Investment
INSIGHTS

EFFICIENT, FLEXIBLE STRUCTURE BOOSTS CIT POPULARITY

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The use of collective investment trusts in employer-sponsored defined contribution plans is growing — fast. By the end of 2023, 84% of plan sponsors had offered CITs as part of their fund options, with target-date fund strategies driving much of the growth, according to the Callan Institute's 2023 Defined Contribution Trends Survey.

More plan sponsors are choosing CITs over mutual funds for a number of valid reasons, said Ryan Dargis, senior vice president of service and strategy enablement in Global Fund Services for the Americas at Northern Trust. "It's driven by efficiency, flexibility and the ability to negotiate costs," he said.

CITs are tax-exempt investment vehicles that are similar to mutual funds in their implementation but different in their structure and regulation. They have seen rapid adoption in recent years for their flexible structure, streamlined reporting requirements and, often, lower costs and fees. CITs can be integrated into plans easily, customized more readily and accommodate more investment strategies than are typically available in traditional mutual funds.

To provide these benefits to a wider number of participants beyond those in 401(k) plans, the DC industry is hopeful it will see full legislative approval for their use in 403(b) plans. In March, an amendment passed in the U.S. House of Representatives, and in August a bipartisan group of senators introduced the Retirement Fairness for Charities and Educational Institutions Act, aimed at clearing the final regulatory hurdle preventing plans sponsored by nonprofit organizations from using CITs.

TDFs LEAD THE WAY

The most dramatic growth area for CITs has been within target-date funds, Dargis said. CITs reached 49% of target-date market share at the end of 2023, and it appears that as of June 2024, they have surpassed mutual funds, reaching 50.5% of the market. CITs are "in a healthy growth mode, with more room to grow," Dargis added, crediting the fact that CITs operate within their own regulatory oversight and governance framework, which is different than mutual funds.

CITs are subject to banking regulations and certain tax and ERISA-related regulations, but unlike mutual funds, they are not regulated by the Securities and Exchange Commission and generally not subject to the Securities Act of 1933 or the Investment Company Act of 1940. "Fewer regulatory oversight requirements translate into less operational complexity to run or set up a CIT," said Dargis, "although they still maintain a reliable governance structure." CITs are overseen by a trustee, a sponsoring bank entity, acting in a fiduciary capacity.

Dargis sees custom target-date funds continuing as a key growth area for CITs because more plan sponsors deploy solutions tied to the unique needs and demographics of their participants. According to the Callan survey, only 16% of plan sponsors used their record keeper's target-date option in 2022, down from 59% a decade ago. "It's easy to plug and play CITs to branch out from a record keeper's proprietary fund lineup and customize your own lineup, whether in custom target-date funds or in single strategies that need to fill a hole on the menu."

Also, if a particular strategy or investment model doesn't already exist, it can be quicker to launch it as a CIT than as a mutual fund. Because there are fewer legal and regulatory considerations, CIT providers have made fund launches highly efficient turnkey processes with quicker speed to market. "There's an established way to go to market with CITs, working with investment managers, the plan sponsor and the plan's consultant or advisors," Dargis noted.

Many DC plans can deploy CITs through their record keepers using the same operational infrastructure, which creates market efficiencies as well. "The ability of CITs to provide different solutions for different types of plan needs lends itself to a level of flexibility that is attractive to both asset managers and plan sponsors."

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WIDER USE CASES

CITs provide an efficient way for plan sponsors to access the different investment strategies that they want to offer in their plan. For instance, they can be an underlying sleeve in a target-date fund and used in combination with other investment vehicles, such as a managed account. CITs can also stand alone as vehicles for white-label investment strategies.

Plan sponsors can use CITs to add exposure to investments not available in traditional mutual funds, such as certain alternative or stable-value strategies, which could provide additional diversification, Dargis said. "CITs can also bring relatively low-cost active management to participants across various asset classes," complementing the use of a passive fund.

EFFICIENT PRICING AND TRANSPARENCY

While mutual fund fees have come down in recent years, CITs have an additional advantage beyond efficient pricing. Since they are not restricted by the rules governing mutual funds, in certain cases, plan sponsors, their advisers and consultants have the ability to negotiate fees on CITs.

CITs allow for different fee structures that can be based on asset size and service relationships versus the fixed asset-based management fees of mutual funds. "Morningstar studied the asset-weighted average expense ratios of mutual funds and CITs in 2020 and found that those of CITs are generally less than half those of their mutual fund counterparts across both active and passive strategies," Dargis said.

This efficient pricing structure can help address industry-wide fee pressures as savings can be passed on to plan sponsors and participants. "The awareness of excessive fee-related litigation, primarily focused on the investments included in the target-date funds of larger DC plans, is another key catalyst driving CIT adoption."

Over the last decade-plus, CITs have continued to leverage the same technology platforms and market infrastructure that traditional mutual funds use, giving plan sponsors and participants access to the same types of information, including daily net asset value, quarterly fact sheets, audited financials and CIT ticker symbols. "Transparency should no longer be a perceived gap for CITs, especially as more real-time performance information is available — both from the provider and through services such as Morningstar or Fi360 — making it easier to track and rate them," Dargis noted.

He emphasized the importance for plan sponsors, as fiduciaries, to compare CITs with other investment vehicles and share classes and evaluate them in light of the size, assets and demographics of their plans. "It's really in their best interest to ask whether the plan — and especially its participants — might benefit by switching some asset categories or target-date suites to CITs."

USAGE TRENDS

CIT growth has been driven mostly by large and mega-sized plans, as they generally have more resources and have become more comfortable with using them versus the small- and mid-sized plans. But Dargis pointed out that utilization has been slowly moving down market, and mid-sized plans are increasingly using CITs as well.

"We're seeing mid-market plans with less than $1 billion in assets adopting CITs, and we expect that trend will continue," he said. "Among smaller plans, there is an educational learning curve to address, but it is underway with DC investment-only providers, plan aggregators and other intermediaries."

With CIT usage in 401(k) plans growing at a healthy clip, making it a critical component of the U.S. retirement market, regulatory approval for its use in 403(b) plans would be a welcome development. As Dargis summed it up: "The efficiency and flexibility of CITs provide plan-level pricing flexibility, a cost-efficient vehicle for custom target-date strategies, an expanded universe of investment objectives and enhanced transparency and reporting to meet the needs of all DC plans and participants."

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