NORTHERN TRUST

A STEP IN THE RIGHT DIRECTION FOR ALTS IN DC PLANS

DC Industry Mulls Over Next Moves for Alternative Investments

Asset Servicing Northern Trust

Seeking higher returns and lower risk, defined benefit (DB) pension plan sponsors for decades have used alternative asset classes to fill performance gaps and hedge risks. Alternative investments can provide the dual benefits of diversification and low correlation to traditional asset class performance, helping reduce volatility and potentially enhancing long-term risk-adjusted returns. And while global defined contribution plans, notably in Australia, have incorporated alternatives into their investment line-ups, U.S. DC plans have not followed suit, being virtually shut out of the benefits of diversification that alternative assets offer investment portfolios.

Plan sponsors remain reluctant to include alternative investments as separate, explicit investment options in 401(k) fund menus, largely because of challenges with respect to fees, liquidity, the lack of transparency of private investments, and the difficulty participants may have understanding these investments.

A recent communication from the U.S. Department of Labor (DOL), in June 2020, clarified the use of private equity assets in DC plans. The DOL concluded that a "plan fiduciary would not, in the view of the Department, violate the fiduciary's duties under section 403 and 404 of ERISA solely because the fiduciary offers a professionally managed asset allocation fund with a private equity component as a designated investment alternative for an ERISA covered individual account plan in the manner described in this letter".[1]

While a step in the right direction, the U.S. DC plan industry likely won't see a sudden increase in inclusion of alternative assets within retirement plans following the DOL's letter. Plan sponsors remain reluctant to include alternative investments as separate, explicit investment options in 401(k) fund menus, largely because of challenges with respect to fees, liquidity, the lack of transparency of private investments, and the difficulty participants may have understanding these investments.

Operational and plan structure options do exist to address these concerns. With ongoing education and clarification around the scalability, liquidity, and valuation needs of their plans and the feasibility of incorporating alternative assets into their line-ups, the industry will see a gradual uptick in their acceptance in DC plans.

TARGET DATE OPTIONS

The DOL, in its letter, clarifies that the best way to incorporate alternative asset investments into DC plans is via customized asset allocation strategy funds.[2]

[1] *https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/information-letters/06-03-2020*

[2] *ibid.*

We work with many clients who seek to benefit from increased diversification that alternative assets can offer by incorporating them in target date funds," said Peter Lantero, Head of the U.S. Institutional Investor Group at Northern Trust. "Along the way, they run into perceived challenges, so they approach a partner like Northern Trust to help them navigate the landscape." These challenges may include having an adequate initial investment commitment, determining appropriate daily valuation, and maintaining liquidity.

TACKLING PERCEIVED CHALLENGES

Recognizing the various challenges around incorporating alternative investments into sponsors' DC plans and having the expertise to craft an operational plan to tackle these issues is key.

For example, alternative assets often require large investment commitments that many DC plans may not have. Plan sponsors with legacy DB plans may tackle this problem by combining DB and DC plan asset pools into a unitized master trust structure to leverage the scale needed for such investments. Unitizing the plan's holdings of alternatives across both the DB and DC plans lets the DC plan leverage the scale of the DB plan. This allows it to buy investments along with the DB plan without having to start a new fund with smaller asset sizes.

Another concern is how to determine appropriate daily valuation when prices for some less-liquid alternatives are only updated periodically. One way is through indexation, which is achieved by applying indexes to the current market value in an effort to mark to market the value daily. Indexation can help smooth out market value spikes associated with periodic updates by creating more accurate valuations. Australia uses this strategy with its superannuation funds. New technology advances have been proven to calculate and track daily PE valuations utilized in some of the largest U.S. University asset pools.

Diligent governance should be applied around the blend of the various indexes to monitor the divergence between their estimates and actual values. Similarly, period statements provided well after month's or quarter's end must be properly updated, since they do not reflect subsequent cash flows tied to events like capital calls and distributions.

However, if prices are only updated periodically, what is an acceptable level of alternatives for a fund to hold? For conservative funds, it makes sense to allocate between 3% and 5% of the holdings to alternatives, while more aggressive funds might find a starting allocation of 6% to 7% appropriate. As plans and their participants become more educated about and comfortable with target date funds and alternatives assets, they may decide to increase that allocation. Under the Investment Company Act of 1940, open-end funds in the United States may invest up to 15% of their net assets in illiquid securities and other illiquid assets.

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WHAT ABOUT LIQUIDITY?

Due to the long-term nature of alternative investments, the need for liquidity can pose a challenge in a DC plan that allows daily participant cash flows. Operationally, how are daily participants' cash flows handled? In a target date maturity fund, one way is to omit these alternative assets from the daily cash flows so that they are absorbed by other option components. With this method, you eliminate the need for a liquidity vehicle such as cash, ETFs or a commingled fund because cash flows for capital calls or from distributions of alternative assets can be coordinated with fund rebalancing.

Rebalancing activities in target date funds also should tie directly to allowable trading windows. The target date fund's glidepath manager should monitor the cash events the alternative assets create and rebalance to, or from, other asset classes in the target date fund series.

Alternately, the manager could use a liquid vehicle like an index fund or ETF within the pool of alternative investments. It would maintain a certain proportion in this vehicle in order to satisfy needs arising from participants' daily activities. However, achieving an adequate liquidity level for the DC plan to use can dampen returns of the alternative assets under the DB plan. This can create drag because assets are held in the liquid vehicle rather than being invested in higher-performing assets. For that reason, variations to the unitized structure should be explored to isolate the impact to the DC plan alone.

There is, however, a risk of over-allocating to the alternative assets class if the capital call requires more funds to rebalance away from other asset classes than the target allocation weights. This means that the manager must understand the committed amount of the alternative assets so it can anticipate how much cash likely will be needed. It also means that new alternatives products may be required to balance the committed amount and any capital calls.

ALTERNATIVES USE SEEN GROWING

As DC plans continue growing and managers seek more sophisticated investment strategies, the use of alternative assets could continue to gradually expand, especially now that the Department of Labor has published their views. The constraints associated with alternative assets in a daily environment can be overcome. But it is important to ensure that the solutions do not significantly diminish the incremental gains of investing in alternatives.

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Adding alternative assets into custom target date fund offerings poses fewer challenges, as the amount of investment allocated to alternative assets is set by the plan rather than individual participants. Integrating them as part of custom target date funds can also mitigate the liquidity constraints present in alternative asset classes. Sponsors also need to be comfortable with the long-term nature of such investments, as selling them in the secondary market can take a large bite out of any accumulated value.

The constraints associated with alternative assets in a daily environment can be overcome. But it is important to ensure that the solutions do not significantly diminish the incremental gains of investing in alternatives.

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