

# Research

Volume 1 Issue 5

## Authors



**Steve E. Ferber**

Senior Vice President, Defined  
Contribution Account Manager and  
Collective Investment Fund Strategist



**Bret Estep**

Vice President, Defined Contribution  
Account Manager and Stable  
Value Services

## Collective Funds: Facts, Figures and Trends

*The retirement market currently is undergoing many meaningful changes, including those resulting from greater scrutiny of fees and expenses by plan sponsors, advisors, regulators and industry providers. As these entities evaluate alternatives to retail mutual funds, the collective fund – an investment vehicle widely used in the past – is undergoing rejuvenated interest and consideration. Further, additional collective funds managed by some of the country’s largest managers are becoming more readily available. As a result the growing supply of collective funds, plan sponsors and advisors now have additional choices when selecting retirement investment vehicles.*

*To help investors and intermediaries evaluate collective funds, this research paper examines the history, oversight, benefits, and limitations of collective funds as well as current market trends.*

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### Historical Background

Collective funds are not new; they've been available for decades. Since by regulation only banks and trust companies may offer collective funds, historically the primary distribution for the funds was limited to the customers of banks offering the funds. As mutual funds' popularity grew, many banks converted their collective funds to mutual funds. One reason was that, at the time, few collective funds were daily valued, a basic requirement for inclusion in a 401(k) plan.

New elements in the collective-fund equation today are operational enhancements and convenience. One of the most significant enhancements to collective fund operations is the development of funds that are valued and liquid daily so they can meet the needs of today's 401(k) plans. Operational enhancements also make portfolio information more accessible to investors, making it much easier for plan sponsors to use collective funds. For example, because of regular provider statements, voice-response services, and plan Web sites, of investors now have ready access to information on collective funds.

Equally important to growth in the use of collective funds were expanded capabilities of the National Securities Clearing Corporation Fund/SERV® platform (Fund/SERV) in 2000 to include collective-fund transactions. This change was crucial to the increase in popularity of collective funds because Fund/SERV has become the processing standard for retirement plan providers. Now plan sponsors and providers can complete collective fund transactions as easily as mutual-fund transactions.

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### What Are Collective Funds?

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A collective fund is a pooled investment vehicle exempt from the definition of “Investment Company” under Section 3(c)11 of the Investment Company Act as long as the fund meets two primary criteria:

- (1) A bank maintains it.
- (2) It consists solely of tax-qualified assets.

“Bank maintenance” means that a bank or trust company sponsors the collective fund and retains meaningful control over it. While the bank must maintain fund oversight and responsibility, it may hire a sub-advisor and be guided by specific investment objectives and guidelines.

Collective funds, by virtue of their bank or trust-company sponsorship, are regulated by the Office of the Comptroller of the Currency (at nationally chartered banks) or individual state banking regulators (at state-chartered

banks). Mutual funds, on the other hand, are regulated by the SEC.

Examples of tax-qualified assets include 401(k), employee stock-ownership, profit-sharing, Taft-Hartley, cash-balance, and government-employee benefit plans. They do not include IRAs, personal trusts, 403(b) plans, endowments, or foundations. Collective funds may only hold the assets of qualified retirement and governmental plans, including certain DB and DC plans.

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### Why use Collective Funds?

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Collective funds have long played a meaningful role in DC plans and increasingly are being used as an alternative to mutual funds for several reasons:

- Modest expenses relative to mutual funds – typically lower startup costs and operational expenses
- No retail investors – appeals to institutional buyers
- Fewer restrictions than mutual funds – no 1940 Act trading restrictions, redemption fees, or 22c-2
- Pricing flexibility – established fee classes rather than share classes

Let’s examine each of these factors in greater detail.

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## Modest Expenses

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Several features make collective funds attractive to investors. Certainly the relatively lower expenses commonly associated with collective funds are an important consideration. For example, compared to mutual funds, collective funds often (though not always) have lower operational expenses embedded into their overall expense ratios. In addition, collective funds' start-up costs typically are lower than mutual funds.

"Cost is certainly a key factor when sponsors consider funds, as it should be," says John Sturiale, field vice president of retirement investment services at Charles Schwab.

"Using a collective fund rather than a mutual fund structure helps plan sponsors keep costs down for participants."

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## No Retail Investors

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Collective funds have modest ongoing operating expenses because, for one reason, they aren't available to retail investors. Therefore, collective funds' sponsors only need to maintain records at the plan level. The plan record keeper maintains individual client balances and transactions, aggregating individual transactions and reporting a single daily transaction amount to the collective fund.

In addition, because collective funds are not subject to the 1940 Act and serve only retirement plans, there are no costs to produce, print and mail proxies and prospectuses.

Instead, collective funds typically offer a disclosure statement, which serves a purpose similar to a prospectus but at a much lower production and distribution cost. The fund typically passes these savings on to the investor in the form of lower operating costs and fees.

Even a relatively small reduction in investment fees can reduce a plan's overall expenses meaningfully because investment costs make up a significant portion of overall costs. Figure 1 shows the typical total plan-cost (all costs associated with offering a retirement plan, including record keeping, investment costs, etc.) breakdown for DC plans.

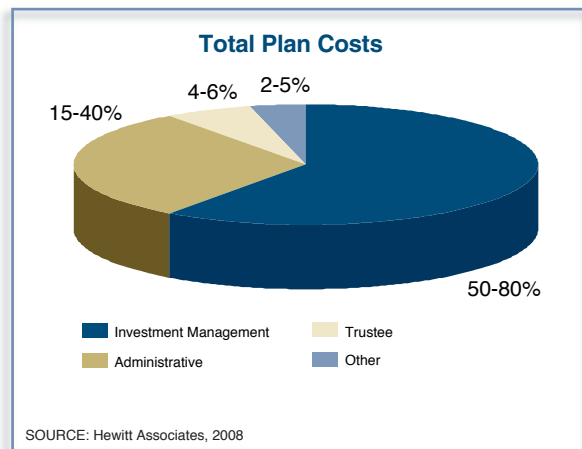


Figure 1

Although fees vary by fund depending on a number of factors, collective funds on average tend to have meaningfully lower fees than mutual funds, as a 2008 Hewitt Associates survey shows (Figure 2).

### Median Expense Ratio by Category

Asset Classes	Mutual Fund (%)	Collective Fund (%)
Intermediate-Term Bond	0.55%	0.30%
Large Value	0.85%	0.55%
Large Growth	0.93%	0.56%
Small Value	1.12%	0.96%
Small Growth	1.20%	0.94%
International	1.05%	0.80%

SOURCE: Hewitt Associates, 2008

Figure 2

Paying higher-than-necessary fees results in lower earnings and can present plan sponsors with risk. Gregory Allen, president and director of research at Callan Associates, notes: “With increasing regulatory [and participant] scrutiny of the fees associated with DC plans, lower-cost vehicles can significantly reduce the liability faced by sponsors in offering these plans. Fees are easily measured, and largely determined by decisions made by the sponsor rather than the participant. As such, they are becoming a primary benchmark in evaluating sponsors with respect to their fiduciary obligations. Low-cost vehicles such as collective funds can help sponsors be better fiduciaries.”

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### Fewer Restrictions than Mutual Funds

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Short-term trading restrictions and redemption fees, as well as 22c-2 regulations, have sent some plan sponsors searching for alternatives to mutual funds. Since collective funds typically don’t have trading restrictions or redemption fees – and since rule 22c-2 doesn’t apply to collective funds – this makes them an attractive alternative.

Mr. Allen continues, “The fact that collective funds can only be held in qualified plans significantly reduces the possibility of trading abuses in these vehicles. While a small percentage of mutual fund trading abuses did occur in 401(k) plans, the vast majority occurred outside of these plans. The fact that hedge funds cannot buy and sell collective funds provides a natural level of protection that can allow for less restrictive trading rules than are necessary in a mutual fund vehicle. While this does not completely eliminate the need for trading restrictions, it can make them far less onerous.”

Sturiale adds, “Also, since the mutual-fund scandals, more plan sponsors are ‘warm’ to the idea of a product geared to the institutional marketplace. I believe they like [the fact] that collective funds are not a product their participants can get off the shelf, and so [sponsors] view access to [collective funds] as a value-add to the retirement plan.”

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### Pricing Flexibility

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Experts predict that pricing flexibility will be the driving factor behind a switch from mutual to collective funds. Many sponsors seek institutional pricing in terms of the expense level (lower than mutual funds) and economies of scale via sliding fees, of which a collective fund vehicle can accomplish both.

Collective funds offer share classes similar to mutual fund share classes, but collective fund share classes don’t require the sponsor to

charge the same management fee to all investors within the collective. This allows the fund to charge larger clients less than smaller clients. The fund continues to commingle assets in one pool, but the fund retains some flexibility in the amount charged to various investors. The trustee can open new fee classes at a minimal cost and the fund can accommodate even a single plan if necessary.

Here is a brief comparison of collective and mutual funds:

#### Collective Funds vs Mutual Funds

Collective Funds	Mutual Funds
Some trade via NSCC	Trade via NSCC
Minimal trading restrictions	Significant trading restrictions
Multiple share classes	Multiple share classes
Easy to open new share classes	Difficult to offer new share classes
Lower cost typically	Higher cost typically

#### Limitations

Along with their benefits, collective funds also present limitations, primarily including:

- Collective funds aren't always less expensive than other vehicles, including mutual funds
- Performance isn't listed in newspapers, and advertising is more limited than with mutual funds
- Collective funds can accept qualified-plan assets only. This limitation prevents investment by several investor types and also doesn't allow collective funds to retain IRA rollover assets

- At present the universe of products offered in a collective fund format is much smaller than the available mutual fund universe

#### Trends in Collective Funds

However, today there are many signs that collective funds' use in the financial services industry is becoming widespread and growing, particularly as a popular DC investment choice. As such, DTCC expects that this will boost significantly the number of collective funds it processes over the next few years.

The Morningstar chart with data from Greenwich Associates (Figure 3) shows trends for retail mutual funds and other popular alternatives.

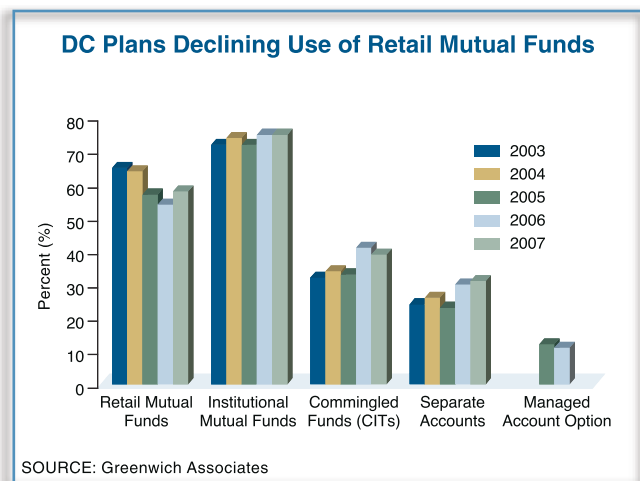


Figure 3

Those who consider a collective fund tend to ask a common question: "Are collective funds' success limited to just stable value?"

Interestingly, data in Figure 4 shows that non-stable value collective funds' volume now exceeds that of stable value collective funds in terms of dollar volume via DCC&S. The trend regarding the number of trades in collective funds also indicates a similar trend.

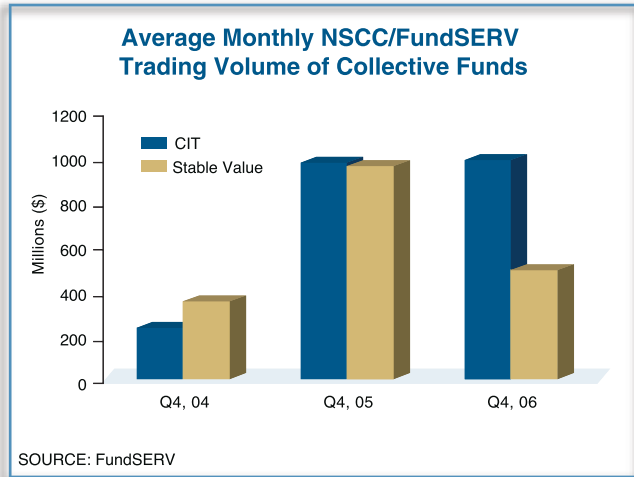


Figure 4

### The Future of Collective Funds in DC Plans

Given that stable value collective funds hold a meaningful portion of DC assets, the data in Figure 4 reveals that the demand for collective funds in a variety of asset classes is high and growing quickly.

Moreover, looking forward, the rapidly increasing use of asset allocation funds (both risk-based funds and target retirement date funds) is likely to produce a further increase in the use of collective funds. That's because collective funds are an excellent vehicle for housing asset allocation funds because of their benefits such as lower cost and operational flexibility, as noted earlier.

Greg Allen confirms this: "The Pension Protection Act is clearing the way for asset allocation funds and target maturity funds to become the standard default option for the industry. Auto-enrollment is also becoming a standard feature in good plan design. These two factors will place increasing importance on the need for sponsors to ensure that their target maturity funds are well diversified, employ the best managers in each asset class, and are offered at the lowest possible fees. Collective funds' flexibility and cost structure make them better suited to achieving these goals than do mutual funds."

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## Appendix

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### Documents Governing Collective Funds

**Declaration of trust** – Establishes the collective fund and governs its operation.

**Adoption agreement** – An agreement between the collective-fund trustee and the plan. This document lists the fees, operations, and details of the plan's particular selected fund.

**Private offering memorandum** – This document contains a description of the trust, the collective funds within the trust, and the trust's objectives and policies. It also names the fund's investment managers and describes eligible investors.

**Investment management agreement** – This is an agreement between the collective-fund trustee and the investment manager hired to manage trust assets on behalf of the trustee.

## **Regulatory Oversight of Collective Funds**

Collective funds are exempt from registration with the Securities and Exchange Commission; however, they are regulated by a number of governmental bodies, including:

**Banking regulators** – Since only a bank or trust company may maintain a collective fund, these institutions are subject to significant oversight by federal or state banking authorities. Banks and trust companies are accountable to the Office of the Comptroller of the Currency (nationally chartered banks) or individual state banking authorities (state-chartered banks). State banks also may be subject to supervision by the Federal Deposit Insurance Corporation and the Federal Reserve Board. Mutual funds, on the other hand, are regulated by the SEC.

**Department of Labor** – In addition, because only qualified retirement plans may invest in collective funds, the Department of Labor also oversees (rather than directly regulates) the plans.

**ERISA** – The fund trustee, as well as an outside sub-advisor if used, are subject to ERISA fiduciary standards, including the prudent-investor rule.

**IRS** – The Internal Revenue Service oversees collective funds because the funds are exempt from taxation. Given that qualified retirement plans are the only investors, income taxes on current income and capital gains generated

within the fund are deferred until the funds are withdrawn from the plan. Premature distributions can result in tax consequences, at the discretion of the IRS.

**Auditors** – Outside auditors typically audit nearly all collective funds at least once a year. Investors must have access to the financial reports based on these audits.

### **About PIMCO DC Research**

PIMCO DC Research is a periodic publication prepared and distributed by the PIMCO DC Practice. Based in Newport Beach, this practice is dedicated to promoting effective DC plan design and innovative retirement solutions.

Our team is pleased to support our clients and broader community by sharing ideas and developments in DC plans in the hopes of fostering a more secure financial future for employees of corporations, not-for-profits, governments, and other organizations.

If you have questions about PIMCO DC Research or a topic you'd like us to explore, please contact your PIMCO representative or email us at [pimcodcpractice@pimco.com](mailto:pimcodcpractice@pimco.com). We're interested in your ideas and feedback!

**Stacy Schaus, CFP®**  
*DC Practice Leader*

**Steve Ferber**  
*CIT Strategist and Account Manager*

**Bret Estep**  
*Stable Value Services*

**Doug Schwab**  
*Plan Sponsor Services*

**Christina Stauffer, CFA**  
*Platform Provider Services*

**Joseph Simonian, Ph.D.**  
*DC Analytics Leader*

*Most of the information in this document was originally produced in a white paper issued by AST Capital Trust (now Wilmington Trust). Steve Ferber, currently the PIMCO collective-fund strategist, produced this paper when he was head of the AST collective-fund business. PIMCO has received approval to use the information.*

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**P I M C O**

840 Newport Center Drive  
Newport Beach, CA 92660  
888.845.5012

DCR005-120908