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The CIT Opportunity

Future Trends in CIT Product Development

Collective Investment Trusts (CITs) have become an important tool in the Defined Contribution (DC) market largely because of their low cost and ability to be customized, two characteristics that satisfy the needs of DC plans.

This alignment has led to a significant increase in the development and use of CITs in recent years. However, prior years' growth just may be the tip of the iceberg, and several developments promise to further increase the demand for CITs. In the fourth brief of our four-part series, developed in partnership with the Retirement Leadership Forum (RLF), we'll explore:

- Broader industry trends boosting CIT usage
- How the changing intermediary landscape is driving new CIT opportunities
- New product development opportunities
- Future factors that will further increase CIT adoption

Changes in Intermediary Landscape Drive New CIT Product Development Opportunity

Flows to CITs have increased steadily over recent years, and industry assets more than tripled in the 10 years ending in 2018, climbing from $896 billion in 2008[1] to $3.1 trillion by the end of 2018.[2] Although CITs are still only a fraction of the total assets in the DC plans compared to mutual funds, with the ongoing changes in the broader intermediary landscape (as well as within each segment), they appear to be poised for continued growth.

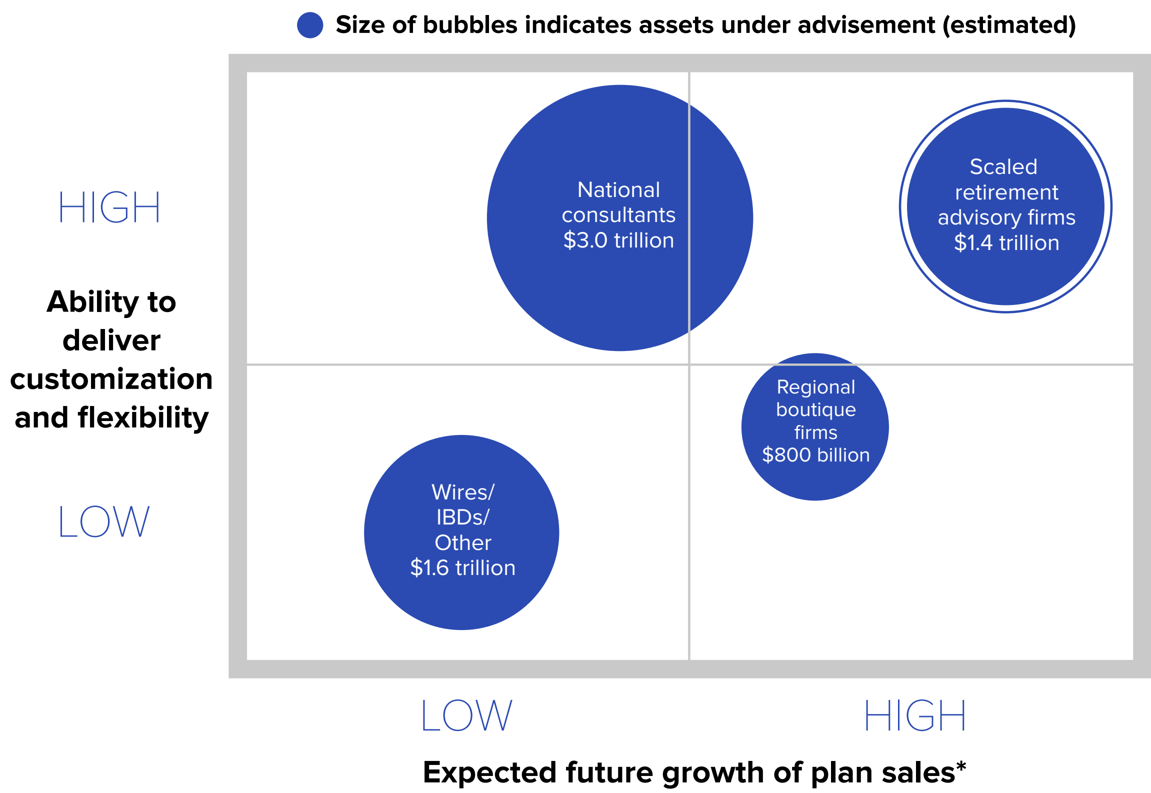
Despite CITs' significant growth, the vehicle's utilization is still most prevalent in the large end of the DC market where national consultants[3]—who, as of 2019, advise nearly $3.5 trillion of the $8 trillion in DC assets[4]—are increasingly pushing large-plan sponsors toward CITs. In this segment, the percentage of plan sponsors using CITs in their plans has increased from 44% in 2011 to 75% in 2019.[5] CITs offer consultants the opportunity to create customized solutions (i.e., white-labeled investment options), at a lower cost than a mutual fund while still providing many of the operational benefits (e.g., a daily NAV, fund fact sheets, etc.). However, having had success and growth in the large end, national consultants have started working with smaller plans and applying their investment expertise in this market. According to asset managers interviewed for this paper, national consultants are starting to work with plans as small as $50 million in assets, and as they do this, they're bringing institutional investment solutions, previously only available to the largest plans, to the masses.

As consultants move from the larger end to the mid-market, they find themselves playing against a set of rapidly growing distribution powerhouses: the scaled retirement advisory firms ("aggregator firms"). Over the past five to 10 years, this group of roughly 15 leading benefits and RIA firms has built specialty retirement practices, and through continued acquisitions, has grown to advise more than $1.4 trillion in DC retirement assets (Figure 1). At the start of the year, we had expected to see record levels of acquisition activity continue since aggregators had planned to acquire, on average, four retirement-specialized firms by the end of 2020.[6] Now, with the global COVID-19 pandemic changing the course of many businesses, most aggregator firms are moving forward with their acquisition plans but report being "more selective" about the firms they are willing to bring on board.

In the past, these firms set themselves apart from the traditional wirehouse brokers with lower fees, larger fund selection and a willingness to take on full fiduciary responsibility. In today's competitive market, in order to remain a step ahead of the wirehouses and put themselves on a level playing field with the national consultants, aggregator firms are adding custom investment products to their service offerings. CITs are at the center of these innovations in that they allow the aggregator firms to negotiate relationship pricing and build their own white-labeled portfolios for which the firms act as 3(38) fiduciaries (i.e., a fiduciary with investment discretion).

And, as aggregator firms continue to gain market share in the mid-market, they are also moving upstream and beginning to serve large- and even mega-plan sponsors. While they may not have the established brands like the national consultants, aggregators also look to use custom CITs to demonstrate their industry and institutional investment expertise and improve regional and national brand awareness.

Figure 1: Retirement opportunity by firm type



Source: Wise Rhino Group, RLF 2019 Recordkeeper Sales and Retention Survey
* Future growth positioning determined by survey of RLF Recordkeeper and DCIO members

Heading further down market, even the traditional wirehouses have begun to tie part of their value proposition to CITs. Over the last three to four years, with the emergence of new fiduciary standards, leading wirehouses have launched "black box" 3(38) offerings for generalist advisors with a set list of "best-in-class" investment options. Many of these firms use CITs as the core investment vehicles to gain the best possible pricing for clients. Interestingly, these 3(38) models were designed to put guardrails in place for the generalist advisor but have also gained some traction with specialist advisor teams at wirehouses that want a scalable solution for smaller clients.

Either way, asset managers are positioning their CIT offerings to gain acceptance in the smaller-plan market. One manager interviewed for this report, in an effort to increase CIT usage among the generalists at wirehouses, recently removed all minimum investment requirements from their CITs and have begun training their retail sales team (who broadly cover wirehouses) on the benefits of CIT structures.

A Deeper Dive on Relationship Pricing

In a previous brief in this series, "Protecting Pricing in the New CIT Landscape," we looked at the prevalence of, and strategies for, relationship pricing. It discussed, among other things:

- The evolution of CIT pricing and share classes
- Factors driving the pressure to create lower-cost share classes
- Best-practice tips from leading asset managers

Broader Industry Trends Further Boost CIT Usage

In addition to intermediaries' accelerating adoption of CITs, there is a set of overarching industry trends that supports the case for continued CIT growth. Sponsors and participants are demanding more personalized retirement solutions that account for a participant's broad financial picture. To build products that meet these demands, intermediaries are creating custom investment products and managed account offerings that are tailored to the sponsor's and participant's needs. CITs have proven to be one of the best investment vehicles for this personalized approach due to their pricing flexibility, short creation and launch time, and the ability to include investment types that cannot be included in a mutual fund (i.e., alternative investments, including real estate, commodities, hedge funds and private equity).

A Shift in Target Date Offerings

Since the Pension Protection Act of 2006, off-the-shelf target date mutual funds have dominated the DC space and become the most popular Qualified Default Investment Alternative (QDIA) option. However, driven by fee pressure from plan sponsors and increased demand for customization, asset managers are positioning cheaper (and often identical) CIT options alongside their standard mutual fund offerings and seeing significant uptake. As evidence of this trend, T. Rowe Price reported target date CIT products' net inflows of $21.4 billion in 2018, while target date mutual funds had net outflows in 2017 and 2018 totaling $23 billion.[7] Of course, the target date CIT trend is driven by factors other than just "cost," such as the ability to tailor the investment to a plan or intermediary firm. And with the growing trend toward using custom investments in the target date slot, CITs are poised to be the target date vehicle of choice and see even more flows in the future. Figure 2 shows a comparison of the attributes of each type of target date vehicle.

Intermediaries have been at the forefront of this trend because creating a custom target date product allows them to demonstrate investment expertise through product creation, not just traditional investment selection. As the competition among intermediaries becomes more intense, an intermediary firm's ability to customize investment solutions becomes an important differentiator. For asset managers, the opportunity lies in supporting intermediaries with a range of CITs that they can quickly deploy within these personalized solutions.

It's important to note that the structure of these new vehicles are often complex: To date, they have been fund of funds and provide exposure to both active and passive investments as well as alternative investments. With these underlying structures, it is critical for asset managers to partner with a trustee that has deep expertise, years of experience and existing relationships to more efficiently create fund of funds with requested managers. Additionally, the sophistication of the trustee is important in that it will help asset managers identify best practices and potential pitfalls of these structures. For example, there are different accounting issues that arise with fund-of-funds offerings that an experienced CIT trustee will be able to navigate easily.

Managed Accounts

To move beyond the simple cost advantage of offering a CIT version of a target date mutual fund, retirement specialized intermediaries are also using CITs to build custom managed account solutions. Research[8] shows better savings rates and asset allocation among individuals who participate in these solutions. Advisory firms such as CAPTRUST and Resources Investment Advisors are partnering with service providers like Morningstar to create white-labeled managed account solutions. Essentially, the intermediary firm builds investment portfolios of CITs, and serves as the investment fiduciary on the investment selection and portfolio construction. The managed account provider then acts as the fiduciary for the portfolio assignment. And, of course, a recordkeeper must build the operational and process "pipes" to facilitate this offering (i.e., allow the participant data to flow securely back and forth). Currently, only 11% of recordkeepers support advisor managed accounts, but a massive 44% are planning to offer them.[9]

Figure 2: Comparison of types of target date vehicle attributes

	Off the Shelf TDF – Mutual Fund	Off the Shelf TDF – CIT	Custom TDF – CIT
Vehicle structure	'40 Act Fund	CIT	CIT
Share of TDF market	51% ↓	29% ↑	20% ↑
Broad, professionally managed diversification for participants	✓	✓	✓
QDIA Eligible	✓	✓	✓
Customize glidepath to plan or participants	✗	✗	✓
Include any asset class (e.g., alts)	✗	✗	✓
Intermediary/sponsor controls manager selection	✗	✗	✓
Intermediary/sponsor controls active/passive mix	✗	✗	✓
Pricing flexibility	✗	✓	✓

Source: DCIIA and Wellington

For the advisor, the appeal of using custom CITs instead of '40 Act funds in managed accounts is primarily the low cost. This allows them to keep the investment solution competitive even with an advisory fee included. Secondly, CITs give advisors the ability to include different asset classes than '40 Act regulations allow in mutual funds. With advisors working on the front line to engage participants and affect participant behavior, we expect the combination of CITs and personalized investment solutions (e.g., managed accounts) to gain popularity over the next five years.

At the larger end of the market, national consultants are looking not only to disrupt the target date space, but also to take on even more of the investment responsibility. Increasingly, large and mega plans are seeking OCIO services for their retirement plans. Defined contribution remains one of the fastest-growing segments for OCIO services. According to Pensions & Investments, DC mandates for OCIO providers grew 44.2% to $164 billion between March 2017 and March 2018.[10] Custom CIT solutions play a critical role in these OCIO solutions since consultants are looking for a combination of low cost, flexibility, customization and high-performing products for their offerings.

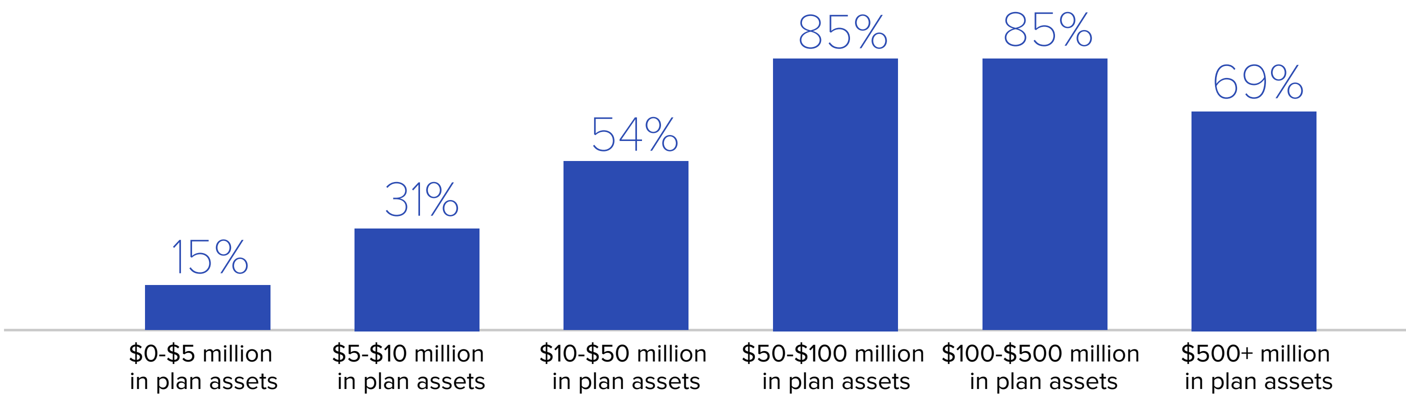
A Brighter Future

While the growth of CIT assets to date in defined contribution plans is already significant, several new developments in the rapidly changing landscape of the DC space are laying the groundwork for additional future growth. The three most important development opportunities for asset managers to explore and participate in include:

- The potential growth of open multiple employer plans (MEPs)
- Proposed changes to 403(b) rules to allow for broader CIT usage
- The rising demand for retirement income solutions

Open MEPs: While the lowering and even elimination of minimum investment requirements has helped CITs move more into the mainstream, their presence in the under $10 million market is still limited (Figure 3).

Figure 3: **Percentage of DCIO providers experiencing increasing demand for CITs, by market segment, 2019**



n=13
Source: RLF 2019 DCIO Survey

However, with the passage of the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 comes the promise of much broader adoption of multiple employer plans in the form of pooled employer plans (i.e., open MEPs). Prior to this new legislation, small business owners had to have a common business interest or affiliation to qualify for a MEP. Now, after the passing of the SECURE Act, any set of employers—related (e.g., members of an association or similar industry group) or not—can participate in an open MEP. These products offer small business owners a cheaper product with less administrative burden. In most of the potential solutions being considered, firms are looking at CITs, noting that their competitive pricing and investment flexibility give firms—recordkeepers, advisors and DCIOs alike—a chance to differentiate. However, there are still a lot of gray areas concerning the open MEP offerings. While the industry continues to get additional government/policy clarity on how to implement open MEPs, asset managers and recordkeepers are lukewarm about the immediate impact of open MEPs but are nonetheless gearing up for a long-term play, with 83% of recordkeepers planning to pursue the open MEP opportunity.[11]

Retirement Income: The SECURE Act includes a provision to provide plan sponsors who adopt annuity products with long-sought safe harbor protection. Much like with open MEPs, the industry is concerned about several gray areas that need additional clarification. Outstanding questions cover a broad range from the portability of any annuity product within a plan to bridging the participant education gap. Despite these issues, leading insurance firms are looking to build new income solutions for retirement plans. In fact, a 2020 RLF survey[12] found that 83% of insurers planned to roll out new, in-plan annuity solutions in the coming 24 months.

In speaking with a number of these insurers for this report, we found the most interesting innovations aren't standalone annuity products but rather an annuity built into a managed account or target date product. CITs would be the most likely vehicle to hold this diverse set of products. If firms can succeed in addressing some of the outstanding issues and get sponsors comfortable with their fiduciary responsibility as it relates to annuity products, the managed account or target date offering with CITs and income products would be the most appealing solution.

Another income solution that some leading asset managers are considering includes a CIT that generates consistent income without an insurance guarantee. For example, building a laddered bond fund with a committed payout in which the fund is managed to pay out at a specific rate—one that may be adjusted over time. Creating a CIT version of this type of fund would not only provide significant cost savings but also allow asset managers to quickly launch the product and avoid all of the hurdles of a traditional mutual fund launch, such as registration and capital requirements.

403(b) Plans: Unlike 401(k) plans, 403(b) plans are prohibited from using CITs, with one exception: church plans [as defined in Internal Revenue Code Section 403(b)9]. Many investment firms and industry associations have been lobbying to allow CITs to be included in all 403(b) plans. There are two important reasons recordkeepers are pushing to include CITs in 403(b) plans. The first is cost savings. The second is consistency; that is, schools, hospitals and other nonprofits should all have access to the same investment vehicles as private sector employees. Especially given that many firms have either a 457 or 401(k) plan in addition to their 403(b), this change would enable consistent investment lineups across plans and open up an entirely new distribution channel for CITs.[13] Asset managers continue to lobby to get these changes approved, and these changes could occur over the next three to five years.

Closing

CITs have grown significantly in the last decade. The initial increase in popularity and inflows was driven largely by an industrywide focus on lower fees and increased flexibility. Today, with personalized and tailored solutions in high demand, CITs will not only continue to grow, but the pace of growth will likely exceed that of the last five years. To take advantage of the positive secular trends affecting the DC market, leading asset managers should create a diverse set of products, vehicles and solutions, and include building an array of CITs to meet specific client demands for personalization at a low cost. As part of creating a robust CIT offering, asset managers should:

- Invest in strategic partnerships with intermediaries to build custom CIT products (i.e., customized to their firm or team)
- Work side by side with sponsors, intermediaries and trustees to create solutions customized to the plan
- Align their solutions to capitalize on opportunities resulting from recent and evolving legislation (e.g., SECURE Act, 403(b) provisions, etc.)

Sources

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200576.01 (6/20)