Seeking Better Retirement Outcomes with INSURANCE COMPANY SEPARATE ACCOUNTS.
Introduction

The concern and scrutiny focused on Plan Sponsors and their Intermediaries to provide appropriate oversight regarding Defined Contribution plan fees has never been greater.

- Fees must be reasonable in light of services or products provided
- They must be cost competitive
- Plan fiduciaries must have a prudent process to equitably distribute fees among all plan participants

Additional concerns have been raised around costs. For example, Callan Associates found that “since the beginning of 2006 the DC Index still trails the average DB plan by almost 140 basis points (bps).”¹ And the Center for Retirement Research at Boston College reported that “…DB plans appear to have outperformed DC plans by 1% and IRAs by 2.8%.”²

The Insurance Company Separate Account is a relatively little-known institutional investment option that is designed to potentially address all of these concerns.

This paper discusses why Plan Sponsors and Intermediaries should consider Insurance Company Separate Accounts when constructing their plan’s investment lineup.

Studies suggest that Defined Contribution plans underperform Defined Benefit plans by as much as 140 basis points.

WHAT IS AN INSURANCE COMPANY SEPARATE ACCOUNT?

Insurance Company Separate Accounts are generally commingled investment vehicles that aggregate assets from more than one retirement plan to achieve economies of scale.

The Insurance Company Separate Account is actually one of three investment vehicles known by the name “Separate Account”:

1 SEPARATELY MANAGED ACCOUNTS (SMAs) are used in the wealth management industry to hold securities managed by an investment manager for a single individual’s investment program.

2 SEPARATE ACCOUNTS are investment vehicles that can be established by large retirement plans through a direct contract with the investment manager, outside of the relationship with the plan recordkeeper.

3 INSURANCE COMPANY SEPARATE ACCOUNTS, for purposes of this paper, are generally commingled investment vehicles that aggregate assets from more than one retirement plan to achieve economies of scale. These investment vehicles are made available through group annuity contracts issued by the insurance company to qualified retirement plans, like 401(k) or profit sharing plans, and governmental plans.

Insurance Company Separate Accounts are similar to retail mutual funds in several key respects. Much like shares of mutual funds, Insurance Company Separate Account investors own “units” that represent fractional ownership of the commingled account.

Furthermore, similar to the share price of a retail mutual fund, the unit value of an Insurance Company Separate Account is affected by the fees of the investment product as well as the performance of its underlying investments.

Insurance Company Separate Accounts and retail mutual funds are both subject to regulation. Mutual funds are regulated by the Securities and Exchange Commission. Insurance companies, and the products they issue, including Insurance Company Separate Accounts, are subject to the scrutiny of state insurance regulators.

Insurance Company Separate Accounts have a level of protection in that assets in an Insurance Company Separate Account are segregated from all other assets of the insurance company. This means that Separate Account assets are insulated from claims against an insurance company’s general account.
UNDERSTANDING INVESTMENT FEES

In 2011, the Department of Labor was unequivocally clear in its position regarding the responsibility fiduciaries had in relation to plan fees. “…fiduciaries have an obligation to consider the fees associated with plan investments and, at a minimum, not to allow the plan to be burdened with a higher fee structure where lower fees for the same investment are readily available.”

The Department of Labor and other government agencies continue to underscore how important it is that Plan Sponsors and Intermediaries understand exactly what the investment fees cover, so that they can make informed decisions when comparing investments from different providers.

For example:

- When comparing retail mutual funds with other commingled investment vehicles, it’s important for Plan Sponsors and Intermediaries to understand that mutual funds will generally consist of both retail investor and institutional (e.g., DC) assets and will typically have higher 12b-1 fees or revenue sharing offsets in their expense ratios to pay for marketing and administration expenses.

- Other investments, like separate accounts established by Plan Sponsors directly with the investment manager may not include some of these expenses. But there may be added costs for including them in a Defined Contribution plan because a separate vendor is needed to strike the unit value for plan participants.

- In the retirement plan context, Insurance Company Separate Accounts are not available to retail investors and the expense of marketing, communication and the required infrastructure to support them is generally less than for retail mutual funds. Additionally, since most Insurance Company Separate Accounts are not regulated by the U.S. Securities and Exchange Commission (SEC), they do not have the overhead of certain registration requirements and as such may be a more cost efficient investment vehicle compared to others.

The complexity of fee arrangements can be overwhelming, but simple measures can often produce meaningful improvements. For example, Plan Sponsors can demonstrate their commitment to monitoring the reasonableness of fees while also achieving significant savings for plan participants by simply moving to lower cost investment vehicles, when available.

Like other commingled funds, Insurance Company Separate Accounts can offer more of a pricing advantage as plan assets grow. The chart to the left illustrates that the use of commingled funds other than retail mutual funds becomes very attractive as plan size increases. However, some investment

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1 Department of Labor Amicus Brief regarding the Tibble vs. Edison International court case, May 2011.

providers may be able to bring the benefits of commingled vehicles further down market so that smaller plans may benefit as well.

ENSURING THE EQUITABLE DISTRIBUTION OF FEES

The allocation of revenue sharing among participant accounts is emerging as a fiduciary issue for participant-directed defined contribution plans, such as 401(k) plans.

“Though the Employee Retirement Income Security Act of 1974 (‘ERISA’) does not specify the process,” retirement industry legal experts Fred Reish and Bruce Ashton wrote in 2011, “the method of allocation is a fiduciary function that is governed by ERISA’s general fiduciary duty and prohibited transaction rules...”

And now, Plan Sponsors offering investments with a revenue sharing component have even more to consider. Should they select investment alternatives that offer revenue sharing or a share class with a lower expense ratio that does not offer revenue sharing? If both are offered in the plan, will some participants pay more for plan administration than others depending on which one they invest in? This gets even more complicated because different mutual funds have different revenue sharing arrangements, and furthermore varying share classes of the same fund family can also share different revenue amounts.

Insurance Company Separate Accounts provide an opportunity to reduce this disparity by either “levelizing” revenue sharing across all participants, or eliminating revenue sharing altogether and charging a separate flat administrative fee.

Consider the following example:

A Plan Sponsor is charged 20 basis points for recordkeeping. They decide to raise those 20 basis points from the underlying investment options and select two funds: Fund A and Fund B.

**MUTUAL FUNDS**

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<thead>
<tr>
<th>FUND A</th>
<th>FUND B</th>
</tr>
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<tbody>
<tr>
<td>25 bps</td>
<td>15 bps</td>
</tr>
<tr>
<td>average</td>
<td>20 bps</td>
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Because most mutual funds pay varying revenue sharing amounts, participants who invest in Fund A are charged 25 basis points, and participants who invest in Fund B are charged 15 basis points. Overall, the recordkeeper receives 20 basis points.

**INSURANCE COMPANY SEPARATE ACCOUNTS**

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However, recordkeeping fees are “levelized” with Insurance Company Separate Accounts. That is, all plan participants are charged 20 basis points, whether or not they invest in Fund A or B, thereby avoiding one participant “subsidizing” another.

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5 “Fiduciary Issues Related to the Allocation of Revenue Sharing,” by Fred Reish and Bruce Ashton, July 2011.
INSTITUTIONAL MANAGERS

As the investment management industry continues to become more specialized, gaining access to boutique and institutional investment managers becomes paramount.

Insurance Company Separate Accounts can provide Plan Sponsors and Intermediaries greater access to boutique and institutional investment strategies that may not be available through a retail mutual fund. Insurance Company Separate Accounts can provide a commingled investment vehicle necessary for many DC plans to access these boutique and institutional investment strategies.

INSTITUTIONAL CASH FLOWS

Protecting DC plan investors against retail cash flow volatility is an important consideration.

Unlike retail mutual funds, Insurance Company Separate Accounts accept only retirement plan money and, as such, can benefit from institutional investment practices. They are less likely to fall prey to the potentially damaging effects of retail cash flow volatility, and as a result, may keep lower cash balances than retail mutual funds. This is an advantage for Insurance Company Separate Accounts in a few ways:

1. Investment managers do not have to raise cash to meet redemptions as often,
2. Plan participant assets are more often fully invested in the market, and
3. Investment managers can avoid year-end selling for dividend distributions or retail client tax loss harvesting. This may result in reduced overall trading costs compared to retail mutual funds.

ACCESS TO INVESTMENT HOLDINGS

In this new regulatory environment, transparency becomes increasingly important—not just transparency of plan fees, but of every aspect of DC plan investing.

It can be difficult to obtain a full accounting of a retail mutual fund’s holdings. Generally, a fund’s “Top 10” or “Top 25” holdings are published quarterly. Alternatively, an Insurance Company Separate Account, depending on the provider, may supply specific stock and/or bond exposures, as well as a full portfolio on a monthly basis. Not only does this provide a better understanding of the plan’s investments, it also allows for deeper portfolio analysis by Plan Sponsors and their Intermediaries of specific company, country or industry exposure.
Conclusion

Plan Sponsors and Intermediaries must be ever vigilant to their fiduciary obligation to act in the best interest of plan participants, not only in regard to the assessment of the “reasonableness” and distribution of fees, but to the pursuit of improving plan participant retirement outcomes.

Insurance Company Separate Accounts can be one more resource to help them do that by potentially providing:

- Cost savings
- Greater transparency
- A more equitable distribution of fees
- Institutional cash flow behavior
- Broader institutional and boutique manager exposure, and as a result
- The possibility of improved performance

Coupled with the increased focus on institutionalization of DC plans, these advantages suggest that now may be an opportune time for Plan Sponsors and Intermediaries to examine whether Insurance Company Separate Accounts are an appropriate investment option for their DC plans.

To learn more about the solution Prudential Retirement offers contact your Prudential Representative.
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