OCIO at a tipping point

Q&A with Liana Magner, CFA, Partner US Defined Contribution Leader, Mercer

By Neil Lloyd, Partner, Head US DC and Financial Wellness Research, Mercer

welcome to brighter

One of the most significant developments in the retirement industry has been the growth in plan sponsors' delegating investment decision-making to third-party providers.

This is often referred to as an Outsourced Chief Investment Officer (OCIO) or a delegated investment arrangement. In delegated mandates, professional firms take on fiduciary responsibility, under ERISA Section 3(38), to manage the Plan's investment options.

It's a notable trend with Pensions & Investments reporting OCIO assets increasing by 23% in the year ending March 2018.[1]

It's also a hot space within the defined contribution (DC) industry. Neil Lloyd, Head of DC and Financial Wellness Research for Mercer, recently spoke with Liana Magner, Mercer's US DC and Financial Wellness Leader, to better understand what's on the minds of plan sponsors around the notions of OCIO innovation. The following interview has been edited for length.

Neil Lloyd: Liana, you've been involved in the DC delegated market for a very long time. What have you found that's been driving the expansion in this market?

Liana Magner: There are two key drivers behind the move toward delegated or OCIO solutions. The most common is plan sponsors trying to do more with fewer resources. People who are responsible for 401(k) plans typically have full-time jobs. Resources are stretched and they don't have the time to focus on day-to-day plan management. A delegated solution allows sponsors to focus their time and energy where they feel they can have the most positive impact, such as strategy, plan design and employee engagement. The delegated provider then handles the management, monitoring and changing of investment managers.

Secondly, we've seen a lot of focus on fees. The majority of 401(k) lawsuits have largely focused on the use of company stock. After that, litigation has zeroed in on fees, questioning whether they are reasonable for recordkeeping and the investment services provided. We've seen the advent of available lower-cost investment vehicles but staying on top of these lower or lowest-cost share classes and managers takes time. That's where delegation can be helpful.

> **Much of the growth in delegated solutions stems from plan sponsors wanting to improve their governance structure, mitigate risk, manage costs and deliver better participant outcomes.**

Much of the growth in delegated solutions stems from plan sponsors wanting to improve their governance structure, mitigate risk, manage costs and deliver better participant outcomes.

Neil Lloyd: Can you share any broad scenarios that illustrate the journey that clients took before engaging with Mercer's delegated offering?

Liana Magner: Most clients want to have varying levels of involvement throughout the investment decision-making process. Obviously, as OCIO, we need to maintain control over certain fiduciary responsibilities and decision-making items, but that doesn't mean a client can't be involved — in fact, some want to remain very involved.

For example, some larger plans have their own investment staffs with whom we collaborate closely. We not only share our investment viewpoints, but also seek to understand any particular philosophical beliefs or investment managers they want to retain. If we feel it makes sense to do so, and if the clients' preferred managers are highly rated by our manager research group, we'll follow a process to take the decision to the full investment committee.

Then, there are a growing number of clients who want to be more hands-off. They largely want us to make decisions and report back to them.

Neil Lloyd: How does outsourcing appeal to sponsors of smaller plans? Can you comment on plans at various sizes that have embraced delegated solutions?

Liana Magner: We've seen keen interest and engagement in OCIO solutions across the spectrum, from small plans through mega-plans. When we first launched our OCIO solution in 2006 for DC plans, it really was geared toward customizing solutions for mega-plan sponsors and their participants.

It's common today for sponsors of any plan with over $1 billion in assets to think about moving away from mutual funds and toward more institutional vehicles, such as separately managed accounts, and custom multi-manager options. When you're moving to a more customized, white-label solution there's more setup work, coordinating between the recordkeeper, custodian and various investment managers. The use of an OCIO solution can greatly simplify this process. While the use of institutional vehicles, such as separately managed accounts and commingled funds, may reduce cost, there is more paperwork involved, and hence legal review required, versus investing in a mutual fund. Again, an OCIO solution can make this easier.

The investment we made in both operations and technology, including our own multi-manager fund vehicles that we launched in 2017, allows us to serve clients with an OCIO solution at the smaller and mid-sized plan market. In fact, in the past two years, we've seen the most growth in the number of small and mid-sized clients looking to outsource.

Neil Lloyd: There has been press coverage lately around increased interest in and adoption of OCIO solutions due to the amount of DC plan litigation and the extensive nature of plan sponsors' fiduciary roles and responsibilities. How has litigation risk come up in client discussions?

> **We've seen keen interest and engagement in OCIO solutions across the spectrum, from small plans through mega-plans.**

Liana Magner: Fee litigation has everyone on edge, prompting sponsors to ask: "Am I managing my DC plan the right way? How can we improve upon that governance process? How can we improve upon outcomes for our participants?"

So, the litigation risk has made an OCIO solution considerably more appealing to plan sponsors. A delegated solution helps mitigate fiduciary risk by promoting a robust governance framework and ensuring that fees are reasonable. In the event of a lawsuit, a plan sponsor would not be the only named party.

There has also been discussion around DC programs lacking innovation as a result of fee litigation. Participants are more aware of fees. I wouldn't necessarily say this is the direct result of their reading "plain English" fee disclosures. However, the disclosure rules have led to improved fee transparency by disaggregating investment fees and administrative fees — and those are good things. It's wrung out a lot of systemic inefficiency.

On the other hand, litigation likely has caused some plan sponsors to be less receptive to some of the newer design features or investment solutions because they don't want to deviate too far from standard practice or raise any concerns that could trigger a possible lawsuit. One example is the use of custom target date funds (TDFs). Part of sponsors' hesitancy to adopt custom TDFs may have been sparked by a lawsuit around a large plan sponsor's custom TDF series that included a healthy allocation to alternatives. The decision resulted in a lawsuit focused on fees related to its high exposure to alternatives.

Neil Lloyd: How is Mercer looking ahead of the curve to innovate and improve its OCIO solutions?

Liana Magner: We try to achieve three objectives for our clients from our OCIO solution. The first is focused around securing their foundation, helping plan sponsors determine the right governance model to use in managing their program.

The second objective is optimizing the participant experience, which speaks directly to the innovation question. Our solution is actively focused on helping participants achieve greater prosperity, to help them get where they need to be in retirement by helping them accumulate a retirement balance that allows them to live comfortably.

You can do that with investment design, which can seek to improve performance and reduce fees. We're also working hard to determine the optimal number and types of investment options to make available to participants and helping "guide me" participants make more informed decisions about their asset-class and investment options.

Multi-manager customized portfolios can be beneficial because they are well diversified and automatically rebalanced rather than portfolios whose initial allocations are rarely updated in response to market changes. Particularly when we're in a period ripe for mean reversion in value versus growth stocks, in active versus passive management, incorporating the thinking of a Delegated Benefits (DB) portfolio into a DC plan can move the needle more predictably.

> **I think growth will continue because the OCIO solution for DC plans is not new anymore. It's a viable and transparent solution that can help improve participant outcomes while, at the same time, reduce fiduciary risk, often without increasing fees across the board.**

Our third objective is to inspire confidence. This works in two ways: We want to inspire confidence in plan sponsors that Mercer is the right firm to partner with in managing their DC plan. This is because we're one of the leaders in the industry, have depth of resources and we're innovative in research (e.g., retirement income strategies). However, we also want employers, employees and plan participants to be inspired and to be confident about their financial wellness beyond simply the investment piece — that there's a strong 401(k) program in place to help them achieve peace of mind.

I think growth will continue because the OCIO solution for DC plans is not new anymore. It's a viable and transparent solution that can help improve participant outcomes while, at the same time, reduce fiduciary risk, often without increasing fees across the board.

Neil Lloyd: Much of the Setting Every Community Up for Retirement Enhancement Act of 2019, passed by the House of Representatives in May 2019, is focused around the idea of open multiple employer plans (open MEPs). This new category of plan would allow unaffiliated employers who meet certain affinity tests to offer a single plan to their employees. How do you think open MEPs could impact overall OCIO plans and how will Mercer support the new category of plans?

Liana Magner: Depending on what the open MEP legislation is, and accompanying regulations, ultimately set out, there may be varying degrees of fiduciary relief made available to plan sponsors through an open MEP. Therefore, we may see many employers outsource those fiduciary duties to a pooled-plan provider who would offer an open MEP solution.

Not all employers will adopt an open MEP at first. However, once they see others offloading fiduciary responsibility, especially smaller companies that may lack the ability to manage the investment and administrative duties of offering a 401(k) plan today, that could be a tipping point. Open MEPs take us one step beyond delegated as an outsourced solution, in my view, because open MEPs allow the employer to offload both the investment and administrative pieces. We'll just have to see what happens in the current regulatory environment.

Neil Lloyd: As you look to the future, where do you see the DC/OCIO market over the next five years?

Liana Magner: Cerulli expects overall OCIO AUM, under full or partial discretion, to have a compounded annual growth rate (CAGR) of 8.1% during the five-year period ending in 2023, when they project AUM to reach $1.7 trillion.[2] They also expect the DC/OCIO market will be one of the fastest-growing segments of that OCIO growth. We have seen that within our own business. Our DC/OCIO solutions have grown at over 30% to 40% year over year for the last four years. It's growing in popularity.

Neil Lloyd: Any closing comments on why a plan sponsor would choose Mercer for OCIO?

Liana Magner: Mercer is a leader in the retirement industry. We've offered OCIO solutions to DC clients since 2006 and we're one of the leading providers of DC/OCIO solutions in the US. We have a strong team of resources and a business supporting our delegated solution from an investment, operations and administrative perspective.

We also have a global approach at Mercer, so we're able to learn from solutions or other consulting experiences that we have around the globe. In our case, one of the first areas in which we offered OCIO was Australia, which is primarily a DC market. There are differences between countries, but we're able to leverage our learning from other countries to improve upon what we can offer in our own home country.

Neil Lloyd: Thank you, Liana.

Have questions or need more information? Learn more about Mercer's Defined Contribution services.

DCFWResearch@mercer.com

Why Mercer for OCIO Solutions?

When you partner with us, you gain a trusted advisor who seeks to understand your organization's unique goals — and works with you to help achieve them.

Offering more than 45 years of experience and a full spectrum of tools, research, advice and solutions under one roof, Mercer is a global leader in delegated solutions, seeking to provide you with:

- An enhanced governance process
- Improved risk-adjusted performance
- Stronger advisory relationships
- Operational and administrative support
- Deeper expertise in specific asset classes
- Cost efficiencies

Mercer Delegated Operations: Our World at a Glance*

310+

Delegated Clients in the US

42

Clients with +$500 Million in Assets Under Management

21

Clients with +$1 Billion in Assets Under Management

[1] "CIO managed assets leap 23%: DB and DC plans contribute to surge in assets managed with full, partial discretion," Pensions & Investments, June 25, 2018.
[2] "U.S. Outsourced CIO Function 2018: Increasing Competition and Service Customization," The Cerulli Report, 2018.
*As of Dec. 31, 2018