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Understanding collective investment trusts

KEY POINTS

- Collective investment trusts (CITs) are gaining acceptance in defined contribution (DC) plans, with interest driven by demand for institutional-quality investment strategies, product flexibility, and lower fees.
- Department of Labor (DOL) regulations and increased third-party reporting allow for easier comparisons between CITs, mutual funds, and other investment alternatives.
- Important features of Wellington Trust Company, NA's[1] CITs that are available to qualified DC plans include daily pricing, daily trading via the National Securities Clearing Corporation (NSCC), and the availability of monthly portfolio holdings, quarterly fact sheets, and annual portfolio profiles.

The investment menus of defined contribution plans have evolved in a variety of ways over time, from the use of a wider array of asset classes to the addition of target-date and other premixed investments. Another notable change in recent years is the growing use of CITs as an alternative to traditional mutual funds. As of the end of 2016, a total of US$2.8 trillion was invested in CITs,[2] including approximately US$969 billion of DC plan assets.[3] In addition, Morningstar has expanded their research coverage of CITs by 55% since 2006,[4] suggesting increasing interest in and adoption rate of these vehicles by plan sponsors.

Interest in CITs has been primarily driven by plan-sponsor demand for institutional-quality investment strategies and product flexibility with the potential for lower fees. DOL regulations governing the disclosure of fees and other investment-related information have helped to facilitate improved comparisons between CITs and other investment alternatives offered to DC plan participants (see box on page 3). Better disclosure has revealed that fees for CITs may be between 10 and 30 basis points (bps) lower than for mutual funds of similar composition.[5]

To help plan sponsors who are constructing or modifying an investment menu, this paper can serve as an educational piece highlighting the main similarities and differences between CITs and mutual funds.

About the authors

As members of our Defined Contribution (DC) Team, **Jed, Brendan**, and **Matt** focus on developing relationships with DC plan sponsors and consulting firms to assist with long-term investment strategy, evaluate portfolio risks and performance, and advise on policy guidelines and applicable regulations.

[1]Wellington Trust Company, NA is a national banking association that offers daily-valued collective investment funds that are available solely to certain qualified employee retirement plans and their plan participants. Please see further disclosure on Wellington Trust Company, NA on the bottom of page 4.

[2]Benefits Pro, December 2017.

[3]Cerulli Associates – The Cerulli Report – US Defined Contribution Distribution 2017: Re-Evaluating the Use of CITs in DC Plans.

[4]The Coalition of Collective Investment Trusts, CIT Myths and Facts, 2015.

[5]Plan Adviser, DST Systems white paper "Understanding CITs and Their New Opportunities," February 2017.

Background on CITs

Collective investment trusts were first introduced in 1927 and began daily trading on the NSCC Fund/SERV© platform in 2000.[6] CIT assets grew nearly 12% in 2016 to total US$2.8 trillion.[2]

Investment structure and management

Both CITs and mutual funds pool the assets of multiple investors, each of whom owns an interest in, or shares of, the CIT or fund. When actively managed, both vehicles generally employ professional money managers to research, select, and monitor the performance of the underlying securities.

Investment availability

CITs are established by banks or trust companies and are only available to qualified plans and plan-related trusts. Individual DC plan participants may invest in CITs only indirectly, when the CITs are included as options in the DC plan menu. In contrast, mutual funds are typically available both indirectly through DC plans and directly to individual investors through the sponsoring mutual fund company or a brokerage firm.

Regulatory oversight

CITs are regulated by the US Treasury's Office of the Comptroller of the Currency (OCC) pursuant to OCC Regulation 9.18, when the sponsoring bank or trust company is federally chartered. CITs sponsored by state-chartered banks or trust companies are regulated by state authorities. Wellington Trust's CITs are regulated by the OCC. The Department of Labor also has oversight authority over most CITs through its oversight of participating Employee Retirement Income Security Act (ERISA) plans and ERISA fiduciary activities. If a plan that is subject to ERISA includes a CIT as an investment option on its menu, the CIT trustee is generally required to comply with ERISA's fiduciary-responsibility provisions in managing and operating the CIT. The trustee of a mutual fund would not be required to comply with these provisions.

A principal difference between mutual funds and CITs is that CITs and CIT interests are exempt from registration with the US Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 and the Securities Act of 1933. As a result, CITs are not subject to the substantive regulatory provisions under those laws, which we believe ultimately results in a more cost-effective vehicle option for participants.

Reporting requirements

Mutual funds are required to report performance and holdings on at least a semiannual basis, in a standardized manner, as well as to provide quarterly account statements to investors. By contrast, OCC-regulated CITs are only required to issue financial reports on an annual basis, although most report performance information to participating plans more frequently. Mutual funds are legally required to provide investors with a prospectus, an offering document that discloses information on a fund's investment objective, portfolio managers, fees, services, restrictions, and policies, along with information related to risks, conflicts of interest, and other topics prescribed by the SEC. CITs do not issue prospectuses. But for certain CITs available through DC plans, there may be fact sheets, profiles, or other available material that provide information such as performance, turnover, expenses, investment objectives, and strategies.

Further, unlike with mutual funds, a plan sponsor or other plan fiduciary authorizing the plan's investment in a CIT enters into a participation or investment agreement with the bank trustee of the CIT. Wellington Trust's investment agreement with participating plans includes terms related to a CIT's fees and expenses, permissible investments, and investment objective.

[6]The Coalition of Collective Investment Trusts, CIT white paper, 2015.

More information, easier comparisons for plan sponsors and participants

In an effort to standardize key disclosures of CITs, mutual funds, and other DC investment alternatives, the DOL's rule 404a-5 under ERISA requires that DC plan administrators provide fee and other information on plan investment options to eligible employees, regardless of vehicle. Under the rule, information about each option's investment objective, risks, turnover, principal investment strategies, broad-based benchmarks, performance, and total expense ratio must be calculated and presented in a prescribed manner.

By standardizing the disclosure requirements for performance, expense, and other information across plan options, and making it more accessible and understandable, the DOL's rule is intended to help plan participants make more informed investment decisions. Further, the DOL believes that the fee disclosure rules may lead to lower total fees over time.

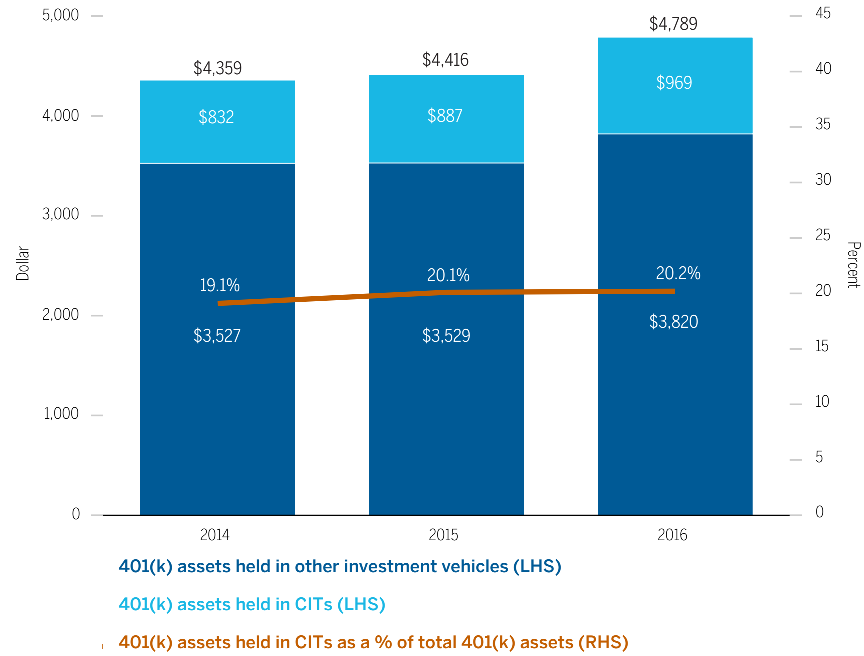
With respect to those Wellington Trust CITs that serve as "designated investment alternatives" for DC plans, Wellington Trust provides plan sponsors with quarterly fact sheets and annual profiles containing information about the CIT's investment strategies, as well as fees and expenses charged within the CIT, based on the DOL standard.

Distribution of 401(k) plan assets

Figure 1 shows 401(k) assets held in CITs versus other vehicles. Total 401(k) assets grew 1% in 2015 and 8% in 2016 (the most recent annual data available), while 401(k) plan CIT assets grew 7% and 9%, respectively.[3]

Figure 1

401(k) plan assets held in CITs (US$ billions)



Total CIT assets include stable value CIT assets held in 401(k) plans. Sources: The Coalition for Collective Investment Trusts, Department of Labor, Investment Company Institute, Callan Associates, Profit Sharing Council of America, Vanguard "How America Saves," Pensions & Investments, Morningstar Direct, Cerulli Associates

Third-party reporting

Third-party reporting on mutual funds is more widely available than on CITs, but that is gradually changing. Data aggregators such as RPAG, Fi360, and Morningstar regularly review mutual funds and make their analysis available to the public for a fee. These firms have been rapidly expanding their coverage of CITs. In fact, Morningstar's coverage has increased to over 1,000 distinct collective investment trusts as of the beginning of 2018.[7] However, this CIT information is not currently available to the public. It is accessible only to consultants and institutions, including plan sponsors and record keepers.

Valuation frequency

In general, mutual funds are required to calculate net asset values daily, and shareholders must be permitted to purchase and redeem shares daily. CITs offered to the DC market are typically priced daily to accommodate plan sponsor preference for daily transactions.

[7] Morningstar, 2018.

Fees and expenses

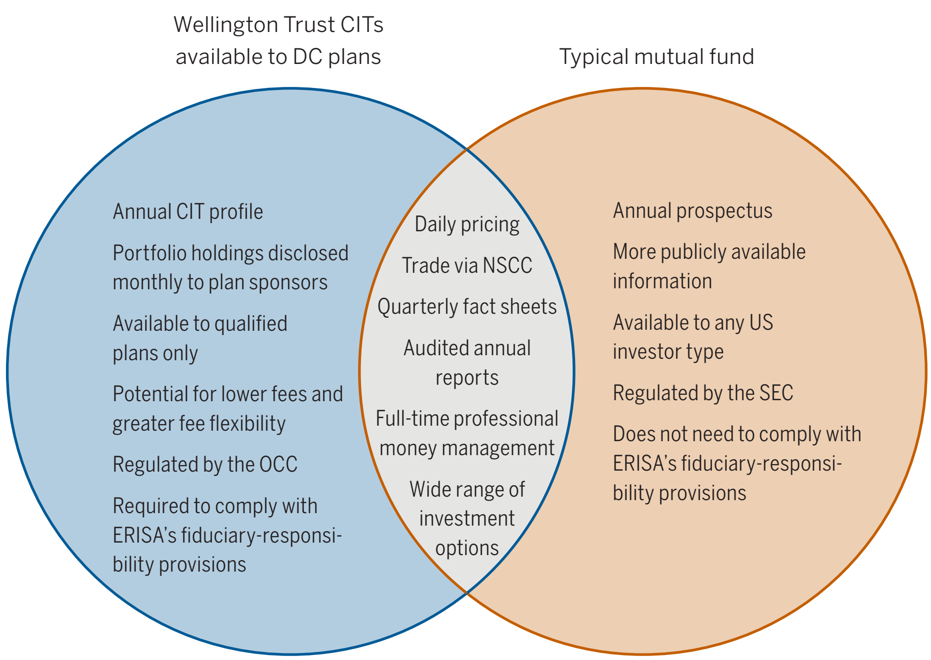
Mutual funds and CITs generally charge management fees and incur operating expenses. Fees can vary widely among individual mutual funds and CITs, but we believe recent DOL rule changes governing the disclosure of DC plan investment-option expense ratios should help facilitate comparisons for plan sponsors and participants. As noted above, thus far, better disclosure has revealed that fees for CITs may be between 10 and 30 bps lower than for mutual funds of similar composition.[5] In addition, more than 70% of CIT managers are open to negotiating custom fee arrangements based on client-specific circumstances such as total client assets under management (AUM) or a consultant relationship.[3] This fee flexibility is not available in mutual funds.

Conclusion

We expect that both CITs and mutual funds will be widely used by DC plans in years to come, and we believe that both merit consideration by plan sponsors. **Figure 2** summarizes the key similarities and differences between mutual funds and a group of CITs maintained and operated by Wellington Management's affiliate, Wellington Trust Company, NA.

Figure 2

Contrasting Wellington Trust's CITs and a typical mutual fund



For illustrative purposes only. Source: Wellington Management

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