Best Practices in Index CIT Funds

Defined Contribution (DC) plans have become the primary retirement savings program for American workers. In 2017, more than 84% of the Fortune 500 retirement plan sponsorships were DC plans, according to a survey by Willis Towers Watson. This is more than double the percentage in 1998. As more workers have come to rely on DC plans for their retirements, the design, implementation, and efficacy of these plans also have evolved—particularly over the last decade. Plan sponsors, consultants, and industry service providers have coalesced around improved investment solutions, enhanced methods for participant engagement and communication, and better strategies to reduce plan leakage. At LGIMA, we expect this evolution to continue, and believe that ongoing efforts to adopt best practices can lead to better, more consistent retirement outcomes for DC plan participants.

The pressure of changing regulations, threats of litigation, and financial market uncertainties have led the retirement planning industry to seek new and better ways of delivering the DC plan. Index funds, or passively managed investment strategies, have gained wide use in DC plans for a number of compelling reasons, and these strategies represent a growing share of the flows and total assets of plan participants across all asset classes. While passive strategies are often considered to be commoditized products with little differentiation outside of costs, we believe there are meaningful differences in implementation and management from one service provider to another.

An earlier paper in this series, "CIT Due Diligence: Unveiling the Hidden Risks and Costs of Index Investing," provided important questions plan sponsors should ask their CIT providers. This paper details the best practices in index fund management that we believe will re-shape the DC landscape over the next few years and redefine approaches to institutional index fund management.

The Framework

We built the LGIMA index fund program seeking to set a higher standard in the three core principals of Governance, Transparency, and Flexibility. Based on these principles, we have implemented five key features into our index fund program that uses Collective Investment Trust (CIT) structures—the increasingly preferred investment vehicle of DC plan fiduciaries and their consultants.

- **The All-In-Fee (AIF) Structure:** LGIMA charges a single and transparent AIF that is inclusive of costs beyond the oft-quoted Total Expense Ratio (TER = management fee + admin cap). This structure allows LGIMA to bear hidden fees, charges, and costs that traditionally have fallen to plan sponsors and their participants.

- **The Independent Trustee**: LGIMA uses an independent trustee to oversee all of our Collective Investment Trusts. We believe this approach reduces conflicts of interest that often exist in the management of index CITs.

- **Competitive Bidding by CIT Service Providers**: LGIMA and our fund trustee contracts with third-party providers for services such as custody, administration, and securities lending program management. We believe that this process ensures greater transparency and more efficient pricing for those services.

- **Individual Share Classes for Each Plan**: LGIMA seeks to provide unique share classes to plan sponsors and certain intermediaries. We believe individual share classes provide flexibility and protect participants from the actions of others.

- **Using an Unaffiliated Securities Lending Service Provider**: LGIMA does not receive any share of revenues from the securities lending program. We believe a lack of financial incentive preserves our objectivity in the oversight of that program and can reduce risk to participants.

LGIMA Index core principles

1 The All-In-Fee (AIF) Structure

- ✓ LGIMA offers an “all-in” **Total Expense Ratio** (TER), illustrating our commitment to **transparency.** (The TER discloses the aggregate costs of transaction based activities, standard management fees, and administrative cap fees.)

2 The Independent Trustee

- ✓ The Trustee and custodian are unaffiliated for all LGIMAs indices, resulting in unbiased practices related to fund oversight.

3 Competitive Bidding by CIT Providers

- ✓ LGIMA and our fund trustee contracts with third party providers for custody, administration, and securities lending program management. This ensures greater transparency and efficient pricing.

4 Individual Share Classes for Each Plan

- ✓ This approach emphasizes minimizing implementation costs, and is more flexible (separate DC share classes).
- ✓ We utilize a strong portfolio management framework that allows for modest, systematic and opportunistic trading and value added in risk controlled manner.

5 Using an Unaffiliated Securities Lending Service Provider

- ✓ Our approach to a lending program provides 100% of net revenue to securities lending unit holders*. This provides focus on risk mitigation within lending programs.

* For this service the lending agent is paid 15% of the gross revenues of the lending program. The remaining 85% of income is paid directly to the fund.

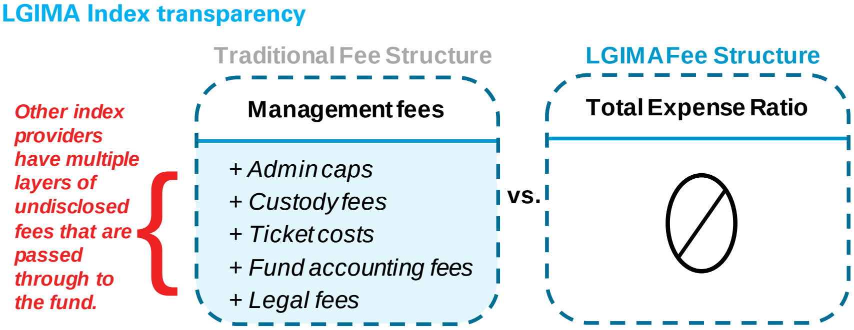
Source: LGIMA

We have chosen to implement these practices to increase transparency into the costs and fees that ultimately erode participant performance. These practices also allow us to be more objective and aligned with participants' interests when we make decisions that directly impact risk and performance. Below is a detailed look at these five features, which we believe represent best practices that lead to a framework for passive investing.

The All-In-Fee (AIF) Structure

We believe that AIF pricing is the natural next step in the industry's progression toward administrative fee caps and total expense ratio (TER) pricing arrangements. The AIF pricing structure allows the investment manager to pay for all administrative charges outside of the fund.

LGIMA Index transparency



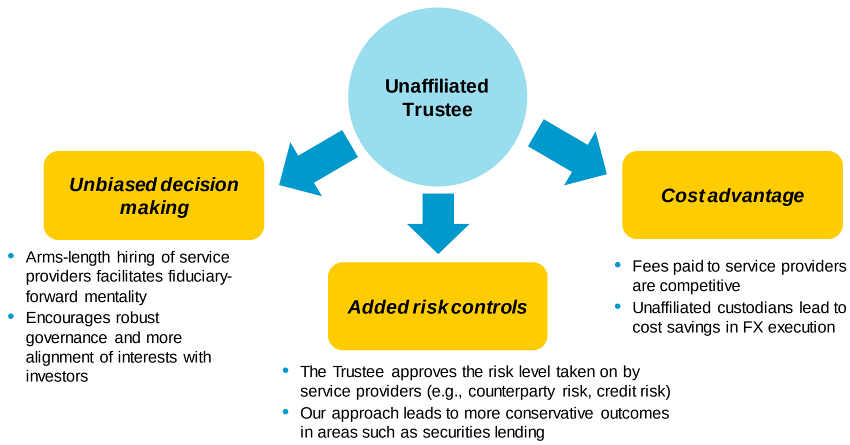
What's more, by seeking third-party competitive bidding for custody, administrative, and securities lending services, LGIMA provides greater transparency into how much participants pay for those services. Using the AIF pricing structure, we can provide plan sponsors specific quotes for how much participants have paid for administrative services such as audit fees, legal fees, index license fees, safekeeping, fund pricing, and other custody service charges.

We believe plan sponsors' must do more than just analyze management and administrative fees, because plans face several other charges that are not incorporated into either of these explicit costs. Admittedly, analyzing these fees can be complicated, but complexity does not absolve plan sponsors of their responsibility to understand the material impact these fees can have on fund performance and participant outcomes. For example, the AIF structure includes costs such as custody ticket charges—"per transaction fees" a fund pays directly to the custodian for trading activity. Because LGIMA pays these charges and other costs that fall outside of the fund, AIF pricing prevents them from eroding fund performance.

The Independent Trustee

It is a best practice for institutional managers to establish governance structures that help ensure investment funds are managed in the interests of plan participants. LGIMA believes that having an independent trustee helps ensure those trustees have the objectivity and authority to pursue their obligations on behalf of a fund's investors.

LGIMA engages with independent, unaffiliated trustees and custodians



Although investment firms can establish control mechanisms designed to mitigate these conflicts, we believe it is better to avoid internal conflicts altogether. Plan sponsors must inquire about the policies their investment partners have in place to reduce or eliminate those conflicts. Using an independent trustee in commingled funds, such as CITs, is already a best practice in other markets around the globe, including the United Kingdom. We believe that independent trustees will emerge as a best practice in institutional index management in the United States as well.

Competitive Bidding by Service Providers

Soliciting bids from third-party providers for services such as administration and securities lending ensures competitive pricing that is easily reportable to fiduciaries and other DC plan decision makers. Competitive bidding by service providers allows LGIMA, as the investment manager, to communicate how much of the AIF is being paid separately for services such as custody, safekeeping, transfer agent, audit, legal and regulatory requirements, fund pricing, fund accounting, custody ticket charges, and securities lending. Contracting with unaffiliated parties not only increases transparency, but it also helps us bring the most effective service providers to the table, with better pricing.

Individual Share Classes for Each Plan

Investment managers commonly create unique share classes to offer greater flexibility on fees, liquidity, or other fund terms as required by a plan's specific needs. LGIMA uses individual share classes to provide greater transparency and cost benefits to each DC plan investing in our index funds. By offering our investors a share class specific to their plan and employing a transaction cost chargeback mechanism, we isolate the costs generated by investors in that plan. Plan sponsors can completely insulate their participants from unrelated transaction costs generated by other plans' participants—with no additional expense or burden.

As an added benefit to plan sponsors, an individual share class provides flexibility around many of the common terms associated with their selected investment. Plan sponsors will not be required to sell in and out of commingled share classes to gain concessions on fees or move from a lending to a non-lending structure. LGIMA can implement these changes at a plan sponsor's share class level with simple amendments to their existing IMA, allowing a plan's investments to evolve more easily with the needs of participants.

Using an Unaffiliated Securities Lending Service Provider

LGIMA believes that using a third-party securities lending provider and rejecting any revenue share or fee from the lending program removes any incentive to increase the amount of risk in the lending program. Further, we believe that an investment manager, along with the fund's trustees, should implement strict risk control guidelines for the securities lending program that mitigate risk to the fund's shareholders.

Using a third-party lending provider and not taking revenue splits or fees from the lending program eliminates conflicts of interest and provides a higher degree of transparency into lending program costs. The lending program service provider alone receives a fixed and well-defined lending program split. Because the investment manager realizes no revenue directly from the lending program, both the investment manager and the independent trustees are better positioned to monitor the program's manager and ensure that the program conforms to well-defined risk guidelines designed to protect participants' interests.

Conclusion

With CITs becoming an increasingly popular investment option in DC plans, we believe that investment firms have a responsibility to manage those vehicles for optimal governance, transparency, and flexibility. The five best practices outlined above can help investment managers meet that obligation and ultimately provide retirement plan participants better, more consistent outcomes. LGIMA has incorporated all of these practices into our own index management program, and we believe that more managers will follow as the industry demands this approach.

To learn about the differences between mutual fund and CIT investing and to discuss which might be most appropriate for your plan's needs, please contact your LGIMA partner or communications@lgima.com.

For further information about LGIMA, find us at www.lgima.com.