fees (both direct and indirect) from qualified retirement plan service providers. These disclosures are a helpful tool for plan fiduciaries seeking to understand the fees being paid by the plan. Fee disclosures can also be used to identify situations that may create a conflict of interest. In fact, the Department of Labor indicated that the 408(b)(2) disclosures should be used for this purpose.²

Not all forms of indirect compensation will create problematic conflicts of interest, and determining whether there is an issue might not be straightforward. The Department of Labor suggests plan fiduciaries start by considering why the indirect compensation is being paid. Additionally, plan fiduciaries should consider if the nature of that compensation might bias service provider recommendations.

Incentives related to anything other than running the plan in the best interest of the plan participants could present significant issues for fiduciaries. For example, advisors who depend on commissions from mutual fund companies might exercise a bias toward funds that offer the largest commissions. Likewise, investment managers who earn compensation through the utilization of their own investment products might encourage the use of those products, even if higher-performing or lower-cost options are available.

How to confirm fees are reasonable

With a better understanding of the total fees being paid by their plans, fiduciaries will be well-equipped to begin evaluating the reasonableness of those fees. There are many different approaches that can be utilized to make that evaluation. Two approaches for consideration are outlined next.

Approach 1 — Make use of publicly available data

Most qualified pension plans must file an annual document called the Form 5500. This filing contains information about each plan's financial condition, investments and operations. When investment fees are paid out of the plan's assets, the annual amount of those expenses is detailed in the filing. The Form 5500 is publicly available, making it an excellent resource for benchmarking investment fees.

To create a baseline understanding, Bank of America analyzed investment fees included on the Form 5500 for all single-employer, multiple-employer and multi-employer defined benefit plans. Within this analysis, the average investment fees paid over a five-year period were calculated.⁵ Only plans that had five full years of non-zero investment fee history were included.

Approach 2 — Ask the market

A more formal approach to obtaining market prices for services could include a Request for Proposal (RFP). This might be the best way for a plan sponsor to explore options, but issuing a full RFP can be a labor-intensive process. A plan's internal staff may not have the capacity or expertise to effectively manage the RFP process. While there are third-party consultants who specialize in managing RFPs, consultant expertise and the associated fees may be hard to justify for a simple price check.

Instead, a less formal route could be useful. Distributing a Request for Information (RFI) tends to be less time consuming than a full RFP and signals to the recipients that the plan is interested in collecting information, rather than receiving an elaborate proposal. This serves as an efficient method to evaluate the market price of investment services. However, service providers may not spend as much time developing fees for an RFI response relative to an RFP response, so the fee information gathered could be less precise.

The best RFIs and RFPs are straightforward and direct. They communicate why the request has been issued, provide basic information about the plan and outline what information is expected in the response. To ensure all responses are comparable, identical information should be provided to all service providers. While it does require additional work to write, distribute and evaluate the responses, the potential for future cost savings can easily justify the investment of time. For an example of how to utilize each approach, consider a hypothetical case study on the following page.

Important: Investment fees detailed on the Form 5500 are not all-inclusive

There are investment-related expenses that are unlikely to be included in the dollar amount shown on the Form 5500. Here are a few examples of situations where fees would not be included:

- Fund-level fees paid as expense ratios for Exchange Traded Funds (ETFs) or mutual funds. Fund managers are allowed to deduct expenses from the fund's market value rather than bill an explicit fee.
- Indirect compensation received by investment service providers such as soft-dollar revenue and commissions.
- Expenses related to staff internally employed by a plan sponsor — especially if the plan's investments are not a full-time responsibility of the staff.

While the fact that the publicly available information doesn't fully capture all types of investment-related expenses is a limitation of the data, that doesn't mean the results are uninformative. Rather, the data reflects the reality that different types of investments and investment service providers charge fees in different ways, and underscores the importance of making thoughtful comparisons.

How plan size can affect fees

As the details in the chart below illustrate, investment fees can be a reflection of plan size in the following ways.

The smallest plans tend to pay the highest investment fees. Investment services are frequently priced at lower rates for larger pools of assets, so this result is not overly surprising. Still, the impact of size is significant. Smaller plans may pay double that of plans in adjacent asset categories.

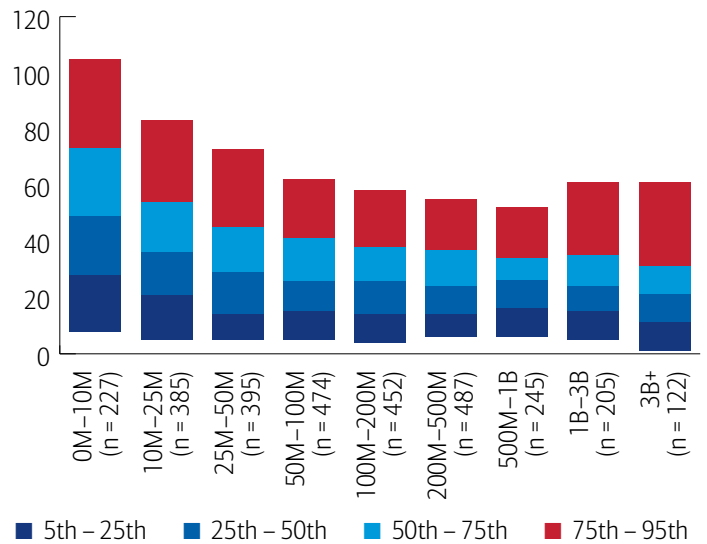
For plans over \$100M in assets, the median investment fees paid are roughly 25 basis points, regardless of size. This result may be a combination of these two factors:

- Larger asset pools tend to use more separately managed accounts while smaller plans tend to use more mutual funds or commingled funds. Fees for SMAs are typically included as investment fees on the Form 5500 while fund-level expenses are not. This may make smaller plans that invest heavily in funds appear as though they have much lower fees. In reality, both are investment expenses, further emphasizing the importance of categorizing the plan's all-in fees as outlined in Approach 1.
- It may indicate that investment providers are willing to cut their fees to work with larger plans, but only to a certain point. Furthermore, it may reflect that very large plans

tend to hire an increasing number of managers or employ more complex strategies — lowering the potential for fee-reducing scale.

Using publicly available information is a valuable step in gaining a high-level understanding of investment fees. That said, it may not be sufficient to determine if the fees currently being paid are reasonable.

Investment fees paid by percentiles



Source: Bank of America, analysis of Department of Labor Forms 5500—schedule H data, for filing years 2017 through 2021. This fee analysis plots the fees in basis points at various percentiles, categorized by asset value as of each plan's last reporting period.

Hypothetical Case Study

Jane is a fiduciary of a \$750M pension plan. The current investment strategy was constructed piece-by-piece over many years, resulting in the payment of investment fees to numerous providers. Jane isn't as comfortable with the plan's investment fees as she'd like, so she decides to take some steps to help ensure that the fees are reasonable.

First, Jane calculates the plan's all-in investment fees. She reviews the plan's current consultants, asset managers and funds; then calculates the fee for each as a percentage of assets. She summarizes this information in a worksheet (see the "Current fees" column of the illustration below). She totals fees at the Program, Manager and Fund level and discovers that the plan is currently paying 25 basis points for investment-related services.

Next, Jane analyzes publicly available data and determines that the median investment fees shown on Form 5500s for similarly sized plans is roughly 25 basis points. This information reassures her that the plan's current fees are probably reasonable. However, she recently read that investment fees for pension plans have compressed over the last decade due to more competition and improved scale. She is concerned that the current program-level fees of 10 basis points may be too high.

Jane decides to issue an RFI for the plan's investment services. Since the plan's current investment strategy has slowly changed over many years, she wants to use a fresh approach for the RFI. Jane writes the RFI and indicates that the purpose is to assess if their current fees are reasonable

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and asks the recipients for their most comprehensive level of investment services. She supplements the RFI with actuarial information relevant to the plan’s liability and future growth needs.

Jane then analyzes the results of the RFI, from which she received three responses—each with different styles of implementation. She summarizes the information received in the worksheet alongside the plan’s current information to allow for side-by-side comparisons.

- **Firm A provides an “ETF-only” approach.** The program fees are low, and there are no manager-level fees. The fund-level fees are also quite low due to a heavy emphasis on passive investments. Jane is enticed by the opportunity for lower fees, but she doesn’t feel that a fully passive approach is right for the plan.
- **Firm B supplies a “manager-of-manager” approach.** Firm B provides high-level guidance and hires third-party managers to implement specific strategies. Jane appreciates the method of implementation, but the emphasis on third-party managers is quite costly.

She decides not to move forward with Firm B but is pleased that it helps to support that her current fees may be reasonable.

- **Firm C provides an “open-architecture” approach,** Firm C offers both proprietary solutions and access to a wide array of investment options through third-party managers. The more customizable approach costs more at the program level. However, access to proprietary solutions helps reduce manager-level fees. The program fees are lower than those under her current arrangement, resulting in lower all-in fees. Jane decides she’d like to have a follow-up conversation with Firm C to better understand their capabilities.

After taking these actions, Jane accomplished her goal. She now understands the plan’s current fee structure better and feels confident that the fees are reasonable. Her confidence is supported by both publicly available data and written responses from her RFI. Additionally, she uncovered a potential opportunity to lower investment fees by exploring the open-architecture solution offered by Firm C.

Jane’s fee-comparison worksheet

	Current fees	Hypothetical Firm A ETFs-only	Hypothetical Firm B Manager-of-manager	Hypothetical Firm C Open-architecture
Program-level fees Fee associated with plan level advisors and investment platform(s)	10 bps	3 bps	5 bps	7 bps
+				
Manager-level fees Fees associated with third-party managers and separately managed accounts	10 bps	-- bps	20 bps	8 bps
+				
Fund-level fees Expense ratios on mutual funds, ETFs and Collective Investment Trusts (CIT)	5 bps	12 bps	-- bps	5 bps
=				
All-in plan fees Total of all fees paid directly, indirectly or charged to the fund	25 bps	15 bps	25 bps	20 bps

Hypothetical firms are for illustrative and comparative purposes only.

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Summary

Investment fees can be complicated, but they don't have to be. By analyzing the 408(b)(2) fee disclosures, publicly available data, and engaging consultants in providing periodic I RFP/RFI processes, fiduciaries of defined benefit plans can uncover whether their investment fees are reasonable or not. No singular process will work for all plan fiduciaries, and consulting with ERISA counsel or other consultants may be advisable. Identifying opportunities to reduce fees may not only help a plan save money, but it also can potentially reduce ERISA litigation and mitigate personal liability for the plan's fiduciaries. For these reasons, at Bank of America we believe that fee transparency is an essential component of pension plan governance.

For more information, please contact your Bank of America representative or visit go.bofa.com/definedbenefitplans.

The case studies presented are hypothetical and do not reflect specific strategies we may have developed for actual clients. They are for illustrative purposes only and intended to demonstrate the capabilities of Bank of America.

¹ This is meant to be an educational guide for pension practitioners. It is not intended to be a legal opinion or consulting advice. Disclosure that this is not intended as legal advice – make sure that disclosure gets added.

² From the Federal Register, Vol. 77, No. 23, page number 5637: "This new requirement will illustrate for the responsible plan fiduciary potential conflicts of interest on the part of the covered service provider (or an affiliate or subcontractor) resulting from the receipt of indirect compensation."

³ An Outsourced Chief Investment Officer exercises full discretionary responsibility for both the recommendation and implementation of a plan's investment strategy, acting as an ERISA 3(38) fiduciary. In contrast, a 3(21) relationship is one where the service provider acts as an investment advisor providing recommendation to the plan's fiduciary but does not bear responsibility for implementing the investment decisions. In other words, the plan's fiduciary under a 3(21) arrangement retains final decision-making responsibility.

⁴ SMAs consist of assets of a singular plan or trust invested in securities in an account run by a fund manager or managers.

⁵ Fees were calculated as a percentage of assets and expressed in basis points (or 0.01%).

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This article is designed to provide general information for plan fiduciaries to assist with planning strategies for their retirement plan and is for discussion purposes only. Always consult with your independent actuary, attorney and/or tax advisor before making any changes to your plan.

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