f1360®

Fiduciary Focus: CITs Capturing Assets and Attention

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Topics

- CITs on the rise How they came into being and why they are taking off now
- Features and benefits
- Fiduciary responsibilities, regulatory oversight, and risk management
- How to perform due diligence on CITs
- Trends and suggested procedures for investment fiduciaries to follow
- Questions and answers

The purpose and origin of CITs

- 1927: First CIT goes live under state law. Created to lower expenses and improve risk management and performance in fiduciary accounts.
- 1936: Congress amended Internal Revenue Code, providing certain CIT's federal tax-exempt benefits.
- 1955: Pooling of pension, profit-sharing, and stock bonus plans authorized by the Federal Reserve; IRS grants tax-exempt status
- 1962: Congress transferred oversight for fiduciary activities of National Banks from Federal Reserve to the Office of the Comptroller of the Currency (OCC).
- 1980's: While used in some early 401k plans, CIT's lost favor to mutual funds due to transparency, trading frequency, etc. (stable value exception)

Source: Comptrollers Handbook on Collective Investment Trusts

CITs sales and offerings are taking off



- CIT assets in DC plans increased to \$1.51 trillion in 2014 from \$895.6 billion in 2008, an increase of 68% (per *Pensions & Investments*)
- 70.8% of plans offered at least one CIT in 2015, up from 60% in 2014, 51.9% in 2013, 48.3% in 2012 and 43.8% in 2011 (per Callan Associates)
- CITs have grown within Vanguard's DC-plan asset allocations to 20% in 2015 from 6.7% in 2010.
- Of the 4113 "surviving" CIT unit-classes in Morningstar's database, 1284 (31%) are less than three years old (as of 7/26/2016).

Drivers of CIT growth in DC plans

- The demise of Defined Benefit plans
 - CIT providers, need to adapt to survive
 - Former DB plan overseers shifted attention to their firms' DC plans
- Technology improvements
 - CIT's added to NSCC's FundServ® trading platform in 2000
 - Daily valuations the norm
- Transparency improvements
 - Morningstar CIT universe now exceeds 4,000 share-classes
 - CIT factsheets almost identical to Mutual Fund factsheets
 - Availability of CIT data in due diligence tools
 - 2012 DOL standardizes risk, performance, and expense disclosures
 - Micro-sites replaced newspapers as quote source
- Fee advantages
- QDIA success/DOL 2013 guidance on target date selection

Features and benefits

	CITs	Mutual Funds
Applicable account types	Qualified plans but no 403(b)	All account types
Primary Regulation	OCC, State Bank Regulators, DOL (via ERISA)	SEC, DOL (via ERISA)
Governance	Declaration of Trust Trustee (bank or trust company) govern.	Prospectus Fund Board (at least 40% independent) governs
Administrative Considerations	Not exchange traded Fees negotiable Potential liquidity barriers	Exchange traded Fees standardized Generally more standardized

Fiduciary responsibilities – 7 Precepts



- Follow applicable standards, laws, and governing documents
- Diversify assets
- Prepare an investment policy statement
- Use prudent experts and document due diligence
- Control and account for investment expenses
- Monitor the activities of prudent experts and service providers
- Avoid or manage conflicts of interest in clients' best interests







2. Diversify



3. IPS



4. Due Diligence



5. Expenses



6. Monitor



7. Conflicts

Regulatory oversight

- Office of the Comptroller of the Currency (OCC) Banking laws are primary
- Department of Labor (DOL)
 - Treated as plan assets subject to "look-through" rule
 - Trustee and adviser/asset manager are ERISA fiduciaries
 - All of the usual ERISA rules apply (prohibited transactions, disclosures, reporting, etc.)
- Securities and Exchange Commission (SEC)
 - Exempt from registration under the Securities Act of 1933 and Investment Company Act of 1940
 - Bank must exercise substantial investment authority
- Financial Industry Regulatory Authority (FINRA) Applies rules relating to firms' sales of exempt securities
- Other regulators IRS, CFTC, states, etc.

Risk management

- Plan fiduciaries must act "with the skill, prudence, and diligence under the circumstances then prevailing that a prudent person" would
- Plan fiduciaries must give considerations to facts and circumstances relevant to a particular investment or investment course of action
- Litigation, such as Bell, et al. versus Anthem Inc. and Pledger, et al. versus Reliance Trust Company
 - Type of investments used in 401(k); i.e. mutual funds, CITs, managed accounts
 - Relative costs for comparable investments
 - Other costs, such as recordkeeping
 - Prudent processes

Due diligence process overview



Needs

- Evaluate participant pool profile
- Review plan governing documents

Options

- Investment vehicle options: CITs, MFs, ETFs, SMAs
- Features, benefits, obstacles comparisons

Selection

- Investment due diligence: quantitative & qualitative
- Check prospectus or equivalent

Investment due diligence

- Minimum track record, with three years history as a suggested minimum
- Stability of the organization and tenure of managers
- Assets in the investment (particularly important in regard to anti-dilution measures)
- Alignment and consistency of the portfolio composition to the desired asset class allocation
- Style consistency with desired peer group representation in the portfolio
- Expense ratios and fees relative to peers
- Absolute and risk adjusted performance relative to peers
- Administrative issues, such as additional services and associated costs, liquidity barriers, disclosures, etc.
- Trustee/asset manager relationship ensure bank not 'renting charter'
- If used as a QDIA, evaluate the glide path and other considerations

Fi360's Fiduciary Score® for CITs

- Utilizes the same nine criteria and thresholds as the score for mutual funds
 - Regulatory oversight, track record, assets in the investment, stability of the
 organization, composition consistent with asset class, style consistency, expense
 ratio/fees relative to peers, risk-adjusted performance relative to peers, and
 performance relative to peers.
- Assesses CITs individually and compares results to pre-calculated MF results, scoring CIT's as an overlay against their peer MF category.
 - Morningstar's peer categories used for scoring
 - No stable value category within Morningstar's MF groupings, so CIT stable value funds compared against short-term bond MFs.

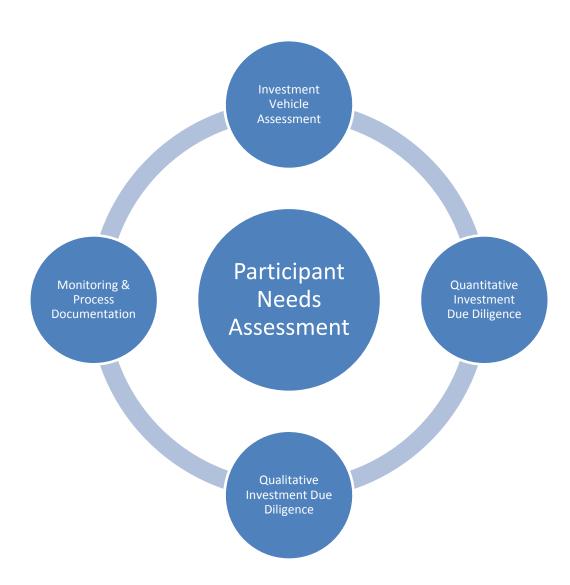
The fi360 Fiduciary Score® represents an objective means of comparing investments according to set criteria and is not intended, nor should it be used as the sole source of information for reaching an investment decision.

Trends

- Marketplace observations
 - CIT and QDIA trends are dovetailing
 - Vantage Point TDF's converted from MF's to CIT's
 - Morningstar/UBS CIT TDF launch in 2015
- Data from fi360/M* CIT Universe fi360 Fiduciary Score® for CITs
 - Improvements in CIT data reporting and usability
 - Scoring lag, from unit-class issuance, creates need for addition due diligence
- What to watch for in the future
 - Continued increases in CIT penetration, depth and breath
 - Discussions expanding beyond absolute fees

Ongoing fiduciary processes





Resources

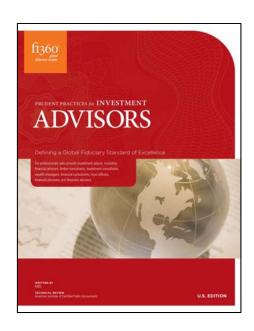
- The Coalition of Collective Investment Trusts (CCIT) http://www.ctfcoalition.com/
- Office of the Comptroller of the Currency (OCC): Collective Investment Funds
 Comptrollers Handbook, OCC's Asset Management group, May 2014
- "Is Cheaper Always Better? The Evolution of Collective Investment Trusts and Considerations for Plan Sponsors", Portfolio Evaluations, Inc., June 2016
- *fi360 Fiduciary Score*® *methodology* white paper, fi360,Inc., June 2016; http://www.fi360.com/fi360-Fiduciary-Score
- Fi360's Prudent Practices handbooks:
 - Designees can download from the Designee Portal
 - Practices can be viewed at www.fi360.com/practices
 - Handbooks can be purchased at <u>www.fiduciarystore.com</u>

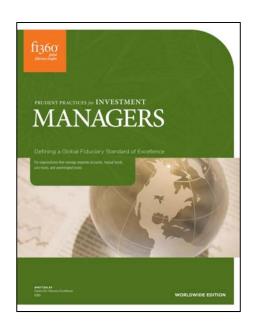
Prudent Investment Practices



- Define an Investment Fiduciary Standard of Excellence for professional fiduciary investment advisors
- Written by fi360, substantiated in law, regulations, and best practices
- Technical Review by the AICPA







Questions

Additional information on fiduciary trends can be found at fi360 Fiduciary Talk Podcast

www.fi360.com/fiduciarytalk

Also available on iTunes

and

fi360 Blog

www.fi360.com/blog

Questions about the content of this webinar or CE can be directed to support@fi360.com.