INVESTMENT MANAGERS BUSINESS

Managing CITs in a world of relationship pricing.

With the rise in collective investment trusts (CITs), requests for discounted pricing have grown in lockstep.

Introduction.

Collective investment trusts (CITs) have cemented their position in defined contribution (DC) plan lineups across market segments.

They've grown from a niche product in the large, institutional space to a staple in virtually all 401(k) plans. CIT assets in DC plans have more than quadrupled in the last decade from $463 billion to over $2.2 trillion.[1]

By all accounts, CITs have been one of the great successes of the DC market, and their benefits are well documented. CITs provide lower costs and better fee transparency for plan sponsors and participants (i.e., employees keep more of their retirement balances) while asset managers benefit from simpler administrative requirements and flexibility. One great strength of CITs is that a newly priced share class can easily be rolled out at minimal expense. Yet, despite CITs' positive growth story and significant benefits, asset managers face some challenges, most notably when it comes to pricing strategies. Because CITs have grown in popularity, the requests for discounted pricing from advisors and consultants have grown in lockstep.

This brief explores recent trends in CIT pricing and provides a deep dive into relationship pricing. While relationship pricing in the institutional market continues, more recently, aggregators, broker-dealers (B-Ds), and recordkeepers are asking asset managers for special pricing on CIT share classes. Pricing concerns have surfaced from some managers, leading them to increase discipline around their CIT pricing strategy. This includes adopting a formal pricing evaluation process and a scorecard to assess the return on investment (ROI) on CIT pricing arrangements. Finally, we'll explore the benefits of working with a third-party trustee for guidance and insights when a manager is developing their CIT pricing strategy.

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[1] "2023 Retirement Plan Landscape Report," Morningstar, April 2023.

Demand for low cost drives rapid growth of CITs.

CITs have been around for decades, but the demand for low-cost investments has led to significant growth in CIT assets in defined contribution (DC) plans in recent years.

In 2020, assets held in CITs accounted for more than 27% of DC assets. Just two years later, that number increased to nearly 34% (Figure 1). In dollar terms, that means CITs accounted for more than $3 trillion of the $9.3 trillion in DC assets at the end of 2022.[2]

Figure 1. Percentage of 401(k) AUM in CITs, 2020 vs. 2022

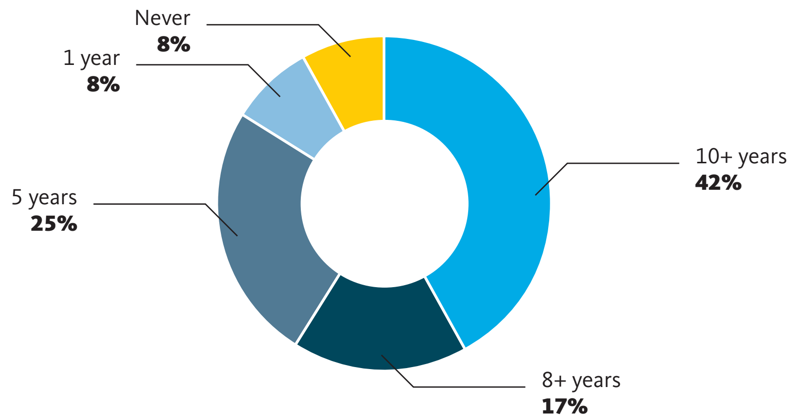
n=14
Source: Retirement Leadership Forum 2021 and 2023 DCIO Benchmarking Surveys

While CITs have several key benefits over their mutual fund counterparts, low cost has been the primary driver of recent CIT growth. In a 2022 Retirement Leadership Forum (RLF) survey, 100% of asset managers cited the "pressure on pricing and fees" as one of the top two reasons for increased asset flows into CITs.[3] No other growth driver, such as the flexibility that makes CITs appropriate for use in various packaged retirement solutions, garnered votes from more than one-third of respondents.

With no letup in the importance of low fees on the horizon, asset managers expect the strong growth in CIT assets to continue to the point where they overtake mutual fund assets in DC plans within the next decade. Ninety-two percent of asset managers believe their CIT assets will exceed mutual fund assets at some point in the future. And while 42% of respondents expect the shift to take 10 or more years, one-half expect to hit this milestone in eight years or less (Figure 2).

2 "Quarterly Retirement Market Data," Investment Company Institute, Q4 2022.
3 "Navigating the New World of Distribution Partnerships," Retirement Leadership Forum, 2022.

Figure 2. Asset managers predict when their CIT assets will exceed mutual fund assets

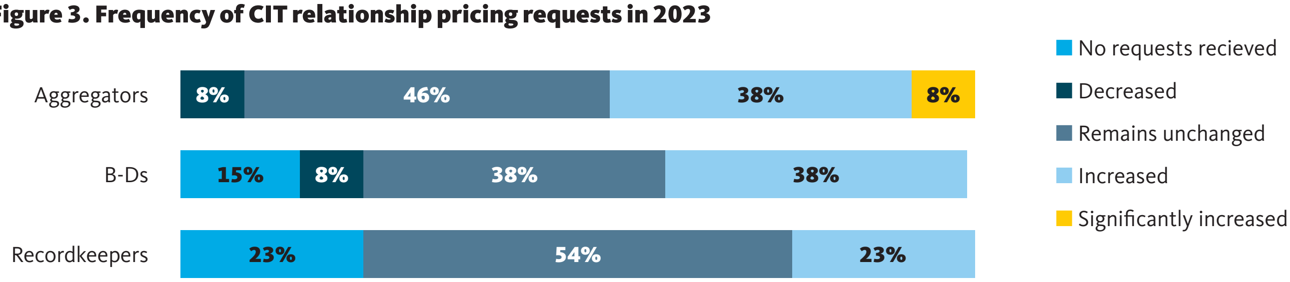


n=12
Source: RLF 2023 DCIO Survey

Relationship pricing adds to downward pressure on fees

Although CITs are widely used and are consistently lower in price than mutual funds, they are facing pressure of their own. The primary factor is relationship pricing, an arrangement in which asset managers offer preferential pricing on CITs to their distribution partners (i.e., retirement advisors) if the partner agrees to hit a minimum asset threshold over a specified period. While the concept is not new, it was previously restricted to very large plans that used their significant assets as leverage to demand special pricing, often supported by the plan's institutional consultant. Today, the frequency of special pricing requests is rising from other channels, including aggregators, broker-dealers, and even recordkeepers. Aggregators lead the way, with almost one-half of asset managers reporting that they are getting more relationship pricing requests from these firms (Figure 3).

Figure 3. Frequency of CIT relationship pricing requests in 2023

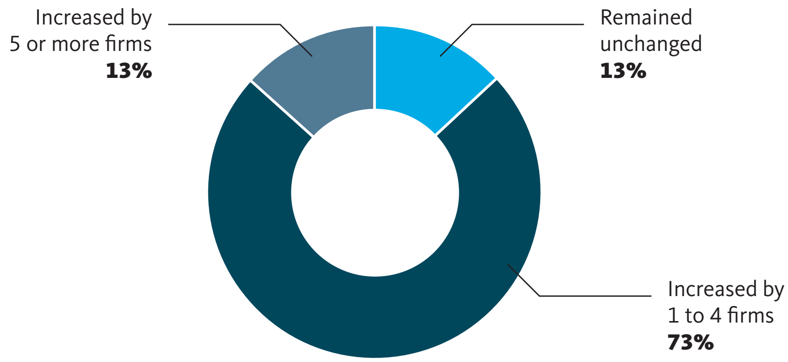


n=13
Source: RLF August 2023 DCIO Survey
Note: Totals may not add up to 100% due to rounding.

Broker-dealers such as Merrill Lynch, Morgan Stanley, and UBS, while later to the CIT game than the aggregators, are quickly trying to catch up—38% percent of asset managers reported more relationship pricing requests from B-Ds in 2023 than in the year before.

It's important to note that nearly all asset managers are actively involved in relationship pricing. This isn't an activity limited to a minority. Just looking at the relationship pricing that asset managers have negotiated with aggregators and broker-dealers, the typical firm has added agreements with between one and four advisor firms in just the last two years. That said, some asset managmenet firms have put at least five agreements in place (Figure 4).

Figure 4. Relationship pricing agreements between asset managers and advisor firms in the last two years

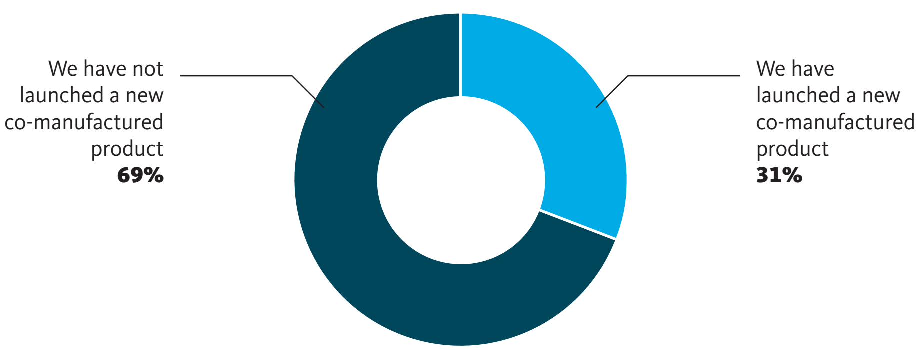


n=13
Source: 2023 RLF DCIO Survey
Note: Totals may not add up to 100% due to rounding.

Recordkeepers will surely add to this number. As noted in Figure 3, 23% of asset managers reported that recordkeepers are increasing their requests for relationship-priced CITs, a trend that we believe is just getting started. As with the aggregators, the recordkeepers are going through rapid consolidation, creating a landscape dominated by a handful of players with tremendous size and scale. With the greater level of influence this affords, recordkeepers are asking asset managers to create "co-manufactured" investment products—a private-labeled version of the asset managers' investment (almost always a target date fund) that may include proprietary investment products from the recordkeeper.

Interviews with asset managers for this report uncovered a strong pipeline of activity in the co-manufactured space. Data from a recent RLF survey backs this up—in just a 12-month period, more than 30% of asset managers have launched a co-manufactured product with a recordkeeper (Figure 5).

Figure 5. Asset managers launching a co-manufactured product with a recordkeeper in 12 months (2022-23)



n=13
Source: RLF August 2023 DCIO Survey

And, not surprisingly, they are often asking for these co-manufactured products in a CIT vehicle with fees that reflect the size of the recordkeeper's potential relationship. The recordkeeper realizes two benefits from these co-manufacturing arrangements. First, because the recordkeeper will often include a proprietary investment in the co-manufactured product, they can use the revenue generated to offset the plan sponsor's recordkeeping fees. And second, because of the relationship pricing, recordkeepers can offer a target date fund to their plan sponsor's employees at extremely competitive fee levels compared to "off-the-shelf" versions of similar target date funds.

So, what's the bottom line on relationship pricing? Relationship pricing is negotiable, and fee differentials should align with the services offered.

Concerns have led some asset managers to put more discipline into the process of evaluating and determining CIT pricing arrangements. In a 2023 survey, the Retirement Leadership Forum asked asset managers to rate their level of discipline around the CIT pricing process on a scale of 1 to 10. Responses ranged from 4 for a firm with an ill-defined process to 10 for a firm that uses a formal pricing evaluation process, including a scorecard for assessing the ROI of offering discounted pricing to a partner (Figure 6).

Figure 6. Asset managers' self-assessment of pricing discipline for CITs

n=13
Source: RLF August 2023 DCIO Survey
Scale: 1=We don't have a process. 10=We have a scorecard and formal process for evaluating a relationships and pricing requests.

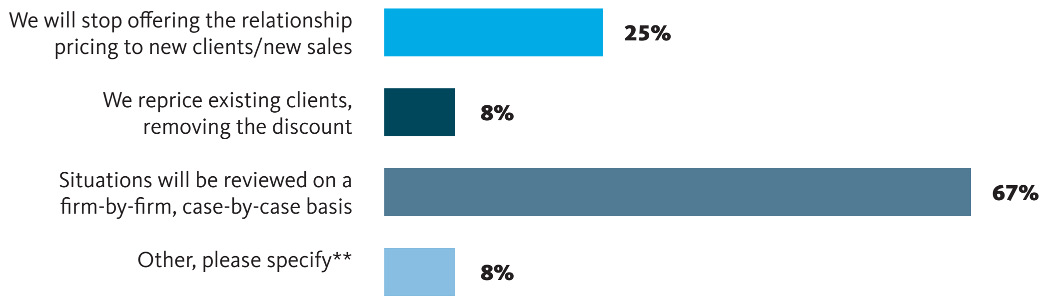
The firm with the 10 rating has implemented several other practices that make their process exceptional:

- They named an executive who spearheads the CIT evaluation process, which ensures accountability and consistency in the process.
- For new CITs or new pricing for an existing CIT, the executive prepares a full, written analysis of the proposed pricing, including:
  - Sales projections for the newly priced vehicle.
  - Expected asset transitions to the new CIT from existing vehicles.
  - The quality of the overall relationship with the advisor or recordkeeper to which they are offering the discount.
  - Estimates of the impact on other relationships from new pricing. For example, will other firms ask for the same pricing level, and is the pricing being offered to a key competitor in an existing relationship?
  - The executive presents the proposal to the firm's global product committee, which has the final approval.

Through this process, the firm can evaluate how the new CIT pricing arrangement impacts asset growth, profitability, and the overall relationship. Beyond a disciplined process, it's important for asset managers to put clear and enforceable "guardrails" into the pricing agreements with advisors and recordkeepers. That is, what happens if the advisor or recordkeeper fails to deliver the assets they promised in exchange for the preferentially priced CIT?

Presently, most asset managers have inconsistent enforcement in these situations. Another RLF survey found that two-thirds of asset managers "evaluate each situation on a case-by-case basis" if a sales partner fails to meet relationship pricing asset requirements (Figure 7). That said, some firms take a harder line by either repricing all of the advisor's clients in that fund and ending the discount (8%) or ending the discount for any new business coming into the CIT (25%).

Figure 7. Actions asset managers take if the sales partner fails to meet relationship pricing requirements*

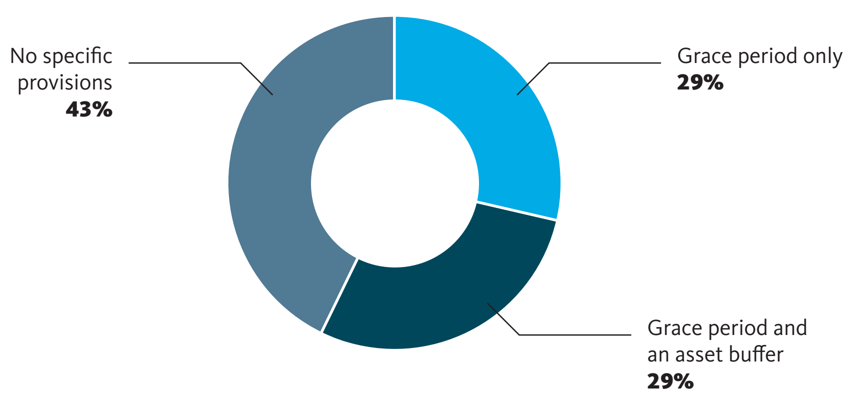


n=13
Source: RLF August 2023 DCIO Survey
*Firms could provide multiple answers.
**The firm responding "other" clarified that: "Pricing is predicated on asset growth over 2 years. We notify the client in writing of our expectations and our right to freeze the dedicated pricing option if not met whithin this timeframe."

Leading firms include clear and enforceable expectations and asset flows, while adding asset buffers or a grace period to reward firms that are close to meeting their commitments. For example, an asset manager might include a buffer of 10% of the asset commitment to account for market fluctuations or an unexpected withdrawal. Or they may offer a grace period of six months to hit the required asset levels after the initial period expires. Finally, they could use a combination of both–they will offer a grace period if the advisor or recordkeeper is within sight of meeting the commitment.

About one-half of asset managers surveyed said they include a grace period provision in their relationship pricing, and about one-third have multiple provisions, typically a grace period and asset buffer. About 43% do not include any specific provisions in their agreements (Figure 8). RLF research found that the typical grace period is 18 to 24 months, and the typical buffer is 10% of the anticipated assets for the strategy. [4]

Figure 8. "Guardrails" asset managers implement for relationship-priced CITs, 2023



n=12
Source: RLF 2023 Relationship Pricing Survey

[4] "DCIO Relationship Pricing Practices," Retirement Leadership Forum, September 2023.

Leverage a trustee's expertise when setting CIT pricing.

Asset managers that work with a third-party trustee have a valuable resource for advice on CIT pricing.

Because a well-established, third-party trustee works with dozens of asset managers, they have "seen it all" and can use this expertise to help asset managers navigate the complexities of relationship pricing and other pricing-related questions. Examples include:

- Providing benchmarks for the typical discounts offered by asset managers
- Setting asset commitments for relationship pricing agreements
- Determining the appropriate grace period or asset buffer to include in relationship pricing agreements

If you are looking to bring more value to the table and rise to a higher, strategic-level partnership, leading CIT trustees are broadening their roles. They are taking a more "consultative" approach to delivering expertise and services to asset managers, plan sponsors, and consultants. Having an expert on call during difficult pricing discussions can help ensure the long-term success of an asset manager's CIT strategy.

Summary and conclusion

The growth of CITs has been one of the most important developments in the DC business during the last decade. CITs offer lower costs to plans and participants, while asset managers benefit from their flexibility and lower administrative costs. And, while CITs have several benefits over mutual funds in DC plans, that low cost has been the primary driver behind CIT growth.

Still, CITs are facing pressure of their own, including relationship pricing on CIT fees. It's important to note that most asset managers are actively involved in relationship pricing, which continues in the institutional market. More recently, aggregators, broker-dealers, and even some recordkeepers are asking asset managers for special pricing on CIT share classes. Concerns from some asset managers have led them to take a more strategic approach to CIT pricing, with greater discipline around the process of evaluating and determining CIT pricing arrangements.

Finally, it's important that asset managers leverage their trustee partners when developing a CIT-pricing strategy. The knowledge a trustee gains by working with dozens of asset managers is invaluable and should be carefully considered by any firm developing a CIT-pricing strategy.

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The company's sole business line is the servicing of collective investment trusts, and through its network of strong relationships with advisers, distributors, and other service providers, it is able to offer flexible products that can be marketed to the U.S. retirement plan market. STC provides trustee, accounting, valuation, administrative, and fiduciary services, including investment management for the CITs. STC utilizes the services of various investment advisers, sub-advisers, and providers of accounting and administrative services (including affiliates) in connection with its responsibilities for maintaining CITs.

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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 retirementlf.com.

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