Defined Contribution Institutional Investment Association

Access to CITs Creates Opportunity for 403(b) Plans

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SECURE 2.0 passed the House in March 2022 and if it passes through the Senate with language that allows institutional 403(b) plans to offer collective investment trusts (CITs), those 403(b) plans would gain access to a new investment vehicle that can potentially introduce pricing and administrative efficiencies, as well as open the door to offer pooled Stable Value funds.[1] Currently, 403(b) plans can invest only in registered funds and annuity contracts. Our discussion is limited to the investment in CITs by institutional 403(b) plans, meaning plans that are managed by a professional fiduciary or governmental entity.

This topic of making CITs permissible investment vehicles in 403(b) plans has been covered extensively over the past several years. DCIIA wishes to focus the dialogue on what, in our view, will be the most important innovations and their potential outcomes should 403(b) plans be allowed to use CITs, namely: potentially lower costs and opportunities for greater administrative efficiency, flexibility for more investment innovation, and more choice in short-term investing options.[2]

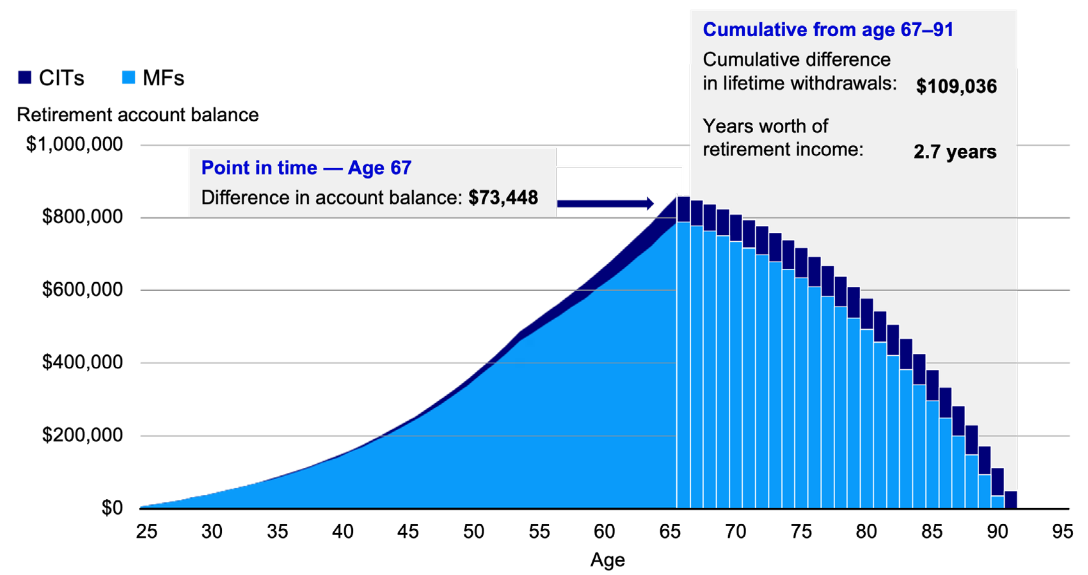
POTENTIALLY LOWER INVESTMENT COST AND OPPORTUNITIES FOR GREATER ADMINISTRATIVE EFFICIENCY

CITs often cost less compared to investment vehicles with similar objectives, such as mutual funds. Because CITs are privately offered, they can have less overhead expenses to pass on to investors (e.g., CITs do not have SEC reporting requirements which can incur costs and CITs do not have boards of directors and their related expenses.) Furthermore, CITs can sometimes offer greater fee flexibility due to their varying pricing structures and the ability, in certain market segments, to negotiate pricing.

In **Exhibit 1**, consider a participant who saves $5,000 annually from age 25 to 66 and retires at age 67. By investing in CIT funds whose fees hypothetically cost 30 basis points less than they do for mutual funds*, the participant's retirement balance would be almost $74,000 higher by age 67. The cumulative impact of this fee differential is 2.7 years' worth of additional retirement income, or an average of $4,500 more each year in retirement up to age 91.

Exhibit 1

Effect of 30bp lower expense ratio on retirement income



Source: Invesco. This hypothetical example is for illustrative purposes only and is not intended to represent the actual performance of any particular investment product or real investor. Actual return is not likely to be constant from year to year, and there is no guarantee that a specific rate or return will be achieved.

Assumptions: $5,000 invested annually from age 25 to 66 (retire at age 67). Annual return of 7% until age 55 and a more conservative return of 4% from age 56 on. Fund expense ratio difference of 30 bps reduces the investment's annual rate of return. Age 67 withdrawal begins with 5% of the account balance increased by an inflation rate of 1.8% annually.

** Source for bps. difference: Morningstar Policy Research, June 2020, "CITs: A Welcome Addition to 403(b) Plas", pg. 3*

Potential fee flexibility

As CITs are institutional structures, they are constructed with share class and fee flexibilities that can drive efficiencies not available with mutual funds open to retail investors. For instance, asset managers and the trust companies they work with may be able to customize a CIT share class and/or fee to meet the specific needs of a plan or group of plans. Depending on constituting documents, CITs may provide fee breakpoints once asset thresholds are reached. Additionally, management fees may be charged outside the CIT, which would allow the employer to pay for some or all CIT expenses.

Opportunities to enhance plan investment menus through administrative efficiencies

Because CITs are generally used as the building blocks for white label and multi-manager products, access to CITs allows 403(b) plans to include these products in their plan investment offerings. White label or multi-manager products can streamline investment menus and provide sponsors the flexibility to add and remove managers more efficiently. Provided the overall fund's objective remains the same, changes to the underlying component managers generally do not require communications to participants. This flexibility can help improve participant's access to diversified investment strategies without increasing the number of options on the investment menu.

Also, because non-traditional investment strategies such as private real estate, private equity and hedge funds are commonly implemented in DC plans through multi-asset, multi-manager strategies, access to CITs could increase 403(b) plans' ability to offer participants access to these kinds of diversifying exposures. DCIIA's white paper "Alternative Investments in Defined Contribution Plans" further discusses the benefits and considerations for offering these complementary asset classes in DC plans.

Finally, as CITs are generally restricted to institutional clients, their cash flows are typically more predictable than mutual funds, which are available to retail investors. More consistent cash flow makes liquidity management easier, allowing the manager to hold less cash in the portfolio. Less cash may potentially result in a greater delivery of alpha and less drag on fund performance, as the assets can remain invested in higher returning investments.

FLEXIBILITY FOR MORE INVESTMENT INNOVATION

403(b) plan participants currently cannot benefit from customized funds, where the investment strategy is customized to reflect the plan's objectives. Such customization is oftentimes implemented using a white label or an "off the shelf" CIT model. If 403(b) plans had access to CITs we expect plan sponsors would find value in the ability to implement solutions customized to their plan needs.

There are several compelling reasons to use white label or other customized strategies:

- Institutional investor-level practices can be incorporated, such as blending compelling active management with passive strategies for greater risk control and above market returns.
- Tailored investment strategies or target date fund glide paths that can reflect unique plan demographics or create greater opportunities for investment options to generate alpha.
- Lower costs can potentially be achieved by negotiating better terms and conditions, as mentioned earlier.

DCIIA has a robust set of research on white label, multi-manager and multi-asset investment options that can be found by clicking here: Defined Contribution 101 - Defined Contribution Institutional Investment Association (dciia.org).

MORE CHOICE IN SHORT-TERM INVESTING OPTIONS

A less commonly discussed potential benefit of allowing 403(b) plans to use CITs is that it would allow sponsors more choice in short-term investing options, including pooled stable value funds. In the broader DC marketplace, diversified stable-value investment strategies, often structured as CITs, have generated significant attention and gathered substantial assets under management. During periods of historically low interest rates, stable-value investments' ability to hold longer-duration fixed income instruments with higher yields than the overnight or other very short-term debt instruments typically held by money market mutual funds has been highlighted. Simultaneously, through multiple wrap arrangements with banks or insurance providers, stable-value investments can minimize potential loss of investment principal; shielding participants from interest rate risk embedded within conventional bond-based investments.

Because 403(b) plans have not been allowed access to CITs, they have not been able to benefit from the broad array of CIT-based stable value funds otherwise available to retirement plans, and their capital preservation options have remained largely unchanged since the 1970s. Although many 403(b) plans are allowed – and often make use of – annuity-based stable value products, which like all stable value investments provide higher yields than money market funds, those products sometimes have significant portability restrictions that apply at the plan – not the participant – level. When present, such provisions can complicate or prohibit a transition to a new recordkeeper's platform and artificially constrain the plan sponsor's recordkeeper choice. In contrast, stable-value CITs generally have fewer liquidity restrictions, potentially providing greater portability and giving plan sponsors greater freedom in selecting service providers.

CHECKLIST OF POTENTIAL CONSIDERATIONS

Sponsors will have an opportunity to review and enhance their 403(b) plans if CITs are allowed. It is a best practice for fiduciaries to evaluate the availability of potentially lower cost investment vehicles, including CITs, for the benefit of participants and beneficiaries. Although each plan's approach may vary, here are some potential considerations for plan sponsors and fiduciaries in their evaluation:

Governance

- √ Investment policy statement may need to be reviewed to ensure it permits investments other than annuities or custodial accounts in the plan.
- √ Consider that public 403(b) plans may be subject to state laws and regulations that specify/restrict the type of investments allowed in the public retirement plan. These state laws or regulations may need amending, which may require changes to state legislation.
- √ Recordkeepers may require 90 to 120 days of advance notice for fund changes, may charge a fee to make the changes, and/or may require amendments to the service agreement.
- √ Switching out a mutual fund that pays 12b-1 fees for a CIT that does not do so may change the recordkeeper's overall fee arrangement, which may support benchmarking the new quoted recordkeeping fee and impact fee allocation.

Investment Structure

- √ When considering CITs, it may be a good time to weigh other investment lineup and fund changes.
- √ Some investment consultants may charge for each manager search, making it cost-effective to bundle together any fund changes, thus also easing participant communications.
- √ Some mutual funds have short-term redemption fees that may apply if the contributions have not been held in the fund for a specified period (e.g., 60 days). The fees would apply to all plan contributions made to the mutual fund within the specified period. Employers may choose to pay these redemption fees rather than have the participants pay.
- √ Plans with annuity products should review the contract terms to see if an exit is possible and whether any exit fees, such as heavy penalties, may apply along with the above-mentioned portability issues.
- √ Coordinate timing of cash outflows from mutual funds and inflows to CITs with the fund managers.

Communications & Notices

- √ Update participant communications to reflect the fund changes, including enrollment kits, summary plan descriptions, fund fact sheets, fee disclosures, participant website, etc.
- √ Participant notices are required 30 days prior to the effective date of fund changes to ensure safe harbor protection under Section 404(c).

DCIIA looks forward to legislation that would allow 403(b) plans access to CITs.

The $35 billion University of California Retirement Savings Program is a great example of the benefits CIT access would bring to 403(b) plans. The University's 403(b)/457/401(k) multi-plan program has been using separate accounts since the 1970s. In the recent past, the investment fiduciaries for this plan moved over $3 billion from mutual funds to CITs *without* changing a single mandate and using 100% of the same portfolio manager teams and overall investment strategy. This move resulted in fund cost savings of more than 0.6%, representing well over $18 million in annual savings for their members. This presents a more compelling case study to consider as we enter this new era of greater flexibility and customization for 403(b) plans.

Endnotes

[1] Our focus for this paper is on CITs. The proposed language for SECURE 2.0 (Securing a Strong Retirement Act of 2021, H.R. 2954) also includes other investment vehicles, such as separate accounts. The parameters and discussion points are similar for both separate accounts and CITs.

[2] Please reference the Coalition of Collective Investment Trusts (CCIT) recent research paper for more expansive discussion on the history and current situation of this issue, including differences in regulatory oversight.

ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of America's workers. To do this, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution outcomes. DCIIA's diverse group of members include investment managers, consultants and advisors, law firms, recordkeepers, insurance companies, plan sponsors and other thought leaders who are collectively committed to the best interests of plan participants. For more information, visit: www.dciia.org.

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