*"The miracle of compounding returns is overwhelmed by the tyranny of compounding costs."* —John Bogle, founder of The Vanguard Group

## *"Defined Contribution Plan design should reduce costs, not quality."* —Third Sigma

Nowhere is John Bogle's admonition about compounding costs more true than in Defined Contribution (DC) Plans, like 401(k) and Profit Sharing Plans. DC plans often have layers of fees, including *hidden fees* (we define *hidden fees* as those fees that are not readily understood by an average plan participant). Recent DOL regulations have required the disclosure of fees to plan participants. These new rules have started to make a difference. We see that plan participants have begun to study their plan's fees and to compare them to other similar plans. Some plan trustees have felt obliged by the new regulations to investigate plan expenses, and to evaluate the reasonableness of their DC plan costs, as well as the quality of their plan's investment offerings.

Third Sigma has developed flexible templates for DC plans that we believe provide best-in-class investment options at a lower than average *all-in* cost (the combination of all investment, record-keeping, advisory, administrative, and custodial fees). Third Sigma wants both plan sponsors and participants to understand the fee structure, because transparency argues for a simpler approach to fees.

Costs for plan services can vary significantly. There are studies which demonstrate that many plan's *all-in* expenses can be as high as 1.5% to 2% or more. Cost is not determinative of a plan design's quality; many plans pay diamond prices for a cubic zirconia.

Threshold questions are: Bundled or unbundled? Proprietary or open architecture? Besides the normal legal and accounting fees for almost any entity, four major categories of services, affecting costs for DC plans are shown here. These services can be bundled or unbundled.


Often bundled services can be more expensive than unbundled services. In bundled arrangements, plan participants frequently have limited investment choices and may be locked into proprietary products, some of which look like publically-traded mutual funds, *but are not.* There may be a greater potential for conflicts of interest as well.

We recommend that most plan sponsors look for highly rated TPAs, custodians, and record keepers that charge a flat fee. Besides the cost, there are other advantages to unbundled services. Providers can be replaced if the plan sponsor is not satisfied with the services provided in one area, without affecting those areas that are acceptable.

Investment Advisors should be willing to accept fiduciary responsibility in writing, like Third Sigma does; we believe fiduciary liability links the advisor's success directly to that of the plan.

In today's marketplace, there is no reason plans should not have dozens of high-quality investment choices. In Third Sigma's DC plans, participants have approximately (but are not limited to) 25 investment options with no increase in plan costs. From those investment choices, Third Sigma constructs five or more model portfolios. Participants can choose a model portfolio or build their own portfolio from the 25 fund choices. Model portfolios are customized for each plan and employ managed asset allocation and *smart rebalancing*. Models can be a combination of index funds (passive) and actively managed mutual funds (active/passive strategy). We believe that a core index approach, with an active manager overlay, can add value and reduce portfolio risk; but if a client prefers, the models can be built using only index funds.

Share class can affect costs in a major way. There are many share classes of the *same* mutual funds. The most common *retail* classes are: A-Shares, B-Shares, C-Shares. A-Shares usually have a load; that is, one pays the broker an up-front fee of 3%-5% when the mutual fund is sold (you just *thought* you invested $100). In addition A, B, and C shares usually have 12(b)(1) fees, which are paid by the mutual fund company to the broker on an annual basis (usually 0.25% to 1%). One also sees fees and charges such as contingent deferred sales charges on B and C Shares. Another type of *hidden fee* is the Sub-Transfer Agent (SUB-TA) fee, which is paid to the custodian or brokerage firm.

The difference in expense ratios (what the mutual fund manager charges the fund) between a *retail* share class and an *institutional* share class can be significant. Third Sigma reduces cost by using the lowest cost share class available—usually institutional share classes (I-Shares) which don't have 12(b)(1) fees. I-Shares sometimes have SUB-TA fees. Most of the service providers Third Sigma works with (like Vanguard), reimburse SUB-TA fees and 12(b)(1) fees, if any, to the plan and participants. Third Sigma is paid directly by the plan and does not receive any payments from any third parties in any form. You can feel confident that your investment success is Third Sigma's goal.

Plan Fiduciaries should know that a plan participant's long-term returns can be eroded by excessive fees, lessening the chances of accumulating sufficient assets for a comfortable retirement.