Mutual Funds, Collective Trusts, and Separate Accounts: Understanding Investment Vehicles

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In this paper, we will explore:
- **The types of investment vehicles available for use in a Defined Contribution plan**
- **The differences between and advantages/disadvantages of various investment vehicles**
- **Trends in non-registered vehicle usage**
- **Gosselin Consulting Group's recommended approach to selecting the appropriate vehicle**

Investment strategies are often made available to Defined Contribution (DC) plans through multiple vehicle types, each with unique pricing structures. As a result, vehicle choice directly impacts a participant's investment fees and performance. As such, evaluating a manager's available vehicles and choosing the most appropriate vehicle is a critical research step that should be completed prior to implementation of an investment option for participant use. Proper evaluation of the various vehicles is also a critical step for plan sponsors with respect to meeting their fiduciary duty to serve the best interests of plan participants.

VEHICLE TYPES

There are three general types of investment vehicles that are appropriate for use in a Defined Contribution plan:

- Mutual Funds
- Collective Trusts
- Separate Accounts

The key differences between these various investment vehicles are described below.

Mutual funds have been the most popular investment vehicle used in the 401(k) market over the past twenty years, both in terms of frequency offered and overall participant assets invested. Collective trusts, which account for the second largest asset base, have traditionally been utilized mostly as stable value or passive offerings, yet have been gaining popularity in other asset classes over the past few years. Separate accounts, though accounting for a sizable asset base, are less frequently utilized in the DC market, due to high minimum account size thresholds and their operational complexities.

The term "non-registered vehicles" is often used to describe collective trusts and separate accounts. Because collective trusts and separate accounts are not currently subject to the same SEC-imposed registration requirements that mutual funds are subject to, they are considered "non-registered". These vehicles are instead governed by banking regulations and the IRS/DOL, in the case of collective trusts, or by investment management guidelines agreed to by the client and the investment manager in the case of separate accounts. The higher operating expenses (those expenses incurred in addition to the investment management fee) of a registered mutual fund drive up the overall cost of the vehicle, making the use of comparable non-registered products appealing to fiduciaries and plan participants alike. *(Please note that these statements do not take revenue share into consideration, rather, they are meant to illustrate the basic vehicle expense differentials)*

Collective Trusts (or collective investment trusts, CITs, or commingled pools, as they are sometimes referred to) are tax-exempt pooled vehicles administered by a bank or trust company that seek to commingle the assets of multiple qualified institutional investors (Defined Benefit & Defined Contribution retirement plans). Separate accounts differ in that they are managed for a particular client/entity (who becomes the direct owner of the underlying securities), and therefore do not allow outside investors to participate in that particular mandate.

In the past, various hurdles limited the use of non-registered products in 401(k) plans. Many non-registered vehicles were valued monthly or quarterly which presented a challenge for the daily-valued Defined Contribution market. If vehicles were daily valued, investment managers rarely promoted their use to the DC market, except in the case of stable value or passive investment strategies. In addition, limited marketing materials were made available and non-performance-related investment information was generally unavailable to participants, making it difficult for them to make informed investment decisions on their plan's investment options if such a vehicle existed in their line up. As such, retirement plan sponsors and consultants tended to utilize mutual funds to build out their investment line-up.

Over the last five years, many investment managers have made a concerted effort to market non-registered vehicles to plan sponsors and recordkeepers, due largely to the industry's focus on fees. Operational enhancements made in recent years, including the transition to daily valuation, have greatly improved the transparency and efficiency of using collective trusts in a DC plan.

Easier access to information via the internet has essentially eliminated what used to be the most common concern regarding the use of non-registered vehicles in a retirement plan — that investment information for non-registered vehicles could not be found listed in the newspaper, unlike most popular mutual funds at the time. Today, recordkeepers provide participants with access to web portals where they can perform transactions and find information on the various investments available to them in the plan. Such customized access allows for information on non-registered investment options to be posted alongside the information on mutual fund options, virtually eliminating the difference between the two vehicle types in the eyes of the participant. In fact, since the introduction of the internet many newspapers have gone so far as to eliminate the listing of mutual fund performance in their daily news, as the internet now gives investors access to real-time data.

In addition to the 24/7 access the internet has provided for participants, asset management firms who run collective trust vehicles now recognize the need for participant-friendly materials and go to great lengths to provide plan sponsors with the information necessary to allow participants to make informed decisions (i.e. fact sheets, product profiles). This information often mirrors the information provided by the product's mutual fund equivalent (if one exists). In addition, the information made available to third-party sources such as Morningstar has been greatly enhanced, allowing for more robust research and monitoring of collective trusts and separate accounts by consultants and plans sponsors.

ADVANTAGES & DISADVANTAGES OF EACH VEHICLE TYPE

Each vehicle type has its advantages and disadvantages, both of which must be weighed when determining the most appropriate vehicle for use in a particular plan. Some key advantages and disadvantages for consideration include:

MUTUAL FUNDS

Advantages:

- familiarity at plan sponsor & participant level
- ease of use; easy access to information in standard format
- transparency
- portable from qualified retirement plans to other account-types

Disadvantages:

- expenses can be higher due to registration requirements
- potential for retail activity to impact retirement plan participants if a retirement-specific share class is not used by the plan

COLLECTIVE TRUSTS

Advantages:

- pricing tends to be lower than mutual fund equivalent
- some flexibility with pricing at client level

Disadvantages:

- participants cannot look up information on public websites or in newspapers
- lack of portability; can only be used in a qualified retirement plan

SEPARATE ACCOUNTS

Advantages:

- ability to name the product in a manner unique to the plan (i.e. ABC Company Large Growth)
- ability to achieve economies of scale with pricing (tiered fee schedule common in DB plans)
- ability to implement custom restrictions (i.e. no tobacco stocks)

Disadvantages:

- can be costly to administer
- requires substantial asset level to achieve pricing advantage
- requires additional level of fiduciary oversight on custodian
- can be challenging in certain asset classes (i.e. emerging markets, due to complexities related to foreign securities)

TRENDS IN NON-REGISTERED VEHICLE USEAGE

The use of non-registered vehicles has historically been more prevalent in the large plan market. However, plan sponsors of all sizes have been using non-registered products for years — often unknowingly — as stable value "funds" are only offered as collective trust or separate account vehicles, and many index products offered by the industry's largest recordkeepers are also offered to retirement plans as collective trusts. This speaks to the seamless nature of using a collective trust in a 401(k) plan.

Recently, as plan sponsors have renewed their focus on expenses, and in some cases have sought to eliminate or reduce revenue share, many plans are looking to non-registered vehicles. Due to the registration requirements imposed on mutual funds (as previously mentioned), expenses tend to be higher than those of an equivalent collective trust. Therefore, where offered, plan sponsors and consultants are turning to collective trusts. Similarly, larger plans often look to separate accounts in light of their associated economic benefit.

GOSSELIN CONSULTING GROUP'S RECOMMENDED APPROACH TO VEHICLE SELECTION

Gosselin Consulting Group recommends exploring the various vehicles available to your plan, regardless of plan size.

As the availability of daily-valued, NSCC-traded collective trusts becomes more widespread across the industry, the benefits of using such vehicles are no longer reserved for the large plan market. If there is a worthwhile expense differential between an investment strategy's mutual fund and its equivalent collective trust vehicle, consideration should be given to the non-registered vehicle. As expenses have a direct impact on investment performance, the cost savings passed on to participants outweighs the perceived downside of not offering a registered mutual fund equivalent. However, if the expense differential is not wide enough to make a material difference, using the mutual fund equivalent may still be a suitable choice. In addition, it's important to note that many mutual fund providers now offer "institutional" or "retirement" share classes, exclusively for the use of qualified plans. The pricing on these share classes is often competitive with the pricing of a collective trust.

Separate accounts should be given consideration only if the asset class makes sense and the economic hurdles presented by separate account administration and unitization can be easily overcome by the scale of the assets invested.

Revenue share should also be considered when selecting an investment vehicle. For those plan sponsors seeking to both minimize expenses and reduce or eliminate the potential for participant subsidization issues caused by revenue share, the availability of a vehicle/share class that offers zero revenue share can help determine the most appropriate vehicle for use in the plan. It's important to note that consideration should also be given to the net cost (expense ratio less revenue share) of each available vehicle/share class, to ensure the zero revenue share option is also representative of the lowest investment management fee. *(For more information on how the use of revenue share can result in participant subsidization, please read our paper titled "Financing Your 401(k) Plan")*

Where appropriate given plan size, Gosselin Consulting Group advocates for the elimination of revenue share through the use of the lowest-cost vehicle/share class of the appropriate investment manager, thereby eliminating the issue of participant subsidization.

In summary, the best investment vehicle for the 401(k) plan market depends on the needs of the individual client and the individual investment product in question; there is no standard answer to the question of which is the 'best" fit industry-wide. An understanding of the various vehicles and share classes available and careful consideration of their unique characteristics can assist plan sponsors with making the most appropriate choice.

SUMMARY OF INVESTMENT VEHICLE TYPES

Listed below is a summary of the key differences between mutual funds, collective trusts, and separate accounts:

MUTUAL FUNDS

- governed by SEC
- available to both retail and institutional investors
- information publicly available via newspapers, online sources
- naming convention is fixed by investment manager
- investment guidelines are fixed
- pricing is inflexible at share class level; number of available share classes varies by fund
- easily portable from qualified retirement plan to IRA or other outside account

COLLECTIVE TRUSTS

- governed by the Office of the Comptroller of Currency, subject to oversight by the IRS and the Department of Labor (ERISA)
- available to qualified institutional investors only; presents issues of portability between account-types
- information typically available only through retirement plan website and/or other sources specific to that particular retirement plan
- naming convention is typically fixed by investment manager
- investment guidelines are fixed by investment manager
- increased pricing flexibility
- must be NSCC-traded and daily-valued to be seamlessly implemented in a 401(k) plan

SEPARATE ACCOUNTS

- governed by client-specific Investment Management Agreement & ERISA guidelines
- available to large institutional investors who meet minimum asset requirements
- information typically available only through retirement plan website and/or other sources specific to that particular retirement plan
- naming convention can be specific to the plan/client
- investment guidelines can be customized per plan/client
- pricing is asset-based, resulting in economies of scale for larger clients
- challenging to implement in various asset classes (i.e. emerging markets)

IMPORTANT DISCLOSURE

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