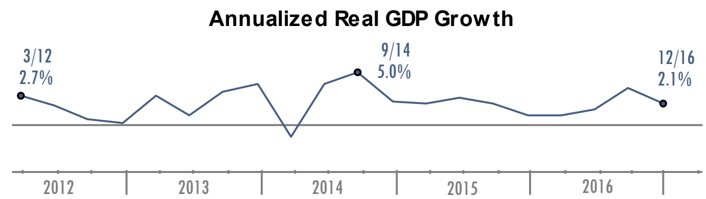
Your Quarterly Update on the Financial Markets
March 31, 2017

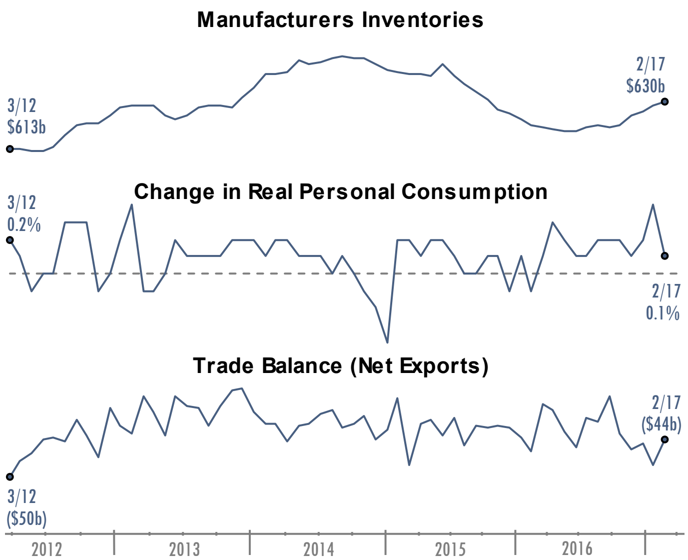
Bellwether CONSULTING

MARKET Recap

The US Economy: "Optimism Trumps Soft Data"

Economic growth continued in the fourth quarter at a slower pace of 2.1%. Although the headline number remains reasonably strong, two components were noteworthy in magnitude. First, imports surged and exports fell, combining to reduce the growth rate by 1.82%. This is the largest negative quarterly contribution to GDP for net exports since 2004, reversing a 3-quarter positive trend.

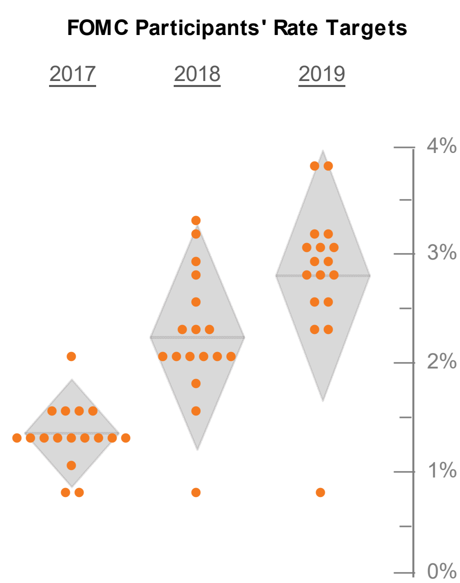




Second, inventories continued to grow, contributing 1.01% to the change in GDP. This is the second consecutive quarter that inventory changes were positive, following a 5-quarter cycle of contracting. Inventories continued to build through February. We know that consumers are currently optimistic – the Conference Board's consumer confidence survey peaked at 10-year record levels in March – and it would seem that manufacturers too are feeling confident. However, inventory investment is inherently a fickle thing. If final demand does not come through as expected, manufacturers will stop adding to inventories, and the associated economic activity will disappear from GDP.

The theory goes that the Federal Reserve can gradually increase rates for some time without significantly reducing final demand, just as they reduced rates to zero without significantly increasing demand. Only when rates exceed a certain critical level will the cost of money begin to influence consumer behavior. Unsurprisingly then, markets have priced in the likelihood of 2 more rate increases in 2017. The Fed telegraphs as much through its latest "dot plot" showing a cluster of Open Market Committee participants projecting year-end rates at 1.25% to 1.50%, 50 basis points higher than today.

However, monetary policy does not work in isolation. Global interest rates are linked to each other through foreign exchange rates, which (provided they are free to do so) will adjust to keep the real cost of money at worldwide parity. To the extent US rates move up and foreign rates do not, the US dollar will rally, making imports cheap to US consumers and US exports expensive to foreign consumers. Consumers will spend, but US manufacturers will not be the beneficiaries of end-demand. Therefore higher rates could impact economic growth not through the supply of money, which has significant "slack" at current levels, but rather through the balance of trade.

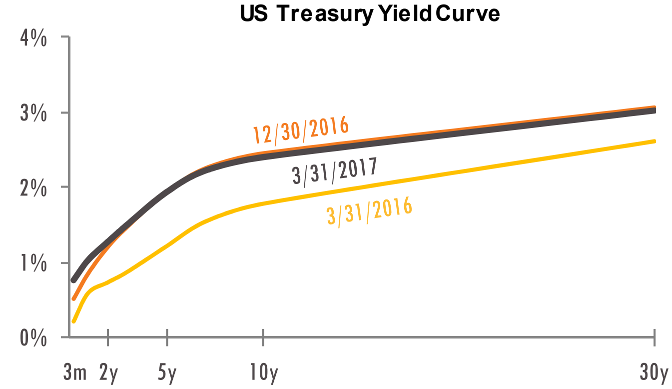


That was the pattern in Q4. Not so in the first quarter of 2017, as the Fed again raised rates on March 15th, but the impact on dollar exchange rates was muted. For the full first quarter the dollar ended lower against a basket of major currencies. The path forward is never straight, and markets never behave exactly as you expect. But we note that the trade balance could decline considerably before testing levels last seen prior to 2007. Efforts to constrain imports would be inflationary and would trigger retaliatory actions against exports. We think full-fledged optimists should consider becoming "cautiously" optimistic instead.

The US Bond Market

As the fed funds target rate increased to a range of 0.75% - 1.00%, shorter-term US Treasury bill yields rose in lock-step. However, intermediate- and longer-maturity yields sat mostly unchanged since the end of 2016. Five-year rates ended the quarter exactly where they had begun, at 1.93%. Longer key rates declined around 5 bps (0.05%), to close the first quarter at 2.40% for the 10-year and 3.02% for the 30-year. The real (TIPS) yield curve was similarly sedated.

US Treasury Yield Curve



Credit spreads continued to tighten, bottoming out in the first week of March. High-yield spreads narrowed the most, coming in 19 bps during the quarter to close at 3.92% (BAML US HY OAS); and, investment-grade spreads narrowed by 5 bps to 1.24% (BAML US Corp. Master OAS). Investment-grade corporate bond issuance was strong at $381 billion, showing promise of continuing a 5-year streak of record-breaking investment-grade corporate issuance. High-yield issuance, at $88 billion for the quarter, exceeded the volume in any three-month period for 2016 and is running at a near-record rate.

US Bond Index Returns

Blmbrg Barclays	1Q17
Aggregate	0.82%
Interm. Gov't	0.54%
Long Gov't	1.45%
TIPS	1.26%
Municipal	1.58%
Interm. Credit	1.14%
Long Credit	1.66%
High Yield	2.70%
MBS	0.47%

A few cracks have shown up in the otherwise-robust US fixed income markets. Vacancy and delinquency rates for commercial properties are gradually rising. The percent of commercial real estate loans in commercial mortgage-backed securities (CMBS) that have passed a 30-day delinquency has grown 115 bps in the trailing year, to 5.37% currently [Trepp]. Delinquency rates have risen uniformly across CMBS sectors, with the exception of multifamily housing, which has averaged less than 3% delinquencies – way down from the double digits seen as recently as 2014.

While the major ratings agencies forecast low default rates for 2017, energy company bankruptcies are still running through the pipeline - a hangover effect from $30-a-barrel oil. Fitch Ratings, for example, lists two high-yield energy companies among its top five borrowers of concern. Two of the companies underlying the CMBS delinquencies uptick also topped this list: Sears and Claire's. These and other mall retailers have made recent headlines promulgating potential pending bankruptcies. Some will join the ranks of Fortunoff's, Montgomery Ward, and Sports Authority. But this is a story of winners and losers. In the first quarter of this year, spreads on credit default swaps (CDS) widened sharply only in isolated cases – pricing in a greater probability these companies will default on some or all of their debt payments.

Rather than portending a 2008-esque global recession, this weakness is largely a result of evolving consumer preferences around whether to purchase online or remain reliant on brick and mortar. Online retailers are exerting seismic pressure. Mall anchor store spaces can be hard to fill when few businesses can make use of such a large retail property. Of those that are able, many operate a similar business likely to face similar struggles. Despite this, contagion appears unlikely. New entrants to these spaces are gearing up with more service and less retail focus - a sign of the times. Mega-gym operator Life Time Fitness has already replaced several department store dinosaurs. Corporate bond bears will need more ammo.

CDS Spread Rates

	3/31/2017	12m	Change
Stable			
Best Buy	1.7%		-15%
Wal-Mart	0.5%		+0%
Lowes	0.3%		+12%
Costco	0.3%		+18%
Deteriorating			
N.Marcus	13.0%		+296%
Sears	41.9%		+173%
Target	0.6%		+157%
JC Penney	6.8%		+35%

Credit default swaps (CDS) gained some notoriety in the 2008 financial crisis. They are essentially insurance, but are traded like bonds, and regulated like neither. SEC regulations are limited to prohibiting fraud, market manipulation, and insider trading. So, the potential did (and does) exist for large, concentrated CDS exposure to bankrupt even some fairly large banks or other financial institutions. Yet in reality, CDS enhance market stability through the information and hedging utility they provide to investors. This maturing product has evolved since 2008 into a more transparent and standardized vehicle that can be traded through a clearing house. While big investment banks, like Deutsche Bank, are exiting the CDS market, the overall size of the market remains quite large, measured in tens of trillions of dollars [Augustin]. The rate of the CDS spread indicates how much the purchaser would pay (annually) during the term of the contract, as a percent of the notional value of the contract, in exchange for receiving the notional value (often minus a recovery rate) under any specified qualifying default events, such as a missed coupon payment or bankruptcy filing.

The US Stock Market

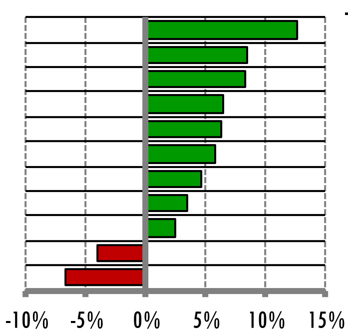
US equities started 2017 on a positive note, extending their climb higher into record territory. Stocks gained over the first two months on reports of mainly positive Q4 economic and earnings data. Productivity, unemployment, and consumer spending all improved at the end of 2016. Corporate earnings grew 8.0% YoY, driven by technology, financials, and utilities. In March, US stocks were flat, largely a result of political events. After President Trump was elected, investor sentiment grew significantly positive on the basis of future fiscal stimulus and reduction in regulations. However, with the failed attempt at repealing the Affordable Care Act, investors grew less confident in the administration's ability to enact policy changes.

US Stock Indices - Total Returns

Large-cap Stocks	1Q17	Mid-cap Stocks	1Q17
S&P 500	6.07%	S&P Midcap 400	3.94%
Russell 1000	6.03%	Russell Midcap	5.15%
Growth	8.91%	Growth	6.89%
Value	3.27%	Value	3.76%
Broad Markets		**Small-cap Stocks**	
Russell 3000	5.74%	S&P Smallcap 600	1.06%
Growth	8.63%	Russell 2000	2.47%
Value	2.99%	Growth	5.35%
		Value	-0.13%

Large-cap stocks outperformed their mid- and small-cap counterparts. From a traditional style perspective, value trailed growth. Among "factors" (which we touched upon in last quarter's Focus article), momentum and quality outperformed, while value, minimum volatility, and high dividend yield lagged. Sector leadership experienced a sharp reversal from Q4 as top performers included technology, consumer discretionary, and health care. Financials, telecommunications, and energy were the bottom performing sectors over the three months.

S&P 500 Economic Group Components - Total Returns



Sector	1Q17
Technology	12.57%
Consumer Discr.	8.45%
Health Care	8.37%
Utilities	6.39%
Consumer Staples	6.36%
Materials	5.86%
Industrials	4.56%
Real Estate	3.54%
Financials	2.53%
Telecom	-3.97%
Energy	-6.68%

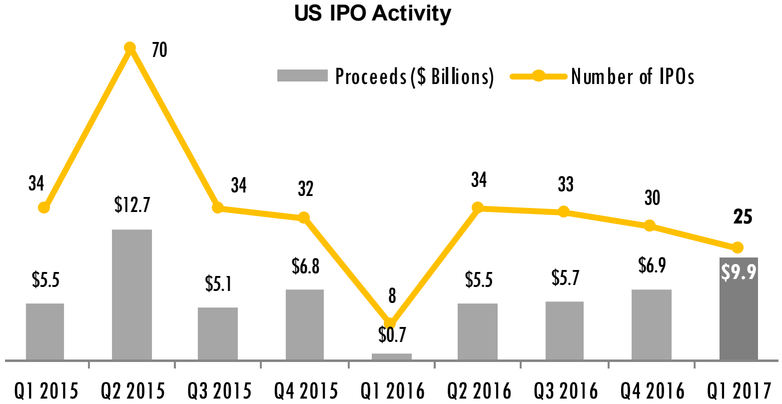
Source: Standard & Poor's

Outperformance within the tech sector was attributable to outsized gains of hardware and software companies, including Adobe Systems, Facebook, and Apple. Sector constituents saw earnings and revenue grow 12.7% and 7.3% over the trailing 12 months, respectively - the highest levels of any sector over the same period. The consumer discretionary sector also showed robust performance. Internet retailers (Amazon and Priceline) were the largest contributors, followed by home improvement (Lowe's and Home Depot) and cable/satellite companies (Viacom and Charter Communications). Health care companies also outpaced the broader index, led by the equipment industry. Even amid negative rhetoric on drug pricing from President Trump, biotech and pharma stocks rebounded nicely from Q4 losses. This was in part due to the potential of reduced burdens around regulatory approval.

On the downside, the energy sector sold off as oil prices declined 6.2%. Not surprisingly, integrated oil and oil exploration & production companies were the most affected by the drop in the commodity's price. The telecommunication sector also ended Q1 in negative territory, however this was almost exclusively a result of losses by wireless giants Verizon and AT&T. Both reported earnings below analyst expectations in addition to increasing competition in the space, particularly around the offering of unlimited data for wireless customers, which led to revised (lower) first quarter estimates. Financials also underperformed the broader market but experienced positive absolute returns. Regional banking and investment banking & brokerage industries led the sector lower, largely a result from profit taking after significant outperformance in the prior quarter.

First quarter IPO activity was notably strong, led by social media company Snap Inc. Over the three months, there were 25 pricings, which totaled $9.9 billion in equity. The Snap Inc. IPO represented roughly 34% of total equity issuance and 85% of technology sector issuance. Other sectors that experienced strong IPO activity included real estate, energy, and industrials. This is in stark contrast to Q1 2016, which recorded 8 offerings totaling $700 million and was limited to only health care. Since that time, energy sector IPO activity has meaningfully increased to 20% of total issuance as commodity prices have rebounded.

US IPO Activity



Source: Renaissance Capital

Overseas Markets

Overseas markets surged ahead as investors seemed relieved at the peaceful transition of power in the US along with a quiet quarter geopolitically. The US dollar eased modestly against most other currencies. Emerging markets appeared to benefit most from the positive energy. Among the euphoria, however, uncertainty around Brexit and upcoming European elections continues to hang like dark clouds over global markets. Investors will be keenly watching the outcome.

Foreign Stock & Bond Indices - Total Returns

MSCI Broad Indices	1Q17	Barcap Global Indices*	1Q17
World Index	6.38%	Global Aggregate	1.76%
EAFE (Developed)	7.25%	Pan-Euro	0.99%
Emerging Markets	11.45%	Asian-Pacific	4.64%
		Eurodollar	1.34%
MSCI Regions		Euro-Yen	4.75%
Europe	7.44%	Other Currencies	9.14%
Japan	4.49%	*Unhedged*	
Pacific ex-Japan	11.76%		
Latin America	12.06%		

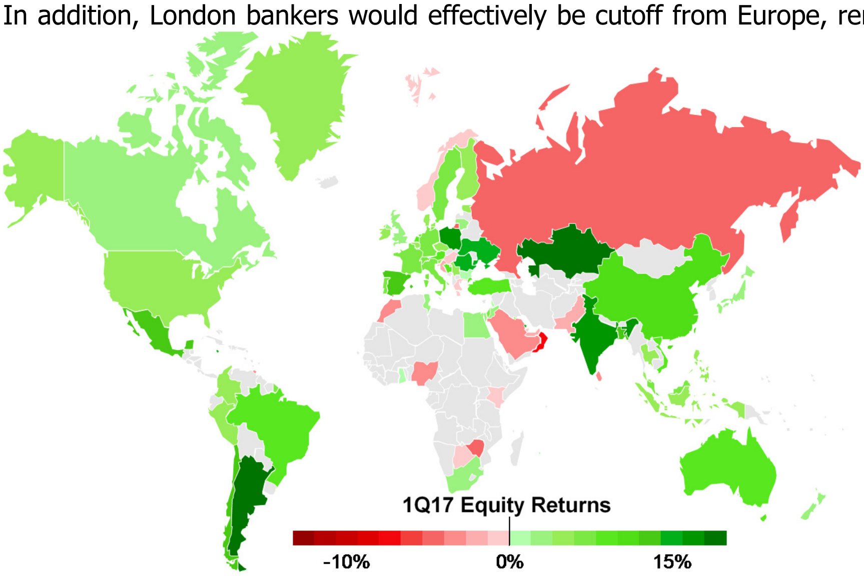
Europe

The eurozone economy showed signs of strengthening as job creation improved. Employment has increased the most since mid-2007, with hiring in the services and manufacturing sectors showing resilience. The IHS Markit Purchasing Managers Index surprised, rising when the consensus expectation was for a decline. The reading showed a quarterly expansion of 0.6%. A broadening recovery has provided some breathing room for the EU to navigate a period of uncertain outcomes including Brexit, US trade policies and European elections. Expectations are that strong growth momentum will carry over into the second quarter.

Euro-area factory activity jumped in March to 56.2 from 55.4 the month earlier. In the index of services, a higher increase, from 55.5 to 56.5, was observed. Activity in both sectors is at the highest in nearly 6 years, with both the French and German economies showing unexpected improvement. In France, consumer prices increased for the first time since 2012. Employers, seeing explicit growth, are looking to increase capacity and their workforces. The combination of accelerating wage growth, increasing pricing power, and rising energy prices is translating into higher inflationary pressures. Euro-area inflation accelerated to 2% in February, the fastest growth in 4 years. While that rate is in line with ECB goals, ECB president Draghi has said that he remains unconvinced that the upturn in growth is sustainable.

The ECB's policy arm meets next in late April. Given positive economic signs, consensus is beginning to tilt toward a phase-out of the QE program. However, consensus expectations of economists indicate that policy makers will wait until the June meeting before reducing bond purchases to ensure nascent growth is not crimped. The bank already said it will scale back monthly purchases in April to €60 billion from €80 billion currently. Analysts believe core inflation will have to creep above 1% and stay there for a protracted period before the central bank will want to reduce its monthly asset purchases further. The tapering process could begin in 2018 and accelerate to a 6 to 9 month schedule, rather than the expected 12 months, given solid economic data and a potential lack of assets to buy under the QE program.

Near the end of the quarter, Prime Minister Theresa May officially initiated Britain's exit from Europe. This move signals the beginning of what will be a complex and politically difficult divorce from the 27-member European Union. The move starts the clock ticking on the 2-year window to negotiate a deal. If no deal is struck by the deadline, Britain and Europe would move into a period of uncertainty, with trade reverting to the rules of the World Trade Organization (WTO). A reversion to WTO rules would expose UK exports to European tariffs and other barriers including health and safety rules. In addition, London bankers would effectively be cutoff from Europe, rendering illegal many common client transactions.

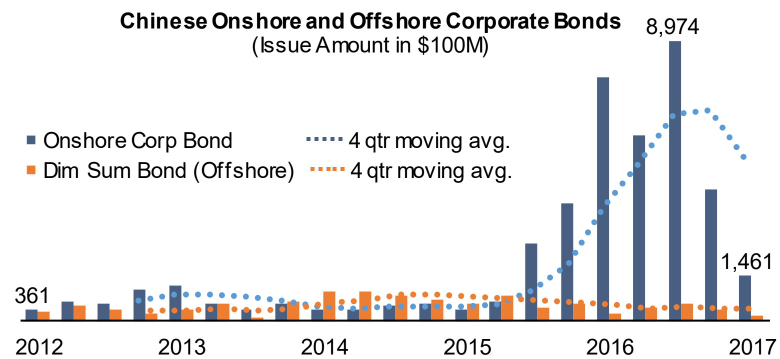


One of the perks of the European and EU Single Market is "passporting." Passporting allows banks and insurance companies to sell their services anywhere in the single market without having to establish a base in every country in Europe. But membership in the single market is conditional upon freedom of movement of goods, services, capital and people. Theresa May has already said she intends to restrict the free movement of people from the EU after Brexit, while EU leaders have meanwhile said the four freedoms are non-negotiable.

Unless there is a negotiation, the UK will lose passporting. While numerous financial services companies have been preparing to move jobs to the continent, other industries have been biding their time and may now feel the need to take action. With this pressure may finally come some of the impact on the UK and European markets that had been expected but, heretofore, has not been seen. Prior to the referendum last year, the British Treasury had predicted that a vote to exit could shrink the economy by up to 6% annually for the first 2 years. The UK economy expanded by 1.8% in 2016 and consumer spending in the UK has been increasingly financed by debt. In addition, the British pound has fallen around 17% against the US dollar since the vote, raising the costs of imported goods.

Asia

Japan's consumer confidence rose sharply between December and January, regaining the ground it lost in November. Despite the jump, it remains below the neutral mark of 50, as it has since 2006. However, since early 2014 there has been a clear, but very mild uptrend of consumer attitudes, as demonstrated in the improvement to Japan's consumer confidence. Although confidence has improved, the overall tone has remained negative for the last 10 years. While consumers are reasonably happy about their income and, therefore, are reasonably disposed to buy durable goods, they lack confidence in employment conditions and are not pleased with the value of their assets. The latter two issues restrain them in their willingness to buy durable goods. The BOJ continues to press ahead with its aggressive program to affect bank reserves and control the yield curve; meanwhile, Japan's manufacturing PMI has been slowly improving.



MSCI's yearly rebalancing of the MSCI Emerging Market Index is set to include some mainland Chinese companies, but the proposed companies will only account for 0.5% by weight of the index instead of the originally proposed 1%. Currently these A-share mainland China companies are already accessible to foreign investors through the Hong Kong exchange. This quarter the bond market in China was shaken by a pair of bond seal forgery scandals, leading some investors to worry about bank guarantees. Investors are beginning to wake up to the excessive debt in the Chinese corporate sector, above 170% of GDP [OECD]. Onshore corporate debt issued in Q1 2017 is still above its long-term average, but far less than Q1 2016. The first quarter of 2017 saw 9 defaults; even still, global investors are buying up Chinese-domiciled, dollar-denominated debt. Dim Sum bonds (Chinese Offshore debt) have continued to shrink. Taken together, these signs indicate China is loosening its grip on foreign investment in the mainland. In a story that is surprisingly common in Hong Kong, Huishan Dairy's shares fell 85% in only 90 minutes, leading to a suspension of trading. The Hong Kong exchange does not have daily limits on price movements, and trading suspensions are known to be of indefinite length, leaving individual investors stuck. With around $1.6 billion in debt payments due within a year, possible help from the Chinese government may be required to stave off collapse of the firm. Despite the risks, the MSCI China index had its best Q1 since 2006, and investors are taking notice of PE ratios that are 22% lower than the MSCI World Index.

Latin America

Brazil is the world's second largest producer of chicken and beef. Meat products are some of its largest exports. But its meat producers are weathering a bribery scandal that lead Egypt, Chile, the EU, South Korea, and China to temporarily halt the import of Brazilian beef and chicken products in Q1. While the bans have since been lifted, the damage may already be done. Share prices in the largest beef and chicken producers JBS SA and BRF SA are down for the quarter. The already struggling Brazilian economy faced further strain from the import bans by its largest buyers and the constant reminder that corruption is a fact of life.

Mexico was battered in the 2016 US election cycle and subsequent Trump victory, leading to higher bond yields and a lower peso. Since then, the peso has been among the world's best-performing currencies. The market is predicting that Mexico could benefit from a NAFTA renegotiation and that the country has more trade leverage than initially thought.

Focus On: *CIT Due Diligence*

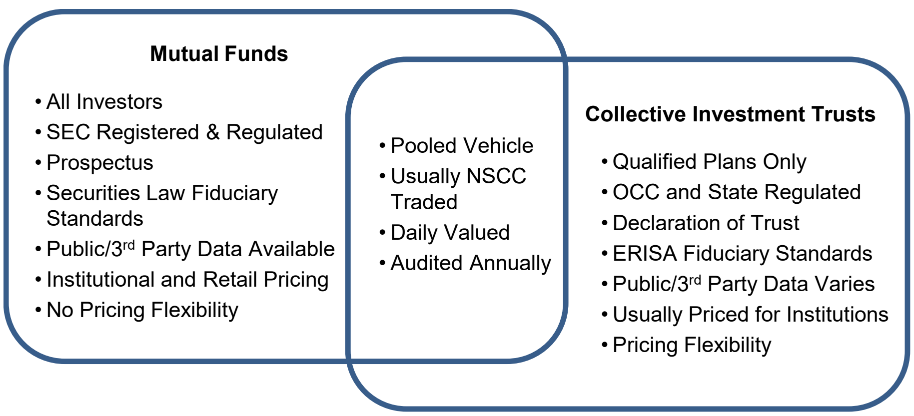
Over the last decade, amplified scrutiny of retirement plan costs has led many plan sponsors to prioritize expense management, making it a key area of fiduciary focus. Investment management fees are often one of the largest overall costs associated with a retirement plan. In this environment, many mutual fund families have responded by offering lower-fee share classes created specifically for institutional clients, including those with zero revenue share.

But lower-fee mutual funds are not the only solution. Many plans are turning to Collective Investment Trusts (CITs) as another way to decrease costs in the investment line-up. Fiduciaries should consider CITs along with other structures when selecting investment funds. But thanks largely to a well-financed plaintiff's bar, rhetoric now exceeds reality. Consider Bell v. Anthem, a case filed in December 2015 in which the plaintiff argues, among other things, that "Anthem also failed to adequately investigate and to offer non-mutual fund alternatives, such as collective trusts and separately managed accounts prior to 2013." Similar language is now common in complaints filed against fiduciaries.

It's widely believed that CITs are always cheaper, and therefore always better, than mutual funds for retirement plans. While CITs are often less expensive, that is not always true. Even when true, the cheapest option is not always the most prudent. A myopic focus on fees can lead to unforeseen issues with potentially expensive consequences. Whether selecting a new investment or reviewing current ones, equal weight should be given to the quality of the investment strategy, quality of operations for the investment vehicle, and fees.

A Plan within a Plan

More properly called a Collective Employee Benefit Trust, a CIT is a trust that combines and invests assets for a group of qualified employee benefit plans (DB and DC). They fall under the regulatory purview of the Office of the Comptroller of the Currency, part of the US Treasury. More importantly, since all investors are benefit plans, they are subject to the fiduciary standards of ERISA. A CIT generally files a federal form 5500 of its own. They cannot be held by individual investors, non-qualified plans (including 403(b) plans), foundations/endowments, or other corporate portfolios.

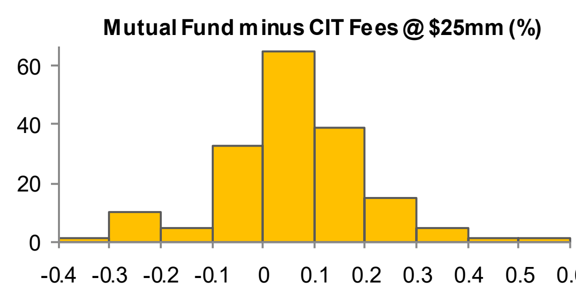


CITs have existed since 1927. Early versions provided little transparency, had limited product offerings, and were valued infrequently, typically once per quarter. Information on CITs was not made available through newspapers. As a result, mutual funds, with their daily valuations and greater transparency, became the more popular pooled investment vehicle.

CITs have come a long way since the late 1920s, particularly over the last decade. In 2000, the National Securities Clearing Corporation (NSCC) added CITs to its mutual fund trading platform, FundSERV, allowing them to trade daily and automatically like mutual funds. Today, most recordkeepers are able to incorporate CITs on their platforms, giving plan sponsors and participants access to websites where they can find information and perform transactions on CITs alongside the other investments in the plan. Asset management firms with CITs now provide more information, such as fact sheets or prospectus-like documents (typically in the form of an offering circular). These operational enhancements and greater transparency, along with an increased focus on retirement plan fees, have increased demand for CITs. At year-end 2015 CIT overall usage reached $1.58 trillion in assets, compared with $0.90 trillion in 2008 (Pensions & Investments).

Driving the Cost Advantage

CITs typically have lower expenses than their mutual fund equivalents for several reasons. CITs are exempt from SEC registration, allowing them to avoid some associated costs such as creating and delivering proxies, prospectuses, and other shareholder materials. They may also be faster and less expensive to create. The relative efficiency of accessing participants through plan sponsors limits the associated marketing and distribution expenses, and eliminates the need for redundant transfer agency and recordkeeper services. Finally, CIT fees may be negotiable, unlike mutual funds. All these features add up to lower expenses with potentially significant savings for qualified plans.



In a sample of 175 strategies, for over 60% the difference in fees between the mutual fund and CIT ranged from 0 to 10 basis points. Source: eVestment, Morningstar

Alas, there is a difference between potential savings and actual savings. The mutual fund industry has increasingly improved its institutional pricing. In practice, the difference in investment fees can be much smaller than many expect. Investment management fees for CITs are often assessed using a sliding scale, which means smaller plans may achieve lower investment fees through an institutional mutual fund.

While management fees are negotiable and will vary based on the mandate, other "operational" expenses are not negotiable – a small CIT may generate higher all-in expenses due to trading and fixed costs, which are spread over a smaller portfolio. It is important to understand if other expenses are capped and, if so, know the expiration date.

While CIT fees can be negotiated, a manager will typically create only a limited number of "net of fee" classes, or series, of the trust to limit operational expenses. If you want to negotiate a better fee level than the lowest-cost class, you would need to invest in a gross-of-fee class and pay the management fees directly. That's easy for a defined benefit plan. But for a defined contribution plan that charges investment fees through participants, the plan's recordkeeper or custodian would need to "wrap" in investment fees, a service for which they might charge extra. It also requires additional customization of fact sheets and websites due to having a unique fee level and net-of-fee performance record. All of these costs must be rolled in before comparing fees.

A Cautionary Tale

It always pays to be careful, but sometimes it pays in a big way. Consider the case of a large 401(k) plan sponsor that elected to use a CIT instead of a mutual fund for one of their investment options. The CIT fee level was lower, although not much lower, than the institutional class of the mutual fund. However, the CIT suddenly and unexpectedly experienced a significant performance gap to the mutual fund – over 100 basis points. The underperformance effectively destroyed nearly 10 years of expected fee savings.

The culprit in this case was cashflow management. The investment firm had a large mutual fund book of business – almost exclusively institutional, but with very few CITs, and most of those recently launched. While assets under management for the strategy were quite large for the mutual fund (many billions of dollars), they were low for the CIT, which made our fictional plan sponsor the largest investor by far in the pool. This meant that actions taken by that plan had an outsized influence on the experience of all the investors in the CIT. Further, the management team, while experienced and familiar with the operational protocols around the mutual fund, were inexperienced with the practices for the CIT, particularly as they related to balancing the operations (e.g., trade executions, cash-flow management, etc.) of the CIT with the mutual fund.

When the plan sponsor in our story mapped the assets from an acquisition into the CIT, it revealed serious operational disconnects. The recordkeeper for the plan did not alert the manager to the incoming cash. The manager did not notice the deposit in a timely manner, and then did not act quickly to invest the cash. As luck would have it, the stock market rallied strongly. The fully-invested mutual fund enjoyed the benefits of a run-up in many of its holdings.

Imagine you are the plan sponsor of a multi-billion dollar 401(k) plan. Your investment line-up includes an actively-managed US large-cap growth equity fund with a "well-established" mutual fund provider in one of their "flagship" strategies that has gathered a significant amount of your participants' assets.

As a good fiduciary of a large plan you already have the lowest-cost share class available installed in the plan, but you recently heard that the fund manager has launched a CIT for the same strategy at a lower fee. Same strategy, same management team, same investment firm - all at a lower cost. The decision is a slam dunk, right?

Now imagine it is six months after you have made the switch and you're hearing that HR is getting calls from participants complaining about the new CIT - something about it underperforming the mutual fund by over 100 basis points. Could that possibly happen? It can...

Because the CIT was not covered by Morningstar or other third-party information providers, some participants were regularly using information on the mutual fund as a proxy for the CIT. When statements were released, they noticed the marked difference in returns between the two vehicles. This forced a number of uncomfortable communications from the plan sponsor to participants, explaining and defending the decision to move to the CIT.

There were clues up front to potential problems. When an old, large mutual fund company decides to "dabble" in alternative structures, it is tempting to cut corners on implementation. To the extent systems are not in place to monitor cashflows, investors are vulnerable – as it is unrealistic to expect a human portfolio manager to pay equal attention large and small accounts. Sadly, all other investors in the CIT shared in the losses, not just the one that mapped in the assets.

In fairness, the reverse situation is also possible. If a manager (typically a custody bank) runs a large, well-established CIT and a relatively small mutual fund, it is the mutual fund that is more vulnerable to bad cashflow management. This situation is less common.

Caveat Emptor

Cashflow management is a big issue to consider, but not the only one. Rules governing investments by CITs are less stringent than those for mutual funds, and plan fiduciaries must be aware of differences in investment policy. For example, securities lending by CITs is not regulated as strictly. In the credit crisis of 2007-2008, some major CITs experienced losses due to impairment of lending collateral, whereas their mutual fund counterparts did not.

While data on CITs is more readily available today than in the past, it is still not always robust or easily attainable. Not all managers offer fact sheets for their products. So for DC plans it is important to check that one will be made available for distribution to participants, or that task may fall to the plan sponsor to sort out. If a fact sheet already exists, reviewing the content for completeness and confirming who will produce it, as well as the specific process for providing it to the recordkeeper, will avoid procedural headaches down the road. Similarly, plan sponsors must look into whether the CIT has an investment overview document and ask the same questions. If the fee savings for the CIT is small, perhaps a prospectus and better quality fact sheet are worth the difference.

Finally, understanding how trades are allotted between the CIT and other investment structures at the investment management firm is also imperative. Is there a process in place to ensure impartiality when more than one strategy or vehicle is vying for a limited pool of assets?

Due Diligence Topics – Beyond the Investment Strategy	
Firm's History	- How long have you been offering CITs? - What percentage of the firm's assets are in CITs? What percentage is in other vehicles? - What are the respective AUM growth rates?
Fees	- What is the all-in fee for the CIT? - Is it less than the lowest mutual fund net expense ratio (including revenue share, if appropriate)? - Are fees on a net or gross basis (i.e., additional cost for recordkeeping, custodian, communications, etc.)? - What portion of the fee structure is negotiable? - Are there fee breaks, caps, etc.? What are the terms?
Pool Composition	- What is the minimum deposit? - What was the inception date, and what is the current AUM? - How many distinct investors are currently in the CIT? - What is the largest position? What is the median position? - What is the growth rate, and how (i.e., what size investor) has it been growing?
Information Provided	- Does the firm create fact sheets for the CIT? If not, who does? - What other information will they provide? - How often is the material updated? - How is the material delivered to the recordkeeper? - What problems have there been distributing materials to participants and how were the situations remedied?
Operations	- What are the procedures to ensure positions are fairly distributed across applicable strategies at the firm? - Have you ever experienced problems interfacing with our recordkeeper on CITs? - What steps do you take to minimize trade costs? - What are the procedures for handling cashflows?
Strategy Management	- Are there ever differences between the CIT and mutual fund version of the strategy? - If so, what are the tolerance bands for this and what controls are in place to minimize them? - Has the historical performance between the CIT and mutual fund been consistent? - Will you report on these regularly?

(Due) Diligence is the Mother of Good Luck

At the end of the day, CITs are much like many of the other products we have covered in our Focus articles over the years – index funds, stable value, hedge funds, etc. They can present a great investment opportunity, but you have to know what you are buying. And unfortunately, there are not any shortcuts to this. You have to look beyond the obvious, simple advantage and see what is under the hood. For index funds, getting beyond the low expense ratio to understand whether the strategy will replicate or sample the index, what characteristic of the index it will approximate along with the tolerance bands, and any terms around securities lending forms the foundation of the due diligence process and, later, the monitoring process. For stable value products, understanding the workings of both the wrap program and the underlying portfolio are as important as reviewing the mechanism to set the crediting rate since all these components are essential to the strength of the guarantee.

For CITs, working through a complete due diligence process that includes the expense structure, the available fund documentation and procedures for distributing it to participants (for use in a DC plan), the operational controls along with any potential points of conflict with the firm's other products, and the strategy management process will lead to thoughtful and well-supported investment decisions in the best interest of plan participants – which may or may not be investment in a CIT. Benjamin Franklin is credited with the quote, "Diligence is the mother of good luck." If he were a plan fiduciary today, we think he would have amended it to highlight the need for appropriate due diligence in advance of any plan investment decision.

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