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Payroll Tribune

More Challenges in Fixed Income Markets

And What You Need To Think About In Investing Tax Deposits

- *Do Your Homework Now to be Prepared for this Market*
- *No one Knows when the FED will act*
- *Be ready for over-reactions and volatility akin to an 8th grade slumber party*

In my last Payroll Tribune I outlined some of the hazards service providers will face as the Federal Reserve begins to sell bonds to push interest rates up. I highlighted that:

- The FED needs to raise rates to take risk out of the economy
- Stating FED intentions, let alone actually acting to move rates, will cause *over-reactions* in the markets and *increased volatility* even to the point of causing *illiquidity* in the markets including large bond managers and bond mutual funds
- Do your homework now to be prepared for this market

Now three things have happened that indicate that you need to move up your planning.

First, The EU has implemented Quantitative Easing (buying bonds) which is causing rates to fall in EU countries, and their currency to drop over 15% to the dollar. Second, Regulators are warning the world's biggest money managers (like PIMCO. Blackrock, and Vanguard) that the debt markets are at risk of seizing up in the event of a sudden rush by investors to pull out their funds. Finally, in a related move, Chase Bank has urged clients to withdraw excess cash or face hefty fees (call it "negative float" if you like).

No one knows when the FED will act. The bond markets largest players are in talks with the FED over their concerns over the growing illiquidity in the markets. They face new capital requirements which have decreased the number of primary dealers, and the banks are being "encouraged to scale back their bond inventories. The dealers are asking the FED to make it easier for them to create automated exchanges and 'dark pools" to create liquidity by increasing deal flows through under regulated markets. Think Michael Lewis and his warning to us about the "flash boys".

The "good thing" about this situation is that the FED and the markets are very focused on these issues. This is not 2009 when suddenly President Bush said that the government would step in and guarantee all money market funds. Fortunately, he never needed to make good on that promise, but it did shock the markets, and some funds took some time to return funds to their customers. **It is good to be aware and to be as prepared as you can be to limit any inconvenience to your customers.**

If I had all the answers on how you should prepare to navigate in this "new new" bond market, I would tell you. For now I want you to be aware of the situation. I think that you could think about a few actions you might take:

- Keep fiduciary funds as liquid as possible – bank deposits, very short term top rated names (avoid the liquidity illusion of derivatives, some ETF's, financial engineered instruments, etc.) in money market mutual funds. Get up to date statements from your money market fund on their portfolio holdings. If they are chasing yield by extending maturities or decreasing quality standards, strongly consider changing funds within the mutual fund's family of funds, or change mutual funds. Morningstar can help you track the portfolios and performance of mutual funds.
- Bank fees for flow of funds transactions have gone up for most service providers. Talk to your primary bank about using compensating balances to pay for those services.
- Diversify your banking/ deposit sources. Most service providers run lots of deposits through their banks daily and monthly. Stay in contact with your bank to reduce the chances that you get a request from them to

More Thoughts on Per Check and Per Employee Per Month

As an industry, we have not always done the best job of pricing services. We may be constrained by the tools used or not used to gather data at the customer level on profitability, or by processes like multiple pricing tables, custom pricing, or loosely bundled pricing. But we need to get better at it because our industry is going through a disruptive change.

The most notable poor pricing example that comes to my mind is the industry's pricing for tax service. Core service costs were not well defined. The risks providers took on of customer credit risk, deposit delays, and some local tax collections and payments seemed to have been left out of the calculations. All the faults from poor analysis, it was reasoned, were to be made up with earnings from the payment of interest on "float". It worked until Warren Buffet's great admonition to us came true. "Only when the tide goes out do you discover who's been swimming naked." or words to that effect. Today the tide is turning and interesting things will soon be exposed.

Historically, the payroll industry at least has had several market leaders who have paved the way for most other providers to follow. They provided ground breaking services at prices which provided recurring cash revenues, at margins that makes at least one of them, a 5 AAA rated company. Most of their competitors discounted from these leaders' prices, taking smaller margins (5 to 25% versus the leaders' 20 to 35%), but they have made a good living providing solid services with a high degree of personal service to their customers. It has been a pretty simple process, and prices were based on a fee per check. A dollar a check was an early standard. That dollar grew to $2.75 to $3.25 a check by adding payroll services.

However, in the last seven years, changes in regulations and technology have disrupted the personnel service business. The services provided employees have increased. More service providers with different services to sell have come into the mix. These service providers have used a different pricing format. They have been used to charging for their services on a per employee per month basis("pepm"). HR departments are used to seeing service packages priced that way. Per check charges will soon become a thing of the past.

So, if change is upon you, how do you find a fair price? What's the cost? What's the risk? How do you go about thinking about pricing?

I want to start with two basic assumptions: workforce management services currently provide HR services (including compliance), payroll (including tax service and flow of funds services), retirement services, and benefits administration services (insurance of various types); the table manners of the players will sort out and products will rationally include fees to all component services. This doesn't mean that some players will not plan to give away payroll to get workers comp business., for example.

Some assumptions:

- Employees are paid 2.4 times a month on the west coast
- Economies of Scale Matter
- Leaders Want Market Share and 30% Margins

I will also assume, somewhat naïvely, that great customer service, providing a good working environment, and developing strong positive cash flows matters. I do understand that grabbing market share quickly, building revenues, and not really caring about EBITA compels many actors in the market place. I do understand that you have to compete against them for people, resources, and customers. I also understand that you can't control many market forces. But, those of you who want to build value, bear with me.

In a normal market place, price will be driven by perceived value. Variations in price will be narrowed by effective competition (so you can't charge anything you want, and some competitors will ask for unsustainable prices). Even the leaders in the industry will be constrained by these market forces.

So what can you control? You can control **your product mix** to some degree, but workforce management tools are beginning to establish that there are several vertical services which will comprise a full service offering: HR admin services, payroll, time clocks, and some employee benefits administration. **You can control service costs**, but it is very important to understand that each of the building block services requires expertise beyond the levels of expertise in any single service vertical. Key staff, in a work force world, have different skill sets, which will add to costs. It will take more planning and skill to build a business large enough to cover these additional costs. **Managers can control some costs by segmenting the market by complexity**, not just complexity which comes with size, but also by the complexity and compliance responsibilities in each of the product verticals.

To control costs managers will need to track them, plan for them, and account for variances between their plans and their actual performance. You can't control what you can't or will not count.

Even More Thoughts

So let's see what happens when the market, efficient or not, begins to put a price on a bundle of workforce services. Because I am not very good at math, let's keep it simple and look at a package price of $10 pepm. Good price or not? Depends.

Assume:

- $10 price
- Payroll is being sold with time clocks at from $2.75 to $3.25 a check or about ($3 x 2.4 = $7.20 pepm
- That leaves $2.80 pepm for HR and bene admin services. Is that enough?

Another way to price is to look at the value-add your service brings to a customer. As an example, consider that you have a customer with about 100 employees, with a 3 person HR staff, and you want to price at a level which saves the customer administrative costs and or improves customer HR management productivity. What's the pool of funds available to you using value-add pricing? 100 employees and $10 pepm is a pool of $1,000/mo. If the average all end cost of an HR staff employee is $50,000 a year or $4,167/mo then the staff of three will cost $12,501/mo. Does your service make the customer 8% more efficient? You tell me.

My point: pepm numbers are being thrown around without enough thought. Providers will have more costs as they add verticals to their product offerings. **Providers need to understand their costs better.** Providers will need to take on more risks, from performance risks to compliance, flow of funds, security, regulatory, and technology risks, than they have in the past. The cost of these risks need to be priced in. **Competition will be an important price driver.** Economies of scale will definitely drive price and costs. Hopefully value will also drive price. The exercise above shows that there is a lot of room for **fair pricing based on value exchanged** between providers and customers. Let's not price these services as poorly as we did with tax services, where prices were set below real costs and fair value. Competition and disruptive technologies will certainly act to drive prices and margins down over time. **Let's price this exchange**

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