The CIT Opportunity

Protecting Pricing in the New CIT Landscape

As the demand for Collective Investment Trusts (CITs) in US-based Defined Contribution (DC) plans gains momentum, asset managers must build a comprehensive strategy for CIT share class creation and pricing that helps them capitalise on the opportunity without further eroding profitability.

This is the third brief in our four-part series, developed in partnership with the Retirement Leadership Forum (RLF), focusing on how the industry's top firms are using CITs to gain success in the DC market. In this installment, we outline how asset managers are reacting to the current CIT pricing and share class landscape.

Key topics include:

- The evolution of CIT pricing and share classes
- Factors driving the pressure to create lower-cost share classes and offer relationship pricing
- Best practice tips from leading asset managers

Pressure from all sides

According to the Investment Company Institute (ICI), employer-sponsored retirement plans held assets totaling US$27.1 trillion at the end of 2018, and of that, employer-sponsored defined contribution plans accounted for US$7.5 trillion. CITs are estimated to account for 25% of DC assets by the end of 2020, up from 14% in 2013.[1]

This growth in CIT popularity started as large plan sponsors, encouraged by consultants and advisers, looked to decrease the cost of their DC plans. Historically, meeting this demand meant that all an asset manager had to do was to simply offer a CIT version of a mutual fund at a discount. Recently, however, a significant uptick in demand from intermediaries and recordkeepers for customised or co-manufactured products has added a significant amount of complexity to managers' CIT strategies. For example, asset managers report that these requests often require them to add new share classes, offer relationship pricing, accept lower minimums or combine all three (Figure 1).

As distribution partners increasingly demand discounted CIT pricing to improve their competitive position, asset managers face difficult choices and must strike a careful balance about 'when to say yes.' While seeking to capitalise on sales opportunities and adding top-line revenue, managers must also protect against margin erosion from the increased cost of managing additional share classes and offering special pricing arrangements.

Figure 1: Factors pressuring CIT share class structure and pricing

NATIONAL CONSULTANTS

Goals:

› Negotiate best pricing for large plan sponsors

› Generate revenue from OCIO programmes

RECORDKEEPERS

Goals:

› Differentiate with exclusive investments

› Generate revenue from asset management

ADVISERS

Goals:

› Generate revenue with multi-manager CITs

› Leverage scale to get best pricing for smaller plans

PLAN SPONSORS

Goals:

› Leverage scale to get best pricing for participants

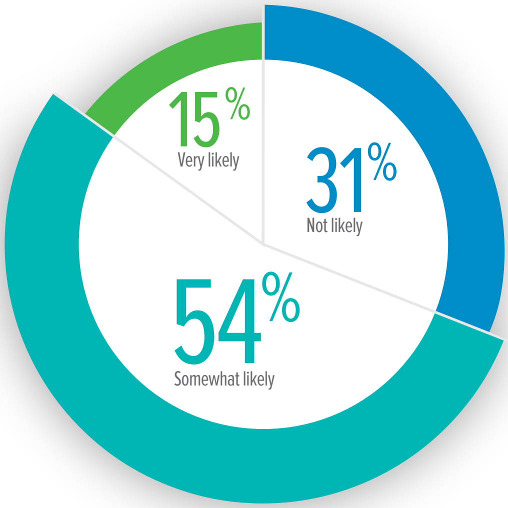
Resulting pressure on asset managers

- Roll out 'special' CIT share classes for new products
- Offer CIT relationship pricing
- Lower CIT minimums

Source: RLF

With this in mind, many managers are reassessing their approach to pricing. Almost 70% of managers surveyed by RLF in mid-2019 indicated they are likely to revise their CIT share class strategy in the coming year (Figure 2). The key theme behind these changes is how to implement a rational approach to pricing, minimums, and share class creation, one that weighs the need for sales growth against the economics of running a business and their desire to maintain margins.

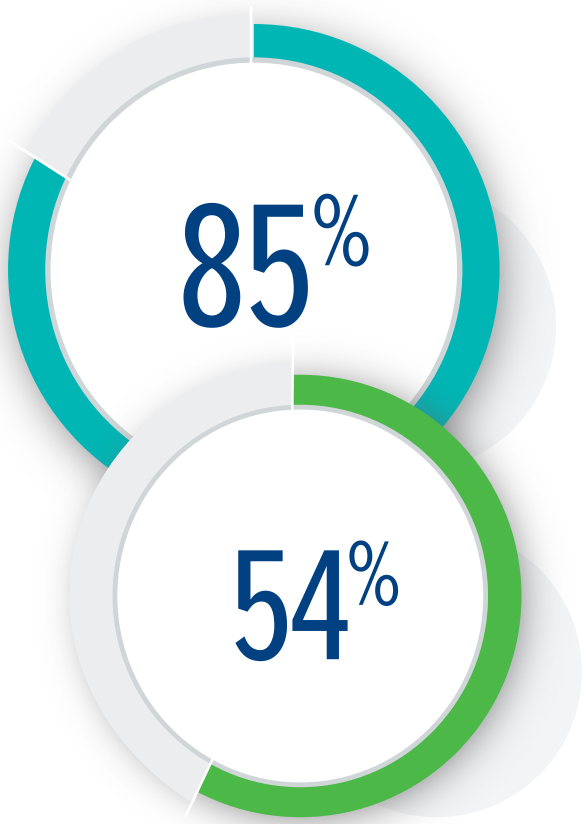
Figure 2: Firms' likelihood to revise CIT share class strategy in next 12 months, 2019



Source: RLF

CITs are continuing to gain momentum 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.[2] According to Callan, 75% of plans in the large market report using at least one CIT in 2018, up from 44% in 2011.[3] Asset managers surveyed by RLF also reported a significant increase in demand for CITs in the in the small-to-mid-market: 85% of managers reported an increase in demand for CITs in the US$50 million to US$100 million plan space, and 54% reported an increase in demand in the plans between US$10 million and US$50 million (Figure 3).[4] CITs' advantageous pricing, flexible structure and speed to market have led to more widespread use of the vehicle in a retirement market that places high value on low cost and efficiency.

Figure 3: Increasing demand for CITs



Source: RLF

The evolution of CIT pricing and share classes

From a pricing and share class perspective, asset managers find themselves following a path that closely resembles the evolution of the '40 Act fund in the DC space. That is, similar to how mutual fund share classes evolved from those with sizeable revenue sharing to today's so-called 'clean shares,' CITs have evolved from vehicles that typically included a revenue sharing component to ones designed for a low-cost, transparent pricing environment. The ICI summarised the evolution as 'driven by a major shift in the industry's business model, as more investors pay directly for investment advice and assistance from investment professionals, rather than indirectly through fund fees.'[5]

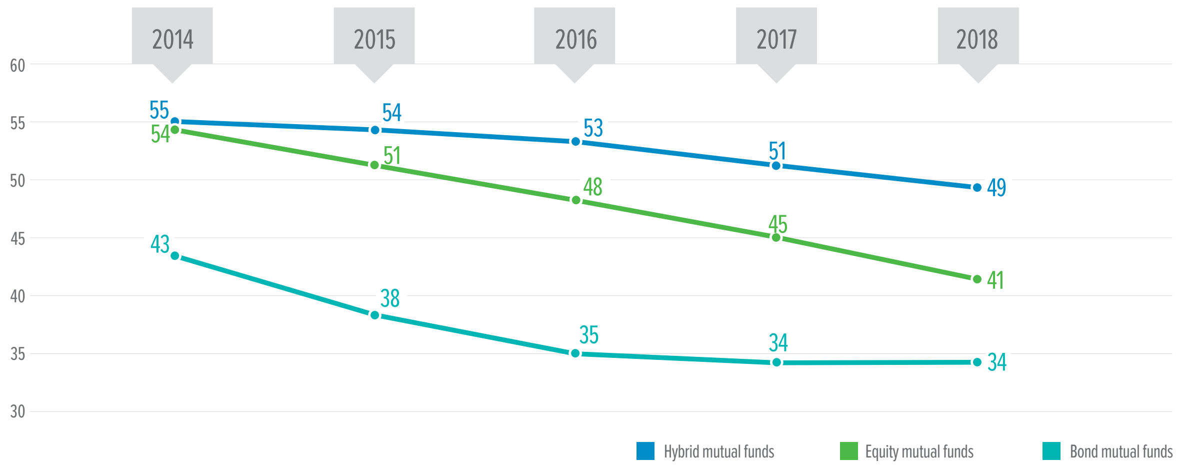
Asset managers are keenly aware of the shift in CIT share class structures and its effect on their CIT offering. A large asset manager's comment on share class creation was typical of the industry sentiment expressed in interviews for this report: 'If we roll out a new share for a CIT class today, it won't have any revenue sharing component, and it's likely to be cheaper than the last one we created.' Another large asset manager noted: 'We don't have any CITs with revenue sharing components...[having] shut them all down and moved the assets into other vehicles.'

However, as the prevalence of share classes with revenue sharing has declined, it's been more than offset by a proliferation of share classes driven by three important DC trends: fee pressure, the advent of outsourced CIO (OCIO) programmes, and the push for higher levels of personalisation in the plan. To understand the challenge this creates for asset managers, we'll look at each of these trends in more detail.

1. Continued industry fee pressure

Finding ways to lower investment management cost, of course, is paramount and the main catalyst behind the rollout of new CIT share classes. The pressure on asset management fees has been extreme, evidenced by the drop in average expense ratio of DC investments across all asset classes since 2014. Most significantly, equity funds, where the largest portion of participant assets are invested,* saw a drop of 13 basis points (bps) over the five-year period ended 2018, the largest of any asset class (Figure 4).[6]

Figure 4: Average cost of DC investments by asset class (in basis points)

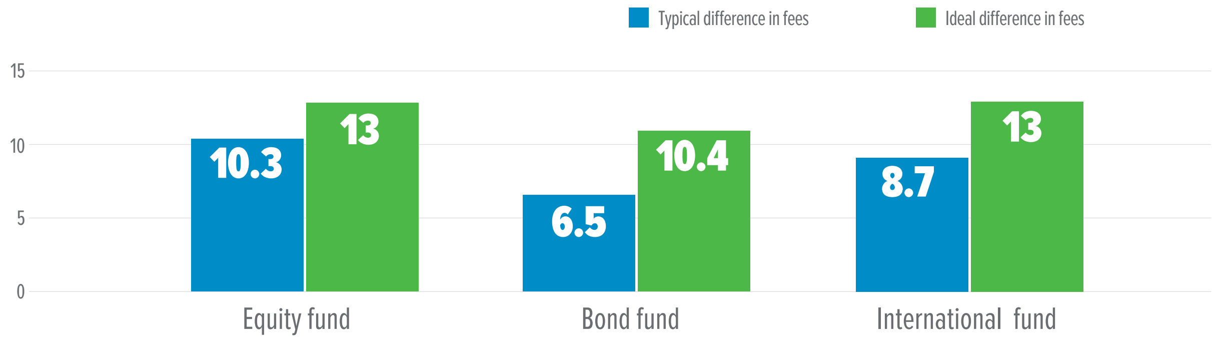


Source: ICI

* EBRI reported that 44% of 401(k) assets were invested in equities in their September 2018 401(k) Balances, Asset Allocation, and Loan Activity Report.

Many managers have turned to CITs because they allow them to quickly and inexpensively roll out new share classes as demand for low-cost vehicles intensifies and pricing continues downward. As one manager told us: 'To win business, we need to have the right vehicle at the right price at the right time. If we fail to deliver quickly, we lose; CITs help us here tremendously.' Indeed, an RLF comparison of CIT to mutual fund pricing shows how significant the price difference can be between the two: 10 bps for equity-type investments, 6.5 bps for fixed income and almost 9 bps for international. Moreover, asset managers believe they need to push the differences 3 to 5 bps higher to keep up with trends in the DC market (Figure 5). Because asset managers have to create a separate class for each new price point, there is a strong correlation between falling asset management prices and the increasing number of share classes.

Figure 5: Difference in fees (in bps) between CITs and lowest-cost mutual fund share, 2019



Source: RLF

While price pressure is the primary driver of CIT share class proliferation, asset managers cited two other trends that are driving the growth of CITs and the number of share classes within them.

2. Outsourced CIO programmes

The increasing popularity of OCIO programmes in the large DC market was mentioned by all of the asset managers interviewed for this report as an important driver of new CIT share class rollouts. According to a 2019 Pensions and Investments survey,[7] OCIO mandates with US DC clients grew 44.2% to US$164 billion between 2018 and 2019. During the same period, OCIO managers reported a total of 3,252 DC plan clients in 2019, up 66.3% over the prior year.

Given these growth rates, asset managers are eager to get their investment strategies onto the approved lists of the top OCIO providers. CITs are ideal vehicles for OCIOs because of their flexibility and pricing advantages. Because these OCIO programmes have the potential for generating significant flows to the asset manager, the latter are typically willing to create new share classes with preferential pricing.

3. Custom investment products

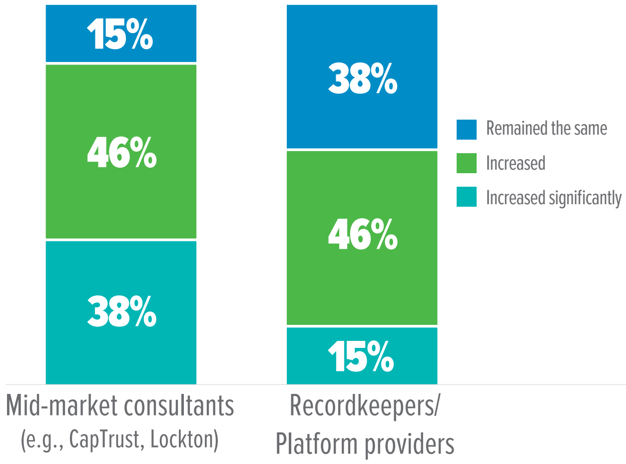
Intermediaries and recordkeepers, seeking to differentiate their offerings in the crowded retirement space are increasingly leaning on their asset manager partners for support in creating custom investment products (Figure 6). CITs are often the vehicle of choice because their flexibility allows them to work well within some of the more innovative products hitting the DC market.

Examples of custom investments where CITs play a significant role include:

- **Multi-manager CITs.** Asset managers are increasingly being asked to participate as a sleeve in CITs created and managed by large RIAs. The RIAs use the promise of significant flows from across their plan sponsor client base as leverage to drive pricing concessions from the asset managers. To meet the pricing requirements for these products, asset managers are often forced to create new share classes with lower fees.

- **Co-manufactured products.** RIAs and recordkeepers are increasingly demanding that asset managers create custom investment products available exclusively to their clients as sources of differentiation and revenue enhancement. As such, asset managers are typically driving product development and rollout for co-manufactured products rather than using multi-manager CITs. These typical offerings might include CIT versions of an asset manager's target date fund complex, at the core, with enhancements designed to make it unique in the marketplace (e.g., by including the recordkeeper's stable value component or a glidepath exclusive to the RIA). As with multi-manager CITs, pricing levels needed to win these exclusive deals often cause asset managers to roll out new share classes with discounted pricing.

Figure 6: Changes in demand for custom investment products, 2019 vs 2018



Source: RLF

While asset managers generally look favourably on these product developments because they represent opportunities for additional asset flows, the rapid rollout of new share classes, each typically with lower expense ratios and management fees, are cause for concern (Figure 7).

Figure 7: Complexity of typical share class structure for a real estate CIT in 2019

Real Estate CIT	Founders' Class	48	Available to participating plans until the date that is the one-year anniversary of the initial funding date or until the fund assets reach US$250 million	'Founders'' class for initial investors
	Class 1	82	Class 1 is open to participating plans initially investing up to US$50 million	Discounts for large initial investments
	Class 2	72	Class 2 is open to participating plans initially investing between US$50 million and US$100 million	
	Class 3	62	Class 3 is open to participating plans initially investing US$100 million or more	
	Class C	52	Class C is open only to participating plans that are entering the fund through mega consulting	Special share class for OCIO programme
	Class R	50	Class R is open only to participating plans that are entering the fund through maxi recordkeeper	Special share class for recordkeeper's co-manufactured product

Source: RLF

The primary area of concern is revenue. Many managers interviewed for this report expressed concern that CIT pricing will undercut the higher price points of traditional mutual funds. In a 2019 RLF survey, 66% of asset managers pointed to the cannibalisation of their mutual funds (and the concomitant loss in revenue) as the most critical challenge to their CIT strategies. Without the appropriate level of CIT pricing discipline, asset managers fear exacerbation of the fee pressure trend. One executive at a large fixed-income manager lamented that 'CITs will accelerate the race to zero that all of my peers and I are fighting against.'

A secondary concern is the explicit and implicit costs to manage the increasingly unwieldy number of CITs and their associated share classes. Indirectly, more complex share class structures require more management time from the investment product teams and make it harder for sales teams to tell a clear pricing story. Finally, there are potential relationship costs if one client of the asset manager (consultant, recordkeeper, adviser) discovers that another has been offered lower pricing.

A third area of concern is insufficient benchmarking. Unlike with mutual funds, as asset managers attempt to price their CITs, there is no widely available set of industry data to benchmark pricing and share class offerings. The most reliable source for pricing data is the larger third-party trustees; due to confidentiality, they cannot share specific pricing data, but they can leverage the insight from working with dozens of managers to guide discussions around CIT pricing. To underscore the current importance of this information to managers, one trustee commented that over 50% of the inquiries they receive from managers involve pricing and share class opportunities.

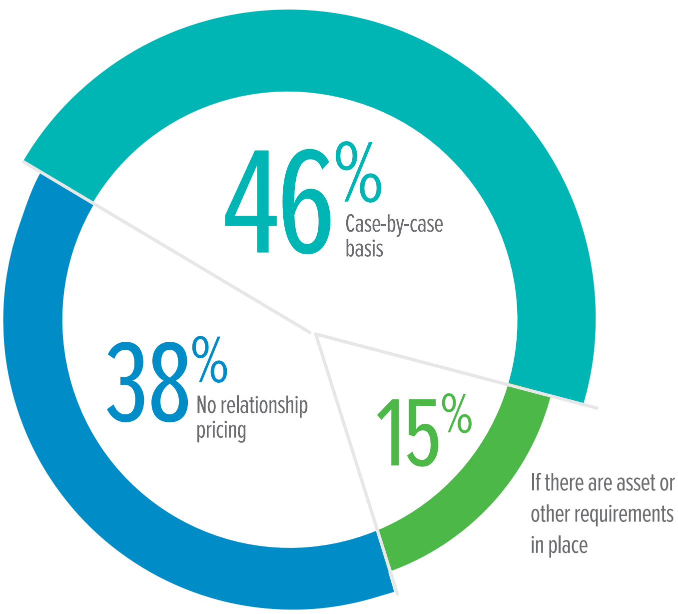
The mandate for asset managers is a difficult one. They need to continue to drive net flows to their firm, and CITs offer a promising outlook, especially for managers willing to create 'special' share classes for their key distribution partners. At the same time, asset managers must guard against accelerating the already alarming trend of eroding fees and find the right balance between growth and margin maintenance.

Best practices from leading asset managers

Redefining relationship pricing

In interviews with asset managers for this report, RLF found that the most difficult pricing decisions were those related to offering more favourable terms for specific partners, most often referred to as relationship pricing. For example, an asset manager might offer a discount of 2 to 3 bps to a specific consulting firm or adviser with whom they'd like to build deeper ties. The difficulty arises in two areas: first, should firms offer discounts to any clients at all, and second, if they do offer relationship pricing, who should get it and what is the criteria for doing so? Based on the 2019 RLF DCIO survey, the industry is very much split on this first question of 'whether to offer it,' with 38% steering clear of relationship pricing altogether, while 15% offer it if there are specific asset requirements in place. The remainder, almost half, took a case-by-case approach (Figure 8). The case-by-case approach is the most problematic because it is frequently based on factors such as the client's 'potential,' 'importance,' 'strategic alignment' or other subjective criteria that can easily be modified from one deal to the next.

Figure 8: Asset managers' approach to CIT relationship pricing, 2019



Source: RLF

The experience of one executive at a US$150 billion active asset manager shows the potential downside of an undisciplined approach to relationship pricing and is indicative of the broader industry sentiment. He said that his firm 'created a suite of new share classes with favourable pricing for a large consulting firm with the hope that it would drive new business. The home office was excited about the deal they struck with us, but with very little buy-in from consultants in the field to make a change, the assets never materialised.' Because of this and several other similar deals in the large plan market, the executive noted that they were left with underutilised share classes that they eventually had to close.

To combat this, the more sophisticated asset managers are putting in place objective rules for relationship pricing and pursuing deals with new partners that promise more significant asset flows.

The most common examples include:

- **Asset commitments with a specific time period.** Firms will offer relationship pricing if a client (adviser, consultant, or recordkeeper) hits a predefined asset threshold within a set time period. If the client fails to achieve the specified levels, the assets are moved into another share class at a higher price point. To ensure that the client's pricing remains most favourable, asset managers may also promise to automatically move the client's assets into the lowest-priced share class if it becomes available at any point in the future.
- **Discretionary asset programmes.** Asset managers will often offer a discount for OCIO programmes where the consultant has discretion. In these cases, the asset manager can justify the discount provided that the decision by the consultant to use their fund will automatically and fully cascade to each plan within the OCIO programme.
- **Adviser team pricing.** A number of asset managers have found success with relationship pricing at the adviser team level, offering discounted CITs to high producers with large books of business. Asset managers report that this more direct approach provides better results more quickly than working through the adviser's home office.

Rethinking breakpoint pricing strategies

Many asset managers use breakpoint pricing for their CITs to give their investors an incentive to put more assets into the product. While this approach is an accepted (and often expected) practice in the asset management world at large, firms interviewed for this report cited two key challenges. First, firms mentioned the growing number and complexity of breakpoints, which creates a management cost for their firm. For example, one firm analysed for this research has CITs with three share classes, each one representing pricing for a specified level of assets. For the same CIT, they also have two founders' share classes, each with four asset breakpoints (Figure 9).

As a second related challenge, many firms cited the challenge of moving investors to the right share class for their asset level in the CIT as asset levels evolve over time. This is especially an issue for a move that requires a higher-priced share class in cases where a client's asset level falls below the minimum for the pricing band. Mangers worry about the relationship and retention impact of raising an investor's pricing.

Asset managers have taken a variety of approaches as they look to manage the number and enforcement of breakpoints, including:

- **Impose stricter breakpoint monitoring.** One firm interviewed for this report recently tightened their enforcement of pricing bands. If a firm falls below an asset threshold, they have three calendar quarters to get asset levels back up or risk an increase in price. Warnings are sent each quarter, and if at the end of the third quarter assets remain below the band, the investor is moved to a more expensive share class that corresponds to their investment value (Figure 8).
- **Eliminating breakpoints.** Another large asset manager has eliminated all breakpoint pricing for their CITs. They now have one share class for all investors and a second share class for specific relationships that is priced 2 to 3 bps lower. While removing breakpoints eliminated the incentive for large investors, it significantly reduced the number of share classes they have to maintain, eliminated the need to monitor and enforce asset levels and prevented uncomfortable repricing conversations if a client fell below the thresholds.
- **Pooling assets.** A number of firms are developing more creative ways to count assets that qualify for breakpoints. While traditional methods use individual plan assets to determine breakpoint pricing, some asset managers are pooling assets across an entire consulting or adviser firm to set the price.

Figure 9: Sample fee breakpoints for an International CIT

Investment name	Share class name	BPs	Breakpoints
International CIT	Institutional share class 1	70	Less than US$10 million in assets
	Institutional share class 2	60	Between US$10 million and US$50 million in assets
	Institutional share class 3	55	More than US$50 million in assets
	Founders' class 4	49	First US$100 million in assets
		44	Next US$200 million in assets
		39	Next US$100 million in assets
		35	Assets greater than US$400 million
	Founders' class 5	49	First US$100 million in assets
		47	Next US$100 million in assets
		40	Next US$50 million in assets
		36	Assets greater than US$250 million

Tapping into the trustee’s expertise

As the typical asset manager’s stable of CITs and associated share classes continues to expand, many managers commented that they leverage their trustee’s expertise to help them manage the important decisions around pricing and share class management. The unique insight that trustees have into best practices of the dozens (or even hundreds) of managers with whom they work can be valuable to managers in setting and maintaining pricing policies.

When working with a trustee, we have found that the guidance asset managers find most valuable includes:

- **Developing a more efficient share class structure.** Because each new share class comes with costs (explicit or implicit), it’s advantageous for asset managers to keep the number to a minimum. Trustees can reduce this cost by eliminating redundant share classes, using share classes to reach multiple audiences, recommending efficient breakpoint structures and generally advising on ways to achieve business goals without continually launching new share classes.
- **Tracking pricing trends.** Consistent with trends throughout the asset management industry, pricing of CITs is constantly changing. An experienced trustee working across many managers has unique insight into these market developments and can help their clients keep up with trends and adjust pricing if needed.
- **Managing founders’ share classes.** As asset managers increase the rate of CIT rollouts, the appropriate management of founders’ share classes (i.e., low-cost classes designed to drive initial investment) is of particular importance. An experienced trustee can answer important questions, such as how long to leave them open, whether to set an expiration date on preferred pricing for founding clients (if any), or how to use the founder’s share class strategically for other investors after the founding period expires.
- **Improving CIT communication strategies.** Asset managers have an obligation to communicate the appropriate information about their CITs to clients. However, unlike in the mutual fund industry, the protocols are much less structured and inconsistently applied. Knowledgeable trustees customise communication at the share class level, striking the right balance between ensuring that clients get the appropriate information without exposing pricing details that other clients consider sensitive. The goal of the trustee should be to communicate in a way that offers insight yet protects client confidentiality.

Regaining control of CIT pricing

With fierce competition for DC assets, plan sponsors, intermediaries and recordkeepers are forcing asset managers to improve their competitive position through pricing. CITs make this easier with their flexible pricing structures and ability to get to market quickly. However, in the face of CIT sales opportunities, these pricing concessions present a challenge for asset managers as an undisciplined CIT pricing and share class strategy will have a negative effect on both revenue and expenses. The 'to do' for managers is to put a rational and documented structure in place for when to offer concessions to investors, or even get ahead of impending demands. Third-party trustees are critical to this process given their industry level insight into CIT pricing best practices. Having an ongoing dialogue with a trustee about share class efficiency and the competitive landscape will enable asset managers to strike an equitable balance between the positive opportunities CITs present and the downward pressure put on ongoing profitability.

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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 advisers, and ultra-high-net-worth families create and manage wealth. As of 31 December 2019, through its subsidiaries and partnerships in which the company has a significant interest, SEI manages, advises or administers US$1 trillion in hedge, private equity, mutual fund and pooled or separately managed assets, including US$352 billion in assets under management and US$683 billion in client assets under administration. For more information, visit **seic.com.**

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About Retirement Leadership Forum

RLF RETIREMENT LEADERSHIP FORUM

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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Reference

[1] Retirement Leadership Forum (RLF) analysis.

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

[3] Callan 2019 DC Trends Survey.

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[5] Investment Company Institute, Trends in Expenses and Fees of Funds, 2018.

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