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iGPS – A Solution in a Fee-Compressed (DCIO) World

Philip Chao, Principal & CIO, pchao@chaoco.com
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The February 7, 2019, Jackie Noblett's Ignite article "Fee Pressure Pummeling Manager Margins[1]" points out that asset managers are watching their product fees and revenue erode at an accelerating pace. Last year, managers' average operating margins plunged to their lowest levels in seven years, according to a new report published by Casey Quirk, a business of Deloitte Consulting. And the pressure is not likely to abate, which means asset managers must adapt their business models to focus less on pure asset gathering and more on meeting revenue growth and profit targets. Across publicly traded asset managers, margins dipped to 29% — a full 5 percentage points lower than the post-crisis peak of 34% in 2014 and 2015. It is also 2 percentage points below 2017's margins.

Asset Manager – the Challenging Way Forward

The 2018Q4 CaseyQuirk white paper titled "Industrial Evolution" offers a framework to secure future profitable growth in the asset management industry. Among other insights regarding the quality needed for growth, the paper suggests four strategies to reinvest in competitive advantage.

1. *Higher-demand investment strategies (page 9)*
   Successful firms are strengthening product development functions by focusing on strategic product development with new technologies, data and analytics. Also, they have aggressively repositioned product array through innovative and inorganic means while sunsetting outmoded investment strategies and legacy products.

2. *Strong Pricing Policies (page 10)*
   Successful firms maintain better economics and charge higher fees than their competitors through capacity limitation, limited lower cost alternatives, aggressive negotiation with large distribution channels, and limited revenue leakage.

3. *Customized Client Experience (page 11)*
   Successful firms are moving from standardized products for wholesale distribution to greater customization since there are less homogenous buyers, increasing intermediary consolidation, increasing portfolio complexity and higher service expectations which are simple. Digital and mobile.

[1] Ignite requires subscription for access
http://ignites.com/c/2196773/266163?referrer_module=SearchSubFromIG&highlight=Fee%20Pressure%20Pummeling%20Manager%20Margins

Successful firms are developing new approaches to asset management distribution that more closely resemble service-oriented businesses with the following common denominators:

- Customization through client segmentation made possible by greater collection and analysis of client and third-party data.
- IP-driven marketing
- Closely aligned marketing, sales and service processes that strengthen client relationships
- Using risk management analytics, asset allocation advice, and custom data analytics that better inform asset owners, intermediary or end users
- Customized delivery of report and portfolio design

4. *Strategic Use of Technology (page 13)*

The greatest differentiator between profitable growth firms and their peers has been their investment in, and use of, technology. Here are four proposed actions:

- Investing in automation, alternative data and artificial intelligence to create new tools and platforms that can help them redefine asset management propositions
- Use technologies to help asset managers mass-customize their engagement models and potentially deliver more services directly to end-users, without dramatic reductions in efficiencies.
- More efficient and automated approaches improve data quality, provide real-time access, accelerate processing and better support portfolio management across more complicated investment strategies
- Harness data at an enterprise level through effective use of master data management.

Target Date Funds

According to the Morningstar "2018 Target-Date Fund Landscape", with an all-time high of $70 billion in estimated net flows during the year, assets in target-date mutual funds eclipsed $1 trillion in 2017. The average asset weighted expense ratio dropped to 0.66% from 0.91% five years ago. Passive target-date series took in nearly 95% of net flows. Vanguard was the big winner with $50.6 billion in net inflows in 2017, or 72% of the total flow for the industry, while 17 of 41 firms experienced negative net flows in 2017.

Bottom line: target funds, the most popular asset gathering strategy for DCIO asset managers witnessed continuing growth but is concentrated in the top three providers with passive significantly leading the way at the expense of active. Profitability is waning and quickly even for well entrenched target date funds due to disproportional net flow and diminishing fee income for every dollar of flow.

Managed Account Solution

A Managed Account solution ("MA") can be defined as a responsive, data driven, algorithmic-based, technology delivered, individualized investment management solution for the masses. When MA is placed in a non-retirement plan context, it is often referred to as Robo-Advice (Robo). MA is thought of more as a service than a product. Purveyors of MA include advice and guidance with portfolio management. The most frequent reasons cited for a low adoption of a MA by retirement plan participants are (1) expense (high fees) and (2) active engagement.

8460 Tyco Road, Suite E, Vienna, Virginia 22182
T: 703.847.4380 F: 703.847.4384 www.ChaoCo.com

Traditional users of MA under a retirement plan tend to require participants to "Opt-In" to the service for those who want to engage in the process to gain maximum benefits. However, when an MA is appointed as an investment qualified as a Qualified Default Investment Alternative ("QDIA")[2], it serves as a default or an "Opt-Out" option. This means that, when participants fail to provide an affirmative written investment instruction, they will see their assets automatically invested in the QDIA. As such, advice services typically associated with an Opt-In MA (for ease of identification we will refer to this type of MA as an individual glide path solution or "iGPS") would not be utilized by default participants since, by definition, they have "defaulted."

Statistics have shown that, when a retirement plan elects a QDIA and re-enrolls participants into the default alternative in conjunction with auto-enrollment of new participants, a significant percentage of the participants remain invested in the QDIA. With this type of asset scale and the absence of the need to provide engagement services or advice, the cost for providing an iGPS is substantially reduced as compared to the Opt-In MA solution. As such from a cost and design standpoint, iGPS can now be a competitive and superior alternative to target date funds service as a QDIA.

iGPS and Asset Manager (DCIO) Distribution Challenge

If you agree with the four CaseyQuirk suggested strategies for forward looking competitive advantage, iGPS checks all the boxes.

1. *Higher-demand investment strategies*
   iGPS is a strategic offering with new technologies, data and analytics. This can be the product for those asset managers without a target date fund series to compete favorably. The asset manager can populate the iGPS portfolio with its best performing and sought after products on a proprietary or multi-asset manager/blend basis. An asset manager with a target date fund series can use iGPS to aggressively reposition its current product to lay the groundwork for sunsetting legacy products in the future. iGPS can be thought of as an intuitive model portfolio.

2. *Strong Pricing Policies*
   The flexibility of iGPS allows asset manager to carefully calibrate the total cost of its offerings by mixing mutual funds with CITs and ETFs and active vs. passive sleeves. At the same time, it provides room for distribution channels (intermediaries and recordkeeper/custodians) to be compensated for their services. iGPS changes the frame by which "price" is viewed. This is a solution and offers a different value proposition that can justify non-price erosion.

3. *Customized Client Experience*
   iGPS, an individualized and responsive solution, moves the QDIA from standardized products such as a target date funds for wholesale distribution to greater customization. Asset managers can partner with recordkeepers/custodians and other intermediaries to create and share digital and mobile platforms to further enhance the user experience.

[2] https://www.federalregister.gov/documents/2007/10/24/07-5147/default-investment-alternatives-under-participant-directed-individual-account-plans

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iGPS and the associated technological creativity more closely resemble service-oriented businesses with the following common denominators:

- Customization through individual participant demographics (age, gender, income, plan assets, deferral and employer contribution just to name a few) made possible by greater collection and analysis of client (if a participant elects to engage) and recordkeeper data
- ERISA expects fiduciaries to act solely in the interest of participants. The inclusion of significantly more information and data regarding each participant, as compared to a one-size-fits-all target date fund, is prudent. The individualization under an iGPS, especially for those unengaged under a QDIA framework is a significant improvement. This single but significant difference would closely align with marketing, sales and service processes that strengthen client relationships because a tailored outcome is more assured. This is a case of doing well by doing right.
- When prudently designed, iGPS uses risk management analytics, asset allocation advice, and custom data analytics that would meet the fiduciary duties of loyalty and due care by the plan sponsors and aligns the interests of intermediaries and asset managers.
- Customized delivery of report and portfolio design

4. *Strategic Use of Technology*

The greatest differentiator between profitable growth firms and their peers has been their investment in, and use of, technology. The iGPS could be the starting point of a continuum through in-plan QDIA Opt-Out to Opt-In MA to Robo advice to systematic distribution/decumulation/annuitization/managed income solutions based on current and evolving technology (such as blockchain). Technology today should include prudent and secured use of participant data, machine learning, reducing prudent portfolio construction principals into algorithmic automation, and integrating into communication and guidance tools to redefine asset management proposition. At the same time, technology is naturally suited to help asset managers mass-customize their engagement models and potentially deliver more services directly to end users, without dramatic reductions in efficiencies.

- By definition, iGPS is a more efficient and automated approach which will further improve data quality, provide real-time access, accelerate processing and better support portfolio management across more complicated investment strategies.
- Asset managers will gain instant and real time data from each participant who is invested in the iGPS and harness data at an enterprise level through effective use of master data management.

In conclusion, there is obviously no single path or a guaranteed set of strategies that would assure the survival and prosperity of asset managers (or DCIO) in a fee compressed, low return and crowded world facing significant demographic challenges. However, the versatility of iGPS embodies many of the obvious strategic reasonings to differentiate and win in today's shrinking and commoditized asset management environment.

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