Collective Investment Trusts in DC Plans

CITs may offer many benefits to your participants as part of your investment lineup.

By Lana Bergstein, Tim Kohn, and Frank Lallos for PSCA's Investment Committee

Collective investment trusts (CITs) have a nine-decade history in the US. But in recent years, these investment vehicles have grown in usage among ERISA fiduciaries, including plan sponsors and advisors.

Although CITs were created in the late 1920s, they initially played a limited role in retirement plans due to their lack of transparency, infrequent pricing, and restricted usage. But technology and regulatory changes have helped transform these vehicles.

Today, CITs offer retirement plan benefits that mirror those of other popular pooled investment vehicles, like mutual funds. These benefits include daily liquidity and valuation, share class pricing, and the ability for plan sponsors to offer more customized solutions in their plan's investment lineup. Together, these features enable fund managers to tailor solutions to the particular needs of defined contribution (DC) plans while giving plan sponsors a potential avenue to better manage their fiduciary risks.

Overview

CITs, also known as commingled investment trusts, are pooled investment vehicles maintained by a bank or trust company and operated exclusively for qualified retirement plans. Units of these vehicles are not publicly traded and, typically, are only offered to a specific group of qualified retirement plans, such as 401(k) or other DC or defined benefit (DB) plans. They are not available to IRAs, health savings accounts, or 403(b) plans.

Although not guaranteed by the FDIC (or any other authority), CITs are supervised by federal or state banking regulators — for example, the Office of the Comptroller of the Currency (OCC) handles supervision when the bank or trust company maintaining the CIT is federally registered. Unlike US mutual funds, the underlying assets in a CIT are treated as ERISA plan assets, which brings them under US Department of Labor (DOL) regulation. Moreover, the bank trustee and any investment manager(s) hired to invest CIT assets are considered ERISA fiduciaries and are held to those standards.

A CIT generally has a specific investment objective, as described in the Declaration of Trust document, and may hold a wide range of investments, including individual securities, mutual funds, REITs, commodities, hedge funds, private equity, and ETFs. CITs also can hold funds-of-funds, such as target-risk and target date strategies.

DC Growth Trends

With the advent of 401(k) plans in the early 1980s, CITs were used primarily in stable-value funds. Since the 2000s, the vehicles have gained broader usage among DC plans. According to DST Systems, CITs have become the fastest-growing investment vehicle in 401(k) plans over the past seven years.[1]

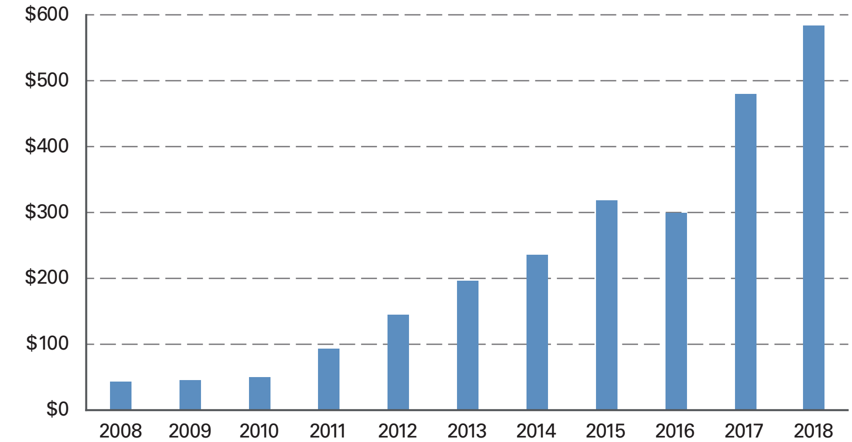
CITs appear to be positioned for continued growth because plan sponsors are often drawn to their customization attributes, the ability to white-label and commingle assets, and potential cost savings over many mutual fund offerings. As shown in Exhibit 1, the value of CIT assets settled grew significantly from 2008 through 2018. During this period, the number of annual transactions through the Depository Trust and Clearing Corporation (DTCC) increased from 1.9 million to 7.8 million. CITs now make up 6% of all trades settled via DTCC and represent 20% of trades in terms of dollars. Exhibit 2 shows the total growth of the CITs market from 2008 through September 2016.

Growing Usage Among DC Plans

"Nearly two-thirds of DC plans offered collective trusts in 2016, up from 48.3 percent in 2012. Meanwhile, mutual funds have decreased in prevalence

[1] Erach Desai and Jason Dauwen, "Collective Investment Trusts—A Perfect Storm" (white paper, ALPS, a DST Company, March 2017). DST Systems is now a part of SS&C.

Exhibit 1: Value of Collective Investment Trust Assets Settled (USD billions)



Source: Depository Trust and Clearing Corporation (DTCC).

Exhibit 2: Annual Collective Investment Trust Assets (USD billions)

Source: ALPS, a DST kasina company (now SS&C); Morningstar CIT database, 2017.

[among DC plans] from 92 percent to 84.3% percent over that same period." — Callan (2017)[2]

"Of the 100 largest corporate DC funds by vehicle in 2016, CITs make up 54.3 percent, more than mutual funds, separate accounts and ETFs combined." — BNY Mellon (2016)[3]

Data from financial-services company ALPS shows that assets in collective investment trusts, or CITs, could surpass the $3 trillion mark by the end of 2018, up from $1.9 trillion at the end of 2015." — Wall Street Journal (2017)[4]

Long History

The first CITs were created in 1927 and were generally used by DB plans engaged in offering stable-value funds. After the stock market crash in 1929, some observers blamed the pooled investment funds for contributing to the crash. As a result, CITs were

[2] Lori Lucas, Jamie McAllister, and Thomas Szkwarla, 2017 Defined Contribution Trends, Callan Institute Survey (www.callan.com/wp-content/uploads/2017/01/Callan-2017-DC-Survey.pdf).

[3] "The Collective Movement: The Rising Popularity of Collective Investment Trusts," Planet DC, BNY Mellon Retirement (Winter 2016).

[4] "CITs, the Not-Exactly Mutual Funds, Are on Pace to Hit $3 Trillion," Wall Street Journal, 3 June 2018

restricted to being offered only to trust clients under the umbrella of an employee benefit plan.[5]

In the 1950s, CITs saw widespread adoption by DB plans after banking regulations allowed banks to pool funds for company pension plans. With the advent and adoption of DC plans in the 1980s, CITs gained some usage among large plans — mostly as stable-value funds. But the infrequent (quarterly) reporting of net asset value (NAV) proved a negative attribute to plan sponsors and participants alike. So, the DC market looked to mutual funds, which reported NAVs daily, had a simpler structure, and offered more investment options.

Two events in the 2000s made CITs more attractive to the DC market. First, the National Securities Clearing Corporation (NSCC) added CITs to its mutual fund trading platform, which opened the door for CITs to be priced and traded daily. Then, the Pension Protection Act of 2006 brought about the use of qualified default investment alternatives (QDIAs), most of which are managed as target date funds and often structured in a CIT format.[6]

CIT Highlights

- CITs are supervised by federal or state banking regulators, generally qualify for exemptions from the Securities Act of 1933, and are generally exempt from requirements to register as investment companies under the Investment Company Act of 1940.
- Assets in CITs are plan assets under ERISA and regulated by the DOL and IRS. A bank trustee and any managers hired to invest the CITs are ERISA fiduciaries. They are held to ERISA fiduciary standards, including the ERISA prohibited transaction rules and the duty to act prudently and solely in the interest of the investing plan participants.
- CITs are typically tax-exempt as "group trusts." To maintain that status, they must adhere to the requirements of IRS Revenue Ruling 81–100, as amended, including the requirement that each investing plan adopt the terms of the group trust.
- CITs generally do not have the same administrative and marketing costs as mutual funds, as they are prohibited by law from advertising. Additionally, CITs are not required to prepare and maintain prospectuses, adhere to the regulatory and compliance reporting requirements of mutual funds, or maintain call centers and offer other services to the public.
- CITs can be structured to cater to the goals of retirement plan investors who may typically invest with longer-term time horizons, as opposed to other vehicles that may be designed for investors with disparate investment objectives.

Potential Benefits/Advantages

CITs have overcome many of the historical disadvantages that enabled mutual funds to become the primary investment structure for DC plans. In addition, some features of CITs make them an attractive solution for retirement plans.

- **Expenses:** CITs may incur low marketing and sales expenses because they are not allowed to advertise. In an environment where the number of lawsuits over excessive plan fees is rising, many plan sponsors may see CITs as an appropriate choice based on these potential lower expense components.[7] However, keep in mind that no investment structure will consistently have the lowest cost since the investment management fee is usually the largest cost component in an expense ratio.
- **Pricing flexibility:** Unlike a mutual fund, which charges investors in a given share class the same expense ratio, a CIT can assess different fee levels for different plans, often based on factors such as the size of each plan sponsor, participant demographics, and any customized features.[8] This flexibility enables a CIT to set its fees like a separately managed account (or segregated mandate), often with breakpoints on a tiered fee schedule.
- **Investment design:** In the early days of 401(k) plans, CITs functioned primarily as indexed and stable-value investment options. Today, they offer a broader array of investment strategies for DC plans.[9] CITs can provide design flexibility so that a manager can tailor strategies for unique investment and risk preferences of plan sponsors, helping them offer more customized investment solutions to meet specific participant needs. These solutions include broadly diversified portfolios, custom target date funds, and even alternative investments. CITs also offer a manager the ability to create certain structures that can be white-labeled or branded without highlighting an asset manager's name.

[5] "Collective Investment Trusts—A Perfect Storm," (March 2017).

[6] "A Fiduciary Perspective on Collective Investment Trusts," DC Dimensions (Winter 2019).

[7] "Collective Investment Trusts—A Perfect Storm," (March 2017).

[8] Fees must be uniform on a class-by-class basis. A share class can offer breakpoints as long as all investors in that share class can participate in the same fee breaks. However, offering a unique fee schedule to an investor requires a different share class.

[9] "Collective Investment Trusts," (white paper, The Coalition of Collective Investment Trusts, 2015).

Exhibit 3: CITs vs. Mutual Funds

CHARACTERISTIC	CITs	MUTUAL FUNDS
Investment Vehicle	Pooled Held by bank or trust company	Pooled Held by qualified custodian
Availability	Available to certain DB and DC retirement plans [not 403(b)]	Available to general public and retirement plans Restrictions specified in prospectus
Enrollment Requirements	Signed participation agreement with pooled fund language	According to prospectus
Governing Body	Trustee and trustee´s board	Fund board of directors
Governing Documents	Declaration of Trust and OCC Asset Management Handbook	Prospectus and additional filings
Oversight and Regulation	Office of Comptroller of the Currency (OCC), local state regulators, IRS, and DOL Fund trustee subject to ERISA standards	SEC and Investment Company Act of 1940 Manager not held to ERISA standards
Compliance	Bank acts as trustee and has ERISA fiduciary responsibility	Independent fund´s board of directors responsible
Fees	Fees are flexible and may vary by plan	Expense ratio is the same for all investors in the same share class
Valuation	Daily valuation has become common Quarterly minimum required	Daily valuation
Performance	Provided by fund accountant	Provided by fund accountant
Clearing	NSCC	NSCC
Prospectus Required	No	Yes
Advertising	Not allowed	Allowed

Sources: DST Systems (now a part of SS&C), SEI.

- **Plan size scaling:** In recent years, CITs have become more economical for smaller plans, and are now frequently launched and maintained for plans with lower levels of assets under management (AUM), such as $25–$50 million. This increased scale is often attributed to greater efficiencies in tracking, operations, and trading.[10]

In combination, these features can offer an expanded toolbox for addressing specific challenges in plan administration and helping participants invest for retirement. The following case study offers an example of using CITs to simplify and enhance a plan's investment lineup.

Case Study: Adding CITs to the Menu[11]

An industrial company with multiple subsidiaries sponsored a DC plan with about $1.5 billion in assets. The plan had a wide range of participants, from salaried to hourly, and offered 25 investment options, all through mutual funds. The lineup included three international funds accounting for $150 million of participant assets.

The investment committee decided to terminate one of the international managers and debated how many funds should replace it. One committee member proposed simplifying the international fund lineup, and another member proposed building a unitized, single, white-labeled international fund consisting of two international managers. Under this structure, the committee would terminate all three current managers, map plan assets from the terminated funds to the new white-labeled fund, and choose new international investment managers. This method was intended to reduce the impact to participants in the event of a future manager change. Also, the fund reduction could have the possible benefit of simplifying the investment options available to participants while enabling the committee to find managers that best aligned with their investment philosophy.

[10] "Collective Investment Trusts—A Perfect Storm," (March 2017).

[11] Case study provided by Global Trust Company/NRS.

The committee found two managers with strong track records and complementary risk attributes. Both offered CITs, with one of the managers using CITs exclusively. (All of the manager's assets were institutional, and the international strategy was the only product offered in the US DC space.)

The plan custodian created a unitized fund, and the committee worked with the recordkeeper to launch the product, with 95 percent of the plan participants in the legacy funds mapped into the new white-labeled structure. As a result, the committee reduced the number of options while offering a new set of managers that participants may not have chosen themselves due to low name recognition. The CIT structure also enabled the committee to include managers with similar plan types in the offering and ensure the managers were held to the same level of fiduciary oversight as the committee.

Potential Key Actions for Plan Fiduciaries[12]

Plan fiduciaries should engage in the usual due diligence. Here are potential key actions to consider:

1. Carefully read the declaration of trust, participation agreement, and any other related trust documentation because important terms cannot be assumed.[13]
2. The investing plan document should explicitly permit investment in a CIT, and the investment should be authorized by a named fiduciary who is independent of the CIT trustee and has authority to direct plan investments.
3. Understand and analyze fees for reasonableness, and test whether fees and investment minimums are negotiable.
4. Learn what kind of performance information is available to participants and plan fiduciaries. Performance data may be available through the recordkeeper or the trustee/manager, and Morningstar offers some CIT details.
5. Find out whether the trustee reports the CIT's assets directly to the DOL; if so, the plan need not report its pro rata share of all of the CIT assets on its Form 5500.
6. Obtain the CIT's IRS determination letter indicating the CIT is a group trust, or otherwise confirm the CIT's tax-exempt status.
7. Ask about reliance on the prohibited transaction exemptions and obtain assurance that any conditions are met.

Summary

Plan sponsors may wish to approach DC plan design and administration by centering on the value delivered to participants. CITs have come a long way since the 1920s. In light of their modernization and growing usage in the industry, sponsors might consider how they could use CITs to improve their offering within their plan lineups.

While fees are a key consideration in any investment decision, they are only one of many factors shaping a participant's overall outcome. Equally important, sponsors should select service providers, investment options, managers, and plan features based on the likelihood of helping participants reach their retirement goals. Focusing on value in addition to fees offers a better way by which to build and monitor your retirement plan benefits.

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[12] "A Fiduciary Perspective on Collective Investment Trusts," DC Dimensions (Winter 2019).

[13] Unlike mutual funds, which have fairly uniform terms and features because they are highly regulated under securities laws, individual CIT terms can vary widely. The documentation controls what the CIT can invest in and how. Also, a specific CIT may allow redemptions only on a quarterly basis or impose lockup periods. The plan sponsor should consider any transfer restrictions the CIT may impose under ordinary circumstances in the event of a participant termination or if the plan merges or terminates. Also, consider whether participant communications and even plan amendments will be required by these restrictions.