



# Considerations for Plan Sponsors

## **COLLECTIVE INVESTMENT TRUSTS AS INVESTMENT OPTIONS IN QUALIFIED PLANS**

In-depth analysis and insights to inform your decision-making.

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### **EXECUTIVE SUMMARY**

Collective investment trusts (CITs) have been available as investment options to tax-qualified retirement plans for decades. However, they have rapidly gained popularity since they were identified as a type of investment vehicle that could meet the requirements of a qualified default investment alternative (QDIA) for defined contribution plans under the Pension Protection Act of 2006. This opportunity to be a QDIA, combined with typically lower fees than mutual funds and a proliferation of strategies, is driving increased interest in CITs for certain retirement plans.

A CIT may be a good investment solution for certain tax-qualified and governmental retirement plans that are seeking characteristics not available with a mutual fund, while avoiding the operational responsibilities and costs associated with a separately managed account.

However, plan sponsors should be aware that adding CIT investments may present certain transparency, portability, and regulatory challenges



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### **A fast-growing segment of the retirement plan industry**

CITs are attracting increased attention from plan sponsors as well as participants. As a result, their assets have increased considerably in recent years. Morningstar's public database now tracks over 7,000 CITs.\*

The growth has two primary drivers:

- 1.** The potential use of CITs as default investment options under the Pension Protection Act of 2006.
- 2.** Fiduciaries seeking investment options with lower expenses and fees.

Plan sponsors considering the adoption of CITs should consider the benefits and potential shortcomings before offering CITs as investment options in their plans. This paper presents the key factors that differentiate CITs from mutual funds, some challenges they pose, and a table comparing characteristics of CITs with those of mutual funds.

### **What separates CITs from mutual funds?**

CITs are similar to mutual funds in that they are composed of pooled assets invested with a specific philosophy and strategy. However, CITs differ in a number of ways from mutual funds.

\*As of 12/31/2020

CITs can offer plan sponsors lower investment expenses, often with greater fee flexibility than mutual funds.

**Different regulators.** Unlike mutual funds, CITs are exempt from Securities and Exchange Commission (SEC) registration under both the Securities Act of 1933 and the Investment Company Act of 1940. Depending on the bank or trust company sponsoring and maintaining the CIT, the regulator will be the federal Office of the Comptroller of the Currency or a state banking regulator. In addition, assets invested in CITs generally include assets of plans subject to the Employee Retirement Income Security Act of 1974 (ERISA); therefore CIT assets are typically considered to be “plan assets” subject to ERISA and overseen by the Department of Labor (DOL).

**For retirement plans only.** In order to qualify for the most commonly used SEC exemptions, CITs must be maintained by a bank or trust company. In addition, investors must be limited to certain types of retirement plans. Consequently, CITs are not available to individual investors and are not advertised to the public.

**No SEC-required reporting.** Not being subject to SEC registration as a mutual fund means that CITs do not issue prospectuses, proxies, or statements of additional information (SAI). Instead, the declaration of trust, under which the CIT is formed, contains provisions governing operations, investment strategy, etc. There also may be related documents, such as investment guidelines or an offering circular or memorandum.

**Form 5500 filing.** Although banks and trust companies are not required to complete Form 5500 filings for CITs, doing so eliminates the need for plan sponsors to “look through” the CIT and its assets in order to prepare their own

filings. CITs, like mutual funds, typically have audited financial statements produced annually that may assist the plan sponsor in completing its 5500 filing.

**Lower costs.** The institutional-only availability and exemption from SEC reporting can result in lower compliance, administrative, advertising, and marketing costs than a mutual fund with a similar investment strategy. In defined contribution plans, these cost savings can be passed directly to plan participants via reduced fees.

**Reduced cash flow volatility.** CITs generally keep lower cash balances than mutual funds because participants in defined contribution retirement plans usually invest with longer investment horizons than retail clients, and inflows typically are more predictable due to periodic contributions. These factors can help reduce cash flow volatility, allowing the portfolio to be managed more efficiently while staying more fully invested than a mutual fund.

**Greater fee flexibility.** A CIT can charge reduced fees for plans with a certain level of assets in the CIT portfolio. Additionally, a CIT can vary how operating and management expenses are charged. For example, CIT “A” may have all operating and management expenses borne by the CIT, which means that plans in the same fee class would transact at a net asset value (NAV) similar to a mutual fund. CIT “B” may have no operating expenses or management fees paid by the CIT. Instead, each plan may pay the bank or trust company an established fee for operating expenses and management fees.

## WHAT ARE COLLECTIVE INVESTMENT TRUSTS?

Collective investment trusts (CITs), also known as collective trusts, commingled funds, or common trust funds, are institutional investment vehicles. Depending on the laws under which they are organized, CITs are available only to certain types of retirement plans, including defined contribution and defined benefit plans. However, these types of CITs are not generally available to 403(b) plans, with the exception of church plans established under Section 401(b)(9) of the IRS Code.

CITs are sponsored by banks or trust companies to pool retirement plan assets into a single portfolio that is invested with a specified philosophy and strategy like a mutual fund. CITs may invest in a wide range of active or passive investment vehicles, including equities, fixed income, mutual funds, alternative investments (real estate, commodities, hedge funds, and private equity), and exchange-traded funds (ETFs).

### Overview of mutual fund vs. CIT characteristics\*

| Item                             | Mutual Fund   | Collective Investment Trust  |
|----------------------------------|---|--|
| Open to individual investors     | Yes   | No   |
| Redemption fees                  | Yes   | Varies   |
| Trading restrictions             | Yes   | Yes  |
| Portability                      | Generally   | No   |
| Share classes/units              | Multiple share classes  | Multiple unit classes  |
| Governing documents              | Prospectus, SAI, terms of account application.  | Declaration of trust, investment guidelines, terms of participation agreement.   |
| Participant-level communications | Extensive public information is available. Extensive support and materials are generally available from the provider.   | No public information is available. Limited information may be available from the provider. Daily NAV and fact sheets may be made available to participants.   |
| Expenses                         | Disclosed as an expense ratio and itemized in financial statements, expenses are paid by the fund and netted out of the NAV. Expenses include a management fee plus operating expenses relevant to the particular share class, which may include registration, custody, accounting, transfer agency, legal, audit, prospectus printing and mailing, and shareholder servicing fees. | Disclosed as a trustee fee, expenses can be paid by the CIT and netted from its NAV or billed separately to the plan. The trustee fee includes an advisory fee and may also cover operating expenses common to all unitholders, such as custody, accounting, legal, tax, and recordkeeping fees. |
| Regulator                        | SEC   | Depending on the bank or trust company sponsoring and maintaining the CIT, the regulator is the federal Office of the Comptroller of the Currency or a state banking regulator. CITs are also subject to regulation by the DOL.  |
| NSCC trading                     | Yes   | Yes  |

\*These are typical characteristics. Actual practices may vary depending on the provider.

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## While offering many advantages, CITs also pose unique challenges

**Transparency.** CITs do not trade on an exchange, and they are less transparent than mutual funds since daily prices aren't publicly available. Investment information and historical return data can be limited to an individual (or specific) trust's inception. For CITs launched in recent years, evaluating their performance may be more difficult for plan sponsors and participants. However, many CIT managers produce investment fact sheets and make information available to third-party vendors. Companies like Morningstar provide CITs' underlying holdings and return data for print materials and websites. Also, under recent DOL regulations, CIT providers are required to furnish to plan fiduciaries information needed to assess reasonableness of compensation received by the CIT provider and/or its affiliates, identify conflicts of interest, and assist plan fiduciaries in meeting the plan's participant disclosure obligations.

**Portability.** CITs are available only to certain types of retirement plans and are generally not portable investments. Participants are limited to holding the CIT within their plan; when they take a total distribution from the plan, they must liquidate the CIT. Finding an identical investment outside the plan may not be possible.

**Returns variance.** Some CITs are modeled after corresponding '40 Act mutual funds. For these CITs, plan sponsors, intermediaries, and participants should not expect identical performance returns. Several factors affect performance, such as the timing and size of cash flows, the ability to obtain capacity in constrained securities, and/or the inability of CITs to purchase certain types of offerings due to tax or ERISA issues. While efforts are made to minimize potential differences in returns, depending on the markets, the factors may enhance or negatively affect performance returns compared with the '40 Act mutual funds.

**Challenges.** While compliance requirements for CITs are generally less restrictive than those of SEC-registered investments such as mutual funds, they are subject to a different regulatory framework. Understanding the applicable state and federal regulations can create additional work and complexity. Managing the specific audit and reporting requirements of an investing plan can be difficult to the extent that a CIT does not voluntarily file Form 5500 or that it operates on a fiscal year different than the plan year of the investing plan.

### FINAL THOUGHTS

Every retirement plan's investment policy is different, with its own objectives, constraints, and considerations. Therefore, it is critical that plan sponsors carefully evaluate the CIT structure, operational responsibilities, and regulatory requirements before offering these investments in their plan. Plan participants should carefully read material supplied to them before investing.

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