

An Idea Development Forum Paper

Alternative Assets: The Next Frontier for Defined Contribution Plans

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Brief Description: Hewitt EnnisKnupp believes the adoption by DC plans will substantially increase as more attractive DC-focused alternative offerings come to market. The time is right for plan sponsors to understand the benefits and how these rapidly-developing options can enhance participants' ability to meet their retirement goals.

Executive Summary

- Alternative investments such as hedge funds, private real estate and commodities have historically been excluded from defined contribution plans. This trend is changing, and we expect the pace of change to accelerate over the next several years.
- Alternative investments are most appropriately included in defined contribution plans through multi-asset funds such as target date funds and diversified core options, which reduces the potential for misuse by plan participants.
- An evolving product space has led to an increasing number of attractive options. Nevertheless, investors must still critically evaluate options—a specific fund may be appealing for institutional investors, but this doesn't always imply that the strategy can be modified in a way that makes it equally attractive for Defined Contribution (DC) plans.

Introduction

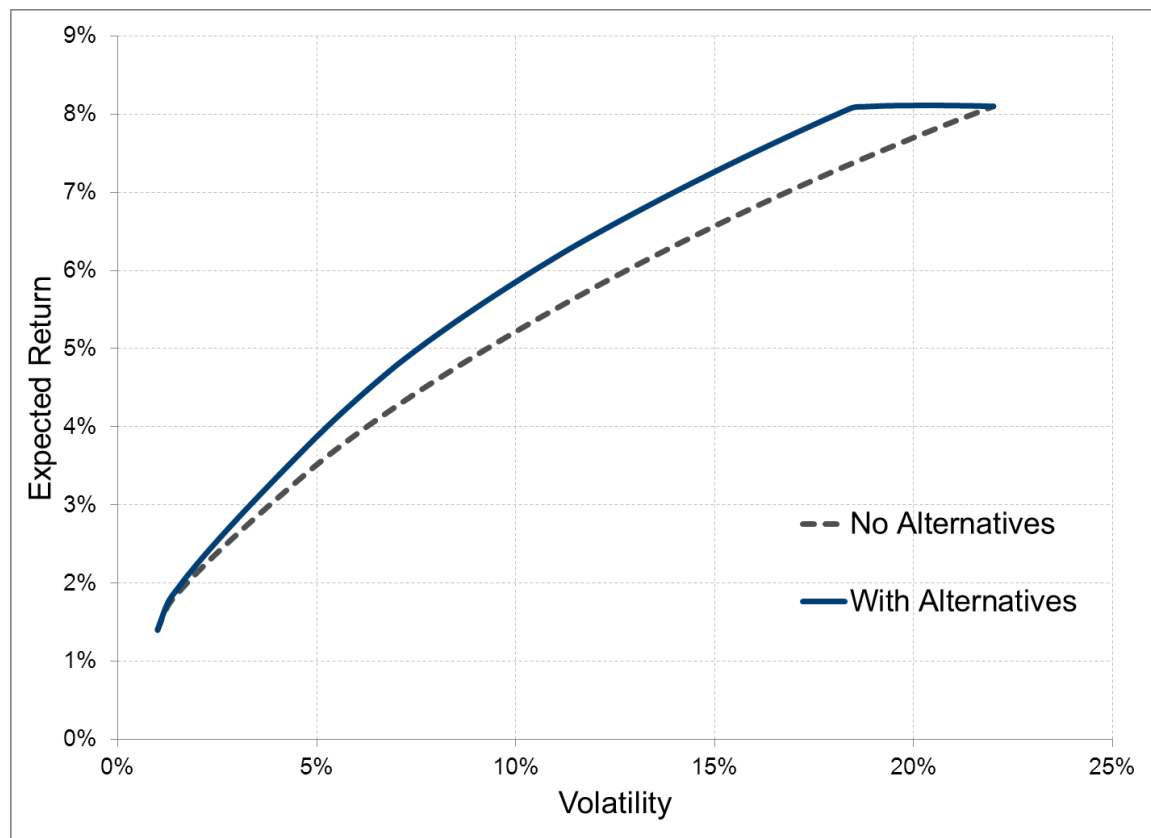
Over the past few decades, an increasing number of investors have been effectively using alternative assets to improve their portfolios. These alternative assets—such as hedge funds, private real estate, private equity, and commodities—often have different properties than traditional stocks and bonds, allowing them to both enhance returns and diversify risks. While the advantages of these strategies have been embraced by defined benefit pension plans and other institutional investors, they have rarely made it into DC plans. Hewitt EnnisKnupp believes the adoption by DC plans will substantially increase as more attractive DC-focused alternative offerings come to market. The time is right for plan sponsors to understand the benefits and how these rapidly-developing options can enhance participants' ability to meet their retirement goals.

The exhibit below shows expected returns and risk for portfolios with and without alternatives.¹ The portfolios with alternatives have both higher expected returns and lower volatility, enabled by increasing the opportunity set to include these complementary investment strategies. Throughout the middle portion of the risk spectrum (volatility of 6-18%), which has a risk level similar to that of many DC portfolios, the efficient frontier with alternatives is about 50-70 basis points higher.² This can translate into additional dollars for DC investors. For participants who make steady contributions over a 40-year accumulation period, an additional 50 basis points of return per year will result in an account balance that is about 12% higher, which is potentially over \$100,000.³

¹ This exhibit is based on HEK's 10-year capital market assumptions as of Q1 of 2013. Traditional asset classes include cash, core bonds, and global equity; alternative assets include commodities, core real estate, and broad hedge funds. Each of the alternative assets was constrained to be no greater than 15% of the return-seeking portfolio, with the total alternative assets not greater than 20% of the total portfolio.

² The historical performance of alternatives also supports the notion that they can improve portfolio characteristics, as described in Sebastian, Mike. "Go Big or Go Home: The Case for an Evolution in Risk Taking." 2012. (<https://ctech.rproxy.hewitt.com/hig/filehandler.ashx?fileid=6811>)

³ Assumes a participant contributes a fixed percentage of pay each year for 40 years, with pay growing at an inflation rate of 2.5%. Note that the dollar-weighted time horizon is shorter than 40 years because much of the contributions are not made until the latter portion on the horizon.



Illiquidity, complexity and fees are among the reasons why alternative investments have traditionally been viewed as less suitable for DC plans. But the landscape is beginning to change in two ways. First, DC plans may evolve in a way that makes it easier to include these strategies. Second, many alternative investment managers are actively embracing new investor channels that include DC plans. As a result, alternative investments are likely to become more feasible for DC plans than in the past.

Fitting Alternative Assets into DC Plans

How can alternative assets fit into DC plans? Due to complexity, potential illiquidity, and/or greater volatility, among other factors, we do not believe that alternative investments should typically be standalone core options for plan participants. However, we believe they can be beneficial within multi-asset funds:

- When participants invest through **target date funds**, they receive exposure to a diversified portfolio more tailored to a desired end objective. Outcomes-based investment offerings such as target date funds can be more effective with a broader tool set of strategies.

- We also see increased use of **diversified multi-asset portfolios** within core options to give participants fewer, better choices. These multi-asset funds offer attractive insertion points for alternatives in DC plans by avoiding participant selection hurdles and providing professional allocation management of less liquid strategies.

Hewitt EnnisKnupp believes the new generation of multi-asset or target date funds should be focused on an open-architecture approach utilizing the best managers in specific asset classes rather than being bound to the proprietary offerings of a particular manager. For plan sponsors to make the most effective use of alternative investments, it may require the use of custom target date funds and/or diversified multi-asset core options.⁴ Though these implementation structures were once rare, they are now increasingly common.

Hedge Funds

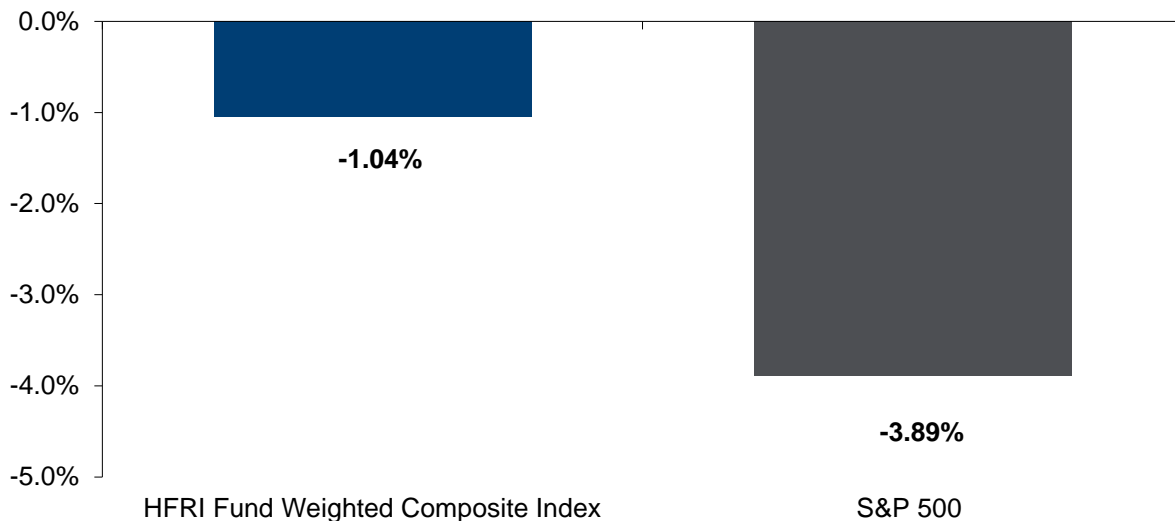
Hedge funds are one type of alternative investment that is at the core of the development of high-quality DC plan options, and for good reason. Risk management is a key driver of value delivered by hedge funds—with a focus on capital preservation often a central tenet—as this enhances the ability to compound capital. Hedge fund strategies in their traditional implementation structures have delivered on this promise, as shown in the following figure:⁵

⁴ Diversified multi-asset core options are discussed at length in our recent white paper “Improving DC Plan Investment Governance: A Call to Action,” which is available at (http://www.hekblog.com/wp-content/uploads/2013/05/2013_05_20-DC-Governance-A-Call-to-Action.pdf).

⁵ The HFR Fund Weighted Composite Index is an equal-weighted index of over 2,000 hedge funds with at least \$50 million under management or a track record of at least 12 months reporting net returns to Hedge Fund Research (HFR).

Downside Protection, January 1994 - June 2013

Average Monthly Return During 83 Negative Months for the S&P 500



Hedge funds comprise a very diverse universe of investment styles and strategies, characteristics that are highly desirable for investors looking to enhance their ability to meet their investment objectives.

Historically, the majority of hedge fund products available to DC plans have not impressed us. The first iteration of hedge fund mutual funds was largely an effort to create “product” for retail investors seeking a way to get a “hedge fund” allocation. These mutual fund offerings often had high fees and high equity market correlation (along with poor performance) that negated the value of such an allocation. Most of these products were not being offered by the most skilled managers.

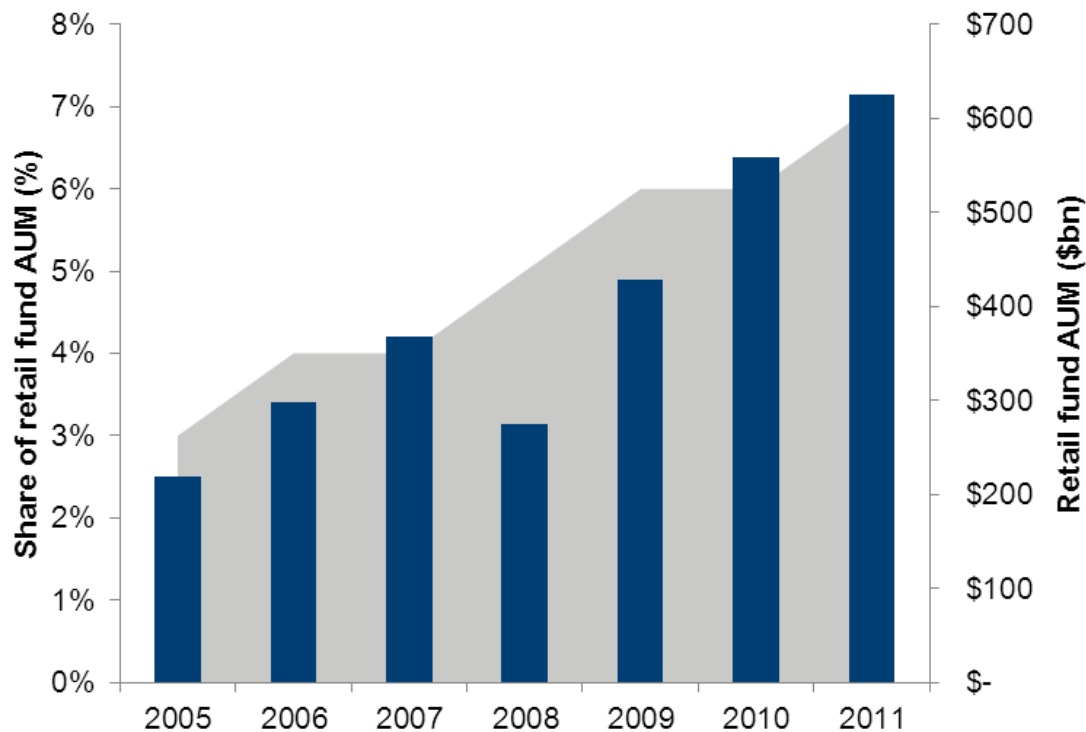
Today we see a different landscape developing. Hedge fund firms are structuring products that are similar to their core strategies but tailored for the demands of DC investors. At the same time, some traditional investment firms are developing higher conviction, less constrained versions of their core strategies to become more like hedge funds. The result is likely to be a melding of attractive offerings from both traditional and alternative firms that must cater to the needs of most DC plans: daily valuation, transparent pricing structures suitable for the DOL’s fee disclosure rules and sufficient liquidity (not necessarily daily, especially when used as a piece of a multi-asset fund). We believe many strategies meet these criteria.

One way for hedge funds to meet the needs of DC plans is to create mutual fund structures, which are registered under the Investment Company Act of 1940 and are referred to as “40 Act” funds. These funds have a number of characteristics that provide greater regulatory safeguards, including mandatory independent fund governance, requirements for custody of assets and leverage restrictions. Several additional differences are summarized in the table that follows.

| | Traditional Hedge Fund Structure | '40 Act Structure |
|-------------------------------|---|---|
| Liquidity Terms | Monthly – Annual | Daily |
| Redemption Notice | 30 – 90 days | None |
| Base Fees | 1.5% - 2.0% | Varies |
| Incentive Fees | Yes, 10-30% of performance | Typically none |
| Transparency | Regularly reported at exposure level | Full position level, typically on a lag |
| Eligibility | Accredited Investors/Qualified Purchasers | All investors |
| Tax Reporting | K-1 | 1099 |
| Subscription Documents | Required | None |

Source: Neuberger Berman Alternatives, Aon Hewitt Liquid Alternatives Research Team

Today the liquid alternative mutual fund universe is more than 300 products amounting to more than \$600 billion in assets.⁶ The number of offerings has roughly doubled since 2009 and the growth trend is expected to continue, which is seen also in the larger institutional landscape where alternatives grew at 14.2% rate from 2005 – 2011 compared to 1.9% for non-alternatives.³ While many alternatives managers will find that their strategies do not match well with liquid alternative structures, the allure will be compelling to create products to tap a private DC marketplace that is at least as large as the size of the private defined benefit universe.⁷



Just as many traditional firms have not put forward compelling hedge fund products, many hedge fund firms will stumble as they find it difficult to morph their core strategies to access the DC space. For example, adjusting their strategies for greater liquidity removes much of the opportunity for some to add value or places an unwanted constraint of realizing value. Hence, while an investment firm's flagship hedge fund may be appealing for institutional investors, it doesn't imply that the strategy is well-suited for DC plans.

Nevertheless, we believe some existing hedge fund strategies are attractive for DC plans, and more will emerge as products geared to these types of investors are brought to market. The preferred strategies will typically be those that do not need to be significantly altered to meet the needs of DC plans. As the universe of suitable managers evolves, investors should expect more attractive offerings. However,

⁶ McKinsey: *The Mainstreaming of Alternative Investments: The Mainstreaming of Alternative Investments*, 2012.

enhanced due diligence and manager selection is imperative as these alternative strategies are more dependent on active management, and, consequently, the return dispersion among them is substantial.

Real Estate

Real estate is another asset class that offers characteristics that could be attractive to DC plans. Some DC plans already include Real Estate Investment Trusts (REITs, which are publicly traded real estate investments), but lack exposure to direct private real estate. DB plans have embraced direct real estate as a key component of their asset allocation, and DC plan sponsors' shift to multi-asset funds presents them with an opportunity to do the same. The benefits of including direct real estate are:

- **Stability:** A large portion of the real estate return comes from a stable income component
- **Diversification:** Low correlation with other asset classes and less exposure to the volatility and equity market beta of REITs
- **Risk management:** Potential for inflation protection

Despite these desirable characteristics, the availability of suitable structures has been limited to only a handful of funds predominantly targeting retail investors. The majority of these funds experienced significant liquidity constraints during the market downturn as a result of limited liquidity and valuation guidelines and the increased trading volatility of retail investors. However, we are now seeing the development of structures addressing the liquidity and valuation challenges experienced by the first generation of funds.

First, daily valuation can be addressed with a combination of staggering more frequent property appraisals and more robust valuation processes from the managers. Though any valuation methodology based on appraisals will have imperfections, these methodologies can be refined to be sufficient for DC plans—similar to how stable value funds are often incorporated based on appraised values. Second, liquidity issues can be addressed using a few tools: incorporating direct real estate into multi-asset funds with liquid assets, and structuring the real estate funds themselves to be mostly direct real estate with some REITs and cash to supply the liquidity. The new generation of funds also including additional liquidity guidelines and only are available to target date funds and other multi-asset funds to reduce trading volatility.

Product Availability – the Present and Future

Many seasoned alternative investment firms are considering launching versions of their existing strategies that are tailored to the constraints of DC plans, and often even mass retail distribution. These funds have features that are attractive to these markets such as management-only fees, leverage limits, enhanced governance and custodian banks rather than prime brokers for safeguarding assets.

In addition, the trend for DC plans to develop customized multi-asset funds, such as custom target date funds, creates an easy insertion point for these strategies—even if they are structured as separate accounts or Collective Investment Trusts, rather than '40 Act mutual funds. So there is a simultaneous convergence of interests: the alternative investment industry is working to make its products more viable

for DC plans, and the DC industry is working to make it easier to include alternative investments. We see both of these trends continuing.

Many strategies have attractive products that would fit well within target date funds and other DC multi-asset funds:

- **Long/short equity strategies and high-conviction long only strategies:** These strategies are a natural extension for DC plans due to their highly liquid nature and ease of implementation.
- **Macro strategies:** Macro strategies can be a significant diversifier, though they can be difficult to implement via a '40 Act Fund due to often high levels of over-the-counter derivatives.
- **Managed futures:** Managed Futures are highly diversifying and generally implemented solely through exchange-listed contracts, offering a high degree of liquidity.
- **Option-oriented strategies:** These strategies can offer a reduced volatility profile to traditional long-only equity funds, and provide moderate protection in down markets. Since they implement via exchange-traded option contracts, these strategies are highly liquid.
- **Unconstrained bond strategies:** Less benchmark-constrained strategies that can add diversification.
- **Multi-strategy, GTAA and absolute return strategies:** Broad strategies that can offer increased diversification and access to differentiated investment opportunities.
- **Commodities:** Although most of this paper focuses on hedge funds and real estate, commodities are also a viable strategy for including in multi-asset portfolios in DC plans.
- **Real estate (public and private):** Properly structured, private real estate expose participants to new return-drivers that further diversify portfolio returns.

With such a diverse array of possible strategies, DC plans already are able to construct diversified portfolios of high quality alternative investments.

Other Considerations

- **Fee levels.** Alternative investments often have higher fee levels than traditional strategies. Though this may not be a problem for DB plans if their returns are considered attractive net of fees, it can be a concern for DC plans as the explicit level of fees is shown in participant disclosures and has become a source of litigation. It is important to realize that the plan sponsor's obligation is to get appropriate value for fees rather than simply minimize them, and successful litigation has only occurred to date when fees were deemed excessive for the value provided. Regardless, the fee implications of alternative assets are something to consider, as they could draw complaints from participants. Fees can be addressed through a number of ways, such as by including lower fee products first, combining alternative assets with passively managed traditional investments, using relatively modest allocations to alternatives, performing fee benchmarking analysis by asset type and implementing a strategy supported by an outside advisor acting as a fiduciary.

- **Fee structures.** Many alternative investments have more complex incentive fee structures, which are not typical for DC plans. The actual fee levels are not known in advance with these structures, so it is unclear how to treat them within the context of the DOL's fee disclosure requirements. It may be preferable to seek a different fee structure and/or consult with legal counsel on how to handle the issue.
- **Liquidity.** Alternative assets are often less liquid than traditional investments, which can clash with the daily liquidity provided by most DC plans. There are several ways to manage this risk. First, plan sponsors only can consider the more liquid strategies, or at least exclude the most illiquid ones. Second, DC plans can include illiquid securities, effectively managing the fund's liquidity needs around the other assets; this is especially effective for target date funds. And lastly, the plans can consider only allowing transactions on a monthly or quarterly basis, instead of daily.⁸ A combination of these strategies may be most effective.
- **First adopter risk.** Even true believers may be cautious about being one of the first plan sponsors to include alternatives in their DC plans. Though some DC plans already have alternative investments,⁹ concerns about being a leading adopter are valid. This concern can be addressed by starting with modest allocations until alternatives are more commonly used by peers, using an outside advisor that supports the strategy, and using similar strategies as in the plan sponsor's defined benefit plan to minimize concerns about investing employee money differently from the plan sponsor's other retirement assets.
- **Committee education.** Many investment committees for DC plans include members who do not have deep expertise in finance and investments, so it can be challenging to provide the background education necessary to make them comfortable with alternative investments.
- **Sizing the allocation to alternative assets.** While theory suggests high allocations to alternative investments are supportable, we are more cautious with DC plans because of many of the considerations described in this paper. We believe it is reasonable to allocate up to 20% of the assets in most multi-asset funds to alternative investments, depending on the liquidity of the strategies used, with lower ceilings for funds designated for older participants. We have previously written about how small allocations to alternative investments can be undesirable¹⁰ due to a significant amount of required additional oversight, which may only be worthwhile if the allocation is large enough to significantly impact the portfolio. This caution applies to DC plans as well, and can be moderated with approaches such as investing in strategies that are already being evaluated (e.g., in the defined benefit plan) or by outsourcing the implementation of alternative investments.
- **Participant communication.** Though many alternative investment strategies are complex and unfamiliar to most participants, their inclusion in multi-asset funds such as target date funds can dramatically reduce the need for detailed communications to participants. In fact, many target date

⁸ Though most DC plans allow participants to trade daily, most law firms we have encountered interpret ERISA 404(c) to require participants to be able to transact at least as frequently as quarterly. In addition, Aon Hewitt's recordkeeping data found that only 14.5% of DC participants made a trade in 2012. So we believe that these restrictions would have a minimal effect on the vast majority of participants, and may enable improving performance for the whole plan.

⁹ Examples of DC plans with alternative investments include plans from McKinsey & Company, Goldman Sachs, JP Morgan's Target Date Fund, and several others.

¹⁰ Sebastian, Mike. "Go Big or Go Home: The Case for an Evolution in Risk Taking." 2012. (<https://ctech.proxy.hewitt.com/hig/filehandler.ashx?fileid=6811>)

funds already use nontraditional strategies such as commodities and REITs, so the issues with participant communications should not be breaking new ground.

Conclusion

Alternative investments were once considered inappropriate for DC plans, but the landscape has changed significantly. Hewitt EnnisKnupp believes there is strong applicability for incorporating alternatives into DC plans and that increasingly attractive offerings are coming to market. We expect to see further progress in this area over the next few years. Value to DC plan participants will be enhanced through white-label and custom offerings that tap into an open-architecture framework. Though some DC plan sponsors already successfully incorporate alternative investments, it is not yet mainstream.

Along with our enthusiasm for this development, we also believe it is important to maintain a skeptical eye. There will always be a smaller universe of strategies and funds that are appropriate for DC plans relative to other types of investors, so high quality portfolios of alternatives will be inherently less diversified. But not all funds will suffer—some strategies can be ported into the DC arena without a significant loss in quality, and it is these strategies that will be most attractive. Investors must critically evaluate each investment option.

The investment strategies that fiduciaries selected several years ago may have been optimal at the time, but fiduciaries are obliged to continue to monitor the strategies in the plan as well as other options on an ongoing basis. New products and approaches have raised the bar, and many plan sponsors would be well-served to reconsider the role of alternative assets in their DC plans. Over the next few years, we expect alternative investments to become much more mainstream in DC plans.

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