



FIDUCIARY CONSIDERATIONS FOR INVESTMENT VEHICLE SELECTION

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Introduction

Over the past decade, twin forces of litigation and regulation have caused plan sponsors to focus on reducing the cost of their 401(k) plan investment options. In the fall of 2006, attorneys from the Midwest law firm Schlichter Bogard & Denton filed lawsuits against 18 large U.S. corporations alleging various breaches of fiduciary duty, including permitting the plans to incur excessive fees. This swarm of suits, known in the industry as the “Schlichter Blitzkrieg,” earned the firm more than \$200 million in legal fees as cases settled, and triggered numerous “copycat” lawsuits. Common defenses included claims that plan sponsors weren’t aware of their plan fee structures, and that participants were responsible for selecting higher cost fund options under the plan. Partially in response to the suits, in 2012, the Department of Labor (DOL) issued final regulations under Sections 404(a)(5) and 408(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA). The 404(a)(5) regulation required plan sponsors to disclose information about fund performance and costs to participants; the 408(b)(2) regulation required plan service providers to provide sponsors with information about fees and revenues received, including indirect revenue from plan investments.

Data from the Investment Company Institute (ICI) indicates that the cost of funds offered

through 401(k) plans has declined significantly in recent years. In 2014, ICI reports that the average cost of an equity mutual fund used by a 401(k) plan participant was 54 basis points (0.54%), down from 77 basis points (0.77%) in 2000. Furthermore, 401(k) fund costs compare favorably to the average fee for all equity mutual funds offered in the U.S., which ICI reports was 133 basis points (1.33%) in 2014 (Collins, Holden, Chism, and Duvall, 2015).

Of course, the problem with evaluating fund costs based on averages is that the averaging process can hide issues in the underlying data. A chart from industry consultant BrightScope provides a more granular view of the distribution of costs in the 401(k) market (Alfred, n.d.):

The BrightScope chart illustrates two significant problems with the averaging process:

1. Smaller plans tend to incur much higher fees than larger plans.
2. Outlier plans with much higher than typical fee structures can be found in almost all plan sizes.

What drives these trends toward higher fees for small plans, and outlier fees in all ranges? While economies of scale are clearly a factor, the common practice of revenue sharing, particularly by mutual funds, explains much of these factors. Revenue sharing refers to the use





of a portion of fund expenses—typically 12b-1 fees or Sub-Transfer Agency (Sub TA) fees—to pay for plan administration or investment advisory services. Revenue sharing has been ubiquitous in 401(k) plans; a 2015 study by consulting firm NEPC reported that 87% of the 113 large 401(k) plans (covering 1.4 million participants) surveyed used revenue sharing to cover at least a portion of the plan’s costs (Breman, 2015). Anecdotally, revenue sharing is even more common among smaller plans. In the 16th edition of the 401(k) Averages Book, HR Investment Consultants reports that revenue sharing for a small plan with 100 participants and \$5 million in assets averages 66 basis points, or 0.66% (Satter, 2016).

In recent years, we’ve seen a downward trend in the use of revenue sharing, and even the elimination of revenue sharing in many instances. NEPC reports that weighted average plan revenue sharing fell from 16 basis points (0.16%) in 2008 to 9 basis points (0.09%) in 2014. Partly to avoid potential litigation, the various parties supporting 401(k) administration are focusing on fee structures, and taking action to reduce expenses. Plan service providers are doing a better job of explaining fee structures, disclosing revenue sharing arrangements, and highlighting potential alternatives. Consultants are reviewing fee arrangements and recommending vendor and fund changes. Plan sponsors are moving away from retail mutual funds and so-called R shares, with high 12b-1 and Sub-TA fees to lower cost institutional or zero revenue share classes. Collectively, these activities explain much of the aggregate fee reduction noted by ICI.

But some plan sponsors want to push further into fee reduction than is possible within the constraints of a mutual fund investment structure. These sponsors are considering non-public institutional investment vehicles such as collective investment trusts (CITs) and separately managed accounts (SMAs) to minimize fee drag on participant accounts. By 2015, for instance, 70.8% of large defined contribution plans offered at least one CIT, up from 51.9% in 2013. Stable value funds, which

are regularly structured as CITs, comprise some of this total. Nevertheless, 7 out of 10 plans that are offering at least one CIT are doing so in a non-stable value asset class (Callan Associates, 2016).

This paper is intended as a resource for those who are considering using non-public investment vehicles in a retirement plan. While CITs and SMAs frequently have lower costs than mutual funds, these products come with certain tradeoffs. Additionally, a more thorough due diligence process is necessary to address practices and considerations unique to these products.

Vehicle Descriptions

Mutual funds, CITs, and SMAs are all investment vehicles that are professionally managed according to a predetermined investment strategy to meet a specified objective. Mutual funds are registered investment companies under the Investment Company Act of 1940 and are regulated by the Securities and Exchange Commission (SEC). They have an independent board of directors that oversees fund management and operations on behalf of fund shareholders. Mutual funds are managed in accordance with the guidelines set forth in the prospectus, the governing document for the fund.

CITs are commingled investment vehicles that are only offered to certain qualified retirement plans. Because they are not available to the general public, CITs are exempt from the investment company registration requirements of the Investment Company Act of 1940 (“40 Act”) and the securities registration requirements of the Securities Act of 1933. Unlike mutual funds, CITs are always sponsored by a bank or trust company, which serves as the fiduciary party and holds the legal title to the assets (though participating interests in a CIT are never subject to a bank’s creditors). Because they are sponsored by banks, CITs are regulated by the Office of the Comptroller of the Currency (OCC) or state bank examiners. CITs are established and governed by a Declaration of Trust, but their fees and investment



objectives are commonly defined in a separate document called the Statement of Characteristics.

SMA's differ significantly from mutual funds and CITs, because they are not pooled fund arrangements. Instead, they are unregistered portfolios of assets established for individual high net worth investors or institutions. SMA investors maintain direct ownership of the underlying assets, unlike mutual fund and CIT investors, who own shares (or units) of the larger pool. Underlying assets are traded specifically for each account owner. Securities registration requirements don't apply, since there are no securities created by an SMA. However, the SEC generally provides regulatory oversight for SMA's, provided that the investment adviser running the SMA is registered under the Investment Advisers Act of 1940. SMA's are governed by an investment management agreement.

Tradeoffs for Non-Public Vehicles

Non-public vehicles like CITs and SMA's offer certain structural advantages over mutual funds. At the same time, mutual funds enjoy benefits that non-public vehicles do not offer. Since fees are not the only factor one should consider when selecting investments, no one vehicle type will be right for all investors. Instead, the decision should be based on the particular investors' needs and circumstances and should take into account all relevant facts and circumstances.

First, we will review a list of common reasons that investors may choose a non-public product over a mutual fund:

1. Lower costs: Cost savings are typically the primary consideration for most plan sponsors when electing to use a CIT or SMA over a mutual fund. Because CITs are restricted from advertising to the public and since both are exempted from registering as an investment company (which eliminates the requirement to produce prospectuses, Statements of Additional Information, shareholder reports, proxy statements and other documents), CITs and SMA's generally have less overhead than mutual funds,

which translates into lower operational expenses. Transaction costs may also be lower for non-public products than for mutual funds. Since the investor base for CITs and SMA's caters to long-term retirement plan participants and prohibits retail investors, frequent trading is less of an issue.

2. Potentially higher standard of care: CIT trustees are ERISA fiduciaries and are held to ERISA fiduciary standards, meaning that they must act solely in the best interest of plan participants and avoid conflicts of interest. Mutual fund managers are not held to ERISA fiduciary standards, although they still must satisfy SEC fiduciary requirements. This distinction in standard of care is frequently evident in target date fund management. Many target date strategies utilize a fund-of-funds structure, whereby the overall portfolio is built from proprietary funds offered by the same management company. Target date mutual funds sometimes charge a management fee at the portfolio level, but almost always charge fees at the underlying fund level. Assessing fees on underlying funds creates a potential conflict of interest, because companies have an incentive to shift assets into underlying funds that generate more revenue for the fund complex. For CITs, such an arrangement would be considered a prohibited transaction under ERISA because the trustee (a plan fiduciary) could affect its own compensation. CITs must also avoid "double-dipping," or charging two layers of fees. As a result, most CITs simply charge a flat management fee for the overall portfolio and rebate any fees from the underlying funds. Others exclusively use non-proprietary managers in the portfolio.
3. Increased investment flexibility: For products using a fund-of-funds structure, CITs and SMA's may be particularly compelling, because unlike '40 Act mutual funds, non-public products may also own other CITs and insurance separate accounts, offering another reason for their structural cost advantage. There are also certain investment strategies, such as direct real



estate, that may offer diversification benefits within non-public portfolios but are restricted in a mutual fund setting.

4. Greater fee flexibility: In addition to potentially lower absolute fees relative to mutual funds, CIT and SMA fees are typically scaled according to investment amounts, and are often negotiable. Mutual funds have a stated expense ratio that is defined in the prospectus and that must be assessed to all clients who meet the minimum investment threshold, regardless of whether the client has \$1 million or \$100 million invested in the fund. Conversely, CITs frequently have breakpoints built into the fee schedule, so that clients are charged a lower asset-based fee as higher investment thresholds are met. Beyond standard fee schedules, custom fee arrangements are relatively common for CITs and SMAs.
5. Reduced cash flow volatility: In the case of CITs, whose investor base is limited to certain qualified retirement plans, CITs typically experience less cash flow volatility than retail mutual funds. Because redemption requests in CITs are generally more predictable and are of a lower overall magnitude than for mutual funds, CIT managers are frequently able to maintain very low cash balances, resulting in less cash drag. However, since CITs tend to be owned by a small number of retirement plans with relatively large balances, cash flows can be large if a plan leaves the CIT. Meanwhile, SMAs completely eliminate the possibility of having unexpected cash flows from outside the plan by virtue of being non-pooled. Reduced cash flow volatility may also lead to lower transaction costs for non-public products.
6. Increased customization: SMAs are designed around the needs of a particular client and can be highly customized. For instance, large publicly traded companies commonly build SMAs that won't transact in the sponsor's company stock. Since CITs are pooled vehicles, there are fewer customization opportunities than for SMAs. However, because CITs are intended for use by qualified retirement plans, they can be

designed to meet special demands of the qualified plan market.

7. Flexibility in fee payments: CITs and SMAs support net-of-fees and gross-of-fees pricing. This means that the trustee or investment manager can invoice investors directly, rather than simply netting fees from investment returns. This gives plan sponsors the flexibility to pay investment management fees outside the plan, if they so choose.

Mutual funds also offer certain advantages over non-public investment vehicles that may be important to plan sponsors. These advantages typically relate to how and how often portfolio data is disseminated. A more detailed list follows:

1. Daily valuation: Mutual funds are required to value their portfolio assets daily and to publish a daily Net Asset Value (NAV). CITs and SMAs are only required to value their assets quarterly. In practice, most CITs use daily valuation, although some CITs investing in alternative asset classes for which valuation data is difficult to obtain (e.g. directly held real estate) value portfolio assets on a quarterly or monthly basis.
2. Easy access to product information: Mutual fund performance is easily accessible via third-party providers, such as Morningstar. The primary responsibility for reporting CIT performance lies with the investment manager directly. As registered investment companies, mutual funds are also required to file most forms electronically using the SEC EDGAR database, something that facilitates compliance with ERISA 404(a)(5) and 404(c) requirements. Third-party performance reporting has traditionally favored mutual funds, as providers like Morningstar reported returns for mutual funds, but not CITs. However, since 2002 Morningstar has begun tracking performance and holdings data for CITs electing to list information in a public database. Although Morningstar's database does not yet include all CITs, third-party coverage of CITs continues to grow and expand.



3. NSCC traded: Historically, many CITs and SMAs did not trade on Fund/SERV, the platform used for processing and settling transactions offered by the National Securities Clearing Corporation (NSCC), putting them at a distinct disadvantage to mutual funds. This began to change in 2000, when CITs were added to the Fund/SERV platform. Today, most CIT trading is standardized and automated through the NSCC.
4. Name recognition: Since they are offered to a larger investor population than CITs, and can be advertised to the public, mutual funds generally have greater name recognition than non-public products.
5. Longer track records: Although exceptions exist, mutual funds often have longer performance histories than CITs. SMAs, by definition, have no prior performance history, although composite performance may be available, and can be shared with proper disclosure.
6. Scale: Because mutual funds have been around longer, they tend to have larger portfolios with more diverse investor bases than their CIT counterparts.
7. Fewer investor restrictions: Certain plan types, such as non-church 403(b) plans and non-qualified deferred compensation plans, cannot accommodate CITs and/or SMAs and must use mutual funds or other investment vehicles.
8. Fewer operational hurdles: Before sponsors can implement a CIT or SMA, they must execute an agreement between the investment manager and the plan sponsor. No such requirement applies for mutual funds.

Considerations for Investing in Non-Public Products

These tradeoffs might not hold for all product circumstances. When considering non-public products, we recommend assessing the manager's commitment to the business, any operational challenges that may exist currently, and portfolio characteristics that could pose future risks to investors. The following is a

representative set of questions whose answers can equip fiduciaries to make informed decisions concerning vehicle implementation.

For CITs:

- How large is the portfolio? How many plans are invested in the CIT, and what percentage of the total does the largest investor comprise?

This information is relevant in determining the vehicle's suitability for your plan, and how susceptible your participants will be to outside cash flows. If your plan's investment would comprise a large portion of a CIT's total assets, that might signal that an SMA would be more appropriate. A persistently small CIT asset base might foreshadow the investment manager's eventual exit from the business and liquidation of the CIT.

If a single investor controls a significant proportion of the CIT's assets, that investor's unexpected departure could create a cash flow problem that detrimentally impacts the remaining investors.

- Can the investment manager impose withdrawal restrictions on investors over a certain threshold? Are there requirements that withdrawals be transferred in kind to another vehicle, rather than first being sold inside the CIT?

If either of these questions is answered "yes," restrictions may offset the large CIT investor liquidity risk for the rest of the pool. This information can be found in the Declaration of Trust. Even if formal restrictions do not exist, certain types of investors, such as defined benefit plans, frequently transact via in-kind transfers. If the largest investor in the trust is a defined benefit plan, therefore, this fact could partially alleviate concerns surrounding the concentration of a CIT's investor base.

- Are the product's investment strategy and guidelines identical to that of the mutual



fund? How closely has performance tracked the mutual fund since inception?

This question presupposes that the CIT being reviewed seeks to mimic the strategy of an established mutual fund. If there are differing guidelines relative to the base strategy, plan fiduciaries must determine that the differences are suitable for the plan. If there are no stated differences, a close correlation between the returns of the mutual fund and the returns of the CIT is expected. Any performance discrepancies that cannot be explained by fee differences warrant further exploration and may be evidence of a lack of scale or cash flow trends that vary materially from those of the mutual fund.

- Who serves as the trustee for the CIT? Are trustee functions retained in house, or is a third-party trust company utilized? Does the trust company have an extensive history of operating CITs without compliance errors or service issues, and are the company's trading and operations divisions appropriately resourced?

Trustees serve a critical role in the operation of CITs. They are responsible for ensuring compliance with the Declaration of Trust, preparing all trust documents, maintaining records, reviewing and processing trades, performing ongoing due diligence of sub advisors, providing performance reports, reconciling positions, and calculating daily unit values, among other functions. Because the trustee is considered an ERISA fiduciary for the assets in the trust, the financial strength and Errors & Omissions coverage of the trust company is relevant to the CIT evaluation.

Determining whether investment managers and trustees are committed to maintaining the CIT is an important step in the due diligence process, particularly for CITs with smaller asset bases. Many large investment management firms retain the trustee functions for their CITs in house, while

others (generally those with fewer CIT assets) partner with third-party trust companies. In some cases, firms that retain trust services in house incur less overhead and can spread costs across a larger asset base.

- Is the CIT daily valued and NSCC traded? Does the trustee report unit values early enough to support same-day updates on the recordkeeping platform?

CITs that do not trade on NSCC or that cannot support daily asset valuation should generally be avoided by retirement plan sponsors.

For CITs and SMAs:

- Do fee arrangements avoid potential conflicts of interest and satisfy prohibited transaction rules under ERISA?

CITs are held to ERISA standards, but that doesn't necessarily mean that they actually follow ERISA rules. Ultimately, plan fiduciaries need to ensure that the product structure is ERISA compliant.

- Are monthly holdings reports and quarterly fact sheets produced by the investment manager? Does a third party independently verify performance? Do they provide performance data feeds into Morningstar's public database?

Having an independent and streamlined data source can significantly reduce the amount of administrative work that is often associated with conducting ongoing due diligence for non-public products. Not only can the use of third-party data providers improve efficiency, but it also reduces the likelihood that manual errors occur. Some investment managers and/or trust companies provide partial data feeds to Morningstar, while others only make information available on a private database. Industry best practice is to send complete performance, fee, and portfolio data for all



available share classes to a public database.

For SMAs:

- What are the cash flow expectations for the plan?

The performance of any portfolio is impacted by the cash flows into and out of the investment vehicle. Plans with stable and positive cash flows may be good candidates for SMAs, while plans with erratic cash flows, or net outflows may be better suited to a pooled vehicle.

- How confident is the fiduciary that the asset manager will be retained long-term?

Given that the costs associated with establishing and transitioning to/from an SMA are higher than for other structures, it is important for plan fiduciaries to gauge conviction in an investment manager before entering into SMA arrangements.

Conclusion

Plan sponsors and advisors have a fiduciary obligation under ERISA to ensure that expenses associated with their plan investments are reasonable in relation to services rendered. As CITs and SMAs have become more commonly available, plan sponsors have additional options to consider for cost reduction opportunities, in addition to traditional mutual funds. Multiple factors beyond potential cost savings influence the investment vehicle decision, and each plan fiduciary should decide which is right for their unique situation. As with most fiduciary practices, the eventual decision is less important than the process followed to arrive at the decision (and how well that process was documented).



Appendix I – Investment Vehicle Comparison Matrix

Legal Structure	Mutual Funds	Collective Investment Trusts	Separately Managed Accounts
Investor Restrictions	Generally none, unless specified in prospectus	Qualified DB and DC Retirement Plans only, no 403(b) plans except 403(b)9 church plans	Qualified DB and DC Retirement Plans only, no 403(b) plans
Vehicle Type	Registered, pooled investment vehicle	Unregistered, pooled investment vehicle	Unregistered, non-pooled investment
Asset Valuation Frequency	Daily	Normally daily, but at least quarterly	Normally daily, but at least quarterly
Ownership	Plan owns shares	Plan owns units	Plan is the owner of the SMA
Fiduciary Party	Independent board of directors	Bank or trust company	Plan committee
Regulatory Oversight	SEC, under the Investment Company Act of 1940	OCC or state bank examiners	SEC if dealing with an RIA registered under Investment Company Act of 1940
Governing Document	Prospectus	Declaration of Trust	Investment Management Agreement between manager and plan sponsor
Clearing	NSCC traded	Mostly NSCC traded	Trustee or custodian that is retained by fiduciary under the IMA
Direct Sponsor Agreements	None required	Agreement between sponsor and asset manager required	Agreement between sponsor and asset manager required
Management Fee Flexibility	Limited (same advisory fee applies to all share classes)	Significant (can offer tiered advisory fees)	Custom to the plan
Share Class Availability	Multiple options frequently offered	Multiple options frequently offered	Custom to the plan, generally zero revenue
Informational Accessibility	Extensive (broadly accessible via Morningstar and other sources)	Limited (rely heavily on provider fact sheets; Morningstar information available through paid database subscriptions)	Limited (rely heavily on provider fact sheets; Morningstar information available through paid database subscriptions)
Platform Availability	Extensive existing availability, new selling agreements occasionally required	Theoretically unlimited, but new selling agreements frequently required	New agreement required
Performance History	Generally more extensive than other vehicle types	Frequently shorter than for mutual funds	Non existent



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