

W H I T E P A P E R

Collective Funds:
Description, Oversight,
Features & Trends

J U L Y 2 0 0 7

*Presented by
AST Capital Trust
with contributions from
Hewitt Associates*

The retirement market is currently going through many meaningful changes, including some resulting from the increased scrutiny by plan sponsors, advisors, regulators and industry providers on fees and expenses. As the market evaluates alternatives to retail mutual funds, collective funds — a widely used investment vehicle in the past — are experiencing a rejuvenation of interest and consideration. Moreover, additional collective funds managed by some of the country’s largest managers are becoming more readily available. The resulting growing supply of collective funds offers plan sponsors and advisors additional choices when selecting investment vehicles.

To assist with an evaluation of collective funds, this white paper examines the history, oversight, benefits and limitations of collective funds and the current market trends related to these types of investment vehicles.

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I. C O L L E C T I V E F U N D S D E F I N E D

A collective fund is an investment fund that is exempt from SEC registration as an investment company under Section 3(c)(11) of the Investment Company Act of 1940 (the “1940 Act”) and maintained by a bank or trust company for the collective investment of qualified retirement plans. Collective funds may only hold the assets of qualified retirement and governmental plans, including certain defined benefit (“DB”) and defined contribution (“DC”) plans. Examples include 401(k) plans, Taft-Hartley plans, profit sharing and cash balance plans, and governmental 457 plans.

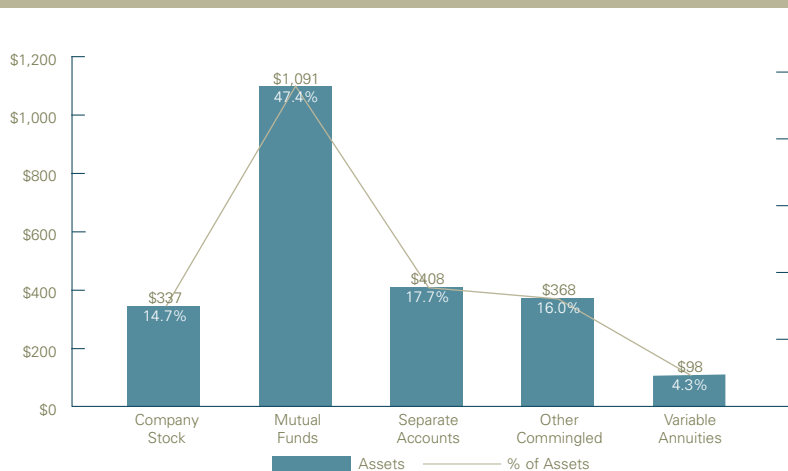
Within a collective fund – like a registered mutual fund – qualified clients with common investment objectives pool their assets into a single portfolio. The bank portfolio manager or a sub-advisor hired by the bank invests these assets according to a specific investment philosophy and strategy. The resulting portfolio is similar to a mutual fund with the pooling of assets creating greater scale, which generally results in increased efficiencies and lower costs to investors. All investors receive the performance of the overall fund, net of associated expenses.

As with mutual funds, collective funds are available in a wide range of investment strategies, from fixed income to equities, and can be actively or passively managed. An individual collective fund operates under a specific investment policy or strategy which

outlines the types of assets the fund’s portfolio manager can invest in (e.g., small-cap growth stocks or investment-grade corporate bonds).

Collective funds – or commingled funds as they are occasionally called – have long played a meaningful role in the DC market. For example, from the outset, stable value has been one of the most popular asset classes in DC plans, and these funds are almost exclusively offered in a collective fund or separate account format. In addition, with increasing frequency in recent years, collective funds now are regularly used as an alternative to mutual funds across all asset classes. The data in Exhibit 1 shows the usage of various investment vehicles within 401(k) plans in 2005 and the role that commingled vehicles (including collective funds) play in this market (16% of total assets).

Exhibit 1: 401(k) Assets by Investment Vehicles, 2005 (\$ billions)



Nearly half (47%) of 401(k) assets resided in mutual fund vehicles in 2005, amounting to \$1.1 trillion. Separate accounts accounted for an 18% share of the market, and commingled funds for an additional 16% share. Company stock’s share of 401(k) assets decreased from 15.4% in 2004 to 14.7% in 2005. Variable annuities held approximately 4% of 401(k) assets in 2005.

Key Implication: The grip is easing on mutual funds’ reign in 401(k) plans. In the early 1990s, mutual funds dominated the 401(k) industry because of brand recognition and daily valuations. This is beginning to break down as these traits are no longer exclusive to mutual funds. Fee disclosure is also more rigorous than before, and consultants are looking for investments that weren’t tainted by the recent fund investigations. This is increasing the adoption of collective funds by plan sponsors who want to pool assets together to benefit from institutional money management but avoid the administrative and marketing costs of mutual funds.

Source: Cerulli Associates

II. H I S T O R I C A L B A C K G R O U N D

Collective funds are not a new phenomenon; they have been available for decades to both DB and DC plans. Since collective funds can be offered only by banks and trust companies, the primary distribution for the early funds was limited to the customers of the banks offering these funds. Then, as the popularity of mutual funds 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 being included in 401(k) plans.

The new elements in the collective fund equation today are operational enhancements and convenience. One of the most significant enhancements to collective fund operations has been 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 have made portfolio information more accessible to investors, greatly boosting the ease with which plan sponsors can use collective funds. For example, due to the availability of regular provider statements, voice response services, provider and plan web sites and traditional fund evaluation services such as Morningstar and Lipper, information on collective funds is now readily available to plan participants.

Equally important to the growth in collective fund usage was an expansion in the capabilities of National Securities Clearing Corporation's ("NSCC") Fund/SERV® platform 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 participants, sponsors and providers can complete collective fund transactions with the same ease as mutual funds.

The Depository Trust & Clearing Corporation ("DTCC"), through its NSCC subsidiary, provides the fund industry with a broad range of services that automate, centralize and standardize fund transaction processing and data exchange. These services have helped support the industry through decades of market growth by linking fund companies to their expanding network of distribution firms, such as broker/dealers, banks, trusts, independent broker/dealers, financial planners and others. Fund/SERV® was launched in 1986 to process mutual funds. In 1992, DTCC broadened Fund/SERV®'s capabilities to handle more diverse investment types, beginning with the addition of no-load and money market funds. Since 2000, DTCC has added numerous other investments, such as stable value funds, 529 state college savings plans, offshore funds, guaranteed investment contracts and, importantly collective funds of all asset classes.

III. REGULATION AND OVERSIGHT

While collective funds are exempt from registration with the Securities & Exchange Commission (“SEC”), they are subject to oversight by a number of regulatory entities.

■ **Banking Regulators:** A collective fund may only be maintained by a bank or trust company, which means they are regulated by banking regulators. Collective funds, by virtue of being sponsored by bank or trust companies, are regulated by the Office of the Comptroller of the Currency (in the case of nationally chartered banks) or individual state banking regulators (in the case of state-chartered banks). Mutual funds, on the other hand, are regulated by the SEC.

■ **Advisor Regulation:** To the extent that a sub-advisor to a fund is a Registered Investment Adviser, the sub-advisor would be subject to regulatory oversight by the SEC. Also, to the extent they act as a broker/dealer, they would also be subject to oversight of the NASD.

■ **ERISA:** The trustee of the fund as well as an outside sub-advisor, if utilized, are subject to the fiduciary standards of ERISA.

■ **Auditors:** Virtually all collective funds are audited by outside auditors.

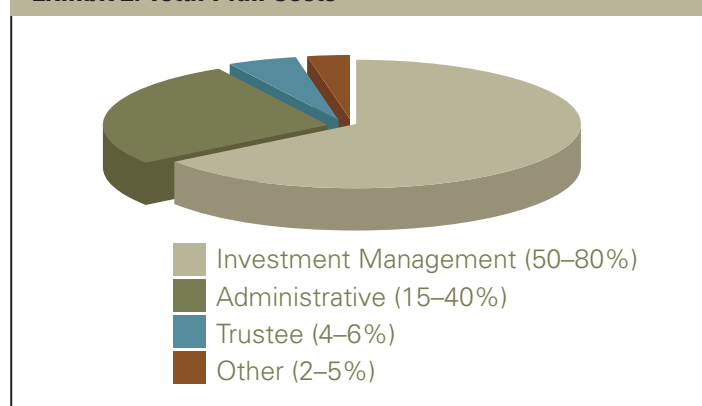
IV. COLLECTIVE FUND FEATURES AND LIMITATIONS

Collective funds have several features that make them attractive to investors. Certainly, the relatively lower expenses commonly associated with collective funds is an important consideration. For example, collective funds often (but not always) have lower operational expenses embedded into the overall expense ratio of a fund compared to mutual funds. In addition, the start-up costs associated with collective funds typically are lower in relation to other structures, such as mutual funds.

Many people question why collective funds typically have modest ongoing operating expenses. One primary reason is that collective funds do not service retail investors. Therefore, there is no need to maintain individual retail client balances and transactions – collective funds only need to maintain plan level investments. In addition, because collective funds are not subject to the 1940 Act, there are no costs to produce, print and mail proxies and prospectuses. These savings typically are passed on to the investor in the form of lower operating costs and fees. (Note: collective funds typically offer a disclosure statement that serves a similar purpose as a prospectus, but at a much lower cost to produce and distribute).

Even a relatively small reduction in investment fees can meaningfully reduce the overall expenses of a plan because investment costs make up a significant portion of overall costs. Exhibit 2 shows the typical Total Plan Costs (“TPC” – all costs associated with offering a retirement plan, including record keeping, investment costs, etc.) breakdown for DC plans.

Exhibit 2: Total Plan Costs



Source: Hewitt Associates, 2006

Although fees vary from manager to manager depending upon a number of factors, on average collective funds tend to have meaningfully lower fees than mutual funds (Exhibit 3).

Exhibit 3: Median Expense Ratio by Category

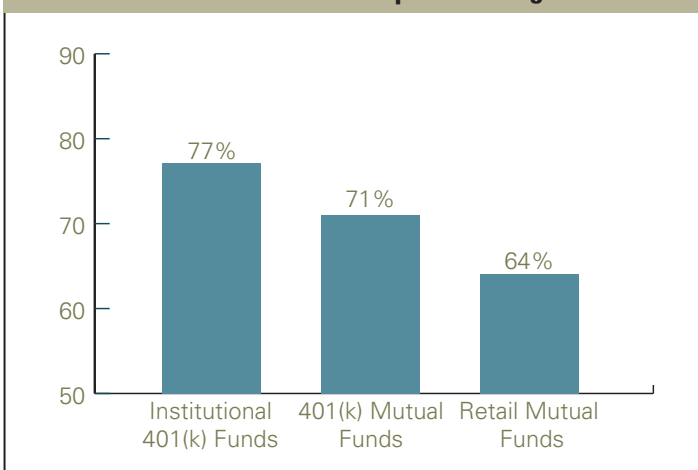
Asset Classes	Mutual Funds %	Collective Fund %
Intermediate-Term Bond	0.55%	0.30%
Large Value	0.85%	0.55%
Large Growth	0.93%	0.56%
Small Value	1.12%	0.96%
Small Growth	1.20%	0.94%
International	1.05%	0.80%

Source: Hewitt Associates, 2006

Interestingly, fund expenses are the most manageable component of TPC. Plan sponsors have hundreds of funds from which to choose with fees varying significantly among the choices available to them.

Exhibit 4 illustrates the impact the reduced fees found in institutional funds can have on the replacement income of an average 25-year-old over her career. The income replacement ratios (the percentage of current income your 401(k) investments will replace upon retirement) can be significantly higher if you invest in institutional mutual and collective funds.

Exhibit 4: Percent of Income Replaced - Avg. 25-Yr.-Old



Source: Hewitt Associates, 2006

“Institutional funds, like collective trusts and separate accounts, are increasingly popular with mid- and large-sized employers as they are significantly less expensive than mutual funds,” says Pamela Hess, Director of Retirement Research at Hewitt Associates. She adds, “A seemingly small number of basis points saved over time can lead to meaningful differences in participant savings.”

“Cost is certainly a key factor when sponsors consider funds, as it should be,” said John Sturiale, Field Vice President of Retirement Investment Services at Charles Schwab. “Using a collective fund structure rather than a mutual fund structure helps plan sponsors keep costs down for participants.”

Paying fees higher than necessary can result not only in lower earnings but can also present plan sponsors with risk. Greg Allen, President and Director of Research at Callan Associates, comments: “With increasing regulatory [and participant] scrutiny of the fees associated with defined contribution 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.”

Another reason collective funds are of particular interest in the market today is the issues surrounding the use of mutual funds. Short-term trading restrictions, redemption fees and the impact of Rule 22c-2 under the 1940 Act all have some plan sponsors searching for alternatives to mutual funds. When considering collective funds, plan sponsors find that:

- Collective funds typically don’t have trading restrictions that are as onerous or difficult to monitor as mutual funds.
- Collective funds often do not have redemption fees.
- Rule 22c-2 doesn’t apply to collective funds.

Mr. Allen comments: “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 that collective funds are not a product that their participants can get off the shelf and so they view access to them as a value-add to the retirement plan.”

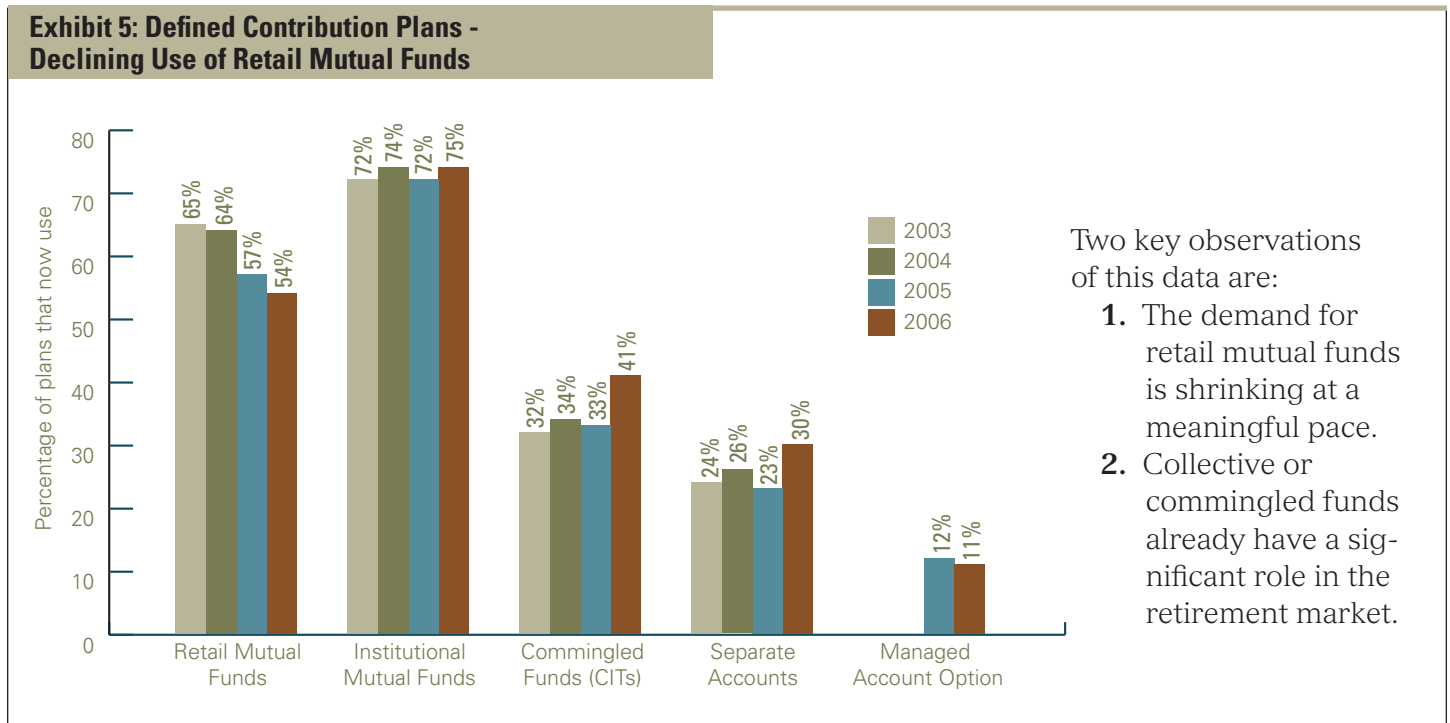
However, along with the benefits often found in collective funds, there are some limitations. These limitations include:

- Collective funds are not always less expensive than other vehicles, including mutual funds.
- Performance is not 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 does not allow collective funds to retain IRA rollover assets.
- At present the universe of products that are offered in a collective fund format is much smaller than the available universe of mutual funds.

V. C O L L E C T I V E F U N D T R E N D S

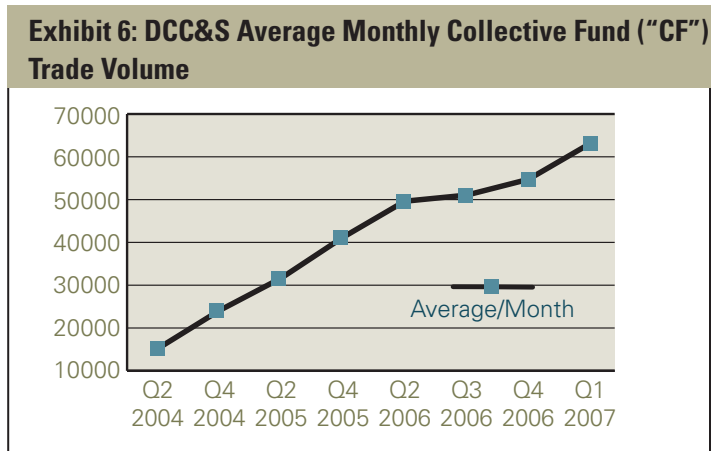
As noted previously, there are many signs of the widespread and growing use of collective funds in the financial services industry, particularly as a popular investment choice in DC plans. As such, DTCC expects that this will equate to a significant increase in the number of collective funds it processes over the next few years.

The Morningstar chart with data from Greenwich Associates (Exhibit 5) shows trends for retail mutual funds and other popular alternatives.

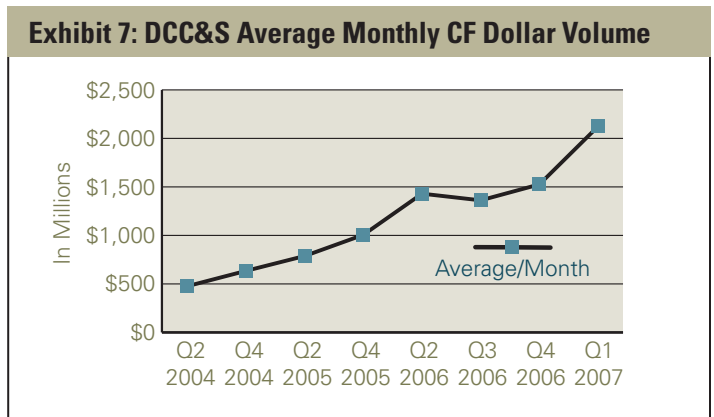


Source: Morningstar/Greenwich Associates

There is more data that is also available on the increased demand for collective funds. For example, a review of NSCC’s Defined Contribution Clearance & Settlement Service (“DCC&S”) transaction data reveals some distinct trends. Exhibit 6 shows the total number of average monthly trades in collective funds handled by the DCC&S and Exhibit 7 shows the dollar volume in collective funds. Although collective fund trading volume on DTCC is still a fraction of overall mutual fund trading, both charts show a consistent and steady increase in the use of collective funds.



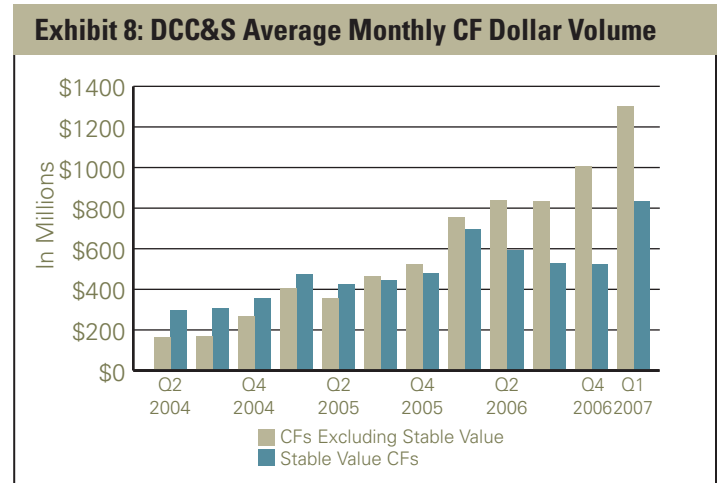
Source: DCC&S and AST



Source: DCC&S and AST

The actual move to collective funds may be larger than the above information reveals. For example, one limitation of the above DCC&S data is that many collective funds still don’t trade via DCC&S, so collective fund trends may be even larger than demonstrated by this data.

A common question asked by those considering collective funds is - Is the success of collective funds limited to just stable value? Interestingly, the data in Exhibit 8 shows that non-stable value collective funds volume now exceeds stable value collective funds in terms of dollar volume via DCC&S. Trading volume also indicates a similar trend.



Source: DCC&S and AST

Given that stable value collective funds hold a very meaningful portion of DC assets, this data reveals that the demand for collective funds in all 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 age funds) is likely to result in a further increase in the use of collective funds. The reason is that collective funds are an excellent vehicle to house asset allocation funds as a result of the same points made earlier in this paper, including low cost and operational flexibility.

Allen of Callan Associates notes: “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. The flexibility and cost structure of collective funds make them better suited to achieving these goals than mutual funds.”

John Sturiale agrees, “Collective funds have long been popular in DB plans—with good reason. As trends like automatic 401(k) plans make DC plans look more like DB plans, interest in and use of collective funds in DC plans will continue to grow.” Pamela Hess is not surprised at the increase in popularity of collective funds, as the fees and operating expenses are so competitive. “Institutional funds continue to be increasingly popular with employers, as they offer strong — and often the same — fund managers at significantly lower fees than mutual funds,” said Hess. “Companies should review their 401(k) investment lineup and evaluate the wide range of investment vehicles available to them. When possible, employers should consider using institutional funds, such as collective funds, as a way to lower fees.”

VI. A P P E N D I X

Non-Stable Value Collective Fund Dollar Volume and # of Trades

Time Period	Average Monthly NSCC/FundSERV® Trading Volume of CFs	Average Monthly CF Trades
Q2, 2004	\$165,230,616	8,129
Q3, 2004	\$167,092,330	9,320
Q4, 2004	\$265,295,845	11,921
Q1, 2005	\$402,565,254	13,932
Q2, 2005	\$355,067,420	16,216
Q3, 2005	\$459,968,440	18,722
Q4, 2005	\$518,589,379	22,948
Q1, 2006	\$751,548,573	28,578
Q2, 2006	\$831,643,239	29,825
Q3, 2006	\$825,170,180	31,211
Q4, 2006	\$998,340,799	34,372
Q1, 2007	\$1,293,786,813	38,949

Stable Value Collective Fund Dollar Volume and # of Trades

Time Period	Average Monthly Trading Dollars	Average Monthly Stable Value Trades
Q2, 2004	\$296,536,703	7,625
Q3, 2004	\$307,211,367	10,013
Q4, 2004	\$355,506,963	13,068
Q1, 2005	\$473,414,303	15,893
Q2, 2005	\$420,001,617	16,609
Q3, 2005	\$443,958,006	17,838
Q4, 2005	\$475,966,246	19,735
Q1, 2006	\$692,943,420	21,355
Q2, 2006	\$590,141,056	21,574
Q3, 2006	\$527,440,653	21,659
Q4, 2006	\$520,824,574	22,316
Q1, 2007	\$826,274,996	26,412

Source: DTCC

VII. G L O S S A R Y

1. Basis Points (bps) – A basis point is 1/100th of a percentage point.

2. Collective Fund – A collective fund is an investment portfolio that combines assets from a variety of qualified plans into one portfolio that is professionally managed, where each plan owns a pro-rata share of the value of the fund. Collective funds operate similarly to mutual funds and are available to qualified plans only. Management is by a bank or trust company. Collective funds are exempt from registering as an investment company pursuant to Section 3(c)(11) of the 1940 Act.

3. Defined Benefit (DB) – A tax-qualified pension plan that guarantees eligible employees a specified monthly income for life, upon retirement. The plan sponsor typically makes all the decisions and is responsible for the funding adequacy of the plan. The plan sponsor bears the liability for future payments to retirees and assumes the risk if the fund underperforms or fails. Benefit payouts are generally based on average salary prior to retirement and length of employment.

4. Defined Contribution (DC) – A tax-qualified retirement plan to which the employee (and in many cases the employer) contributes a specified amount to a plan. The benefit amount depends upon both the contributions made and investment gains/losses realized. 401(k), 403(b), Money Purchase and Profit Sharing plans are defined contribution plans.

5. Investment Only – Providers who sell investment services or funds as stand-alone investment services or products without requiring the purchase of other services along with the investment services.

6. Mutual Fund – A registered investment company that enables its shareholders to pool their funds for professional management as a single investment account; a fund operated by an investment company that raises money from shareholders and invests it in stocks, bonds, options, commodities or money market securities.

7. No-Load – A mutual fund or investment option, shares of which are sold without a commission or sales charge. There is no commission or sales charge because shares are distributed directly by the investment company, rather than through an intermediary, such as a broker.

8. Stable Value (SV) – Stable value investments are one of the most popular investments within 401(k) plans. SV is a fixed income fund that is “wrapped” to stabilize the performance of the fund and principal. SV typically is delivered through collective funds or separate accounts managed for larger plan sponsors.

9. Total Plan Cost (TPC) – The combination of explicit and implicit expenses that employers and employees pay for their defined contribution plan; the sum of investment management, administration and trustee costs.

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About AST Capital Trust Company

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