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Collective Investment Trusts Reduce DC Plan Costs

Collective investment trusts (CITs) have continued to grow in popularity since we first wrote about their relevance in defined contribution (DC) plans more than 10 years ago. In that time, plan sponsors have used CITs to lower plan costs and increase operational efficiency. As employers adapt to changing market conditions, the need to bring participants cost-efficient investment options that offer transparency is more important than ever.

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Executive Summary

Collective investment trusts–CITs for short–are tax-exempt, pooled investment vehicles that have been in use for nearly a century. They're maintained by a nationally chartered bank or state-chartered trust company, which provides fiduciary governance and oversight akin to the role of a mutual fund board of directors or trustees.

The key difference between a CIT and a mutual fund, exchange-traded fund or other commingled vehicle is that only certain retirement investors are eligible to use CITs—primarily ERISA-qualified defined contribution (DC) and defined benefit (DB) plans, 457(b) plans and other less common plan types.

While CITs have been around for a while, they've historically been tools for the institutional market, with large public pensions and corporate "mega" plans frequently leveraging them to fill out their investment menus. CITs have a number of attractive features, but are most appealing for their simple—and often lower-cost—fee structure. CIT sponsors and sub-advisors also enjoy the flexibility of different management fees for different plans–often depending on size, something unavailable to mutual funds.

One hurdle to broader CIT adoption—its somewhat archaic operating model—has largely been cleared. Over the last decade, CITs have achieved operational parity with mutual funds and other products: most CITs offer daily liquidity, increased transparency and streamlined onboarding.

Smaller plans, as well as their consultants and advisors, have taken notice of CITs' many advantages, and their increased adoption has stoked demand for strategies wrapped in the CIT structure and created new opportunities for distribution. Consolidation in the retirement advisor, consultant and registered investment advisor communities has spread knowledge about CITs and created more direct routes for product distribution.

Uptake of CITs in the retirement plan market continues to accelerate, and it has become a virtual necessity for investment managers to offer certain asset classes in CITs to compete effectively in the retirement space. This paper takes a closer look at the latest market trends and the structure, advantages, operational aspects and future outlook of CITs.

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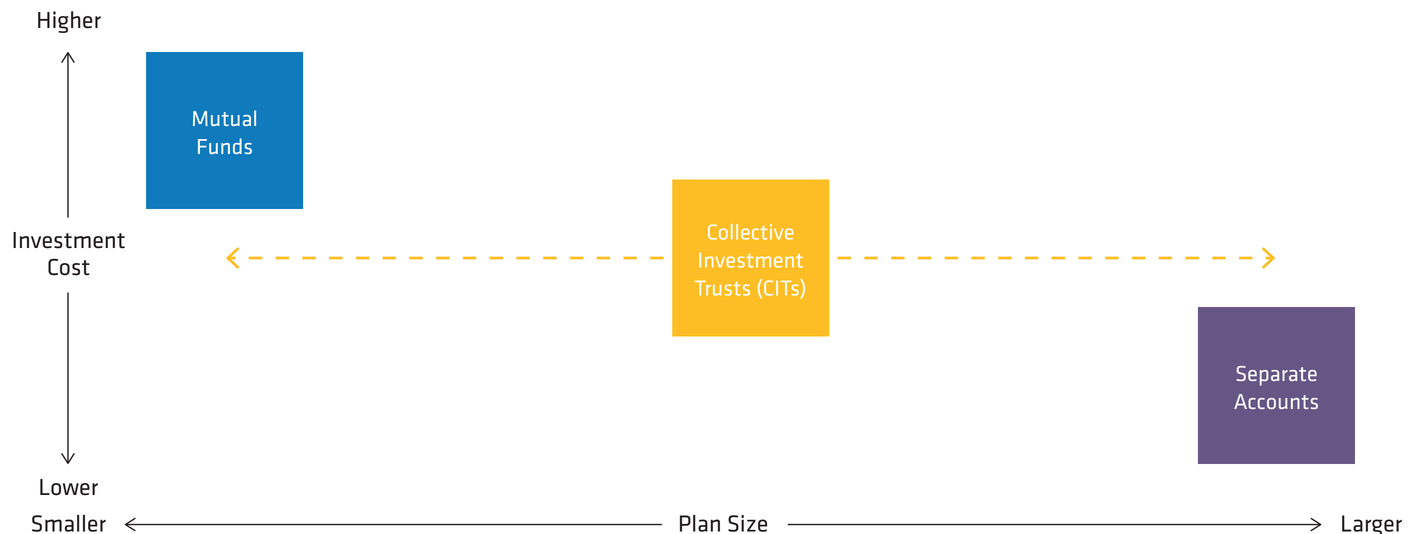
CITs: Why Now?

CITs have been around for nearly 100 years, but thanks to operational enhancements implemented in recent years, these investment structures are more accessible to the retirement market than they have ever been. What appeal does this revamped product have for sponsors of 401(k)s and other DC plans?

CITs continue to grow in the DC market, with a projected $5 trillion+ in assets today. These vehicles combine the cost savings of a separately managed institutional account with the convenience of a mutual fund. With the ever-growing scrutiny of plan fees and continued onslaught of litigation, CITs present a transparent and lower-cost option for plan sponsors.

DISPLAY 1: CITS ARE AN ECONOMICAL OPTION FOR DC PLANS



For illustrative purposes only

As of September 30, 2023 | **Source:** AllianceBernstein (AB)

CITs: The Basics

Who's Eligible to Use CITs?

Plans that can use CITs include:

- DC and other ERISA-qualified 401(k) plans and profit-sharing plans
- Defined benefit (DB) plans
- 457(b) government plans
- Some insurance company–sponsored separate accounts
- Certain Keogh plans

Plans that are ineligible to invest in CITs include:

- 403(b) plans, which serve some nonprofit organizations*
- 457(f) government plans
- Insurance-company general accounts
- Private foundations and endowments
- Individual plans such as IRAs

*The ineligibility of most 403(b) plans has been a gap in the growing availability of CITs. Recent legislative efforts to address 403(b) eligibility for this important segment of retirement savers is cause for optimism.

What Are CITs?

CITs are tax-exempt, pooled investment vehicles maintained by a bank or trust company exclusively for qualified retirement plans and certain types of government plans (*see* "CITs: The Basics," *left*). With lower marketing, overhead and compliance-related costs than comparable mutual funds, they're more economical for investors. Originally, plans used CITs mainly for stable-value and passive portfolios, but they're now offered for a full range of investment mandates. Only separately managed accounts, which require much higher asset minimums for most managers, may be less expensive (*Display 1, page 1*).

With CITs, dedicated share classes for individual plans provides customized pricing (like in a separately managed account), which allows sponsors to benefit from economies of scale in advisory fees and from the lower operating costs that come with a larger investment pool.

CITs are hardly a new invention. They existed in the 1920s, became widespread in the 1950s and were commonly used within pre-401(k) savings plans. They remained popular with 401(k) plans until the 1980s. But then this popularity began to change. CITs generally don't need to determine their net asset value more often than every three months, and they don't need to process transactions daily. In the 1980s, they rarely did these things, so user-friendly mutual funds quickly became the vehicle of choice—and stayed that way until the early 2000s. Now, CITs have been modernized to trade as easily as mutual funds because most are valued daily. They continue to appeal to plan sponsors and participants as timely, low-cost investment alternatives.

Today, fiduciary pressures are growing for DC plan sponsors. There are more frequent lawsuits over disclosures, fees and appropriate share classes, making sponsors more sensitive to their fiduciary risks and responsibilities. There's also greater focus on fee transparency and revenue-sharing practices—and on sponsors' ongoing monitoring of investments and costs. Plan sponsors can be liable for violating their fiduciary duties to the plan and its participants, so they need to ensure that they're fulfilling these duties.

CITs can help sponsors with this challenge. As institutional vehicles, they generally cost less than mutual funds. And like their "no revenue sharing" mutual fund counterparts—often called R6 shares or Z shares—CITs offer full transparency and share classes without built-in revenue sharing for recordkeeper offsets. Ongoing monitoring and due diligence have become much easier; CIT information is more readily available in the third-party databases that consultants and financial advisors frequently use.

CITs will continue to play an important role as DC investing evolves. Plan sponsors have a fiduciary obligation to explore all their investment options—a search that is leading larger plans to CITs as the best choice. And as minimum asset thresholds decrease or are eliminated completely, small and midsize plans are now often eligible for CITs too.

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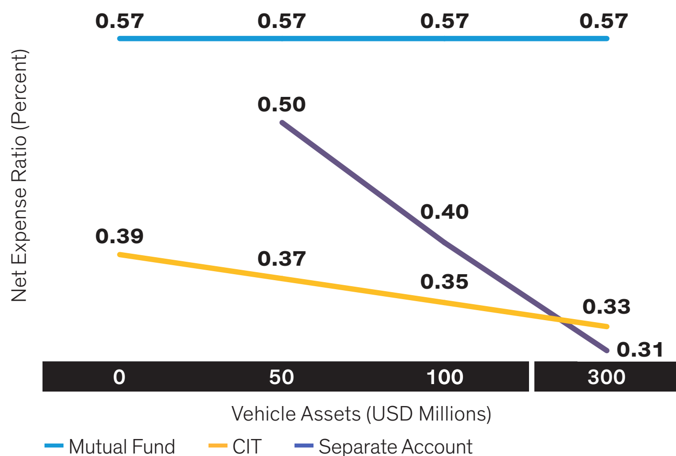
DISPLAY 2: SIZE TYPICALLY BRINGS ADVANTAGES AND REAL CHOICES FOR LARGER PLANS



For illustrative purposes only. There can be no assurance that any of the above-cited advantages will apply to a particular CIT or similar investment product or service.

Total expense ratio for mutual funds and CITs include operating expenses. Expense ratio for separate account does not include operating expenses.

Source: AB

How Are CITs Regulated?

CITs are overseen by federal or state banking authorities. National banks are accountable to the federal Office of the Comptroller of the Currency (OCC), while state banks answer to state authorities. State banks may also be supervised by the US Federal Reserve Board or the FDIC. Savings and loans are also regulated by the OCC.

CITs are also subject to the fiduciary rules of the Employee Retirement Income Security Act of 1974 (ERISA), including the "prudent investor" rule and the prohibition against conflicts of interest.

Every CIT must be audited at least once a year, and a financial report based on the audit must be available to current and potential investors. CITs are required to report net asset values quarterly, but most CITs now offer daily pricing and daily liquidity. Unlike mutual funds, which are governed by the Investment Company Act of 1940, CITs are exempt from US Securities and Exchange Commission (SEC) registration.

What Are the Potential Benefits of CITs?

Benefit #1: Low Cost and Transparency

CITs generally cost less than mutual funds. They're exempt from SEC registration, which generally lowers their legal-, board- and compliance-related costs. In addition, sponsoring institutions can offer CITs directly to employees without having to market them through a federally registered broker-dealer.

This streamlined process can reduce sales and marketing costs for things like the Blue Sky registration process, advertising and prospectus mailings. CITs' multiple pooled share classes can provide better pricing when a plan has more to invest. The cost savings from using CITs can be dramatic, particularly for large plans that can get the best rates for a dedicated share class.

Even without a dedicated share class, an investment manager's CITs are typically less expensive to operate and service than mutual funds. Because only qualified retirement plans can invest, CITs have lower transfer-agency expenses since they don't have thousands of retail investors to keep track of and service. They also tend to have more efficient regulatory requirements than mutual funds and a more streamlined cost structure.

Display 2 compares the total expense ratio of an equity CIT with the expense ratio of a mutual fund and a separate account in the same category at various initial investment levels.

At $50 million, the CIT has a total expense ratio of 0.37%, much lower than the 0.57% ratio for a "clean" share-class mutual fund (R6 or Z shares), with no 12b-1 fees or revenue sharing. At $50 million, a CIT can be less expensive than a separate account. In this example, the separate account expense ratio is 0.50%, plus operating expenses. Typically, as investment assets grow, so do the savings. As asset levels rise into the hundreds of millions and billions of dollars, a separate account will eventually offer better pricing than a CIT. However, for larger investments where the plan sponsor prefers a CIT, the CIT provider may offer a competitive rate for a dedicated share class.

Plan fiduciaries may be able to reduce the investment advisory fees paid by plans under their oversight by aggregating those plans within a common share class of a single manager's CIT. Managers will often extend discounts to a group of plans under the direction of a common 3(38) fiduciary based on the combined AUM level, with cost savings spread proportionately across the plan accounts per ERISA requirements.

Revenue sharing is less common with CITs, and many plan sponsors are moving away from these arrangements. However, some asset managers are making share classes with revenue sharing available for plans that still need to use this method to offset plan costs.

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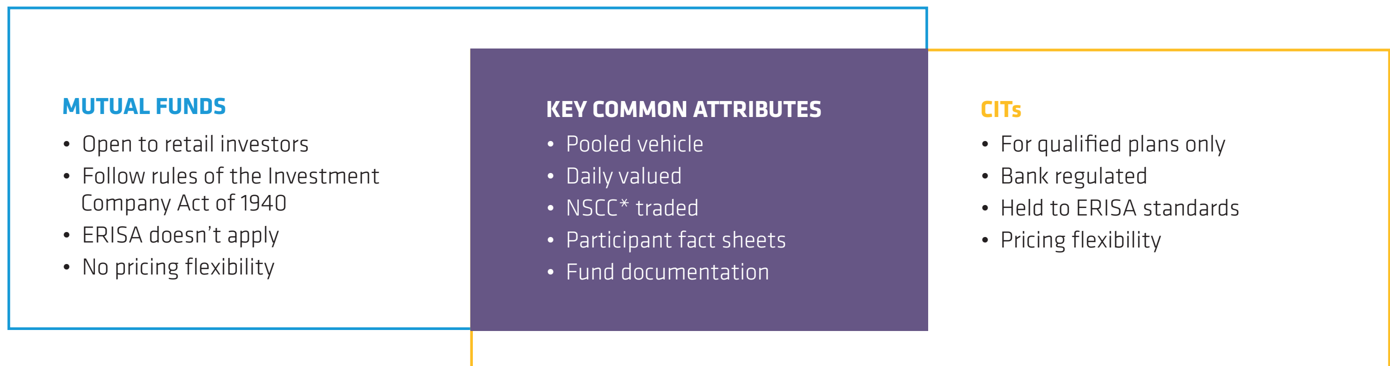
DISPLAY 3: CHARACTERISTICS OF MUTUAL FUNDS AND CITs



For illustrative purposes only. There can be no assurance that any investment attributes will apply to any particular CIT or similar investment product or service.

*****National Securities Clearing Corporation

Source: Coalition of Collective Investment Trusts and AB

Benefit #2: Operational Efficiency

For trading and recordkeeping, CITs are just as easy to manage as mutual funds. Banks can hire affiliated or third-party investment advisors to sub-advise their CITs, while retaining the ultimate investment responsibility. Servicing arrangements between plan recordkeepers and either banks or asset managers that sponsor and maintain CITs often allow trades by individual employees to be reported in aggregate form.

Unlike separately managed accounts, CITs have most of the basic technical features of more retail-oriented investments. They can obtain CUSIP numbers and tickers, and trade through the National Securities Clearing Corporation (NSCC). Like mutual funds, CITs can be valued each business day and are available in a wide range of asset classes and styles.

Benefit #3: Easy Access to Information

One concern some plan sponsors had about using CITs was that plan participants wouldn't be able to easily access daily information about the strategy's pricing and performance. Today, CITs look just like mutual funds to a participant, because daily information is posted on the recordkeeper's website and on the fact sheets provided with enrollment materials. (*See* "How Do Employees Keep Tabs on Retirement Savings?" *on page 5 for more details*.)

CITs offer a disclosure document known as an offering memorandum, which is like a mutual fund's prospectus. The offering memorandum includes the relevant information about the CIT, and the document can be posted on the plan's website for participants to access. Additionally, the number of CITs with ticker symbols is growing.

Plan sponsors—and the financial advisors and consultants who help them choose and monitor investments—now have much more information to help evaluate and track performance. As of March 2023, Morningstar housed data on more than 8,116 CITs,[2] including many with Morningstar ratings. As CIT use grows among small and midsize plans, rating services like Fi360 and eVestment are developing screening and rating tools for these vehicles, just as they have for mutual funds.

CITs have clearly come a long way since their early days. As a viable alternative to mutual funds, they give plan sponsors more choices when designing their retirement plans (*Display 3*).

1 "US Retirement Markets 2022: The Role of Workplace Plans in the War for Talent," Cerulli Associates.

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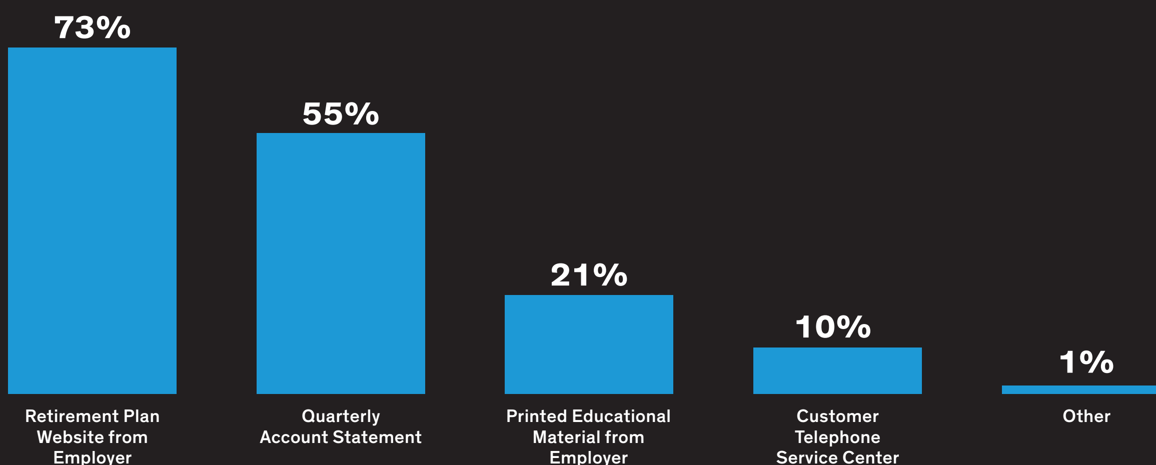
How Do Employees Keep Tabs on Retirement Savings?

Today, the number of CITs with ticker symbols is growing. That means participants can access information about them via the internet or through printed materials from their provider.

In the past, many plan sponsors were wary of CITs because their performance and pricing data weren't published in newspapers—back when that was the most common way for people to keep track of their 401(k) investments. Today, millions of people of all ages manage their personal finances online, so how participants follow their plan investments has evolved.

In our own research, we found that 73% of participants get their information from their employer's retirement plan website, while 55% rely primarily on quarterly statements (*Display*). The takeaway: based on the way participants get information, CITs and mutual funds now look the same in terms of account information.

HOW PARTICIPANTS KEEP TABS ON THEIR RETIREMENT SAVINGS



Percentage of people participating in a workplace retirement plan who answered the following question: How would you prefer to access information about the money in your retirement account?

Surveyed a national sample of 1,200 employees who were eligible for their companies' retirement plans, were at least 18 years old and worked for firms that offered DC plans.

Source: AB, *Inside the Minds of Plan Participants*, 2023.

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DISPLAY 4: CITS OFFER THE SAME APPEALING ATTRIBUTES AS MUTUAL FUNDS

Vehicle	Pooled	Daily Valued	Flexible Fees	Standardized Clearing*	Participant-Friendly Communication
Mutual Funds	●	●		●	●
CITs	●	●	●	●	●
Separate Accounts		●	●		●

For illustrative purposes only. There can be no assurance that any investment attributes will apply or that any objectives will be achieved.

***NSCC platform**

Source: AB

How Do You Implement a CIT in Your Plan Lineup?

Because 401(k) plans and other qualified retirement plans are the only eligible investors in a CIT, the plan itself must enter into an agreement with the bank or trust company offering the CIT. First the plan sponsor will review documents, including the declaration of trust, offering memorandum and adoption agreement. After that review, the sponsor will typically complete and sign the adoption agreement, providing the plan's IRS determination letter and related documents to confirm the plan's qualified status and secure the CIT's tax-exempt status.

Implementing and managing a CIT has become much less complicated over the years because of the trust companies who increasingly act as service providers. These companies offer a platform where plan sponsors and their financial advisors can access a variety of CITs. They have made the onboarding process more streamlined, and they also manage the back office, operational and administrative components of the fund. This "one-stop shop" makes it easier for plan sponsors of all sizes to consider CITs.

Choose the Strategy, Then the Vehicle

For plan sponsors, financial advisors and consultants who are adding a new strategy to a DC plan, evaluating and determining the best investment strategy should be the first step. Once the strategy and manager have been chosen, the next step is to select the best available vehicle.

This choice involves several factors, including the size of the plan's investment, the vehicles the plan is eligible for and their respective fees. Other factors could include whether sponsors want to be able to customize how the portfolio is managed and whether they'd prefer not to comingle plan assets with those of other investors. These considerations could lead larger plans to choose a separate account.

With the refinements that have been made in CITs, these vehicles now offer the same appealing attributes as mutual funds (*Display 4*). So it makes sense to consider CITs when selecting investment vehicles.

The Growing Popularity of CITs

The "institutionalization" of DC plans is a well-established trend. More and more, DC plans are applying the best practices of traditional pension plans. As this process happens, plan services such as recordkeeping and trust and investment management are being unbundled.

Bundled service packages were the preferred choice decades ago, when 401(k) plans were exploding in popularity. But since then, market and fiduciary pressures have been leading sponsors back to the more open structure typical of DB plans. Under an open structure, administration, trust and investment services are selected and priced separately. Unbundling has helped many sponsors by making costs transparent and clarifying revenue-sharing agreements that can be obscured by bundled arrangements. Unbundling also allows sponsors to pursue the best choice for each aspect of their plans—rather than the best combined package.

Given institutionalization, unbundling and other trends, we expect CITs to play a continuing role as plan sponsors address their fiduciary responsibilities. CITs can help lower costs, increase transparency,

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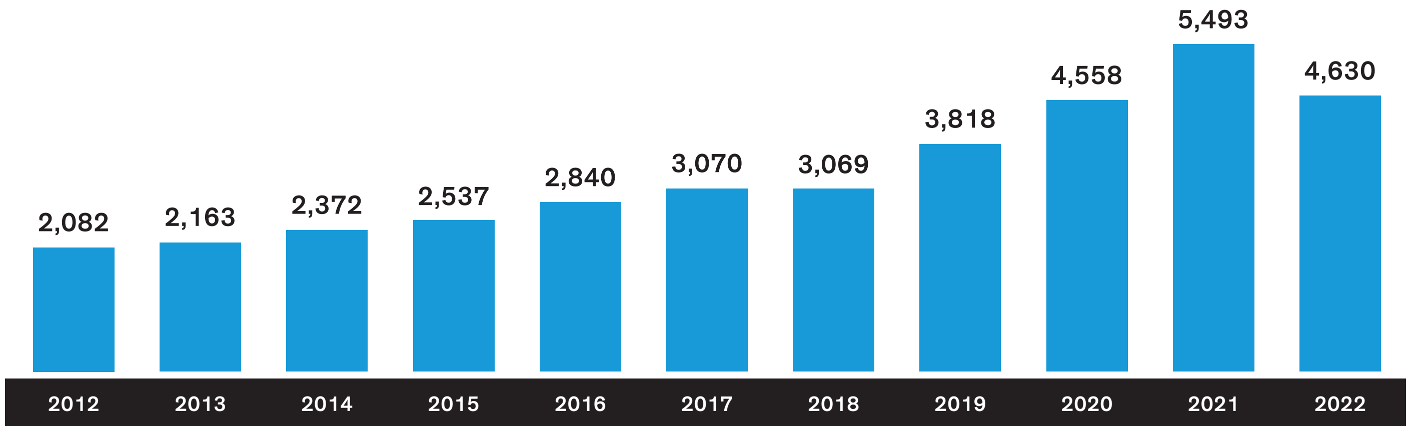
DISPLAY 5: CIT ASSETS HAVE MORE THAN DOUBLED OVER THE PAST DECADE

Total CIT Assets, 2012–2022 ($ Billions)



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2020 CIT sizing reflects total trusteed assets. Prior-year assets have been restated. The Office of the Comptroller of the Currency, which regulates collective investment funds, defines them in the *Code of Federal Regulations* (12 C.F.R. § 9.18) as including two types of fund structures—bank common trusts, frequently called A1 funds in reference to the paragraph of the *Code* in which they are defined, and collective trust funds (CTFs), similarly called A2 funds. Data shown tracks primarily A2 CTFs (available to retirement plans); A1 bank common trusts are typically closed-architecture offerings available only to the bank's clients but are captured, when possible, through proprietary Cerulli survey data.

As of September 30, 2023 | **Source:** *U.S. Defined Contribution Distribution 2022: Uncovering Investment-Only Distribution Opportunities*, Cerulli Associates and Morningstar Direct in partnership with the Coalition of Collective Investment Trusts.

and reduce the risks and costs of litigation. Since the attributes are comparable to mutual funds, they're being used by plans of all sizes. By the end of 2022, total CIT assets stood at over $4.6 trillion, having more than doubled over the past decade (*Display 5*).

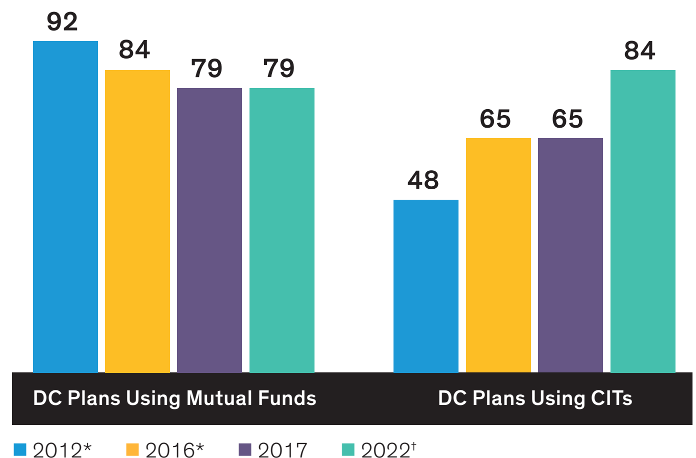
Over the past 10 years, the use of mutual funds in DC plans has fallen by more than 10%, while the use of CITs has nearly doubled (*Display 6*).

CITs Can Be the Optimal Choice

CITs are a versatile, cost-effective and competitive alternative to mutual funds for DC plans. As these plans have evolved to become the core retirement option for most workers, plan sponsors have become increasingly concerned about their fiduciary responsibility to provide appropriate and reasonably priced investment options.

We believe this tidal shift favors CITs: they offer most of the convenience of a mutual fund, with lower fees and flexible pricing. We expect CITs to remain the best choice among the available options for many larger plan sponsors. CIT adoption by small and midsize plans has begun and will continue to grow as more plan sponsors, financial advisors and consultants become familiar with their benefits.

DISPLAY 6: PERCENT OF DC PLANS USING MUTUAL FUNDS AND CITS



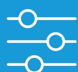
Historical analysis does not guarantee future results.

*Callan Associates, 2017 Defined Contributions Trends Survey
†Callan Associates, 2022 Defined Contributions Trends Survey

Source: Callan Associates and AB

Separating Myths from Facts

Although CITs have been gaining in popularity for years, some plan sponsors still hesitate to include these vehicles in their plan lineups. Most plan sponsors have heard about CITs, but much of what they have heard may not reflect reality. Here are some facts to consider.



Myth: CITs are exactly like mutual funds.

Fact

- CITs tend to be more cost-effective than mutual funds, with lower costs associated with compliance, administration, marketing and distribution—and may offer flexible pricing.
- CITs are available only to qualified retirement plans subject to ERISA.

Myth: CITs don't have the same level of reporting as mutual funds.

Fact

- While reporting may vary, most leading CIT providers offer reporting similar to that of mutual funds.
- Many third-party data providers, including Morningstar, offer CIT databases to monitor or analyze CITs.

Myth: CITs have less regulatory oversight than mutual funds.

Fact

- CITs must comply with ERISA and are held to US Department of Labor fiduciary standards.
- CITs must be sponsored and maintained by a bank or trust company and are audited annually by independent auditors.

Myth: CITs have high minimums.

Fact

- Many CITs, especially if traded through the NSCC, have no or low minimum-investment requirements.
- Recordkeepers may offer omnibus structures, making it possible for small and midsize plans to access CITs.

Myth: It's complicated to educate participants about CITs.

Fact

- CITs look the same as mutual funds to participants, and educational materials are the same regardless of vehicle.
- Information, including performance and pricing, is readily available through Morningstar, on the recordkeeper's website, and in statements and fact sheets.

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Are CITs Right for the Plan?

Among a plan sponsor's fiduciary responsibilities, regularly evaluating and documenting a plan's investment options is a top priority. After determining the strategy and managers, the next step is choosing the best available vehicle. As many plan sponsors are acutely aware, they're obligated to act in their participants' best interests—especially when it comes to keeping plan fees reasonable. Adding a CIT to the investment lineup can help. Here are some things to consider when determining whether a CIT is right for the plan:

- Is it a qualified retirement plan subject to ERISA regulations?
- Are CITs offered on the recordkeeper's platform?
- Is there room for cost improvements in the existing investment vehicle?
- Could custom vehicles be right for the plan?
- Would the reduction in fees be worth it?

For more information on how you can help your clients offer a versatile, cost-effective and competitive alternative to mutual funds for DC plans, please contact your AB Retirement Specialist.

In my 15-years in the industry, I've watched CITs evolve from opaque institutional products to the preferred investment vehicle for retirement plans of all sizes—they have never been in greater demand."

Adam Kornegay
Director, Defined Contribution Business Development

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