Collective Investment Trusts: What You Need to Know

Interest in collective investment trusts (CITs) has been steadily growing within defined contribution (DC) plans as modern CITs have increased transparency, ease of use and flexibility, in contrast to earlier versions of CITs, which were mainly utilized by defined benefit plans. But how can plan sponsors be sure CITs are an appropriate investment vehicle for their plan? In the following pages, we provide a short discussion covering the history of CITs, how they differ from other investment vehicles and what steps fiduciaries can take to add them to a DC plan.

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ABOUT NEUBERGER BERMAN

Founded in 1939, Neuberger Berman is a private, 100% independent, employee-owned investment manager. From offices in 31 cities worldwide, the firm manages a range of strategies—including equity, fixed income, quantitative and multi-asset class, private equity and hedge funds—on behalf of institutions, advisors and individual investors globally. With more than 500 investment professionals and more than 1,900 employees in total, Neuberger Berman has built a diverse team of individuals united in their commitment to delivering compelling investment results for our clients over the long term. Our culture has afforded us enviable retention rates among our senior investment staff; it has earned us a citation as the second-ranked firm (among those with 1,000 or more employees) in the *Pensions & Investments* 2017 Best Places to Work in Money Management survey, after we had finished in the top three from 2013–16.

CIT Basics

CITs, also known as collective investment funds, collective trust funds, common trust funds or common funds, are tax-exempt, pooled investment vehicles maintained by a bank or trust company (the "trustee") exclusively for qualified retirement plans that are exempt from federal income tax, including 401(k) plans, defined benefit plans, Taft-Hartley plans and certain government plans. Like mutual funds, they comprise an investment portfolio managed by a professional with a defined objective. Unlike mutual funds, a host of regulatory rules limit the eligibility of CIT investors. The table below is a general illustration of the types of investors a CIT may be expected to permit, and those which it may not.

Permitted Investors	Ineligible Investors
Qualified 401(k) Plans	Health and Welfare Plans (VEBAs)
Qualified Profit Sharing Plans	IRAs[2]
Qualified Stock Bonus Plans	Certain Section 403(b) Plans
Certain Taft-Hartley Plans	Non-Qualified Deferred Compensation Plans
Qualified Pension Plans	Individual Investors
Certain Government Plans[1]	Foundations
Certain Master Trusts of Qualified or Governmental Plans	Endowments
Certain Insurance Separate Accounts	

[1] Those that are within the meaning of IRC Section 414(d) or an eligible governmental plan trust or custodial account under IRC Section 457(b) that is exempt under IRC Section 457(g).
[2] Usually ineligible due to securities law reasons.

CIT Regulation

Because CITs hold qualified retirement plan assets, they are generally required to comply with applicable provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA). The Trustee is subject to supervision and regulation by the Office of the Comptroller of the Currency for national banks or state banking authorities for state banks and the Department of Labor (DOL). As such, a CIT trustee is held to ERISA fiduciary standards for the ERISA plan assets invested in CITs. However, due to exemptions from the registration requirements of the federal securities laws, CITs are not typically registered with the Securities and Exchange Commission (SEC) or any state securities commission, unlike mutual funds.

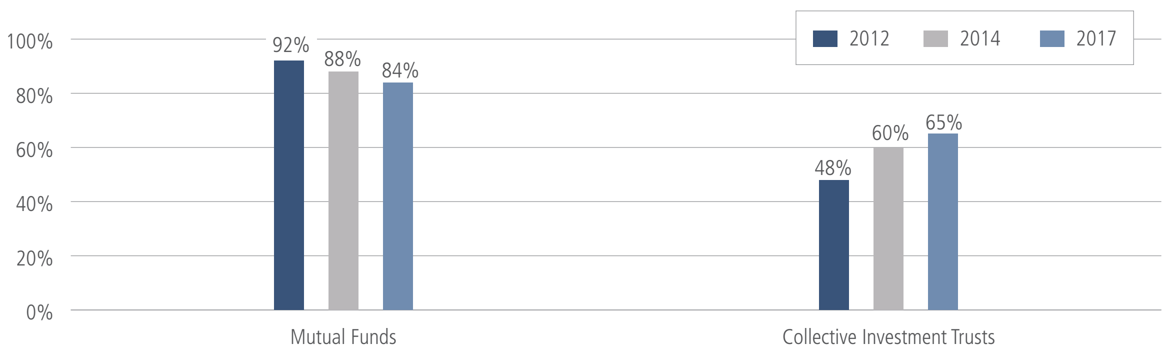
Growth of CITs

CITs were first introduced in 1927. Early versions of CITs required investor purchases and withdrawals to be processed manually and were valued infrequently, typically only once per calendar quarter, providing investors little access to portfolio and performance data. For this reason, the early adopters of CITs were defined benefit plans.

But starting in 2000, CITs began operating in ways that many believed were more comparable to mutual funds, providing daily valuation and standardized transaction processing, which greatly increased adoption by defined contribution plans. Then, in 2006, the Pension Protection Act provided for a new default investment election for unallocated 401(k) participant assets. These Qualified Default Investment Alternatives (QDIAs) include certain types of "approved" investment strategies and may take the form of managed accounts, target risk funds and target date funds. Many target date funds—the most widely adopted QDIA—are implemented as CITs, and as their assets have grown, so have the assets of CITs generally. Recently, CIT coverage by database vendors such as Morningstar has increased as well, providing additional transparency and reporting capabilities.

CITs have become a popular alternative to mutual funds within qualified retirement plans. CIT assets in retirement plans could surpass $3 trillion of the estimated $32.5 trillion in all retirement assets by the end of 2018, up from $1.9 trillion at the end of 2015. Already, CIT asset growth has outpaced the overall retirement market with a 7-year CAGR of 14.4% compared to less than 9% for the retirement market.[1] Since 2012, CIT use has grown by 35% within DC plans, while the usage of mutual funds has decreased[2]—a trend that we expect to continue.

Percent of DC Plans that Offer CITs within the Fund Lineup



Source: Callan 2017 and 2018 DC Trends surveys. Multiple responses were allowed.

Possible Reasons for Increased Usage of CITs Include:

Flexibility

- Ability to use in combination with other investment vehicles like mutual funds and separate accounts in one plan, or even within one asset allocation vehicle (like white label funds or target date funds)
- Fees and investment minimums may be negotiable
- May be used across multiple plans within one organization, such as a defined benefit plan and a defined contribution plan, where judged suitable for each plan, thereby potentially reducing the burden of a plan fiduciary's governance process

Increased Transparency and Reporting

- Daily valuation
- Standardized and automated daily processing
- Fact sheets and enhanced data reporting
- Increased coverage by Morningstar and eVestment
- Standardized strategy, risk, performance and expense disclosures
- Limited revenue sharing

Increased Investment Choices

Originally, CITs were a vehicle used predominantly to deliver stable value or passive strategies. Today, CITs are broadly available across asset classes and investment disciplines, including equities, fixed income, alternatives, multi-asset strategies and international and domestic orientations. They can be actively or passively managed, and can be—and often are—used in a fund of funds structure, like target date or target risk funds.

Suitability

Because of the variety of investment vehicles that now exist for retirement plans, including mutual funds, CITs and institutional separate accounts (ISAs), it is both more difficult and more important than ever for plan fiduciaries to understand the various vehicles and make informed choices. Plan fiduciaries must evaluate many factors to determine which options will serve the needs of the plan participants and their beneficiaries.

[1] Erach Desai and Jason Dauwen. DST Systems and ALPS. *Collective Investment Trusts—A Perfect Storm,* March 2017.
[2] Callan 2017 DC Trends Survey.

Examples of Considerations for Suitability

Investment Strategy: Naturally, one point of evaluation should be regarding the *strategy* itself: whether it has an attractive track record, sound process, experienced manager, etc. From there, the plan sponsor can evaluate the *vehicle* through which the strategy is delivered: mutual fund, CIT or an ISA.

Cost: An important factor is evaluating the cost of each investment vehicle.

Size of Plan: The size of the plan can be an important consideration and even a limiting factor: Mutual funds are often better able to accommodate the needs of smaller plans that don't have the plan assets needed to hit the required investment minimums for CITs (often $10 million, but will vary). By contrast, very large plans may have the scale and interest to seek the customization of an ISA if fiduciaries deem that appropriate for their plan's needs. CITs probably fit somewhere in the middle, but can be used by mid, large and mega plans.

Additional Considerations: Also, plan fiduciaries should carefully consider the provider's available investment universe, the plan's own investment policy statement (IPS), trading and operational considerations, market trends, the demographic makeup of the plan's participants and the current regulatory environment. Further considerations are shown in the accompanying table.

How do CITs Compare?

Selected considerations when evaluating vehicles for a DC plan.

CHARACTERISTICS	MUTUAL FUND	COLLECTIVE INVESTMENT TRUST	INSTITUTIONAL SEPARATE ACCOUNT
Eligibility	All Eligible Investors	Qualified Plans Only	Single Investor
Regulators	SEC	OCC, DOL	DOL, SEC
ERISA Fiduciary Standards[1]	No	Yes (CIT trustee)[2]	Yes[3]
Ownership	Plan owns shares in the fund—not the fund's underlying securities.	Plan owns units in the fund—not the fund's underlying securities.	Plan owns underlying securities.
Valuation	Daily	Daily	Daily
National Securities Clearing Corporation (NSCC) Traded	Yes	Yes	No
Liquidity	Daily	Daily for defined contribution participants	Daily
Governing Documents	Prospectus and additional documents	Declaration of Trust and other documentation provided by sponsor	Custom Agreement
Fees	Not negotiable; share class management fee is defined	May be negotiable; May be scaled	May be negotiable; May be scaled
Pooled Vehicle	Yes	Yes	No
Portability to IRA	Sometimes[4]	No	Sometimes
Ticker	Yes	No	No
CUSIP	Yes	Yes	No
Reporting	Extensive public performance information available	Performance available through recordkeeper, by trustee/manager and some CITs are reported on by Morningstar	Performance available through recordkeeper and plan sponsor

[1] Applicable to assets of vehicle.
[2] The sponsoring bank as Trustee serves as fiduciary.
[3] For plans subject to ERISA.
[4] Depending on which share class; R6 classes are not portable to IRAs.

Are CITs Right for Your Plan?

Only your plan's fiduciaries, in consultation with legal, investment and other advisers, can decide what investment strategy or investment vehicle may be suitable for the plan's participants. Many of the questions in assessing a CIT are the same questions one would entertain for any investment vehicle or strategy. Some examples are listed below:

- Is the plan's current investment universe appropriate and comprehensive?
- Does the plan have sufficient investible assets for investment in the vehicle? Are there securities law, tax, ERISA or other restrictions?
- Is the cost structure appropriate given the plan size, services provided and the scope of desired investment options?
- What type of data and/or reporting will be supplied to the plan? Will this reporting be sufficient for participant needs?
- Are there any liquidity boundaries, trading issues or operational considerations?
- Is the investment vehicle the best fit for the plan participants?

Implementation

Once a decision has been made to include a CIT in a plan's investment lineup, various practical steps will follow. The plan sponsor, along with his/her advisor or consultant, will work with the bank or trust company that serves as trustee to review documents, including a declaration of trust and fund declaration. Plan sponsors will then enter into an agreement, often called a "participation agreement," with the institution offering the CIT, and will provide documents that validate the plan's qualified status. The plan's recordkeeper will also need to execute certain documents with the trust company.

Final Thoughts

CITs are growing in popularity and may be of interest to certain qualified plans. However, when evaluating whether an investment is truly in the best interest of your plan participants and their beneficiaries, be sure to consider all the facts and consult your independent professionals, including investment and legal professionals.

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