CIT Due Diligence: Unveiling the Hidden Risks and Costs of Index Investing

As we reviewed in our first paper of this series, "Index Investing: Why the Rise in CITs?," the retirement industry has experienced two tidal shifts in investing preference: The rise of CITs and a shift toward passive index investing.

More than a third of all mutual funds and ETFs and almost 15% of the entire U.S. equity market now using indexed strategies. Morevoer, more than a third of all retirement qualified plans have adopted CITs as the vehicle of choice for index strategies because of their low cost, tax-treatment, and flexibility. The confluence of these trends makes it critical that retirement plan sponsors and participants understand and make informed decisions around the risks and rewards of index CIT investing.

Given index CITs' low-cost and passive investing framework, some plan sponsors might consider them to be undifferentiated and commoditized products that require less due diligence. LGIMA believes, however, that not all funds are created equally and there are meaningful differences in implementation and management from one service provider to another—particularly among CITs where the lack of readily available, public data makes nuanced differences in governance and costs more opaque and difficult to compare relative to other vehicles like mutual funds. Plan sponsors should not overlook these nuances, particularly in their search for passive solutions partners, where costs are assumed to be low and tracking error to the benchmark tight. Understanding these differences and their impacts on participant outcomes is core to plan sponsors' fiduciary duty.

This paper will examine the primary areas plan sponsors should consider when evaluating an index CIT investment structure, while discussing some of the potential differences among providers.

Index CIT Due Diligence

CITs now account for more than $3 trillion in assets, having grown more popular since 2000 when the structure became tradable on the National Securities Clearing Corporation (NSCC) mutual fund platform. CITs' institutional nature and design for retirement investors allows them to play a significant role in a 401(k) line-up. However, their similarities to other unregistered products—especially regarding contracting and limited public disclosures—means plan sponsors must uphold higher standards of due diligence to ensure the investments are suitable for their participants. This standard of care is present even for indexed strategies, which otherwise might pass underneath the bar due to their relatively straightforward investing approach.

There are four key areas of passive CIT funds that require additional due diligence from plan sponsors: Independence and Disclosure, Direct Expenses, Structure and Indirect Costs, and Securities Lending. For each of these themes, LGIMA highlights key questions that we believe plan sponsors should consider during their due-diligence process.

1. Independence and disclosure

In a CIT, trustees have ultimate responsibility for hiring, monitoring, and potentially replacing all CIT service providers. These providers include the fund accountants, transfer agents, legal representatives, auditors, and other sub-advisors.

Despite a trustee's obligation to oversee the investment manager and any sub-advisors, there is currently no requirement—nor is it common practice—for CIT trustees to be independent of the investment manager for whom they conduct oversight. This lack of independence can create conflicts of interest, including the potential for uncompetitive pricing in services delivered by affiliated providers.

Everyone agrees that managing and monitoring costs in a DC plan is a primary fiduciary responsibility. Comprehensive monitoring requires transparency into how much participants pay for various services. Even with administrative fee caps, plan sponsors and their consultants face a difficult, sometimes impossible task identifying how much participants have paid or will pay towards various services, as this information is generally undisclosed. The use of a total expense ratio (TER), similar to those in 40-Act structures, can provide greater transparency into the total costs participants pay for a fund.

Index CITs typically do not disclose payments to individual service providers, nor do they disclose how those payments may be subject to change. Moreover, conflicts of interest may leave funds in uncompetitive service provider pricing arrangements for undue periods of time.

What should plan sponsors be asking?

Q *Do you openly bid various support functions to external service providers, such as the role of the trustee, auditor, legal representatives, fund accountant, custodian, transfer agent, and securities lending agent?*

Q *Is the total expense ratio (TER) for each fund disclosed to the plan sponsor or end-investor?*

LGIMA believes…
It is a best practice to unbundle the services provided to a fund from the fund manager and trustee, while also disclosing a full TER so sponsors know the full cost of their chosen investments.

Service Providers Charging your CIT

1 Fund Accountants

The Fund Accountant is primarily responsible for all aspects of day-to-day accounting for one or more assigned funds. They prepare timely and accurate Net Asset Values, yields, distributions, and other fund accounting output.

2 Transfer Agents

The function of a transfer agent is to maintain up-to-date records of the ownership of a corporation's securities and to execute transfers of the corporation's stock and other securities. They are responsible for seeing that stock and other securities transfers are properly executed.

3 Legal Representatives

The legal representative bears administrative and criminal responsibility on behalf of the company. They need to understand the laws, regulations, and responsibilities to ensure proper legal management of a company's activities.

4 Auditor

An auditor's job is to make sure that information reported on financial statements is true and accurate and that the financial statements are prepared according to GAAP principles.

5 Investment Manager

This role helps identify, evaluate and manage investments within a particular portfolio. Sub-Advisors are usually chosen based on their investment style, specific expertise, and track record within specific investment strategies.

Source: LGIMA

2. Direct expenses

Prior to passage of the Dodd Frank Consumer Protection Act (Dodd Frank), CIT managers only had to report a fund's asset management fees to plan sponsors. Affiliate service providers' fees were vaguely disclosed through the investment management agreement (IMA). Important details—including how much service providers charge and who paid the expense—were often hidden. Plan sponsors could find the only real evidence of these costs by digging into fund performance, since fees were not always billed separately to the plan and sometimes netted from the NAV as they were paid by the CIT. Dodd Frank regulations now provide more insight into how CITs are generally structured, but plan sponsors and participants are still left in the dark about many fees (e.g. recordkeeping, accounting, tax, custody, legal), as transparency requirements mostly adhere to disclosures within the IMA.

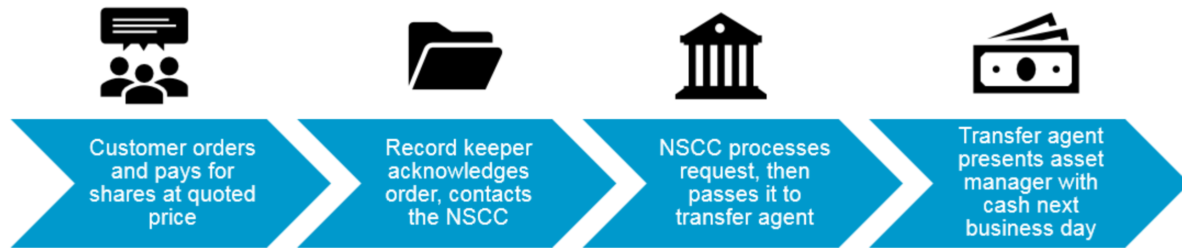
Typically, when plan sponsors and consultants analyze CIT fees, they focus primarily on the investment manager's fee and the administrative fee cap paid to administrative service providers. Management fees are generally well understood across the industry and arguably are the most transparent charge applied to any fund. Plan sponsors' understanding of administrative fees has improved in recent years, but questions remain around which charges a CIT includes in the broad category of "administrative fees," the charge for each service, and whether those costs are competitive. Although the investment manager controls the total level of all these costs through the administrative fee cap mechanism, it is difficult—if not impossible—for plan sponsors to disentangle the timing and amount of each cost.

Managing a CIT fund incurs multiple costs, the majority of which are reasonable. But, in an opaque environment, it is difficult for plan sponsors to know exactly what these costs are. Simply "not knowing" is an indefensible position for plan sponsors who bear fiduciary responsibility for their participants.

What should plan sponsors be asking?

Q *How do you determine which expenses fall within the fund expense cap and which fall within the fund but outside of the expense cap? Which expenses are charged directly to clients?*

Investor Transaction



Q *Who bears the cost of fund launch charges, trustee services, fund accounting & administration, transfer agency charges, legal fees, custody, and index license fees—and how are those fees collected? Does the CIT treat custody costs of safekeeping and per-ticket trading costs differently, and does the fund pay any soft dollar commissions?*

> **LGIMA believes…**
> Fund providers should fully disclose all costs, or bear those costs themselves when disclosure is not feasible, to avoid increasing a plan sponsor's fiduciary risk.

3. Structure and indirect costs

Investor transactions generate costs that are shared among all of a fund's investors. These transaction cost include commissions, ticket charges, and taxes on foreign securities. While portfolio managers and traders should take every precaution to minimize the impact of those transactions, many of those costs are fixed and unavoidable. LGIMA's internal data reveals that these costs can amount to several basis points per year.

Beyond the costs associated with frequent trading, the lack of transparency regarding how an index fund carries out market orders can hide the impact of "market slippage" on DC participants. Market slippage is the difference in a fund's value between the time a participant invests his or her money and the time the order is completed.

For example, a plan participant orders a specified number of shares and pays for those shares based on the price quoted at that time. The request is submitted to a record keeper, who formally acknowledges the order and contacts the NSCC. It takes a few hours for the NSCC to process each request, at which point the order is passed along to a transfer agent who finally presents the fund manager with the cash at the beginning of the subsequent business day. If the fund's value rises between the time at which the participant invested his or her money and the time at which the order is implemented, the fund's other investors will bear the increased cost of that transaction, as the initiating participant will receive their quoted (lower) price.

The impact of transaction-based charges increases if investors trade at a high velocity. Similarly, DC participants contribute to their funds on a regular basis, often twice a month, leading to more costs that must be shared among the fund's other investors.

As assets grow and perspectives shift, plan sponsors may request changes in the way their funds are managed—including a fee reduction or a switch from lending to non-lending vehicles and vice-versa. These changes can increase transaction costs for the same reasons described above: Movements may require a change in fee-based share class or may force the plan sponsor to create additional transactions by moving from one CIT fund to another.

Given the intense scrutiny on fees and relative performance of index funds, it is prudent for plans to attempt to avoid these costs completely. Plan sponsors invested in a commingled share class leave their participants more exposed to "market slippage" and undue transaction costs. LGIMA believes it is critical for sponsors to understand whether their investments are commingled, and if so, with whom. It is also important to understand the potential impact of their peers' investment policies on their own assets. Alternatively, plan sponsors can request a separate share class to isolate their assets from the effects of others in a commingled fund.

What should plan sponsors be asking?

Q *How do you charge for both cash and in-kind activity when clients enter or exit the fund? Would a DC investor experience any additional expenses compared to a DB investor within the fund structure?*

Q *What is the process to move between lending and non-lending funds or between differently priced share classes, and who bears the cost of these transitions?*

> **LGIMA believes…**
> CIT index investments should be structured with the greatest degree of flexibility to avoid costs associated with changes that routinely occur during the course of business.

4. Securities lending

Securities lending programs offer the potential for additional returns in index funds, but there is no "free lunch" as those returns come with additional costs. Investors face two types of costs from securities lending: lending program splits and lending program fees.

The lending program split represents the share of lending revenue divided between the fund's investors and the lending service provider, who is often affiliated with the asset manager. Lending program fees represent the basic administrative and operational costs of running a lending program. Unfortunately, there is no standard method for representing these costs, making them hard to untangle. Providers can choose to reflect the programs as gross or net of fees, as well as pre- or post-revenue split. This means a 50/50 net split program could outperform a 60/40 gross split, if the additional fees taken from the latter offset increased revenue from the more favorable lending split. Plan sponsors must fully understand the nuances of a securities lending program to understand the costs their participants ultimately will pay.

Lending programs also can create the risk of an illiquidity event (investors being unable to withdraw from the fund). It can be particularly difficult for investors to measure and monitor that risk until the event occurs—when it is already too late. Illiquidity risk comes in two forms: counterparty risk and collateral risk. Counterparty risk is the chance that a borrower of fund securities fails to return them. Collateral risk is the chance the cash or cash equivalent held in lieu of lent securities suddenly loses value or becomes untradeable, as happened in the repo markets during the 2008 recession. Either of these events could result in the fund manager gating flows out of the fund until it reestablishes liquidity—a significant issue for DC participants who expect daily liquidity.

Some asset managers and trust banks use their securities lending program as significant sources of firm revenue. Given the pressure to lower management fees in the index fund space, investment managers may be tempted to boost revenue by taking on more risk in their securities lending programs. There is a conflict of interest when an affiliated lending program manager or the investment manager controls the amount of risk inherent in the lending program and also receives a split of lending program revenues.

What should plan sponsors be asking?

Q *What percentage of revenue proceeds are paid to the fund versus the lending agent for each fund we invest in? Are there any expenses or costs from the securities lending process that are applied to the funds and not borne by the lending agent?*

Securities Lending and Illiquidity Risk

Collateral Risk

- The chance the cash held in lieu of lent securities suddenly loses value or becomes untradeable
- Types of collateral:
  - Cash
  - Money Market Funds
  - Repurchase Agreements
  - Deposits

Counterparty Risk

- Counterparty risk is the chance that a borrower of fund securities doesn't return them
- Counterparties:
  - Hedge Funds
  - Mutual Funds
  - Exchange Traded Funds
  - Pension Funds
  - Insurance Companies

Q *What indemnification do you provide for losses incurred from securities lending and collateral re-investment?*

LGIMA believes…
It is best practice to use an independent lending service provider and to provide detailed disclosure of a program's fees and risks. This approach helps protect CIT index investors from unknown risks and enables plan sponsors to make more informed investment decisions.

Conclusion

The DC industry has responded favorably to an evolving regulatory, legal, and financial market environment in recent years. Plan sponsors, consultants, and industry service providers have generally worked constructively to implement best practices across the industry—including passive strategies and institutional fund structures—that can improve potential outcomes for DC plan participants. Despite these advances, plan sponsors still must conduct proper due diligence on these institutional structures. At LGIMA, we believe meeting the needs of plan participants in the future will require a greater focus on efficiency, transparency, and objectivity.

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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