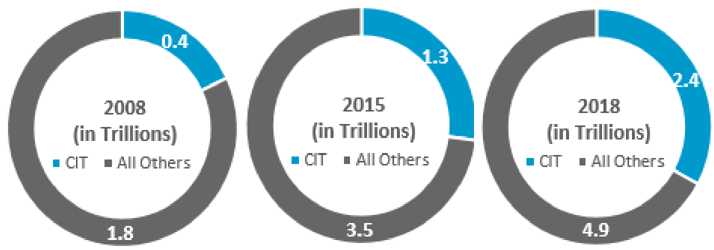
Index Investing: Why the Rise in CITs?

The retirement planning industry has experienced a dramatic transformation. From the types of employer-sponsored plans offered to the investing methods and vehicles available to accomplish investor objectives, retirement investing looks much different today than it did 20 years ago. One investment structure that has become increasingly popular is commonly called the Collective Investment Trust (CIT). The use of CITs has grown substantially, totaling over $3 trillion in retirement assets today, with $2.4 trillion in 401(k) plans alone, thanks in part to regulations that allow this structure to be a Qualified Default Investment Alternative for retirement plans. According to Callan's 2019 Defined Contribution Trends Survey, as of 2018, 75% of the 106 plan sponsors surveyed offer CITs to plan participants, up from 65% in 2017.

Growth of CITs in 401(k) Plans



Source: DST Whitepaper: Collective Investment Trusts- A Perfect Storm

At the same time, the asset management industry has also seen a tidal shift in investing preference—namely, the transition from active to passive strategies. A study from the Federal Reserve Bank of Boston highlights the growth of passive investing within the U.S. mutual fund and ETF markets, growing from 3% to 37% in 20 years.

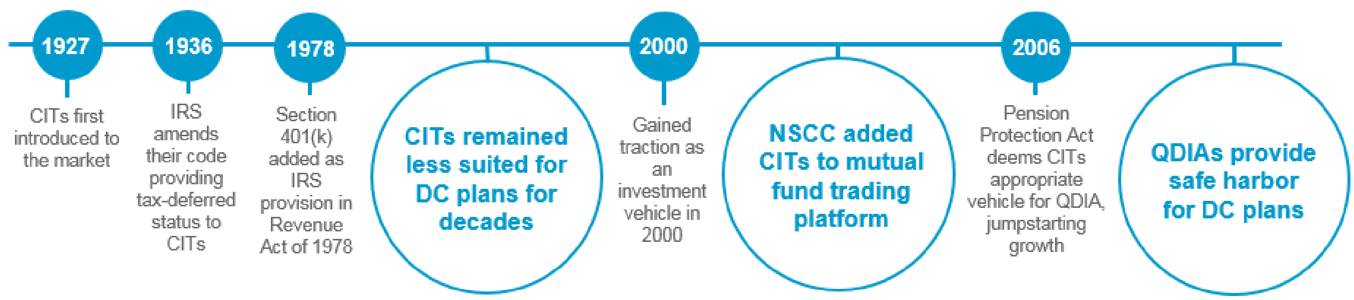
The recent growth in CIT adoption and preference for passive investments are among the new investing structures and strategies that have left many plan sponsors and participants wondering what their best options are in this rapidly changing world. What makes CITs an attractive tool for reaching your investment objective? How are these vehicles different from existing comparable passive options and how are they different between managers? Ultimately, we want to identify the best practices in index investing and use of CITs—as these two trends represent some of the greatest exposures for the retirees of today and tomorrow.

This paper is the first in a series of four pieces that will examine the basic characteristics of CITs, due diligence considerations for evaluating an index CIT investment, LGIMA's best practices for passive CIT structures, and investment methods inside our index CITs. Our goal is to provide information for plan sponsors to help their participants pursue the best possible outcomes.

Collective Investment Trusts (CITs): A Brief History

CITs, first introduced in 1927, are tax-exempt pooled investment vehicles for qualified retirement plans, including defined benefit plans and certain defined contribution (DC) plans. Defined benefit plans began using CITs for passive strategies in the 1970s, in part due to their reduced costs but also for tax, flexibility and regulatory reasons discussed in more detail below. Yet for decades, CITs remained less suited for DC plans due to an inefficient, manual investor transaction process combined with limited access to valuation and performance data.

The CIT: Then and Now



Source: DST Whitepaper: Collective Investment Trusts- A Perfect Storm

CITs began gaining traction as an investment vehicle in DC plans in 2000, when the National Securities Clearing Corporation (NSCC) added CITs to its mutual fund trading platform. This change allowed for standardized transaction processing and daily valuation reporting. CIT growth received another jumpstart in 2006, when the Pension Protection Act allowed CITs to be considered an appropriate vehicle for a Qualified Default Investment Alternative (QDIA), the mainstay safe harbor of any DC plan for participants who opt not to make their own investment elections. This consideration was important because QDIAs often receive up to 80% of every dollar flowing into DC plans.

Comparing CITs to Mutual Funds

CITs and mutual funds share several important similarities:

- Both CITs and mutual funds have an investment portfolio, or fund, of combined assets managed by an investment professional according to a specific mandate and objective.
- Both investment vehicles are cleared on the NSCC, have daily valuations, and are audited annually.
- Unlike separately managed accounts, in which the plan owns the accounts' underlying securities, both mutual fund and CIT investors own units or shares in the fund rather than its underlying securities.

At this point, it may seem like mutual funds and CITs are basically the same investment vehicle. However, plan sponsors should understand that these vehicles are vastly different in three major areas: regulation and oversight, tax treatment, and flexibility.

Regulation and Oversight

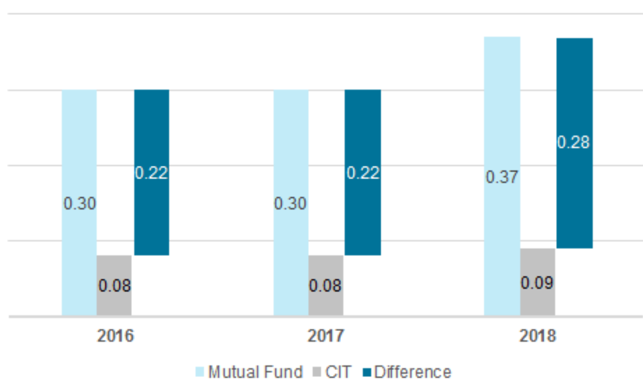
Mutual funds are available to all investors, are required to be registered, and are regulated by the Securities and Exchange Commission (SEC). The SEC is tasked with oversight for specific regulations that are meant to protect retail investors, such as Dodd Frank. These protections also require mutual funds to have a high level of disclosures regarding their investment holdings and fees. Most mutual funds have a ticker symbol, making it easy for investors to find daily information and pricing through a variety of publicly available resources, such as Google Finance.

The same protections do not apply to CITs. CITs are regulated by the Office of the Comptroller of the Currency, or a similar state banking authority, and are only available for qualified retirement plans (including 401(k) plans, defined benefit plans, Taft-Hartley plans, and certain government plans). This difference means disclosures and pricing information are less transparent for CITs than mutual funds. The availability of data has improved greatly in recent years due to technology advancements and the efforts of stakeholders, but it is still difficult to find CIT performance and pricing information outside of private databases and trustees/record-keepers. Regardless of the accessibility to data, plan trustees are subject to Department of Labor fiduciary standards regarding ERISA plan assets—placing the burden of fiduciary due diligence on the plan sponsor. As such, use of CITs in a retirement plan requires increased scrutiny on the part of the plan sponsor.

Tax Treatment

Tax treatment is another key difference. CITs are only available for tax exempt investors—specifically those in qualified retirement plans—which allows them to be more tax-efficient than mutual funds. For example, dividends on investments within mutual funds are taxed at the local-authority dividend tax rate. In contrast, CITs may receive more favorable dividend taxation rates given their tax-exempt status. For example, when looking at the dividend yield over the past three years for the MSCI World ex U.S. index, one observes an average 24 bps hurdle that mutual funds must overcome versus CITs solely due to the difference in tax treatment.

Dividends-Weighted Tax Impact



Source: MSCI World ex U.S. Index.

Similarly, capital gains attributed to non-investor driven flows (such as reconstitutions or rebalancing) in a CIT may receive a more favorable capital gains tax rate. The impact of these tax differences may be borne out in the performance of comparable CITs and mutual funds that are invested in the same benchmarks.

Flexibility

CITs provide more flexibility for plan sponsors because an investment management agreement (IMA) between a plan and the investment manager outlines the investment guidelines, fees, and overall cost of the product. In some cases, plan sponsors can negotiate differing fee structures for CITs and receive invoices separately through a gross of fee fund, versus mutual funds in which fees are typically pre-established through the fund's prospectus. For instance, a plan sponsor may establish a tiered pricing structure that declines as assets reach certain levels in a gross of fee CIT.

In contrast, mutual funds, which are geared largely toward retail investors, are fully pooled funds. This structure means fees associated with one individual's trading activity are shared by all fund participants. Given the wide base of retail investors in a mutual fund, excessive transaction costs from a handful of participants may be passed through the fund, ultimately impacting performance. CITs, in comparison, can adopt safeguards that help mitigate adverse costs associated with excessive trading. These safeguards include anti-dilution levies, which charge plans for higher transaction fees that dilute the value of the fund's units, along with the availability of different share classes.

Lastly, because of safeguards designed to protect retail investors, mutual funds have more restrictive rules governing securities lending, including limits on lending amounts, acceptable types of collateral, and allowable borrowers. These limitations can have both positive and negative effects. For example, mutual funds have experienced fewer instances of illiquidity than CITs due to failures in the lending mechanism. However, these restrictions can come at the cost of lower lending revenue, which passes through a fund in the form of additional returns.

Comparing CITs and Mutual Funds

	Collective Investment Trust	Mutual Fund
Regulators	OCC, DOL	SEC
ERISA Fiduciary Standards[1]	Yes (plan trustee)	No
Eligibility[2]	Qualified plans	All investors
Valuation	Daily	Daily
Liquidity[3]	Daily	Daily
Ownership	Fund units	Fund units
Fees[4]	May be negotiable/scaled	Not negotiable
Taxability	Tax-exempt[5]	Taxable
Reporting	Available through recordkeeper, trustee; many reported on Morningstar	Public performance available

1 The trustee is subject to ERISA fiduciary standards for ERISA plan assets.

2. Qualified plans are retirement plans which are federally tax exempt and may include 401(k) plans, defined benefit plans, Taft-Hartley plans, and specific government plans.

3. Generally, liquidity is daily for defined-contribution plans.

4. Fees depend on the ultimate assets contributed, the investment manager, type of investment mandate, and other fee sharing considerations managed by the CIT trustee.

5. Investment activity within CITs are tax-exempt with limited exceptions, including investments that may generate Unrelated Business Taxable Income (UBTI).

Source: LGIMA

Conclusion

The use of CITs has grown alongside the popularity of employer-sponsored retirement plans (DB and DC) in the United States—boosted in part by increased transparency of performance and fee data over the last 20 years. CITs' similarities with mutual funds make them feel somewhat familiar to plan sponsors seeking an appropriate investment vehicle for their participants, with the potential added benefits of flexibility, tax-exempt status, and lower costs. Yet it is paramount that plan sponsors understand their fiduciary responsibilities with CITs and ask the right questions when conducting their due diligence.

LGIMA believes there has never been a greater need to understand these due diligence requirements and the nuances of CITs versus mutual funds. In our second paper in this series, we will review the vital questions plan sponsors should ask when evaluating a CIT as an investment option for plan beneficiaries.

To learn about the differences between mutual fund and CIT investing and to discuss which might be most appropriate for your plan's needs, please contact your LGIMA partner or email DC_Team@lgima.com.

For further information about LGIMA, find us at www.lgima.com

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