LINE OF SIGHT

DEFINED CONTRIBUTION PLANS

ADDING ALTERNATIVE INVESTMENTS TO DC PLANS

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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. With the shift to defined contribution (DC) plans, alternatives use is growing as sponsors encourage participants to diversify their portfolios to help them reach more desirable retirement outcomes.

The trend is even more apparent globally than it is in the United States, where 20% of pension fund assets were allocated to alternative investment in 2013. Internationally, many countries have significantly raised their exposure to alternative assets in recent years, with Australia increasing the most (from 8% to 25%), followed by Canada (from 8% to 21%) and the United Kingdom (from 3% to 14%), according to a 2013 Towers Watson study.[1]

Alternative investments can provide the dual benefits of diversification and low correlations to traditional asset class performance, helping reduce volatility and potentially enhancing long-term risk-adjusted returns. But for DC plan sponsors considering using alternatives, figuring out how to embed these products into their plans brings its own set of unique challenges. Concerns around the scalability, liquidity, and valuation needs of such plans has inhibited the use of alternatives as a viable investment option.

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The flexibility to move in and out of these investments for events like plan divestitures is also limited. "We've seen plenty of interest from plan sponsors who are considering adding alternatives as an investment option, most of whom are asking us how to best do this," said Tom Lauer, DC asset servicing consultant with Northern Trust, about adding alternatives to DC plan investments. "And what does that mean operationally? Fortunately, there are operational and plan structure options available to address these issues for the plan sponsors that want to include alternative assets in their DC plans."

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TARGET DATE FUNDS

According to the Defined Contribution Institutional Investment Association,[2] two of the best ways to incorporate alternative asset classes into DC plans are either via a strategy such as target date funds or through a bundled alternative assets portfolio. They also could be added on a stand-alone or index basis.

White labelling, or moving away from brand-name mutual funds to more generically named ones customized for a specific DC plan, is a path that DC plans increasingly are taking. It can increase the plan's flexibility, helping it cut costs, streamline investment menus and reduce participant confusion over investment choices. That approach also can allow plans to leverage their existing plan managers and potentially achieve higher alpha.

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Increasingly, alternative assets are held inside target date maturity funds, including white labels. In particular, commingled DB/DC structures are housing more alternative investments such as real estate investment trusts, currencies and commodities wrapped into investment vehicles like hedge funds, private equity, mutual funds, exchange traded funds (ETFs) or separate accounts. This also can be structured so that the alternatives are excluded from the target date fund's cash flow, an action that is necessary because alternatives don't accommodate daily liquidity.

"We have a number of clients who want to put alternatives in target date funds for their DC plans but for various reasons can't get it done," Lauer added. "We are able to propose solutions that allow them to work around perceived challenges."

UNITIZATION

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. One way sponsors with legacy DB plans tackle this problem is 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.

Indexation can help smooth out market value spikes associated with periodic updates by creating more accurate valuations.

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.

Diligent governance should be applied around the blend of the various indexes to monitor the divergence between their estimates and actual values, said Lauer. 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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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.

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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.

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ALTERNATIVES USE SEEN GROWING

As DC plans continue growing and managers seek more sophisticated investment strategies, use of alternative assets will also continue to expand. 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.

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.

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1 "Global Pension Fund Assets Hit Record High in 2013," February 2014.

2 "Is It Time to Diversify DC Risk with Alternative Investments?" Defined Contribution Institutional Investment Association, May 2013.

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