Investment Management

Advancements in target date fund delivery

Weighing the pros and cons of collective investment trusts and customization in target date design

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Executive summary

Bank or trust company-maintained collective investment trusts (CITs)—pooled investment vehicles exclusively designed for qualified retirement plans—continue to gain attention from defined contribution (DC) plan sponsors and their advisors interested in optimizing retirement outcomes for participants. Customized target date funds—which employ a glide path specifically tailored to a plan sponsor's needs—and mutual funds represent additional structures.

Although each of these investment vehicles—CITs, mutual funds and custom target date funds—offers distinct features and potential benefits, target date CITs are becoming increasingly accessible and appear likely to play an expanding role in DC investment menu lineups for plans of all sizes.

This paper provides insights to help plan sponsors understand the features and potential benefits of CITs, mutual funds and customized target date funds, and when they may or may not make sense for a plan and its participants.

Key points

- Target date CITs typically offer expense advantages over mutual funds.
- Trading technology and wider availability now make CITs more accessible to plans of all sizes, even those with $250 million or less in plan size.
- Custom target date design typically involves greater fees, administration requirements and litigation risks, making such vehicles seem warranted only when unique plan factors make these vehicles more attractive than CITs.

CITs: A practical solution to help lower plan costs

CITs are widely used institutional vehicles that have been quickly emerging as a popular retirement plan alternative to mutual funds. A primary benefit of this structure is the potential cost savings. Expenses depend upon the strategy and asset class but tend to be less than a comparable institutional mutual fund.[1] These savings can be due to regulatory and operational differences, as well as generally lower administration, marketing and distribution costs.

Consequently, CIT interest and usage both continue to grow, driven primarily by heightened fiduciary sensitivities around plan fees and the Department of Labor's (DOL) 2013 tips for target date fund selection, which reiterated the importance of reviewing expenses when comparing strategies.[2] In the Callan 2018 Defined Contribution Trends Survey, 65% of larger plans reported using CITs in 2017, this is up from 43.8% of plans that reported using CITs in 2011. Moreover, adoption appears to be moving down market with more sponsors taking advantage of these cost benefits.

Comparing CITs and mutual funds

Many plan sponsors may already be familiar with the CIT structure through their lineups' stable value funds. Similar to mutual funds, bank or trust company maintained CITs are managed pools of assets that are typically priced and traded daily. There are, however, several key differences:

- **CITs are designed for tax-qualified plan assets.** On the positive side, this translates into generally lower trading volumes and less cash flow activity relative to mutual funds, which helps keep assets invested and reduces trading costs. Conversely, it also means CITs cannot be used for individual retirement accounts (IRAs) or held in retail brokerage accounts, which might affect participants leaving a plan who wish to in-kind rollover their assets.

- **Primarily regulated by federal and state agencies.** CITs are subject to federal or state banking regulations, and in some instances subject to both, while being exempt from the registration requirements of the Securities Act of 1933 and Investment Company Act of 1940. CITs are therefore not required to prepare a prospectus, although many banks publish comprehensive fund disclosure documents to improve transparency. In addition, CITs must follow IRS rules to retain tax-exempt status.
- **Subject to ERISA.** Because CITs are typically deemed to hold ERISA "plan assets", trustees generally serve as ERISA fiduciaries and must comply with ERISA fiduciary standards in managing the CIT, in essence offering a "built for fiduciaries by fiduciaries" investment vehicle that inherently aligns a CIT with investors' best interests.
- **A nimble structure.** CITs can be quickly created and allow investment flexibility to customize allocations for overall plan needs or to react to market events. The vehicles are generally less restricted in their investment universe, encouraging greater diversification and portfolio management flexibility. The nature of the structure also means they do not need to manage tax consequences. In addition, CITs may offer multiple share classes for different plan pricing situations or even allow for more customized pricing arrangements for larger plans.

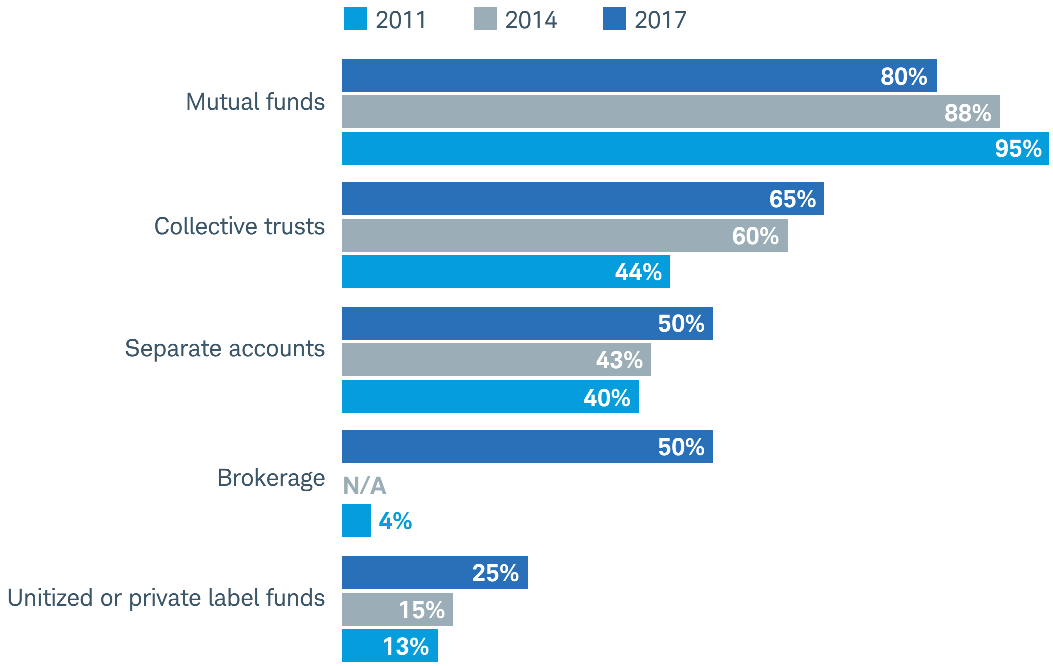
CITs provide many of the same major benefits traditionally associated with mutual funds, including professional management, accessibility, streamlined recordkeeping and daily valuation and liquidity.

While understanding these differences is important, CITs also provide many of the same major benefits traditionally associated with mutual funds, including professional management, accessibility, streamlined recordkeeping and daily valuation and liquidity, while generally being provided in a more cost-efficient structure for clients.

Of course, mutual funds may still be a more appropriate choice for plan sponsors more comfortable with the familiarity, transparency, offering prospectus and traditional SEC regulatory oversight of this structure. The ability to roll over assets into an IRA or other non-tax-qualified vehicles, and the ease of tracking performance in newspapers and other widely available sources, can also be important participant benefit considerations. Additionally, mutual fund solutions are readily available to plans of any size.

CIT adoption continues to grow

Does your plan offer the following investment types within the fund lineup?



Additional categories (2017 data): Fixed annuities (8.5%), Pooled insurance accounts (7.7%), Registered variable annuities (4.3%), ETFs (2.6%), Other (1.9%).

*Multiple responses were allowed. Some respondents offer multiple asset classes in each vehicle type, e.g., both stable value and another asset class are offered as a collective trust and/or separate account.

Source: Callan 2012 Defined Contribution Trends Survey, Callan 2016 Defined Contribution Trends Survey, Callan 2018 Defined Contribution Trends Survey.

Frequent CIT misconceptions

Even as CIT usage has expanded across a wider range of DC plans, several misperceptions persist that may be making plan sponsors hesitant to explore this typically lower fee alternative. In Table 1 are some common misperceptions about CITs.

Target date CITs can provide a cost-efficient strategy to help participants keep more of their retirement savings hard at work.

The bottom line

Target date CITs can provide a cost-efficient strategy to help participants keep more of their retirement savings hard at work. The structure offers a number of compelling benefits to enhance target date fund design, and as low-to-no minimum offerings become increasingly accessible CITs are likely to play an expanding, valuable role in developing DC investment menu lineups for plans of all sizes.

Evaluating custom target date solutions

Another option is custom target date funds, which are designed for a specific retirement plan and utilize a customized glide path and/or selected underlying strategies in portfolio construction. The Callan 2018 Defined Contribution Trends survey reported that the use of custom target date solutions has leveled off in the last few years settling in the low 20% range. In 2017, 20.7% of larger plans offered custom target date strategies down slightly from 20.9% in 2016. The DOL's selection tips also highlighted the need to inquire if a custom strategy may be a better plan fit.[3]

The potentially higher costs and elevated fiduciary risks of delivering a tailored strategy are usually most warranted for very large plans with distinguishing characteristics that make prepackaged offerings less effective. For example, a company may also offer a defined benefit (DB) plan, which could allow for a more aggressive glide path, or its employee demographics may be differentiated from the general working population, such as airline pilots who, as a group, typically retire at an earlier age.

Table 1: CIT misconceptions vs. our perspective

Misconception	Our perspective
CITs are not widely available on recordkeeping platforms.	Most CITs are now traded on Fund/SERV, allowing for much easier administration for plan recordkeepers.
CITs require high account minimums often out of reach of small- and mid-sized plans.	Minimum investment amounts have been trending lower in recent years, with multiple share classes allowing for different price points and even smaller mandates.
CITs lack transparency.	Similar to mutual funds, most CITs provide daily valuation and monthly performance and holdings, as well as tools like fact sheets, commentary and attribution. Many third-party data providers and plan consultants also now include CITs in their databases.

A decision to customize must evaluate the perceived benefits against any increase in costs to the plan or employees.

A decision to customize should evaluate the perceived benefits against any increase in costs to the plan or employees. Fiduciaries must not only consider the initial time and cost to design and build the custom solution but also consider the expenses needed to run it on an ongoing basis. Frequently, there may be fees from multiple service providers covering aspects such as unitization, custody, performance calculations and other periodic reporting. Factors such as these make customized TDFs less feasible outside of larger mandates. It also potentially places the onus on plan sponsors to demonstrate the delivery of a more optimized solution than the numerous industry TDF providers. Many of these providers offer long track records for a wide range of broad-fit options developed with deep resources and extensive asset allocation and DC investing research and experience.

Frequent custom design misperceptions

In Table 2 are three of the top reasons cited by plans for selecting a custom design, and why a tailored approach may not offer the best solution.

The bottom line

It may seem intuitively appealing, but the reality is that most participant populations do not require a custom design. Carefully consider whether the added costs, administration and risks genuinely help better position participants or if selecting the right glide path design from a prepackaged offering provides a more efficient way to optimize outcome potential.

Table 2: Reasons vs. our view for selecting custom design

Reason	Our view
Better cost structure.	A custom design can increase product and operational costs for plans with less size and scale.
Seek best-in-class underlying funds or to use funds in core lineup.	Existing open architecture target date funds may be a more suitable way to achieve this goal, without elevating costs or litigation risks to the same degree as a custom design. Optimizing outcome potential through portfolio construction is more nuanced than simply putting a group of top-performing funds together. It requires understanding how overall holdings work collectively and the additive characteristics of each as market conditions and participant life stages change, including the addition of strategies that may not be appropriate standalone investment options.
Prefer to control the glide path.	Without unique plan or participant factors, a custom design may be unnecessary and even potentially riskier to plan and participants. Most prepackaged glide paths have been developed with in-depth research.

Source: Callan 2018 Defined Contribution Survey.

Conclusion

Today's expanded tool box of DC investment design options can offer an array of useful solutions to help strengthen participant investment outcome potential. The interest in CITs and custom target date design offers added innovations for plan sponsors and advisors to help participants better prepare for their self-funded retirement goals. Advancements in technology, transparency and broader availability have helped more plans at all asset levels access the lower fees, greater flexibility and embedded fiduciary alignment of CITs. In contrast, the case for customization is less clear cut and may be a prudent choice for a relatively smaller number of plans. Deciding when either of these options makes sense in context of a specific plan's needs ultimately hinges on how effective they are in placing participants on a firmer path to retirement security.

About Charles Schwab Investment Management

With a straightforward lineup of core products and solutions for building the foundation of a portfolio, Charles Schwab Investment Management advocates for investors of all sizes with a steadfast focus on lowering costs and reducing unnecessary complexity.

Important Disclosures

Target date fund asset allocations are subject to change over time. The principal value of the funds is not guaranteed at any time, and will continue to fluctuate up to and after the target date. There is no guarantee the funds will provide adequate income at or through retirement. The funds are built for investors who expect to start gradual withdrawals of fund assets on the target date, to begin covering expenses in retirement. The funds are subject to market volatility and risks associated with the underlying investments. Risks may include exposure to international and emerging markets, small company and sector equity securities, and fixed income securities subject to changes in inflation, market valuations, liquidity, prepayments, and early redemption.

[1] Ignites: CITs: A Cheaper Option Many Sponsors Ignore, July 1, 2013.

[2] Target Date Retirement Funds–Tips for ERISA Plan Fiduciaries, U.S. Department of Labor, February 2013.

[3] *Ibid*.

Investors should consider risk tolerance and personal financial conditions along with age and retirement date when investing in target date funds.

Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

This information is being furnished as educational material and is not intended to constitute individualized investment advice. Readers are expected to consult with their legal or financial advisors as applicable.

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