# The Defined Contribution Market Meets Its Match

**CITs pair well with DCs, offering flexibility and options to plans of all sizes.**

# INTRODUCTION

As a follow-up to our 2016 report on the evolving U.S. retirement market, we continue to take a closer look at the opportunities and challenges facing professionals in the defined contribution (DC) marketplace.

In concert with Strategic Insight, we'll be releasing a series of shorter industry briefs in which we discuss specific key trends, features, obstacles and opportunities for asset managers currently (or planning on) participating in the U.S. retirement marketplace.

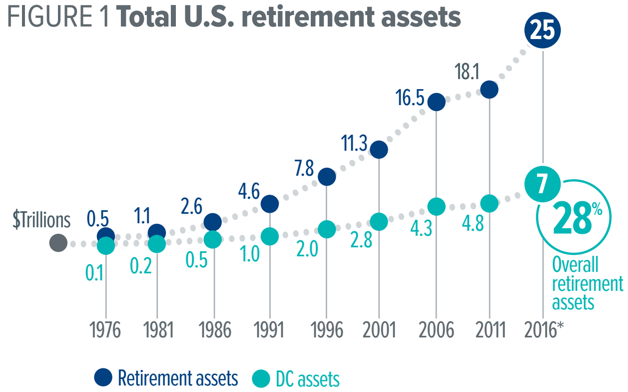
## The defined contribution market opportunity

The DC market opportunity for investment managers is as robust as it has ever been, with $7 trillion in play, representing 28% of overall retirement assets. As recent as a decade ago, the assets managed in the DC industry were equally split between proprietary funds and investment-only (DCIO) managers (Figure 1). Today, however, the market opportunity for DCIO managers has swelled to almost 60% of industry assets and is expected to go higher still in the coming years (Figure 2). Progressive growth, though, rarely comes in a clear path, and managers should expect obstacles as they seek success in this market.

The common challenges managers face stem from the current regulatory environment, which includes heightened fiduciary concerns regarding plan fees and expenses. Still, managers are not without recourse and many have overcome these headwinds successfully. Rising to this challenge, many managers have looked to DC's origins and rediscovered collective investment trusts (CITs) as a means of tacking into the wind.

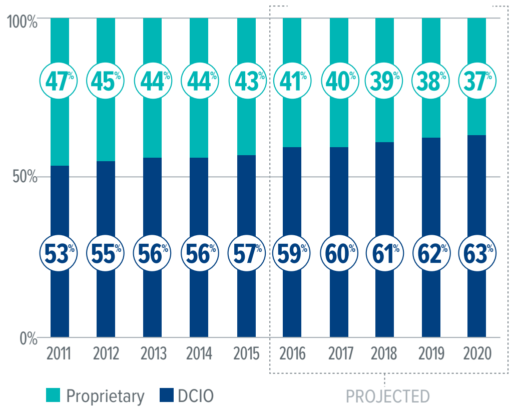
CITs aren't new. In fact, before the advent of daily valuation recordkeeping and the ascent of mutual funds as the investment package of choice in the mid-1990s, CITs were the predominant vehicle used for investments in DC plans. However, the CITs used today have much more in common (in terms of shared features and functionality) with mutual funds than their quarterly valued predecessors (Figure 3). More important, they have some key distinguishing advantages. This brief will focus on the strategies that market leaders have pursued and the best practices others can emulate.

FIGURE 1 **Total U.S. retirement assets**



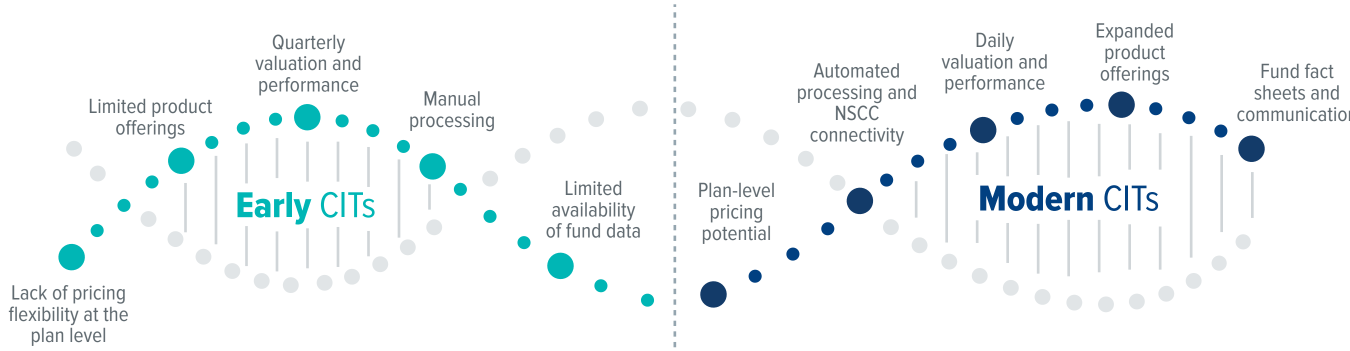

*Data reflects year-end totals, apart from 2016 which reflects assets of September 30.
Sources: Investment Company Institute.

FIGURE 2 **DCIO market opportunity**




Sources: Coalition of Collective Investment Trusts and Strategic Insight.

FIGURE 3 **CITs evolve**




Sources: Coalition of Collective Investment Trusts and Strategic Insight.

# Collective investment trusts

## The basics

**What are they?** CITs are pooled institutional investment vehicles that are intended for use by qualified retirement plans and governmental plans, and are not publicly available. The trust must be established by a bank or trust company that will act as a fiduciary and maintain the ultimate responsibility for the discretion and control of the trust.

**Who governs them?** CITs are regulated and governed at the federal or state levels by the Office of the Comptroller of the Currency (OCC) or by state banking entities. Unlike mutual funds, they are exempt from SEC regulation and are not subject to the Securities Act of 1933 or the Investment Company Act of 1940.

**In what markets are they available?** CITs are available in both the DC and DB market. However, these vehicles cannot currently be used by most 403(b) plans, some 457(b) plans, 457(f) plans, funded welfare plans, or IRAs.

## The benefits

**Pricing:** Generally CITs have a low-cost advantage over mutual funds due to different regulatory requirements and other factors.

**Flexibility:** Managers have the ability to offer multiple fee classes to clients, which includes a sliding fee schedule based on invested assets. Further, distinct service fee share classes can be offered.

**Speed to market:** The setting up of a CIT takes less time than launching a comparable mutual fund while most often costing less.

**NSCC trading:** Trading through the NSCC allows CITs to provide the same operational efficiencies as mutual fund structures.

## CITs: Attractive option for plan sponsors

Hardly a day can pass without reading about litigation related to plan fees and expenses. Not surprisingly, plan fiduciaries are constantly seeking the means to control plan costs as a mitigation strategy for managing their fiduciary risk. One strategy is to seek a lower priced mutual fund share class. This approach has proven to be very popular. Research by Strategic Insight indicates that retirement share classes, which don't charge 12b-1 fees or pay sub-TA fees (i.e., zero/zero classes), have garnered almost 15% of DC mutual fund assets in just 10 years, with a compound annual growth rate of 58% over this time period. While stripping away 12b-1 fees may lower investor cost, it does nothing to address the underlying expense associated with a fund's management fee. Mutual funds remain the packaging structure of choice for DC plans overall, but the pricing benefits of CITs make them particularly attractive to larger plan sponsors, presenting a competitive advantage to managers that offer the products.

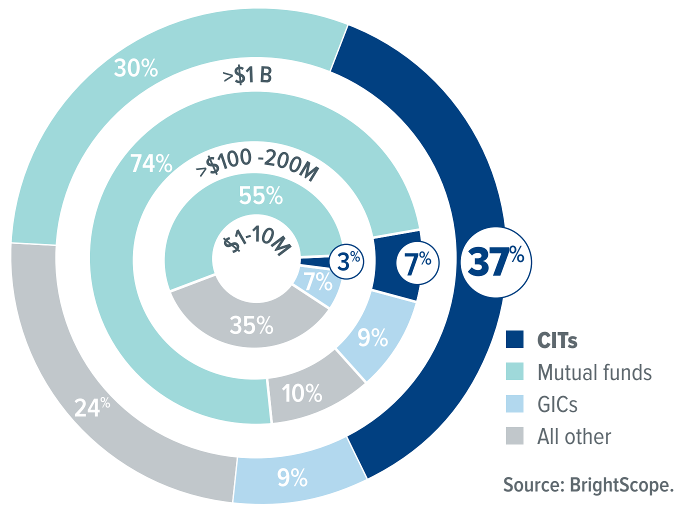
Research by BrightScope, a subsidiary of Strategic Insight, suggests that CITs have become increasingly attractive to plan sponsors when plan AUM exceeds $100 million. Further, BrightScope's analysis of 2014 Plan Year Form 5500 data reveals that plans with greater than $1 billion in AUM held 37% of assets in CITs, the largest investment vehicle category (Figure 4). Moreover, in a recent survey of large plan sponsors conducted by Callan Associates, two-thirds of respondents stated they hold CITs in their plans.

**There are three main advantages that CITs offer, which are driving the growth of the products:**

### 1. Advantageous pricing capabilities

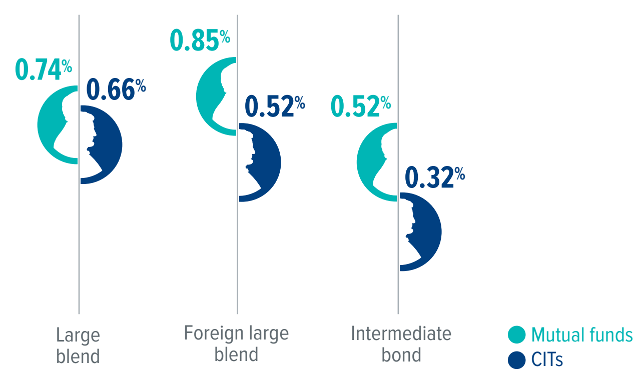
Historically, the absence of 12b-1 fees have provided the lion's share of cost savings associated with CITs. However, as plan sponsors seek additional sources of savings, the breakpoint pricing capabilities of CITs afford the products a distinct advantage as mutual funds are unable to offer this flexibility on their management fees (Figure 5). Plan sponsors will also likely feel the weight of more attention on fiduciary duty, which will make them sensitive to the most advantageous pricing arrangements. While a plan sponsor's fiduciary responsibility extends further than simply using the cheapest investment options, managers who aren't prepared to offer CITs may find themselves unable to vie for a certain segment of plans in the market for these products.

FIGURE 4 **DC investment packaging by plan size**




Source: BrightScope.

FIGURE 5 **Mutual fund vs. CIT fees** (weighted average)




Data reflects active funds only using net expenses, Q3 2016.
Sources: Morningstar and SEI.

## 2. Underlying structure offers cost advantages

In addition to explicit pricing advantages, plan sponsors using CITs benefit from the simpler underlying cost structure of the product as compared to mutual funds. These values are displayed in three primary ways. First, there is a lower regulatory cost structure as CITs fall under the purview of the OCC and state banking regulators rather than the Securities and Exchange Commission (SEC). Part and parcel with this is an exemption from SEC reporting requirements. Second, the absence of a lengthy SEC fund registration process aids in speed to market of new funds and share classes. This translates to a lower manufacturing cost. Further, because CITs limit who may invest in them, investment professionals have a reduced risk of facing the same cash flow volatility that open-ended mutual fund managers face. As a result, the portfolio may be managed more efficiently and stay more fully invested than a mutual fund.

FIGURE 6 **Comparison of investment vehicles used in DC plans**

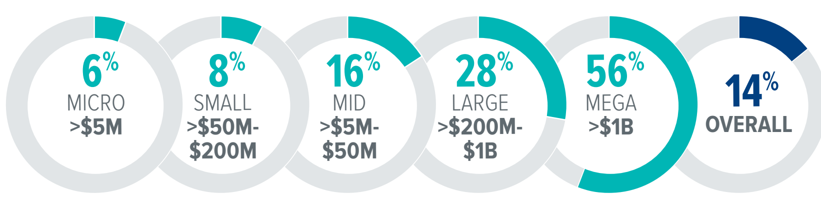
| | Mutual fund | CIT | Separate acct | ETF |
|---|---|---|---|---|
| Daily liquidity | Yes | Yes | Variable | Yes |
| Transparency for participant | High | Low | Low | High |
| Transparency for plan sponsor | High | High | Moderate | High |
| Availability in retail market | Yes | No | No | Yes |
| Customizability | Limited | Limited | High | No |

## 3. Bespoke packaging and communication

While cost may be the primary reason that plan sponsors look to CITs, managers also gain the flexibility to package products in a manner that is truly reflective of their client's wishes. Oftentimes a plan sponsor may wish to customize a portfolio to a specific need (e.g., exclude certain securities), rename a fund to simplify investor communication, or even create branding specific to the plan. CITs provide a very accessible structure for asset managers to offer this type of customization to plan sponsors. In fact, many of the largest plan sponsors—such as Delta Airlines, General Motors, Kaiser Permanente, Lincoln National Corp., and United Technologies—use them for these very reasons.

However, while the appeal of CITs is currently most pronounced in the large (>$200M to $1B) and mega (>$1B) plan segments, CITs are becoming popular alternatives with smaller plans as well (Figure 7). In fact, large RIA groups such as Centurion Group, Global Retirement Partners, Pensionmark, and Sheridan Road are creating their own branded CITs and making them available to plan sponsors who, otherwise, would lack the resources and sophistication to access them. This presents an emerging opportunity for managers.

FIGURE 7 **CIT usage by DC plan size**




Sources: PLANSPONSOR and Strategic Insight.
Data Source: 2016 PLANSPONSOR Defined Contribution (DC) Survey.

## Mitigating unintended consequences of regulation

Perhaps the greatest headwind that asset managers face is the consequence of the Pension Protection Act of 2006. Over the past decade, the creation of safe harbors for default investments (qualified default investment alternatives or QDIAs), and auto-enrollment or auto-escalation, has created winners and losers.

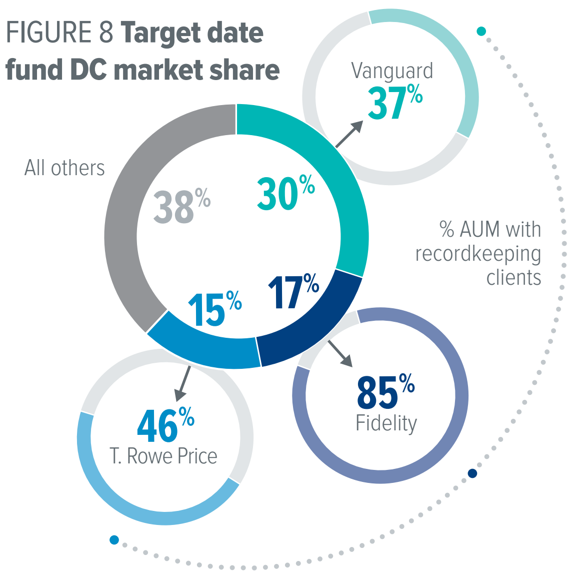
To date, the winners have typically operated both recordkeeping businesses and proprietary target date funds (TDFs), by far the most popular of the three designated long-term QDIAs. Not surprisingly, these funds typically use a closed architecture and limit the underlying funds to strategies managed by the sponsoring distributor. The last several years have seen the introduction of multi-manager mutual fund TDF series, but the established hierarchy in this area is still dominated by the top three players who collectively manage more than 70% of overall TDF assets and more than 60% of DC TDF assets in affiliated products (Figure 8).

However, recent regulation may accelerate the demand for open-architecture TDFs. Paradoxically, it's often fiduciary concerns about fees and a desire for best-in-class managers in every asset class or strategy that is driving plan sponsors to unbundle their QDIAs, often giving the reigns to managers-of-managers or investment consultants. A recent survey of consultants by PIMCO illustrates this trend where more than half (52%) of the consultants surveyed have clients using custom TDFs (Figure 9).

As a result, this is creating opportunity for managers who have built CITs for the new fabricators of QDIAs. The pricing and packaging advantages of these products, as mentioned previously, have provided an environment where CITs have often become preferential over mutual funds for unaffiliated product offerings.

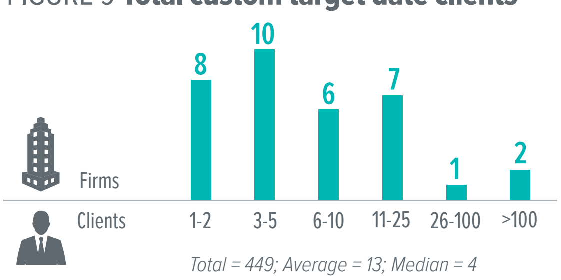
The unbundling of QDIAs does not only benefit traditional asset managers. It also creates opportunities for alternatives managers who see the DC market as a growth opportunity. The past few years has seen a flurry of activity among private real estate managers, such as Heitman, J.P. Morgan, Prudential and UBS along with private equity managers, such as Pantheon Ventures and Partners Group. All have developed strategies for the DC market. A commonality among them is that they have chosen CITs as the structure best suited for them to gather assets in the DC market.

FIGURE 8 **Target date fund DC market share**




Source: Brightscope, 2014.

FIGURE 9 **Total custom target date clients**




Source: 2016 PIMCO Defined Contribution Consulting Support and Trends Survey.

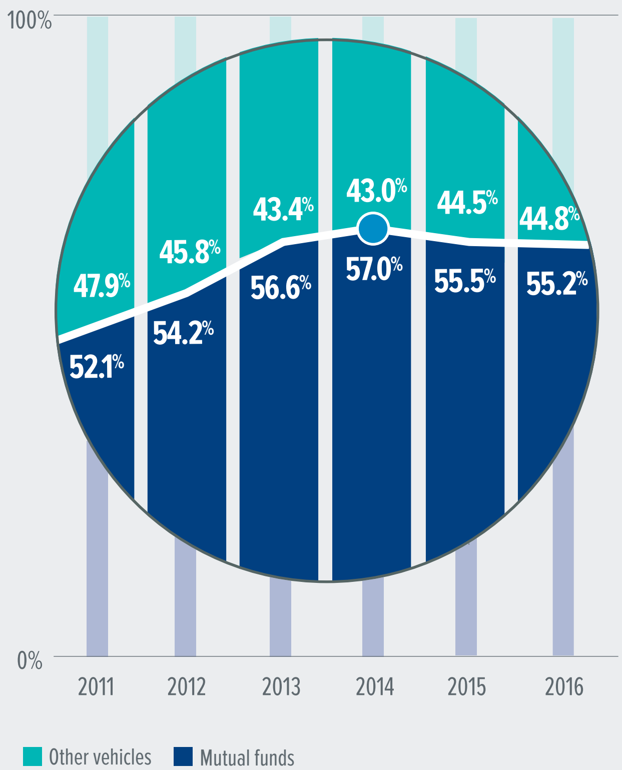
# Market dynamics and structural advantages present opportunities

Representing close to one-third of overall retirement assets, the sheer scale and magnitude of the DC segment makes it an attractive marketplace for many managers to ply their wares. However, success is not simply a function of presence. The past 20 years have undoubtedly been the era of the mutual fund in the DC market. That era of dominance may have peaked as we witnessed what could prove to be an inflection point for DC mutual fund allocations after 2014 (Figure 10). Fiduciary concerns and competitive forces are collaborating to drive greater pricing efficiency from investment managers. Mutual funds will be suitable for some DC investors while CITs will be a better fit for others. Thus **it is essential that investment managers be strategy focused and vehicle-agnostic**.

Further, pricing efficiency alone will not be sufficient. Flexibility will be required as well. Research suggests that **pricing flexibility is a powerful tool to bring to the DC market**. The flexibility and breakpoint schedules inherent to the CIT structure make it a tool for all seasons and many clients.

**CITs offer unique structural benefits compared to mutual funds**. A feature, such as the ability to white label, allows plan sponsors the means to simplify investor communications to plan participants. Further, it may also offer the opportunity to create company-specific branding that enhances the value of the benefit provided. These are features unique to CITs and can be marketed as selling features.

FIGURE 10 **Mutual fund allocations in DC**




Source: Strategic Insight.
Note: "Other vehicles" includes separate accounts, collective investment trusts, employer stock, self-directed brokerage and other.

**The institutional nature of the DC market and CITs complement each other**. Less onerous regulations and speed to market allows investment managers to quickly bring strategies to market and be responsive to the needs of clients and prospects. In a similar vein, the inherent flexibility of the CIT structure creates opportunities for retirement investors to invest in more esoteric asset classes. As DC plan investing becomes increasingly institutional in nature, benefits previously available only to the largest plan sponsors are becoming readily accessible to more modest-sized plans. With the ability to invest in asset classes, such as real assets, private equity, private real estate and hedge funds, CITs will ease the way for the managers of such “alternative” asset classes to gain greater market share within small and mid-sized plans not previously able to obtain such exposure.

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