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The CIT Opportunity

The Critical Role of the Trustee

According to the Investment Company Institute (ICI), employer-sponsored retirement plans held assets totaling $27.1 trillion at the end of 2018, up 12.9% from year-end 2015.[1] Of that, employer-sponsored defined contribution (DC) plans accounted for $7.5 trillion, of which collective investment trusts (CITs) are estimated to account for 25% by the end of 2020, up from 14% in 2013.[2] To capitalize on the popularity of CITs and the accompanying growth in industrywide assets, investment managers must ensure that they fully understand the nuances inherent in the CIT product structure, including the array of services that different trustees provide. Not commonly understood, the role of the CIT trustee is critical and is executed heterogeneously by different trustees.

As a follow-up to our 2017-18 series for investment managers participating in the U.S. retirement marketplace, SEI, in collaboration with the Retirement Leadership Forum (RLF), is releasing a new series of briefs. Each brief will provide a deeper look into how the industry's top firms are using CITs to gain success in the DC market.

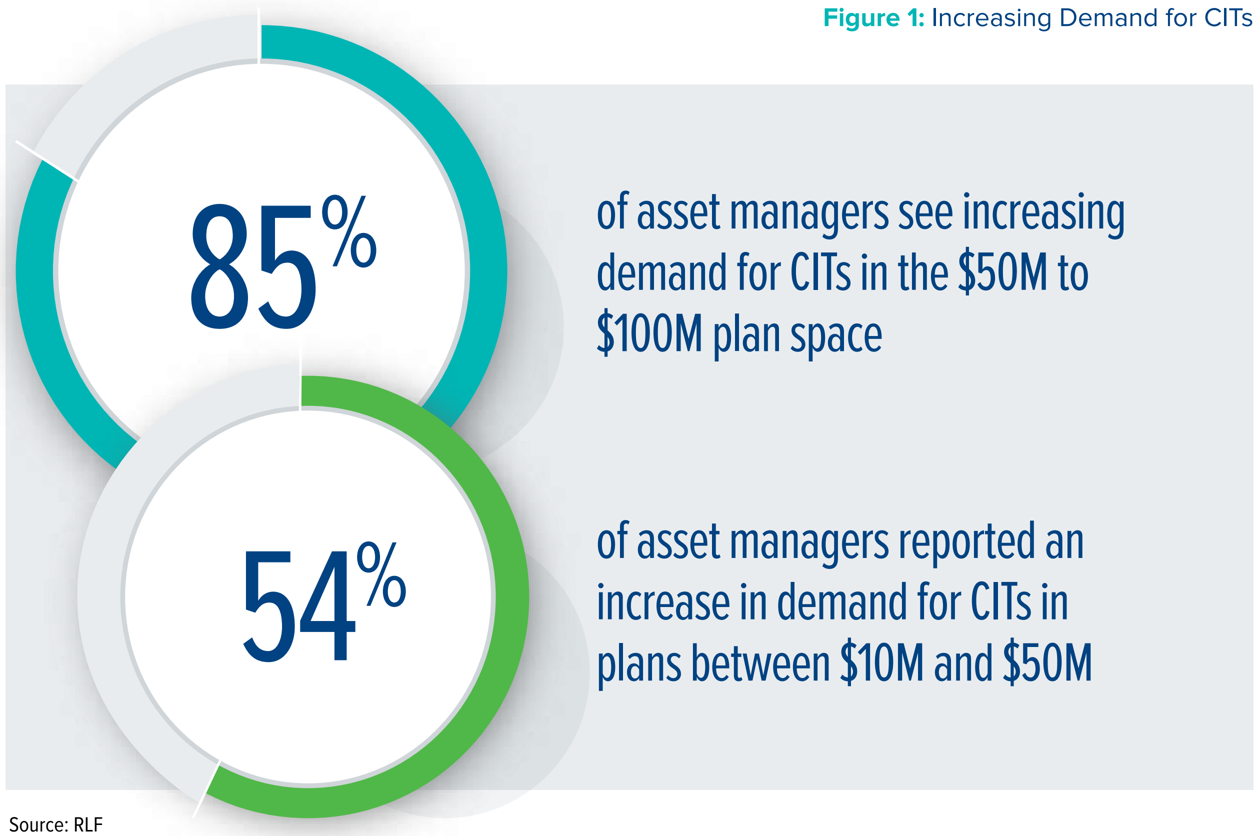
The second brief in our four-part series will explore how leading trustees are evolving into true product development partners who can play a more significant role in CIT offerings. We will discuss:

- The current trustee landscape for CITs
- What makes a good trustee: the view from asset managers
- New trends toward flexibility and innovation in trustee partnerships
- The opportunity to work with a leading trustee

The current CIT landscape

CITs are making a comeback in the retirement plan space, taking share from separately managed accounts in the large market and from traditional mutual funds in the small and mid-markets.[3] Their advantageous pricing, flexible structure and speed to market are leading to more widespread use of the vehicles in a retirement market that places high value on low cost and efficiency. CITs are strengthening their traditional foothold in the large market—according to Callan, 75% of plans reported using at least one CIT in 2018, up from 44% in 2011.[4] Additionally, asset managers we surveyed also reported a significant increase in demand for CITs in the small-to-mid-market. Eighty-five percent of managers reported an increase in demand in the $50 million to $100 million plan space, and 54% reported an increase in demand in the plans between $10 million and $50 million.[5]

Figure 1: Increasing Demand for CITs



Source: RLF

Responding to this demand, asset managers are rapidly rolling out additional CIT versions of their mutual funds, retooling their CIT share classes, and customizing pricing structures to complement their distribution strategies. These actions are part of the reason for the recent increase in CIT flows, but other trends are contributing to their resurgence as well. In the large market, separate account providers are moving more business to CITs because of their cost advantages, and consultants are building white-labeled CIT solutions to help sponsors simplify investment lineups. In addition, CITs are finding their way into smaller plans, as recordkeepers launch custom products that capitalize on CITs' flexible pricing structure.[6] Also, in the small and mid-markets, independent advisory firms and individual financial advisory practices are building custom investment portfolios as part of a white-labeled, managed account or target date fund offering.

In the 2019 SEI paper, "Capitalize on the Demands for Customization and Collaboration," we highlighted the strategies successful asset managers are implementing to participate in all facets of the CIT opportunity. Those include aligning sales and relationship resources to the CIT opportunity, building incentive and compensation programs that target CIT growth, and educating stakeholders about the merits and applicability of CITs across market segments.

The broader growth of CITs has driven asset managers into deeper partnerships and to new levels of collaboration with their intermediary and recordkeeping counterparts. However, amid these expanding partnerships, many asset managers have overlooked the potential role a trustee can play in a successful CIT strategy.

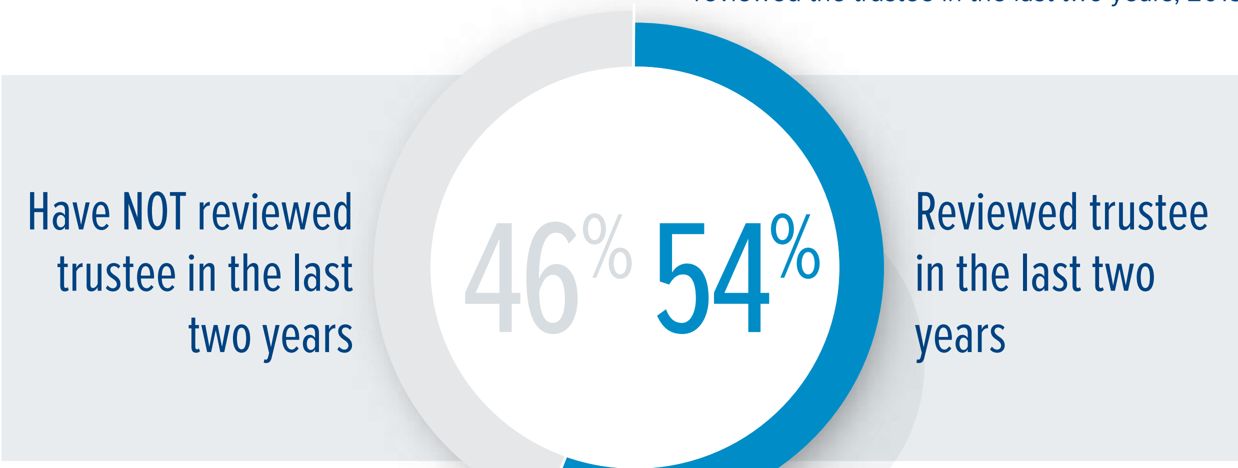
What makes a good trustee?

As a starting point, it's worth reviewing the critical services a trustee provides in a CIT offering:

- **Trust establishment:** Establishing and maintaining the trust, the sub-trust/fund structure and all of the associated documents.
- **Investment guidelines:** Providing investment guideline development, approval and ongoing oversight. When drafted properly, this important control document prevents managers from drifting outside their fund objective and/or using underlying investments that aren't permitted in a CIT structure.
- **Onboarding process monitoring:** Ensuring that all incoming investors are treated appropriately, experience a smooth onboarding process and are invested in the suitable share class.
- **Investor oversight:** Providing approval, monitoring and ongoing support of all investors, ensuring that investors' trades are handled appropriately and that they remain invested in the correct share class—recognizing that, depending upon the documents, their share class eligibility may change in direct response to the market value of their position or their affiliation with a particular consultant or professional firm.
- **Investor eligibility:** Ensuring compliance with tax and U.S. security laws by preventing ineligible investors from participating in the CIT.
- **Regulatory and investment compliance:** Ensuring that compliance with the appropriate CIT regulatory standards is actively and accurately occurring.
- **Marketing material oversight:** Ensuring that marketing material is developed and used in a way that meets CIT marketing standards, understanding the differences in collateral that is developed for consumption by the plan sponsor/plan consultant versus materials that are intended for use by plan participants.

While most trustees offer these baseline services, how these services are delivered depends on whether asset managers work with an internal (i.e., an affiliate) or third-party trustee.[7] More than half of asset managers have an internal trustee and tend to give them high marks for being a good partner who makes it easy to deliver CITs to clients. However, working with an internal partner comes with challenges. Several asset managers in our research commented that their internal trustee employs more conservative practices than what they have seen from third-party trustees, ranging from being less willing to take on measured risk to an unwillingness to improve the efficiency of standardized processes. In addition to the rise of co-manufactured products (that require a third-party trustee), this conservatism has in fact driven firms to reassess their trustee relationship. As noted in the RLF 2019 DCIO Survey, we found that 54% of asset managers considered seeking new trustee business relationships in the last two years. Yet even after thorough analysis, most decided to stay with their internal trustee largely because the relationship provides a healthy revenue stream for their firm. Only one surveyed firm decided to move from an internal to third-party trustee during the last two years.

Figure 2: CIT providers who have/have not reviewed the trustee in the last two years, 2018.



Source: RLF

Asset managers with a third-party trustee relationship realize a number of advantages that offset the potential revenue loss and coordination costs, according to executives interviewed for this research. First and foremost, managers benefit from a third-party trustee's breadth of experience. Third-party trustees with a long history of working with other leading investment firms bring a much broader perspective to the table. One large asset manager with AUM of approximately $700 billion elaborated on this advantage: "We are constantly reevaluating our share class offering and working with a third-party trustee that understands industry standard helps us evolve and simplify our offering."

As noted earlier, some asset managers feel that the key advantage of an internal trustee is simplicity. However, the feedback from those working with third-party trustees indicated that they are even easier to work with than an internal one. One leading asset manager commented, "I have a direct line to the head of business, so if anything goes wrong with a client, I know I have an ear, and that's extremely valuable." Going hand-in-hand with accessibility, "ease of doing business with" is a phrase frequently echoed by asset managers. Working with a third-party trustee who has an incentive to do things in a very efficient manner that streamlines the process for plan sponsors and asset managers is important. This is one reason that third-party trustees are especially popular with asset managers looking to drive CIT adoption, particularly in the small and mid-markets. One asset manager we spoke to for this survey stated: "Our trustee has simplified their participation agreement and made it easy to show plan sponsors' performance out of the gate. That helps a lot as we try to make the product more mainstream and drive adoption down market."

Finally, asset managers benefit from the broad fiduciary expertise of their third-party trustee partners. In RLF research interviews, asset managers commented on the value added by their trustee's fiduciary input and oversight to ensure that CITs stay within the parameters of their product offering. The most established trustees have Employee Retirement Income Security Act (ERISA) counsel on staff and offer a direct line to clients for any fiduciary questions. These ERISA attorneys also spend a great deal of time working with asset managers and clients on complex letters of understanding, where their knowledge and expertise is invaluable. For example, because plan sponsors need to conduct in-depth due diligence on their service providers before implementation, working with an experienced ERISA attorney will help provide them with added comfort and confidence prior to making an investment in the respective CIT. Finally, in a world where fiduciary lawsuits are a real threat, both asset managers and the CIT investors will benefit from the protection offered by an experienced trustee.

Trends in third-party trustee partnerships

With access to a handful of third-party trustees that have a history of delivering seamless service, it's easy for asset managers to view the trustee as nothing more than a fungible commodity. However, in the current DC environment where recordkeepers, asset managers and intermediaries are creating complex asset management partnerships, the trustee relationship should not be overlooked. Instead, it should be made a point of focus. In fact, some recent product development initiatives have caused asset managers to rethink their stance.

> **For example,** in the face of unrelenting margin pressure, many recordkeepers and intermediaries are turning to the asset management business as a new source of revenue. The typical example is one where a recordkeeper works with an asset manager to build co-manufactured products (target date suites, personalized QDIA offerings and managed account-type products) that contain a mix of proprietary and open architecture investments. A majority of these products use CITs as the underlying investments and, because they use multiple asset managers, require a third-party trustee.[8]

Intermediaries are taking an approach like those of recordkeepers by creating custom investment products to offset fee compression and provide a source of differentiation in a competitive sales environment. In the large end of the market, firms like Mercer have created custom asset management solutions available exclusively to their plan sponsor clients. In the small to mid-market, newly launched solutions range from NFP's FlexPath to CAPTRUST's Advisor Managed Accounts. Each of these examples heavily relies on CITs for the underlying asset management vehicles.

It's important to note that with these customized solutions, the intermediary or recordkeeper selects the trustee. As a side benefit, every new product launch is an opportunity for asset managers to work with a new trustee and be exposed to what each brings to the table.

Interestingly, while many asset managers view the work involved in moving legacy business over to a new trustee as a major undertaking, it's relatively easy to work with additional trustees for newly launched funds/strategies with little downside. With an efficient due diligence review, firms can typically have a

CIT up and running with a new third-party trustee in four to eight weeks, depending upon the investment strategy. Client-facing staff will just need to understand the differences in paperwork and process. For example, some trustees may have longer or shorter participation agreements, and some firms may have different processes for onboarding or answering investor questions to satisfy investor requests for clarity.

This is also an effective means of comparing trustees. By opening up funds with a new trustee, asset managers can directly experience how working with that trustee will progress, and they will be able to compare one versus the other. As with any other outsourcing relationship, if they have a positive experience, they may evaluate the possibility of consolidating legacy business with the new trustee.

2019 Expanded Trustee Role

- Serve as a fiduciary for the trusts
- Select (and remove) the investment managers and sub-advisors who execute the investment strategy and manage the portfolio assets for the trust
- Responsible for compliance reporting, fee disclosures, investor fact sheets, and communications
- Share thought leadership and weigh in on:
  - Product development ideas
  - Pricing and share class strategies
- Provide insight into the latest fiduciary rules and regulations

Source: Brown Brothers Harriman

As asset managers look to participate in more of these custom product opportunities, a trustee can be an important partner for many reasons. First, top trustee firms can act as a key source of intelligence for their asset manager partners, sharing information on the competitive landscape and their perspective on best practice. This is also where a trustee's experience with a breadth of asset managers, plan sponsors and intermediaries pays dividends. Trustees' insights into the challenges that each of these firms faces allows them to suggest creative options and outside-the-box solutions to meet a client's specific needs. For example, one leading trustee we interviewed was working with multiple asset managers to create a CIT lineup for a large plan sponsor and noticed the client was becoming overwhelmed by the conversations and steps with multiple asset managers.[9] Recognizing the opportunity, the trustee suggested that the asset managers work together in a customized, multi-manager solution that better suited the client's needs. The trustee's strong relationship with each of the underlying asset managers and thoughtful solution benefited all parties involved.

While trustees can help asset managers identify new solutions and understand best practices, they are also there to keep the fiduciary guardrails in place amid a rapid acceleration of CIT innovations. Their ERISA counsel can provide a view on what may be overstepping the limits of the vehicle. Leading trustees typically employ a deep bench of legal expertise to help keep asset managers in compliance and up to speed on the latest fiduciary rules and regulations, which also includes an understanding of the various requirements of banking and security laws. Offering this type of insight and thought leadership is another example of how a deeper partnership with a trustee can pay dividends.

The opportunity

Trustees have always been viewed as a very clinical part of the CIT offering. Their services are a necessity, but asset managers and intermediaries (or recordkeepers, for that matter) haven't spent much time considering the broader value a trustee may bring. Looking to bring more value to the table and rise to higher partnerships standards, leading CIT trustees are broadening their role and becoming more flexible in their offering. Asset managers who don't take advantage of potentially having another expert set of eyes during the product development process, during strategy meetings or even just in day-to-day operations are missing out on an opportunity to improve their CIT offering and better serve their clients. The question asset managers need to ask themselves is, "Am I getting more from the trustee in 2019?" If not, it's time to revisit that relationship.

References

[1] Investment Company Institute, Investment Company 2019 Fact Book.

[2] RLF analysis.

[3] Callan 2019 DC Trends Survey; 2019 RLF DCIO survey.

[4] Callan 2019 DC Trends Survey.

[5] 2019 RLF DCIO survey.

[6] RLF Research Interviews, January-July 2019.

[7] RLF 2019 DCIO Survey.

[8] RLF Research Interviews, January-July 2019.

[9] RLF Research interviews, January-July 2019.

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After 50 years in business, SEI (NASDAQ:SEIC) remains a leading global provider of investment processing, investment management, and investment operations solutions that help corporations, financial institutions, financial advisors, and ultra-high-net-worth families create and manage wealth. As of September 30, 2019, through its subsidiaries and partnerships in which the company has a significant interest, SEI manages, advises or administers $1 trillion in hedge, private equity, mutual fund and pooled or separately managed assets, including $335 billion in assets under management and $662 billion in client assets under administration. For more information, **visit seic.com.**

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RLF RETIREMENT LEADERSHIP FORUM

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The Retirement Leadership Forum (RLF) is a best practices research firm serving the needs of more than 30 recordkeeping and DCIO businesses. Spun out of the Corporate Executive Board, the RLF has more than 15 years of research published in the retirement space. The group is known for providing leading industry insight and hosting superior executive events. For more information, please visit **www.retirementlf.com.**

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