CITs POISED TO SHINE ACROSS THE DC STAGE

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The use of collective investment trusts is becoming increasingly common in employer-sponsored defined contribution plans, challenging the dominance of traditional mutual funds. In Callan Institute's 2023 Defined Contribution Survey of plan sponsors, 84% of respondents said they used CITs, while 79% of respondents said they offered mutual funds.

CITs are tax-exempt, pooled investment vehicles — similar to mutual funds — but are held by a bank or trust company and not offered to retail investors. The vehicles differ in structure, regulation, investor experience and availability. CITs have attracted DC plans due to their lower cost, less onerous reporting requirements and greater flexibility. To learn what's powering CIT uptake and how plans are fitting them into their investment lineup, Pensions & Investments spoke with David Cohen, portfolio manager and head of institutional and retirement products at John Hancock Investment Management; Matthew Brenner, managing vice president and head of investment product management at MissionSquare Retirement; and Ryan Dargis, service & strategy enablement, global fund services, Americas, at Northern Trust.

Pensions & Investments: What makes CITs attractive to DC plan sponsors compared with traditional mutual funds?

DAVID COHEN: DC plan sponsors that are attracted to CIT funds display a strong preference towards the lower-cost solutions that CIT funds may offer. Operational costs are lower for CITs mainly because regulatory compliance and reporting costs are significantly lower. For example, CITs don't usually have 12b-1 distribution fees. Similarly, CITs are free of the mutual fund rules that restrict the ability of plan sponsors, their advisers and consultants to gain buying power by leveraging the scale of their investments and negotiating potentially lower fees.

Other ways CIT funds work well is their ease of customization. Plans can white-label them, which allows for more flexibility. Also, transparency has improved. Over the past several years, CITs have adopted the same technology platforms that traditional mutual funds use, and plan sponsors now have access to the same types of information. Examples include daily pricing, quarterly fact sheets, audited financials and, more recently, Nasdaq tickers. Information is publicly available for plan sponsors and, obviously, their participants.

RYAN DARGIS: When comparing CITs to mutual funds, efficiency and flexibility are the two pillars that make CITs attractive. Operationally, the CIT vehicle is an efficient way for plan sponsors to access investment strategies and the managers that they prefer to have in their plan lineups. Also, CITs now utilize much of the same market infrastructure that the mutual fund industry has created over several decades, which creates market efficiencies as well.

For example, it's not unusual for a plan sponsor to like a particular strategy or target-date fund or investment model. If it 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. Many CIT providers have made fund launches highly efficient, turnkey processes with much quicker speed to market. There are also cost advantages. In addition to lower administrative costs, the flexibility of a CIT structure allows for different fee structures based on services and assets, which does not exist in the mutual fund space that generally has set asset-based management fees.

MATTHEW BRENNER: Typically, the main characteristics that the market focuses on are the lower fees and the ability to negotiate certain fees. But those aren't the only characteristics that make CITs attractive to DC plan sponsors. The CIT structure can also allow for more investment strategies than those that may be available in [funds covered under the Investment Company Act of 1940].

DAVID COHEN
Portfolio Manager,
Head of Institutional and
Retirement Products
John Hancock Investment Management

MATTHEW BRENNER, CFA®
Managing Vice President,
Head of Investment Product Management
MissionSquare Retirement

RYAN DARGIS
Service & Strategy Enablement,
Global Fund Services, Americas
Northern Trust

Many fund companies launch CITs as clones of their ’40 Act funds. Some clients may want the ’40 Act fund, some may want the CIT. But managing the CIT the same as the ’40 Act version does not take advantage of the vehicles’ differences, as CITs can allow different investment approaches. A prime example is stable value, which is common in a CIT structure but not available as a mutual fund.

There are different liquidity requirements in CITs as well. For a defined benefit plan on a corporate balance sheet, a foundation or endowment or a public plan, the investment strategy leverages different layers of liquidity that may not be available in a ’40 Act fund. But if it’s available in a CIT, that means there are many institutional-like strategies that could be made available to DC platforms and, ultimately, to participants that haven’t had that access before. As more CIT providers take advantage of the vehicle differences, it will allow for new investment strategies that are not available in the ’40 Act space.

P&I: CITs are structured differently than mutual funds. What do plan sponsors need to know?

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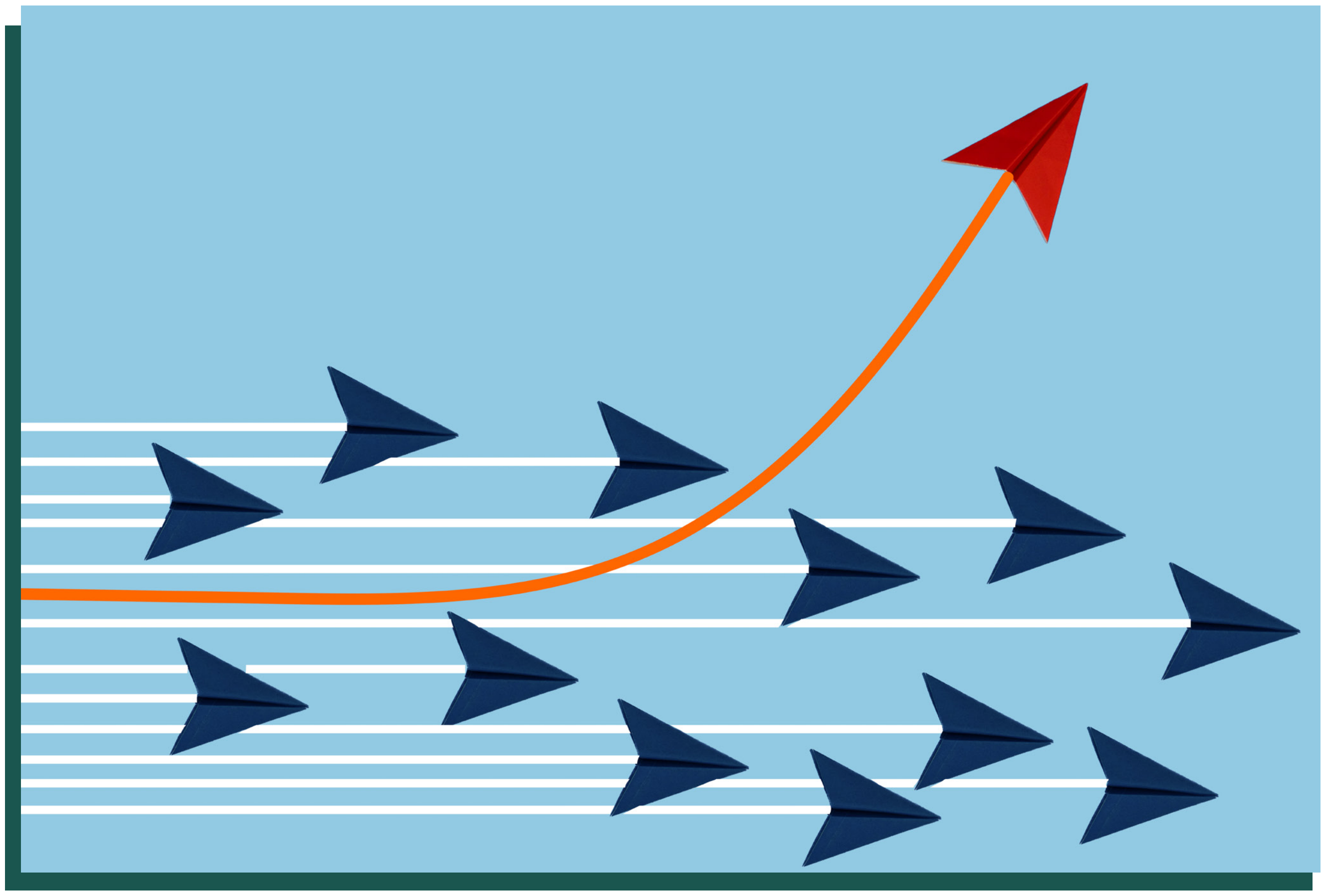
>
> — RYAN DARGIS, NORTHERN TRUST

DARGIS: Even though CITs are structured differently, many DC and DB plans can still deploy them in the same way they’ve historically used mutual funds — DC plans particularly, through their record keepers using the same operational infrastructure. CITs are by no means unregulated funds, but their oversight structure is different. Unlike mutual funds, they are not registered with the [Securities and Exchange Commission] and they exist outside of SEC rules. CITs are sponsored by banks and their structure allows for the sponsoring bank to handle fund governance and oversight within its own processes and committees; there is generally no explicit fund board oversight but CITs are still subject to thorough bank exams. They are also subject to different regulatory obligations around disclosure, such as mutual funds’ prescribed prospectuses. Instead, there’s a governing trust embodied in a trust declaration and usually a fund declaration, or equivalent, that describes a specific fund’s processes, strategy, and objective. The process to invest in the fund is usually facilitated through a participation agreement between the plan and the fund’s trustee. So, there are still documents and paperwork, but they’re different and tend to be more concise.

COHEN: One key difference that plan sponsors need to be aware of is CITs’ eligibility requirements. For the most part, mutual funds can be included in the assets of any kind of plan but at this point, CITs still cannot be included in 403(b) plans, which we hope will be changing soon. They are also not eligible for 457 plans, [individual retirement accounts,] Keogh plans, nonqualified deferred compensation plans,



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[Voluntary Employees' Beneficiary Association] plans and most endowments and foundations.

Another key difference is that while both CIT funds and mutual funds are regulated, CITs are regulated by different entities with different requirements. This leads to structural differences between the two types of funds. Mutual funds are regulated under federal securities laws while CIT funds are regulated under state and/or federal banking laws, the Internal Revenue Code and the Employee Retirement Income Security Act of 1974. Because of these differences, CITs and mutual funds require different plan-sponsor onboarding processes and governance documentation. They both provide transparency and oversight in terms of the investment.

BRENNER: The process for a plan sponsor to add a CIT to its lineup is a little different than for a mutual fund. Typically, a subscription or participation agreement is required, and reporting disclosure requirement for CITs are a little different than for '40 Act funds. And while the primary disclosure document for a mutual fund is a prospectus, CITs are governed by a declaration of trust. They also have offering documents, and those documents typically provide similar information to a mutual fund prospectus. So, plan sponsors have to be aware that they're not going to see exactly the same thing. As another example, if they go to look at a CIT's ticker, it's not going to be located the same way that a ticker for a '40 Act fund would be located.

P&I: What are fiduciary, regulatory and compliance issues when using CITs versus traditional mutual funds?

BRENNER: Mutual funds are registered with the SEC, and their disclosure document is a prospectus. CITs are different — they're governed by a declaration of trust and their offering documents provide information similar to a mutual fund prospectus. It's important to note that even if CITs aren't registered with the SEC, they're still subject to multiple and overlapping levels of regulatory oversight. For example, as CITs are maintained by a bank or trust company, they're subject to oversight from the OCC and each state's bank regulator, which oversees the bank or the trust company where the CIT is maintained. But by extension, the SEC oversees registered investment advisers, and even if the CIT itself is not regulated by the SEC, the adviser that provides some type of service to that CIT is regulated. Broker-dealers that market CITs still have to comply with federal and SEC rules.

DARGIS: The plan sponsor always has a fiduciary obligation to act in the best interests of its participants and its plan. In most cases, introducing CITs simply brings a relatively less expensive option than mutual funds and that falls under a plan sponsor's obligations to include reasonable and appropriate investments for the plan, including the investments' costs. But it's not all about costs — caution matters too. Anecdotally, lawsuits in the DC market, for example, involve plan participants who question appropriate investments in relation to their fees. The ultimate compliance responsibilities for a plan don't change. For example, corporate plans are governed by ERISA, and they need to meet their disclosure obligations to plan participants regardless of the investment vehicle.

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> — MATTHEW BRENNER, MISSIONSQUARE RETIREMENT

P&I: What types of plan sponsors, by size, industry or investment objective, are using CITs?

DARGIS: The big-picture trend for the last decade or longer has been CIT utilization slowly chipping away at mutual funds' dominance. That utilization has been driven largely by large and jumbo-sized plans, which makes sense. Bigger plans generally have more resources and have gotten comfortable with the CIT concept more quickly than small and mid-sized retirement plans. But utilization has been slowly moving down market, and small- and mid-sized plans are increasingly using the CIT vehicle as well.

The other trend has been the use of CITs in target-date funds. Target-date funds have comprised probably half of new CIT fund launches that have taken place over the last five or six years, and about 30% of the CIT market is represented by target-date funds. As this slice of the market grows, CIT utilization is approaching parity with mutual funds in the target-date space. That's all driven by the same things: flexibility, efficiency, and attractiveness around the ability to negotiate costs.

COHEN: The initial trend of CIT use was among larger plans, as they were specialized products that didn't have the same transparency. But today, besides the continued use among large plans, we're seeing mid-market plans starting to adopt CITs, and we expect that trend will continue. To put a number on it, there's significant interest among plans with $75 million to $500 million in assets. Interest among plans below that level is rising, and CIT use will continue to move downward by plan size, but it's not quite there yet.

BRENNER: On our own platform, we have gone to a full CIT lineup for our proprietary funds, and this has not posed any issues with our plan sponsor clients. Still, some plan sponsors remain focused on '40 Act funds. Some have longstanding track records and known tickers, so CIT versions of those existing funds may cause confusion and hesitation for a subset of plan sponsors. They may not understand that they are distinct investments; they may think they're clones. While CITs are not exactly the same, in many cases the CIT versions of given investment strategies are substantially the same with the same objectives, portfolio management team and management approach. But the CIT structure means there are slight differences in the makeup of the fund.

P&I: Where are CITs being used most: target-date funds, core menu plans, managed accounts or other types of investments? Has that trend changed?

COHEN: Without question, most of the CIT money is going to target-date funds, followed by stable-value collectives. Given the percentage of assets that they capture within a retirement plan, it's understandable that target-dates would capture those assets in a big way. The other reason is that a lot of litigation, particularly against bigger plans, addresses the investments that are included in a target-date fund. Did it purchase the most cost-effective solution and were cost-effective measures considered? Did it purchase the cheapest option available, either with a passive strategy or CIT versus a mutual fund? When considering available options, a lot of larger plans have moved their target-date strategies into the CIT space.

DARGIS: Notwithstanding the prevailing growth in target-date CIT funds and the related target-risk variations of those particular funds, we still talk to a lot of advisers around single-strategy options, which work well when a plan really likes a manager's particular investment strategy and it wants it as a CIT. So, you still see some single strategies as CITs that might be in a core lineup or as a component in an investment sleeve as a white-label offering the plan has put together for its participants.

P&I: In the past, CITs have been less transparent than mutual funds, but now provide daily pricing and performance reporting. What are the main differences and how have providers made CITs more participant friendly?

BRENNER: As CITs have continued to evolve, there have been efforts to give them more features like '40 Act funds. As an example, it is more common these days for a CIT to strike a daily net-asset value, which may not have been the case in the past. But now most CITs are traded daily and they're going to be priced daily. Having an NAV reduces the friction for a participant between a CIT and a mutual fund. A ticker still may not be readily available for a CIT, but a plan sponsor can subscribe to a database that contains robust CIT information, and there is still the ability for the plan sponsor to make information available to participants about the composition of a fund similar to the disclosures of '40 Act funds.

Investment Management

John Hancock Investment Management
197 Clarendon Street
Boston, MA 02116
jhinvestments.com

Gene R Huxhold, CFP, AIF
Senior Managing Director
John Hancock Investment Management —
Investment Only Retirement
847-224-9862
gene_huxhold@jhancock.com

> In addition to lower administrative costs, the flexibility of a CIT structure allows for different fee structures based on services and assets, which does not exist in the mutual fund space.
>
> — DAVID COHEN, JOHN HANCOCK INVESTMENT MANAGEMENT

RETIREMENT

MissionSquare Retirement
777 North Capitol Street, NE
Washington, DC 20002
missionsq.org

Matthew Brenner, CFA®
Managing Vice President,
Head of Investment Product Management
202-962-8036
mbrenner@missionsq.org

Northern Trust
50 S Lasalle St
Chicago, IL 60603
northerntrust.com

Ryan Dargis
Service & Strategy Enablement,
Global Fund Services, Americas
312-444-7278
rd57@ntrs.com

It's possible that, in many cases, participants don't know the difference between a CIT and a mutual fund. Education is important, and the plan sponsor should work with providers that offer participant-friendly reporting. If you're going to add a CIT to your lineup, finding providers that recognize the importance of maintaining a high level of communication and availability of information to participants is a priority.

COHEN: In the past, CITs weren't tracked by Morningstar or Fi360 [Fiduciary Score], which are some of the traditional ratings services for retirement plans. The only way to get updates was through the providers themselves, and if they provided it quarterly, you still might not have seen it for 30 to 45 days. So it was a challenge for those who wanted to monitor CITs' progress or track their assets, which was always touted as a big negative.

Today you can get a ticker for a CIT and there's much more real-time performance information, both direct from the provider and through services such as Morningstar or Fi360. This now makes it easier to track CITs and rate them. Over time, as the CIT product structure moves down market and providers feel competitive pressure, it will become even easier to get information and data, and transparency won't be an ongoing issue.

P&I: In which DC plan segments do you expect to see most growth in usage of CITs, and why?

DARGIS: If you were to ask many CIT providers or advisers in this space where they would like to focus more, it would be heading into the mid-sized and smaller plan space — less than $1 billion-sized plans. Greater adoption there would represent notable growth given CITs' current uptake rate. Looking three to five years ahead, that's a space where I see significant growth potential. There is an educational learning curve to address and help ease this process, but it is underway with [defined contribution investment only] providers, plan aggregators and other intermediaries to an extent already, and it will eventually ease use into the smaller plan space.

BRENNER: Besides the lower costs that CITs can offer, CITs may allow for better investment design that's specifically geared to the retirement market. A mutual fund that's used in a defined contribution lineup is also typically available for retail investors, but the goals and investment objectives of those two groups aren't necessarily the same. So, to the extent that target-date funds support the retirement market, we can see a world where target-date fund providers are working on improving their investment design.

COHEN: With the ongoing growth of CITs, Sway Research predicts that CITs will be the dominant vehicle by assets in 401(k) plans by 2025. That reflects that mega-sized plans have adopted CITs, and they represent the lion's share of the assets. But as CIT usage moves down market, we see more understanding, education and adoption within the broker-dealer community. Broker-dealers have seen the trends occurring at the larger end of the market, but as they have such a wide range of coverage along the entire plan spectrum, their smaller-sized plans are starting to see more engagement. They're providing more manager research expertise in the CIT space, and because of that, we expect to see more opportunities within the broker-dealer community to leverage CIT funds in the next three to five years.

P&I: What kind of innovation do you see in CITs?

BRENNER: We've talked about stable-value strategies that have a long history as CITs. There are also certain characteristics of stable value, particularly the insurance-wrapped contracts, that asset owners could use to wrap other types of assets. Typically, in stable value, the insurance-wrapped contract is used to wrap fixed-income securities, but as CIT innovation continues, asset managers perhaps could work with insurance companies to provide a wrap for other asset classes like equities. That could be an area where there's innovation by managers that are looking to expand the types of offerings on a record-keeping platform or in a corporate sponsor's lineup.

DARGIS: One challenge for the retirement market is addressing exposure to private equity and other types of alternatives. Another current area of focus for the industry is providing retirement income options within the plan lineup, so that plans can support post-retirement participants more robustly. It might be part of a target-date solution with an income option at the end that leverages stable value or annuity products.

Another area of indirect innovation is the potential to include CITs in 403(b) plan lineups. Regulation still prohibits their use. SECURE 2.0 took care of some of the historical hurdles to participation, but there is securities law regulation that needs to be addressed. While it looks like there's some bipartisan support to keep up the momentum, it's unclear when that can actually happen. When it does, it will be a game-changer for those plans, and it could expand CIT eligibility to over $1 trillion in additional plan assets, thus leveling the playing field between 401(k) and 403(b) plans and their offerings.

COHEN: We believe we need to listen to what plan sponsors and their participants need and want over the next several years, especially when coupled with legislation coming out of Congress. There's a significant focus on retirees and those planning for retirement, and product innovation needs to reflect where that's headed. One example that we see today is continued CIT fund innovation focusing on retirement income solutions. We see more participants wanting to stay in their plans longer, especially during the decumulation phase.

Another area of innovation that we see is offering plan sponsors access to new investment strategies that are not common in the DC space. These may include more environmental-, social- and governance-based CIT funds and access to private-market strategies, like real estate and infrastructure, as a component of a target-date or managed account solution. Typically, those strategies have been reserved for large institutions, but we're starting to see that DC plan sponsors and participants want access to them as well. ■