# New Cars, Share Classes and the Role of an Institutional Investment Consultant

When I was in college I never went anywhere without my HP-12C, a hand held financial calculator known to almost any student of finance. With the press of a few buttons I could discount a stream of payments into comparable present dollar terms, or unveil an imputed interest rate or figure out how many payments away from being a millionaire someone was.

To the mathematically (or finance) handicapped, this skill was nothing short of magic. I was very popular with friends, family or acquaintances who were buying homes or cars and I sat in on many closings, 12C in hand. I was also the bane of many a sales manager and real estate agent.

A typical scenario in an auto dealership usually went like this. Having decided upon a make, model, color options, etc., we would sit down with the salesperson and start talking price. Invariably the sales people would want to talk about payments and not total price so I was basically there to interpret. With an agreed upon down payment they would write a three digit number on a piece of paper and ask 'how's that sound for a payment?' I would identify the term of the loan and the stated interest rate (you would be surprised how little they liked such questions) and, using my handy calculator, reveal the actual price they were asking for the car. It was always too high, of course, and once we said so the salesperson would paint a look of concentrated bewilderment on their face and leave the room to discuss this dilemma with the sales manager.

Not surprisingly they would always return with an optimistic smile and a revision of some sort. Only the revised payment amount usually relied on a greater number of payments, or perhaps a small change in the rate. I would diligently input all the new numbers and then lean over to show my friend or relative the new price that appeared on the calculator's display (we weren't beyond some theatrics of our own). And it was no surprise that the total price for the car rarely changed.

It didn't take too many of these little dramas to realize that explaining our logic to the sales person was usually useless. What I learned to do was to play the game and wait. It always took about three trips to the sales manager and three refusals from us before the all powerful manager himself would return with the sales person. Now was the time to make some progress.

The manager would usually start by explaining that he had done all he could to get us the very lowest payment possible. At which time we could explain gingerly that it's not the payment we were worried about but the total price. Now was the time to turn the tables on them and play interpreter once again. Having established the fact that they would have to lower the price of the car I would usually talk to them in the same obfuscated terms they tried to talk to us. That is, I would suggest payments and terms to them based on our desired total price.

## Parallel Universes

The investment industry has many parallels to the business of car sales as I have described above (not to mention the similarities between stock brokers and car salesmen). Both use sophisticated machinations and the veil of mathematics to hide, or at least disguise total costs. And make no mistake about it, in both worlds, total cost is what you need to know.

As an investment consultant I still rely on my HP-12C every day and I am still trying to demystify the cost/price puzzles created by salespeople. In the retirement plan business it has been a pleasure to find some firms that think like we do and are willing not only to disclose the terms of all their selling agreements but to outline their profit targets and their overhead levels.

Many bundled retirement plan providers earn their revenue from the mutual funds they make available to participants on their plan platform. Selling agreements are made between the mutual fund companies and the plan provider to outline what portion of the fund expenses paid by participants will be distributed to the provider as revenue. These agreements also often provide the terms of additional compensation such as finders fees.

With all this information we can create a very accurate picture, not only of total cost to the client, but also of total compensation to the provider. Yet there are still other firms, more than not, that are unwilling to disclose this information. Working with these companies is a lot like sitting in a car dealer and trying to negotiate your total costs.

## A Practical Example

Recently we had the pleasure of helping one of our clients choose a new small cap growth fund for their $80 Million participant directed 401k plan. Once our make and model was decided upon we submitted the request to the plan provider (one of the largest 401k providers in the country).

Just like car dealers have a dozen or two ways of packaging extra costs under different labels etc. Mutual fund companies have come up with dozens of different ways of selling the same product: *share classes*. For those unfamiliar with share classes I should say that they were created to facilitate different distribution networks. Each one has a slightly different cost and compensation structure depending on who is buying it and who is selling it and how they will be compensated. For example, A shares usually have a front load, or commission, that goes to a broker at the time of sale and a 12b-1 fee to provide the broker a smaller annual payment on an ongoing basis. There are also often B shares, C Shares and so on. (American funds recently introduced several new share classes for retirement plans and 529 plans, a trend being followed by many fund families, and now have a total of 18 different share classes for each fund.)

Every investor, however, should be interested in buying only one share class, the one with the lowest cost (this is usually called the institutional class). This is the version of the fund without all the sales and distribution costs, the version in which your *Total Costs* have been minimized. Unfortunately these share classes are only available to certain investors through certain channels. It is not hard to understand why a stock broker would be unlikely to sell institutional shares: this stripped down version of a fund provides no broker compensation. Likewise such versions do not provide compensation for plan providers but there are usually several other classes available to plan providers, each with differing compensation structures.

When the provider in this story received our client's request for a specific small growth fund they were reluctant to acquiesce. Based on differences in profitability they prefer to use only their own products. However, with properly applied pressure and the insistence of our client the provider agreed to add the fund in question.

Their agreement, however, stipulated that they use Class A shares. A shares being the most expensive shares available (and those with the greatest revenue to compensate the provider), this

declaration came with as much surprise as the return of a car salesman with a new lower payment based on a longer term loan. I unsheathed my 12C and made some notes.

We all know that the plan providers have to make a profit. We all have to make a profit. The question is, how much is enough? ASI understands the costs and profit goals throughout the industry and we keep that frame of reference available but our real goal is to help make sure that our clients pay as little as possible and get as much as possible in return. We keep our eyes on *Total Costs* and the *Value* received for said costs.

So we were quick to tell the provider that there was a less expensive share class available and that was the one we wanted to make available to plan participants. We had to wait while the provider went to talk with his sales manager. Compared to new cars there's a lot more money at stake in this business so instead of a few minutes it took more like a week or two to get a response. And that first response was rather vague, a simple we can't use that class. No explanation, no reasons, just no. So we asked again and once again it felt like we were waiting in a small little office somewhere with pictures of automobiles and a salesman of the month plaque on the wall while the powers that be discussed our fate.

The next response we received was still no, but this time they included an explanation. We do not get any revenue from that class, they claimed, and we only get 25 basis points from the A shares. This was their way of trying to say that 25 basis points wasn't enough in the first place so they were doing us a big favor to add even the A shares. In other words we should just forget about the other class.

ASI has a very diverse group of clients. We serve foundations, wealthy individual investors, small retirement plans run through third party administrators (TPA's) as well as large retirement plans that use bundled plan providers. This diversity, and the years of diverse experience our consultants have, provides us with an in depth knowledge of the various compensation structures prevalent in the industry. It also has taught us a great deal about profitability and given us the framework to identify the reasonable from the extravagant. When it comes to situations like the one I am describing here this experience and insight provides us with a significant advantage. It is sort of like going to a car dealer with the manufacturers invoice for your car in one hand and a copy of the dealer's rebate, incentive and other collateral agreements in the other.

We politely sent the salesman back to his manager with the suggestion that they re-examine their contracts to see if, perhaps they were mistaken. Three polite refusals was what it took in the car dealership and three times was what it took here. While we sat waiting we were not idle. We got on the phone and started paving the way. We called the fund family, we called another division of the plan provider, the one that sells funds to retail investors, we called the provider's people responsible for maintaining their TPA network. And we waited.

## A Happy Ending in the Making

The proverbial sales manager appeared and was suddenly much more ready to do business. Their problem now was that they did not have an agreement to receive revenue on the less expensive share class. He was offering a sincere explanation but was still angling to use the more expensive class. Having already laid the groundwork for him we suggested he pursue an agreement on the other class.

We began our work behind the scenes knowing two things. First we knew that the prevailing revenue rate on the A shares they were offering was more than twice the 25 basis points they claimed to receive. Second we knew the share class we wanted to use provided 35 basis points to other providers. Given the size of this plan provider they should be able to receive not only these amounts, but possibly more. They were, after all, the largest provider in the business.

So we waited and made a few more calls.

"I have GREAT news!!!" was how the email started. As I read it I slipped my trusty 12C back into its case and began to smile. It was sent from the sales person to our client and went on to explain how the plan provider had negotiated a new revenue agreement with the fund family and the share class we requested would now be available to participants and would give the provider 35 basis points in revenue.

When giving us their kudos our client asked us if we had negotiated a finders fee for helping this giant provider increase their revenue by what would probably amount to millions of dollars over the next few years. We were happy enough to know our client got the best price on their new fund.

ASI provides institutional investment consulting services to corporations, foundations, endowments, individuals and families throughout the Pacific Northwest. ASI is an independent consultant with no broker dealer affiliations and no conflicts of interest.

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