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Positive Outlook Exists for Collective Trusts in Defined Contribution Plans

BY STEVE DEUTSCH

Collective investment trusts (CITs) are enjoying a renaissance with defined contribution plans. With some distinct advantages and differences from mutual funds, the adoption of these investment vehicles, especially of the target-date variety, is increasing among plans. The outlook for the use of CITs in plans remains positive so long as the industry self-regulates to a higher standard as to transparency and improved performance reporting.

What Are CITs?

CITs are unregistered investment vehicles for institutional investors, used for a variety of investment goals—

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not just retirement. They are truly global investment vehicles. Unregistered means that collective trusts are not governed by the Securities Act of 1933 or the Investment Company Act of 1940 and don't have to be filed with the Securities and Exchange Commission.

CITs in the United States are banking products, and the closest to a regulator is the Treasury Department's Office of the Comptroller of the Currency. Despite some initial speculation, the OCC survived passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law No. 111-203). It seems as though CITs were not a high-priority item on previous OCC bank examinations, and this will not likely change under the new acting director, John G. Walsh, who was formerly chief of staff and head of public affairs for the comptroller's office.

Other than the absence of registration requirements, CITs are like other investment vehicles in that they are subject to the general overview and guidelines of the Internal Revenue Service, Employee Retirement Income Security Act, and the Department of Labor.

Since CITs are unregistered and loosely regulated, there is no general agreement on what these products are called. Under the authority of the SEC, everyone calls an exchange-traded fund, which is an investment fund traded on a stock exchange, an ''ETF.'' But without SEC governance, CITs are also referred to as collective trusts, collective funds, commingled funds, pooled funds, private funds, and, more recently, collective trust funds (CTF).

The distinguishing traits between CITs and mutual funds extend beyond regulation and can be broadly summarized in this chart (http://op.bna.com/pen.nsf/r?Open=dbrh-889rxl).

By Morningstar's estimate, there is about $1.6 trillion in CIT assets spread between defined benefit and defined contribution plans for corporations and nonprofits, as well as other institutional investors. This es-

timate is based on the assets under management that Morningstar can track publicly, with 1,200 listed CITs and associated fee bands (fee bands are roughly the CIT equivalent of mutual fund share classes). We know, for example, that currently there are probably another 1,000 CITs that are not reporting publicly as they are either unique to certain large investors or closed to further investment. More CITs are joining the database regularly.

Origins and Predominant Orientation of CITs

By some estimates, CITs have existed in the U.S. for eight decades, possibly preceding the creation of mutual funds.

The foundation of CIT use in pension plans was built on stable value strategies. While surveys from Greenwich Associates, Stamford, Conn., found that up to 45 percent of defined contribution plans are using CITs in their lineups in some capacity (where at least one of the plan choices is a CIT),[1] it's likely that stable value strategies contribute a great deal to that result. For years, stable value ''funds'' that were actually wrapped in a CIT or a separate account, were added to defined benefit and defined contribution plans as foregone conclusions.

After the ''subprime credit crisis'' of 2008-2009, and the withdrawal of available credit, stable value is currently faltering, with asset managers unable to find insurance firm providers that will ''wrap'' or ''guarantee'' the value of the underlying short-term fixed-income obligations. With little appetite from insurance firms for credit risk, some asset managers have thrown in the towel and instructed their investors to switch to money market mutual funds. Even if a new model is found, stable value is not driving CIT vehicle origination or asset growth.

One lasting effect of the stable value origin of CITs is the enduring nature of passive investment vehicles. A large proportion of CITs are index oriented or otherwise passive, which may account for the presumption that CITs are, by nature, lower cost than many other types of investment vehicles.

Re-Emergence of CITs

So why are CITs now a force to be reckoned with in the U.S. retirement industry? Why do they now have a higher profile? And what's new?

The answer is the enactment of the Pension Protection Act (PPA) of 2006 (Pub. L. No. 109-280), which granted CITs the status of qualified default investment alternatives (QDIAs). The PPA also gave target-date fund strategies, which involve investments in a mixture of stocks, bonds, alternatives (like real estate) and cash that are adjusted more conservatively over time as the target date nears, the ability to serve as default investment alternatives for plan participants who chose not to select any investments in their defined contribution plan.

The QDIA status and target-date provisions within the PPA combined dramatically to raise the profile of CITs. As this chart (http://op.bna.com/pen.nsf/r?Open=dbrh-889se7) indicates, since 2005, the Morningstar CIT database has doubled in size and the bulk of the originations have been driven by target-date strategies.

The opening of the gate to defined contribution plans has transformed the CIT landscape with:

- new money management firm entrants to provide CITs,
- established money management firms offering CITs to preserve market share,
- trusts consolidating and competing for all of this potential asset management business,
- competition leading to lower investment minimums, and
- advisers serving defined benefit pension plans and smaller defined contribution pension plans, beyond large plans/institutions and investment consultants, now considering and adopting CITs.

Regarding investment minimums, a quarter of the CITs that Morningstar tracks retain a minimum initial investment of more than $1 million; many of these require tens or even hundreds of millions of dollars. However, the remainder either have low or no required minimum investment. These lower investment minimums have led trustees of varied pension plans to look at CITs. As CITs can be lower cost with minimal or no investment minimums, it is consistent with trustees' fiduciary responsibility to provide low-cost options for their pension plan participants.

Thus, both financial advisors providing guidance to smaller pension plans and investment consultants serving large plans are becoming much more attuned to CITs and how they differ from registered investment vehicles like open- and closed-end mutual funds or ETFs.

Comparison of CITs and Mutual Funds

Advantages and Disadvantages. There are two primary benefits to CITs that can usually be obtained by determined and knowledgeable plan trustees or administrators and their consultants or advisers: lower costs or a negotiable fee schedule and portfolio customization. The advantages, especially the cost aspect, are heavily marketed. Having those benefits delivered depends again on knowledge and determination.

Lower Costs, Lots of Caveats. In theory, CITs appear to have a natural price advantage. Beyond the preponderance of passive management techniques, which includes target-date CITs as well, CITs don't have to be widely marketed or build a brand name with retail investors and there are cost savings from not having to meet the requirements of product registration with the SEC.

Even with these built-in advantages, the pricing advantage of CITs varies relative to mutual funds, depending on:

- the type of investment strategy or style being sought;
- whether the strategy is active or passive;
- whether the asset allocation is domestic or foreign, and to what degree; and
- the amount of assets under management potentially coming from the pension plan into the CIT investment strategy.

[1] ''Defined Contribution Investment Vehicles - Currently Used,'' Greenwich Associates, 2009.

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This chart (http://op.bna.com/pen.nsf/r?Open=dbrh-889r8y) indicates some current pricing differences between CITs and mutual funds.

With these variables and depending on the time periods, the cost of CITs can sometimes exceed or fall below the cost of mutual funds, even in target-date or target-risk strategies, where investors can match their perceived risk level to an investment designed to maintain such level of risk.

As more asset management firms have entered the CIT arena, there has been a noticeable trend to try and establish fees tied to various bands of asset under management to obtain a rigid pricing structure. Again, the plan trustees, plan administrators, and their advisers and consultants need to understand that these are still ''list prices'' and the suggested fee schedule can still be negotiated. On a car lot, you don't accept MSRP–and it's the same for CITs.

Portfolio Customization. With more firms entering the CIT business or offering more CITs there has also been a decreased inclination to offer valuable portfolio customization to plan sponsors and other investors. This can be seen as an unfortunate carry-over from firms offering registered products.

For publicly listed firms providing company stock as a retirement plan choice, portfolio customization is a good way to ensure that employees who choose CITs won't unintentionally end up with more exposure to the same industry sector as the firm they work for.

A good example would be PepsiCo, which provides company stock as a pension plan option, but is attempting to decrease or eliminate exposure to other process and packaged goods investments in the large-growth-type of CITs provided as choices to their plan participants.

Disadvantages and Potential Issues—Short of Mainstream Practices

The disadvantage of CITs is that many money managers are, not surprisingly, trying to have their cake and eat it too. CITs are sold in an institutional setting, but they are then provided to millions of individual investors, and many plan sponsors and participants are not adequately aware of the nuances of CITs.

CITs are gaining traction and becoming mainstream, and yet many CIT providers are retaining their institutional practices by not providing transparency. A noticeable minority of CITs do not provide the details of their portfolios timely or at all to participants and independent third parties, like Morningstar, to review their strategies.

Although Morningstar trusts these managers, it nevertheless uses their portfolios to verify that their investment strategies are truly as indicated and to provide insight to consultants, trustees, administrators, and participants. In addition, a number of CIT money management firms continue to disclose returns on only a quarterly basis, maintaining that investors only review performance quarterly, instead of monthly or daily. CIT performance reporting gaps have been a source of considerable institutional investor and plan participant discomfort, especially during the subprime credit crisis.

Reporting on a quality and timely basis is an equal challenge in the CIT industry. Plan sponsors' reliance on returns in selecting CITs is often not ''. . .a meaningful composite to reflect overall performance,'' as one CIT provider reports in their performance disclosure in the Morningstar CIT database. Composite performance definitions are also often radically changed throughout the performance history of the CIT and, in other cases, preliminary results are posted and then revised.

Another disadvantage is that in the rush to enter defined contribution plans, the money management industry is over-simplifying.

Too often, CITs are presented to plan trustees and participants as nothing more than low-cost mutual fund clones. As the chart (http://op.bna.com/pen.nsf/r?Open=dbrh-889rby) indicates, even target-date CITs and mutual funds from the same parent company are run by different money managers, have different asset allocations, and consequently and importantly, have different return and risk parameters.

Finally, CITs are offered through banks and trust companies only. The expectation is that there is some investor benefit from the fiduciary care that is supposed to result from the involvement of banks or trusts in selecting and monitoring investment management firms and investment strategies.

There's little evidence of banks or trusts exercising this fiduciary review because of economic incentives. The economic incentive for banks and trusts is to grow assets under management. Qualitative CIT narratives in the Morningstar database, which are provided by each asset manager, bank, or trust, to assist with their screening by investment consultants and financial advisors, contain little if any discussion of these duties or benefits to investors.

On April 8, 2010, in remarks before the Practising Law Institute's Investment Management Institute 2010, Andrew J. Donohue, Director of the SEC's Division of Investment Management warned:

> ''. . .[there is] one investment practice that I am increasingly concerned about. And that is the use of collective investment trust platforms. . .Collective investment trusts are regulated by the banking agencies, and may rely on an exclusion from registration under the Investment Company Act. The premise underlying this exclusion is that banks exercise full investment authority over the pooled assets, among other things. As collective investment trusts become more popular and their structures more varied, the Division is looking at whether, under certain conditions, this exemption is properly relied upon and consistent with the Act and whether it denies investors appropriate protections. For example, are banks operating merely in custodial or similar capacity while providing a place for an adviser to simply place pension plan assets of its clients?''

The Outlook for CITs

CITs will continue to be driven by the ramifications of the PPA, populated by a mix of boutique firms that concentrate on institutional products and assets under management aggregators offering CITs as part of their corporate strategy to cover the waterfront.

CITs have become victims of their own success—their increased adoption evidenced by the growth of industry assets under management is raising their profile.

And that means the industry is approaching a crossroad. The CIT industry, the money management firms, and their bank or trust partners will either choose to continue widespread incomplete and loose compliance with voluntary Chartered Financial Analyst Institute

Global Investment Performance Standards (CFA GIPS) and other self-regulated guidelines or risk increased scrutiny and regulation by the OCC, SEC, or the Labor Department acting in concert or on their own in the future.

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