

TPA Alpha: Why Quality Ingredients Matter

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This article is a sequel to ["TPA Alpha": A New Approach to Evaluating TPAs](#)

Not knowing all the pertinent details when making important decisions can have a dramatic impact on desired outcomes. Of course some details are more critical than others, but studying the elements and getting all of the relevant information available can help you make the most informed and prudent decision. With that idea in mind, I want to talk to financial advisors about how they can receive a high level of consulting and avoid future headaches by choosing to partner with high quality TPAs over cheap ones.

I can recall a time that I went to the local specialty meat shop to get some Italian sausage, chorizo and brats for an annual neighborhood cookout. As I walked up and down the cooler to review what was available, I noticed some popular name brand varieties and some options prepared that morning by the shop. Now, I for one typically opt for the freshly made options prepared by our neighborhood market as they have been around for years and do quality work. However, as I casually scanned the options available, the shop owner seemed to get a little perturbed that I was taking so long to make a decision. After a few more minutes of perusing, he asked me in a sarcastic tone, “Have you ever looked at the ingredients listed on the back of the packaging?” I smirked and said, “no, I just assumed the contents were basically all the same.” Well, that comment did not sit well with him and he proceeded to give me a very interesting dissertation on “what makes quality sausage” and how his has no fillers, starch or something he referred to as “gum.” Now that I have that wealth of knowledge I can assure you that I will never buy pre-packaged again! It may cost a little more, but the quality and flavor of the local market products more than makes up for any variance in cost. It also helps keep me in good graces with the shop owner.

This life lesson of “needing to perform full & proper due diligence” and not “broadly assuming that everyone has/uses the same ingredients” also correlates with the review and selection process of retirement plan service providers. In our last article, we explored the concept of Alpha generating TPAs and asked the question, “If advisors utilize Alpha (among other variables) as a metric for selecting investment options for retirement plans, why not incorporate a similar thought process when evaluating TPAs?” The overall objective was to have retirement plan advisors and plan sponsors scrutinize their TPA partners for performance and value in a similar fashion as they do plan investment options. To further illustrate this idea, we have included a chart below that lists various Target Date funds with 2030 vintages, along with their applicable net expense ratios. With only this limited information considered, which Target Date alternative(s) would be selected? In most cases, without evaluating additional variables, the lowest cost option would be the defaulted choice; however, there are obviously a lot more variables to consider.

2030 TDFs	Net Exp
Active TDF 1	0.67%
Active TDF 2	0.46%
Passive TDF	0.15%
Category Index	0.89%

Now let's take another look at the same Target Date fund options, but with some additional information to better understand the performance and quality being provided for the associated cost.

2030 TDFs	Net Exp	Std					# of Holdings
		Return*	Alpha*	Beta*	Dev*	To/Through	
Active TDF 1	0.67%	5.51%	1.80	0.82	11.26	To	21
Active TDF 2	0.46%	6.42%	2.07	1.01	13.92	Through	22
Passive TDF	0.15%	5.65%	1.36	1.00	13.76	Through	5
Category Index	0.89%	4.22%	0.00	1.00	13.68	N/A	N/A

*6/1/2008 - 3/31/17

With the additional data taken into consideration, would the low cost option still be the best choice? Variables such as, active return performance of the manager (Alpha), systematic risk associated with returns (Beta), return volatility (Standard Deviation), whether a “To” or “Through” retirement strategy is being incorporated and the number of underlying holdings used for diversification have a dramatic impact in determining the overall quality and objectives of the investment. There is obviously more data that could be included for review, but knowing just “these additional ingredients” enables the vetting process to be far more qualitative and not driven merely on price alone. It also provides great insight as to how net returns were generated over varying economic climates. These variables are significant and help validate both the advisor and plan sponsor’s prudence in the investment selection process.

→ What is Alpha?

The rate of return that exceeds what was expected, or predicted.

A similar evaluation process is paramount in selecting the strongest TPA firm for a plan sponsor to engage. As illustrated in the investment comparative above, this vetting process should go well past comparing cost. The chart below highlights some of the key components that should be focal points when evaluating the services, capabilities and competency of a given TPA firm.

Nutrition Facts Found in Alpha TPAs	% of Total Recommended Value
Responsive Plan Assistance and Support	24%
Data Security	18%
Strategic, Tactical and Personalized Plan Design	16%
Operational Risk Mitigation	14%
Market Intelligence and Business Development Support	12%
CEFEX Certification	10%
Trust Accounting, Contribution Accruals and Census Data Verification	6%

*% of Total Recommended Value weighting is hypothetical—actual value weighting will vary based on individual opinions.

In most cases, like our food choices, quality will and should win over “cheap,” especially when considering the consequences of a plan becoming non-compliant. The main thought in hiring any TPA should be, “Which firm provides the best opportunity for my plan to stay operationally compliant, mitigate risk and receive the highest level of consulting at a reasonable cost?” Without reviewing all of the relevant factors that make up a quality TPA, one will never get a full understanding of the services, value and capabilities being offered. Just like my neighborhood shop owner said, “Make sure you review the ingredients before you buy because quality makes all the difference!”

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