June 17, 2008

White Paper: Net Cost Advantages of Collective Investment Funds
By Lance M. Roberts, Senior Vice President, 401kDIRECT

In an article in P&I Magazine on 10/27/07 by Jenna Gottlieb, the experts predicted that the majority of assets in retirement plans would switch to collective investment funds ("CIFs"). [1] This White Paper intends to focus on the net cost advantages of this shift, which are the end result of a focus on investment product cost, as an eventual determinant of prospective investment performance.

Understanding the True Cost of Mutual Funds

How many of our readers assume that the overall expense ratio ("OER") of a mutual fund is that which is laid out and fully disclosed in the prospectus? Wrong – the OER does not include trading and turnover expense of the product, which is an acceptable omission by the Federal regulators.

How many of our readers are familiar with the scope of trading expense? In his book on mutual funds, John Bogle, President of Vanguard, states that the average mutual fund has an OER of 140 bps., an average portfolio turnover of 100% annually and an average trading cost of 124 bps.[2] **In other words, the 'True Cost' of the average mutual fund is not 140 bps. as reported in the prospectus, but 264 bps.**

The trading figure referenced is confirmed both on the non-profit website: www.personalfund.com, as well as in a study – "Scale effects of mutual funds performance: the role of trading costs" published on March 17, 2007.[3]

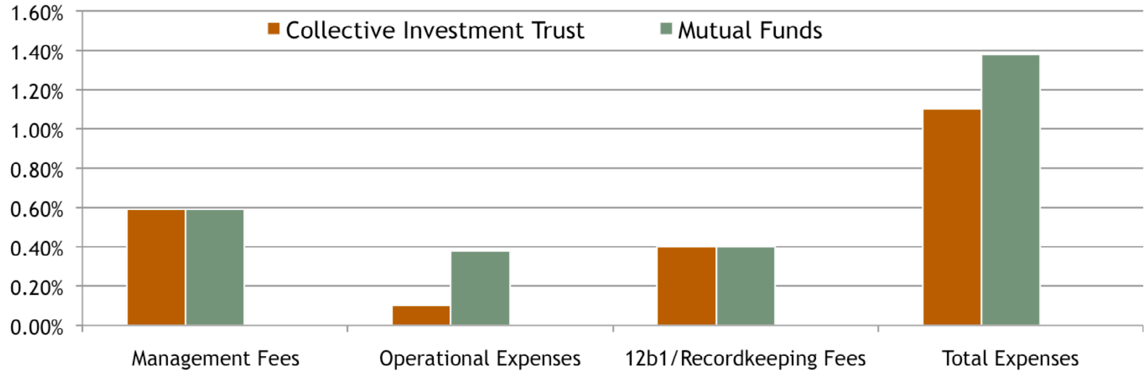
Understanding Collective Investment Funds

The American economy is based on taking its products and fracturing them, retaining that which works efficiently and profitably and outsourcing that which works inefficiently and unprofitably. If one fractured a mutual fund, we would keep the managers and the daily pricing parts and outsource the trading and custody parts. The end result is a collective investment fund.

In a recent White Paper released by SEI in May 2008, entitled: "Collective Investment Trusts: The New Wave of Retirement Investing"[4], the following exhibits **partially** quantify the net cost differences between acquiring money managers in a mutual fund and a CIF wrapper, first in terms of a large cap investment category, then in several key investment categories.

EXHIBIT 1

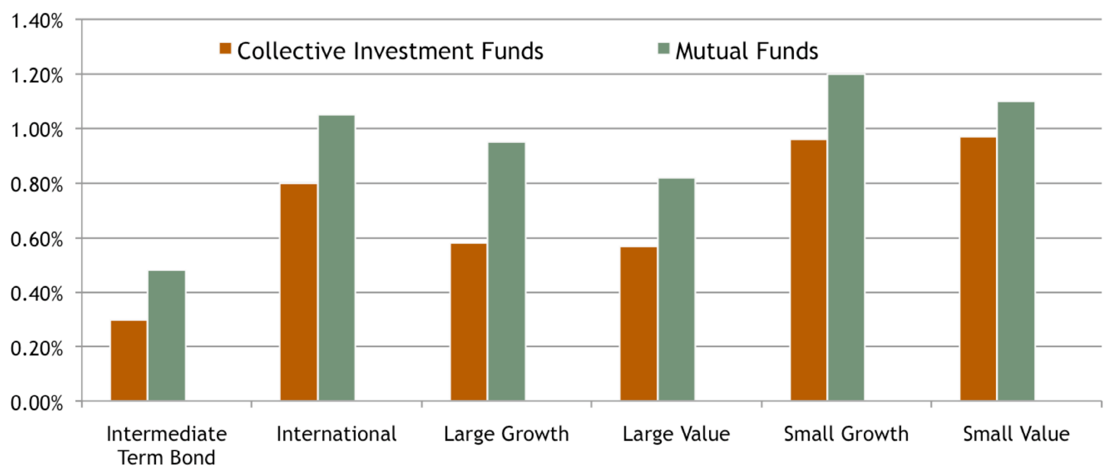
Comparison of Average Fees for CITs vs. Institutional Large-Cap Equity Mutual Funds



Source: SEI, Strategic Insights AITE

EXHIBIT 2

Median Expense Ratios: CITs vs. Institutional Mutual Funds



Source: SEI, Strategic Insights AITE

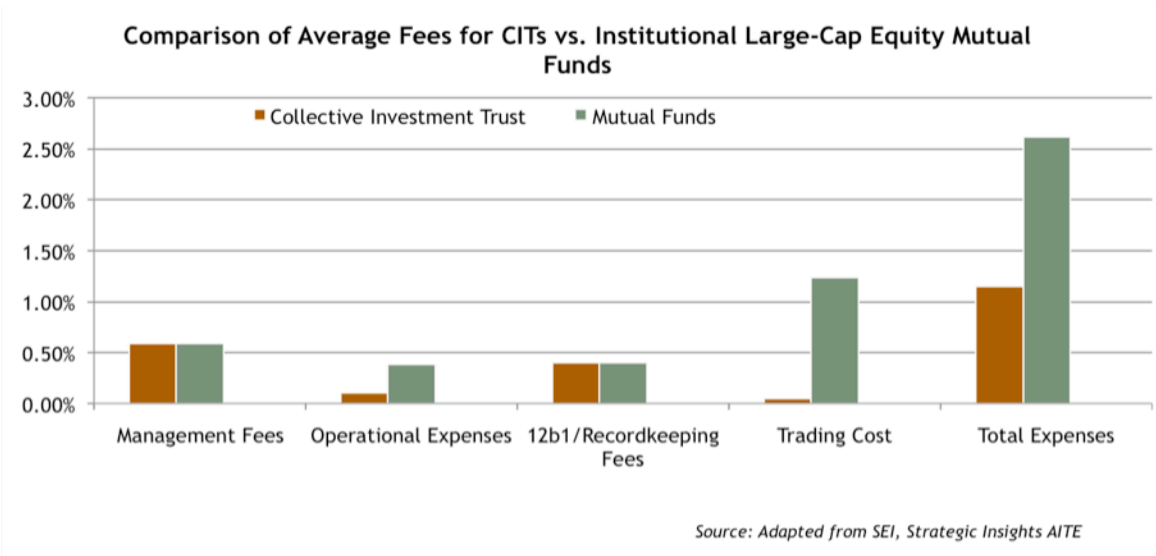
Focusing exclusively on the *fully disclosed* expense ratios of each product, the key result is that accessing a manager through a mutual fund wrapper results in an average 26 bps. additional cost, due to compliance, documentation and regulations borne by mutual funds.

The Additional Cost of Trading Expense

While one might contend that in the world of reality that a mere 26 bps. is not sufficient to sway a Plan Sponsor away from a well-branded mutual fund alternative, an understanding of the relative *non-disclosed* trading costs between mutual funds and CIFs is the ultimate key to understanding why the shift in retirement assets from MFs to CIFs is occurring.

EXHIBIT 3

Fees for Collective Investment Trusts vs Mutual Funds plus Trading Costs



GlobalBridge (Minneapolis MN) provides money managers outside of a mutual fund wrapper to regional bank trust operations nationally. In 2007 they provided trading services for 60 managers involving $1 BIL in assets. Their aggregate trading costs were 5 bps.

Discipline Advisors Inc. (Mankato MN) is an investment advisory firm that provides managed portfolios, employing seven different managers outside of a mutual fund wrapper. In YTD 2008, their annualized trading costs for all managers was 6 bps.

Conclusion

In an article published by *Pensions and Investments:* "Study: Mutual Funds lag by 250 bps. – Agency costs hit for underperformance versus separate accounts"[5], the renowned retirement journal attempted to quantify relative net performance for Plan Fiduciaries.

In an economy that has generated volatile performance figures since 2000 and promises more of the same in the near future, all Plan Fiduciaries need pay close attention to their investment products and to demand full accounting of the True Cost of the resource.

References:

1. *Gottlieb, J. (2007, October 29). "Move Over, Mutual Funds, Here Comes Comingled". Pension and Investments Magazine. Retrieved June 08, 2008 from http://www.pionline.com.*
2. *Bogle, J. Bogle on Mutual Funds: New Perspective for the Intelligent Investor. Boston, Massachusetts: McGraw Hill, 1994*
3. *Edelen, Roger, Evans, Richard and Kadlec, Gregory. "Scale Effects in Mutual Fund Performance, The Role of Trading Costs". (2007, March 17). Retrieved June 10, 2008 from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951367.*
4. *SEI Knowledge Partnership (2007, May). "Collective Investment Trusts: The New Wave in Retirement Investing". Retrieved June 03, 2008 from http://www.seic.com/ims.*
5. *Payne, B. (2007, April 16). "Study: Mutual Funds Lag by 250 Basis Points". Pension and Investments Magazine. Retrieved April 11, 2008 from http://www.pionline.com.*