Mind Your ETFs and CITs

By Editor Test *Tue, Apr 24, 2012*

In this data-rich report, the president of the Center for Due Diligence, a Chicago-based organization for plan advisors, explains which way the winds of the 401(k) world are blowing. (Hint: Think passive and low-cost.)

Major changes are afoot in the financial services and the retirement plans industry. These changes are taking place at multiple levels and they will have a major impact on the industry. To stay relevant, prosper and survive, advisors must acknowledge and adapt to these changes.

After extensive research and networking, the CFDD has identified the primary paths to growth for retirement plan specialists. Industry research has always been overly optimistic. Automatic enrollment has been a positive, but future retirement plans asset growth will be fueled by market returns, not formations, participation or contributions.

In spite of this observation, *the asset shift within retirement plans will be of epic proportions*. That shift will include investment categories, vehicles and strategies. In other words, the flow of money is the path to growth and it will dwarf the opportunities created by disclosure and new fiduciary definitions.

ETF net new flows were reported at a record $55.9 billion during the 1st quarter of 2012. Fueled by market gains, the robust flows helped ETF assets reach $1.21 trillion, up from $1.06 trillion at year-end.

Net long-term mutual fund flows were reported at $106.3 billion during the same first quarter period, up sharply from the $67.1 billion captured during all of 2011. Excluding money market funds, long term US mutual fund assets increased to $8.70 trillion during the 1st quarter, up from $7.96 trillion at year-end.

ETF growth has been championed by the media, but ETF growth is benefiting from far more than lower fees, liquidity and transparency. In addition to lower costs, *less than stellar active management results are dr*Not surprisingly, *Vanguard's $36.8 billion in net new mutual fund flows during the 1st quarter of 2012 were 35% of total industry mutual fund flows and 100% ahead of their 1st quarter 2011 flows.*

Looking back to the 2011 calendar year, Vanguard captured $43.8 billion in net new flows, 65% of the mutual fund industry's total flows.*iving investors of all stripes towards passive investment strategies, a trend unlikely to be reversed*. The dynamics of ETF distribution will also play a major role in transforming the industry.

These changes will certainly have a major impact on investment managers, but *the shift to passive investments will also have a significant impact on investment strategies and investment vehicles*, particularly target date funds (TDFs) and Collective Trust Funds.

Net New ETF Flows **Billions** **(Source: ETF Industry Association)**

Category	2011	1st Qtr. 2012	1st Qtr. 2011
Industry	$115.2	$55.9	$28.2
Vanguard	35.8	17.2	10.4
Vanguard % Total	31.1%	30.8%	36.9%

The ETF picture is much the same. *Vanguard's $17.2 billion in net new ETF flows during the 1st quarter of 2012 were 31% of total industry ETF flows and 65% ahead of their 1st quarter 2011 flows.*

Looking back to the 2011 calendar year again, Vanguard captured $35.8 billion in net new flows, 31% of the ETF industry's total flows.

The regulators are clearly encouraging a passive approach and investors may or may or may not embrace active management in the future. If they do embrace active management, *the costs and margins are still headed for the basement.*

Net New Long-Term Mutual Fund Flows Billions (Source: Morningstar Direct)			
Category	2011	1st Qtr. 2012	1st Qtr. 2011
Industry	$67,121	$106,315	$85,310
Vanguard	43,745	36,825	18,020
Vanguard % Total	65.2%	34.6%	21.

The aforementioned observation is important because industry margins are shifting away from traditional investment managers. Going forward, *the money will be made on the construction of low cost solutions, tactical applications, alternatives and advanced risk management.* As indicated by robust flows, firms with unique skill sets, like PIMCO, JP Morgan and others, can still participate in the consolidation-driven growth cycle in a big way.

One final thought on mutual fund flows. If we eliminate the domestic equity outflows after the 2008 financial crisis, the industry's net new flows look quite robust. Indeed, the net new flows into bond funds have been staggering in recent years. The record inflows into bond funds are also one of the primary reasons equities have rallied and why the bond bubble will eventually burst.

A trillion here, a trillion there…

Based on ICI input, the DC plan market, including 403(b), 457 and other DC plans, totaled $4.5 trillion at the end of 2011. Mutual fund assets were reported at 52%, or $2.3 trillion, of total DC plan assets. Based on additional ICI data, DC plans held $303 billion, or 13%, of total mutual fund assets, in passive investments.

Assuming 13% of the other $2.2 trillion in non-mutual fund DC plan assets were indexed, an additional $286 billion was held in passive investments. In other words, approximately *$589 billion of total DC plan assets are invested in passive investments.*
If we subtract DC plan assets ($4.5 trillion), annuities ($1.6) and IRAs ($4.9) from the $17.9 trillion in total retirement plan assets reported by the ICI, that leaves us with $6.8 trillion in other retirement plan assets, including state & local government plans, private DB and federal pension plans.

Assuming 13% of those assets were indexed, that leaves us with another $884 billion held in passive investments, bringing the total to $1.5 trillion.

Given that the $500 billion held in The Federal Thrift Savings Plan, the world's largest DC plan, is passively managed via BlackRock index funds, we can account for another $386 billion (100% -13% = 77% x $500). *This increases the total retirement plan assets held in passive investments to $1.9 trillion.*

After analyzing large DB plans, it is interesting to note that over 50% of the domestic equity assets are invested in passive/enhanced investments and approximately 23% of the domestic fixed income assets are indexed. A smaller percentage of foreign and alternative investments are indexed. *Given that about 25% of total DB plan assets are indexed, we need to add at least another $400 billion* to the total.

Ignoring non-profit DB plans which are not picked up by the reporting services, approximately *$2.5 trillion of the nation's retirement plan assets are held in passive investments and the growth is accelerating.* It is not well understood, but *the vast majority of these indexed assets are held in collective trust funds*, conclusions supported by our collective trust fund analysis below.

Due to varying approaches and weighting alternatives, indexing can be complicated. Sponsors and participants may not fully understand indexing, but the flows and reduced costs are irrefutable. When the world's largest active investment manager, Fidelity Investments, is recommending the addition of index options to their retirement plan clients, it's easy to conclude that The Times They Are A-Changing. Indeed, as Bob Dylan would say, "You don't need a weatherman to know which way the wind blows."

Collective trust funds
Collective investment trust funds (CITs) have been around a long time, but the *increased scrutiny on fees, regulatory changes, operational enhancements, NSCC capabilities and custom solutions have catalyzed new interest in CITs.*

When compared to other investment vehicles, CITs offer pricing flexibility, fewer trading restrictions, lower operating costs and no redemption fees.
Fee issues, conflicts and the costs of running multiple CITs can be an issue, but successful advisors eventually get too big for model portfolios. Given the availability of multiple platforms, *CITs can offer a distribution solution not available to model portfolios.*

The additional costs can be offset by utilizing individual securities, institutional share classes, other collective funds and ETFs. The CITs may also use alternatives and there are multiple ways to structure fees and contracts to eliminate conflicts.

Regulated by the Office of the Comptroller of the Currency (OCC) and/or state regulators, CITs have long played a meaningful role in the nation's retirement plans. CITs holdings are limited to qualified retirement and governmental plans, including certain DB and DC plans. They are not available to 403(b), endowments, foundations, IRAs or personal trusts.

Working with Hand Benefits & Trust, a BPAs company, we put the market for CITs under the microscope. Based on Morningstar data for state institutions without FDIC insurance and the OCC call reports for other institutions, CITs and Common Funds were reported at $2.7 trillion at the end of 2010.

Based on the 2010 report, we estimated Common Fund assets (not eligible for retirement plans) at about $500 billion. In other words**,** *CITs held about $2.2 trillion in employer sponsored retirement plan assets at the end of 2010.*

Approximately $900 billion of the $2.2 trillion in CITs was held in DC plans, including 23% stable value, 5% Target Maturity, and 62%, or $646 billion, in other private DC plans. The remaining $1.3 trillion was held by private DB and government pension plans.
The call reports and Morningstar data reported at the end of 2011 totaled $3.0 trillion, including $2.4 trillion in Bank & Trust Company holdings and $605 billion in Uninsured State Chartered Trust Cos.

Supporting our observations on passive investments within CITs, the top five Bank & Trust Companies held $1.9 trillion and included BlackRock, State Street, BNY Mellon, Wells Fargo and JP Morgan, all big players in the world of passive investments. The top two uninsured State Chartered Trust Cos held $500 billion and included Vanguard and Northern Trust.

Compliance challenges and solutions

The July due date for 408(b)(2) fee disclosure is closing fast and covered service providers are scrambling for a solution. With RIAs/IARs and TPAs far ahead of B-Ds and registered reps, many B-Ds will not have a solution in place by the required date.

Expectations of another delay or that other service providers would come forward with a solution have faded. In short, *large blocks of retirement plans business are about to become prohibited transactions.* The cost of building a solution just to keep what they already have is no doubt part of the B-D dilemma. Indeed, *the cost of servicing retirement plans has gone up and even after the expenditure, there is no guarantee of capturing increased business.*

The costs associated with building and maintaining a solution are not only exorbitant, but complicated as well. Given that only large B-Ds can absorb the cost, *the B-D community should be pursing outsourced solutions NOW! Small and mid-sized B-Ds should also consider combining resources.*

FRA/PlanTools and Fiduciary Benchmarks Inc. both offer outsourced 408(b)(2) solutions. Their services may not be comparable, but FRA/PlanTools seems to be the industry's low cost provider. For more information, contact David Witz at dwitz@fraplantools.com or Tom Kmak at tkmak@fiduciarybenchmarks.com.

While 408(b)(2) gets most of the media coverage, *404(a)5 will subject discretionary Model Portfolios to participant disclosure rules.* The requirements include, but are not limited to, a website with updated fee information, quarterly performance calculations and annual information for investment comparisons.

The coordination and negotiation with record-keepers and TPAs over which duties are considered *covered services* is another compliance consideration for advisors offering Model Portfolios. If the models are not unitized, fees will be subject to explicit quarterly fee disclosure. Risk-based models may also not benefit from 404(c) protection if participants select models through an advisor's assistance.

In summary, *advisors can keep their existing Model Portfolios and provide the quarterly disclosure along with the required investment information and hard dollar fees. Alternatively, they can convert their models to Collective Investment Trusts and let the trustee provide the proper disclosure.*