IS IT TIME TO DIVERSIFY DC RISK WITH ALTERNATIVE INVESTMENTS?

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In the early days of defined contribution (DC) plans, investment menus were limited largely to guaranteed investment contracts, large-cap equity funds, balanced funds and company stock. During the bull-market years of the 1990s, menus expanded to include equity funds of all shapes and sizes, multiple fixed-income funds and self-directed brokerage accounts. Finally, the Pension Protection Act of 2006 ushered in a new generation of managed solutions, such as target date funds and investment advice tools. Despite these changes to–and, in some cases, improvements in–the DC investment architecture, the volatility of the past decade suggests that a critical vulnerability remains: Many participants' portfolios are ineffectively diversified and dominated by public equity risk.

DIVERSIFYING FOR PERFORMANCE

The Defined Contribution Institutional Investment Association (DCIIA) believes that DC plan sponsors should consider adding an investment offering that provides better risk balance, in an attempt to enhance returns and to reduce the volatility that the typical plan participant experiences. One solution is to provide access to an asset category broadly referred to as "alternatives." For years, defined benefit (DB) plans have allocated to alternative asset classes, whereas DC plans have not. These allocations have contributed to DB plans' overall performance outcomes. DC plan sponsors could incorporate alternative investment strategies and best practices used by DB plans, potentially helping to close the performance gap that has long existed between the two plan types.

ASSET ALLOCATON IS A KEY EXPLANATION FOR THE DB/DC RETURN DIFFERENTIAL

Several industry participants have noted the performance gap between DC plans and DB plans. Callan Associates reports that DB plans achieved an annualized outperformance of approximately 200 basis points relative to DC plans from 2006, when it began tracking the comparison, through 2011[1]. CEM Benchmarking (CEM) indicates that DB plans' total returns outperformed those of DC plans by approximately 140 basis points over the 15-year period from 1997 to 2011, as shown in the chart below[2].

Asset Mix and Returns of Defined Benefit Plans Compared to Defined Contribution Plans 1997-2011[3]

ASSET CLASS	ASSET MIX		RETURNS	
	DB	DC	DB	DC
TRADITIONAL				
LARGE-CAP STOCK	29%	33%	5.8%	6.4%
SMALL-CAP STOCK	6%	8%	7.7%	8.2%
FOREIGN STOCK	23%	7%	5.7%	7.0%
EMPLOYER STOCK	0%	18%	n/a	7.9%
FIXED INCOME	31%	11%	7.4%	6.1%
STABLE VALUE/GICS	0%	19%	n/a	4.6%
CASH	2%	3%	3.5%	3.1%
ALTERNATIVES				
REAL ESTATE, REITS & OTHER REAL ASSETS	4%	0%	9.5%	n/a
HEDGE FUNDS	2%	0%	7.1%	n/a
PRIVATE EQUITY	3%	0%	11.9%	n/a
TOTAL	100%	100%	7.2%	5.8%

A CLOSER LOOK AT ALTERNATIVES

DB plan sponsors, endowments, foundations and other institutional investors have long used alternatives. Studies conducted by the Center for Retirement Research at Boston College, John Hancock, CEM and others have shown that they have experienced better returns than the typical DC plan, and that their use of alternatives contributed to that outperformance. Another, more forward-looking argument for the use of alternatives — both for return enhancement and portfolio diversification — is that many investors are concerned about future equity and fixed income returns, due to the challenging economic environment and the potential for interest rates to rise following the long fixed-income bull market.

There are many definitions of “alternatives” in the investment industry. Alternatives can include “non-traditional” asset classes such as commodities, real estate (public and private), hedge funds and private equity. These alternative asset classes can provide diversification and return enhancement beyond those of traditional asset classes. Private securities may also provide a liquidity premium that can benefit long-term investors such as DC plan participants.

Note: Most practitioners include hedge funds, infrastructure, private equity and real estate under the “alternatives” umbrella. Some might also consider high-yield, distressed debt and natural resources etc., as part of this general classification. For the purposes of this paper, however, we are focusing on the following strategies:

- *ABSOLUTE-RETURN AND TOTAL-RETURN STRATEGIES:* These strategies may invest in traditional or non-traditional asset classes and, importantly to DC plan participants, may offer low or negative correlations to equities. They often are in a hedge fund investment vehicle form, but increasingly are seen in mutual funds or commingled pools. Total-return strategies typically have some market exposures (betas) that will vary based on the manager’s outlook. Investors rely on a skilled manager to find assets with a strong upside and to avoid assets with a greater potential downside. Absolute-return strategies tend to avoid market exposure and are generally focused on relative-value opportunities. They seek to provide positive returns, regardless of the market environment.
- *PRIVATE EQUITY STRATEGIES:* Private equity strategies provide access to a broad universe of private companies and opportunities otherwise inaccessible to public market investors. Through active governance and control, private equity managers drive company performance. Investors look for managers with the skill sets to source, execute and strengthen target-company investments. In addition, investors may be able to access new, fast-growing companies prior to initial public offerings. This category also includes infrastructure (e.g., tollways, courthouses, parking meters and bridges), and master limited partnerships (e.g., pipelines).
- *REAL ESTATE STRATEGIES:* Real estate strategies pursue opportunities to invest in the commercial and residential real estate markets, which may be less correlated to other asset classes. Real estate investments may include a combination of private real estate investments and publicly traded real estate investment trusts (REITs).

EMBEDDING ALTERNATIVES IN DC PLANS

An important consideration for DC plan sponsors is where alternatives should reside within the plan’s investment offerings. One option is to incorporate them into target-date funds or other multi-asset class pre-mixed investments; this gives plan sponsors greater control over how they make alternatives available to plan participants. In some respects, embedding alternatives within multi-asset class strategy funds simplifies their incorporation, allowing DC plan sponsors to effectively take advantage of the benefits. Another option is to incorporate alternatives on a standalone or index basis so that DC participants can allocate from the plan menu. In this second case, it may be most effective to bundle multiple alternative strategies into one offering on the menu.

Embedding alternatives may be viewed as a logical continued evolution of retirement-plan portfolio construction. Under the Employee Retirement Income Security Act (ERISA) the investment of U.S. retirement assets began using modern portfolio investment theory, in which a plan’s fiduciary pledges to manage its investments according to

ERISA's prudent person standard of care. As a result, since ERISA's passage in 1974, pension assets have been moving continuously into the broader universe of investment alternatives, including equities, derivatives and alternative asset classes such as those noted in this paper.

THE CASE FOR ALTERNATIVES IN DC PLANS

Alternative investments provide an important avenue for effectively diversifying the risk in DC plans. By complementing traditional DC offerings, an alternatives strategy can improve a portfolio's efficiency and serve the interests of DC plan participants. The potential benefits of incorporating a well-executed alternatives strategy include:

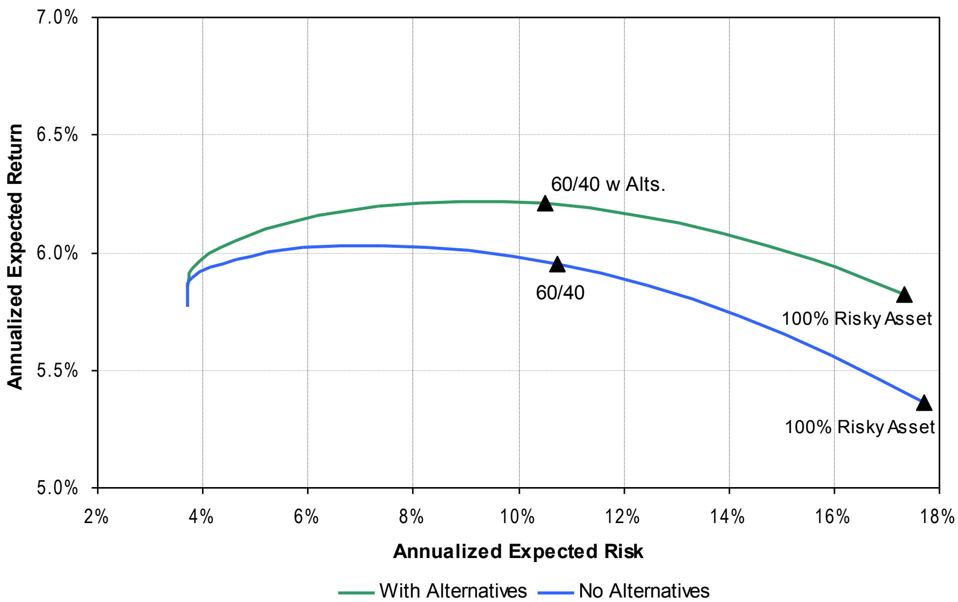
- *POTENTIAL FOR IMPROVED TOTAL-RETURN PERFORMANCE:* Including alternative investments within broad portfolios can contribute to improved plan performance for DC participants, similar to that experienced by institutional investors.
- *REDUCED RELIANCE ON TRADITIONAL EQUITIES AND BONDS:* Alternatives enable DC plans to complement the traditional asset classes to which DC participants have historically been exposed.
- *INCREMENTAL PORTFOLIO DIVERSIFICATION:* Alternatives can diversify the risk within DC plans' portfolios, allowing for blended investment portfolios with complementary characteristics.
- *LOWER PORTFOLIO VOLATILITY:* Alternatives have the potential to lower the portfolio's volatility, through the plan's investment strategies and through lower correlation to traditional asset classes.
- *INCREASED CONSISTENCY OF RETURNS:* The combination of portfolio diversification and lower volatility may allow DC plans to potentially achieve increased consistency of returns over time.

These benefits are important considerations for any investor in today's market. Just as institutional investors refine their approaches in order to diversify risk, DC plans can continue to selectively employ similar strategies to improve portfolio efficiency.

ALTERNATIVES IMPROVE PORTFOLIO EFFICIENCY

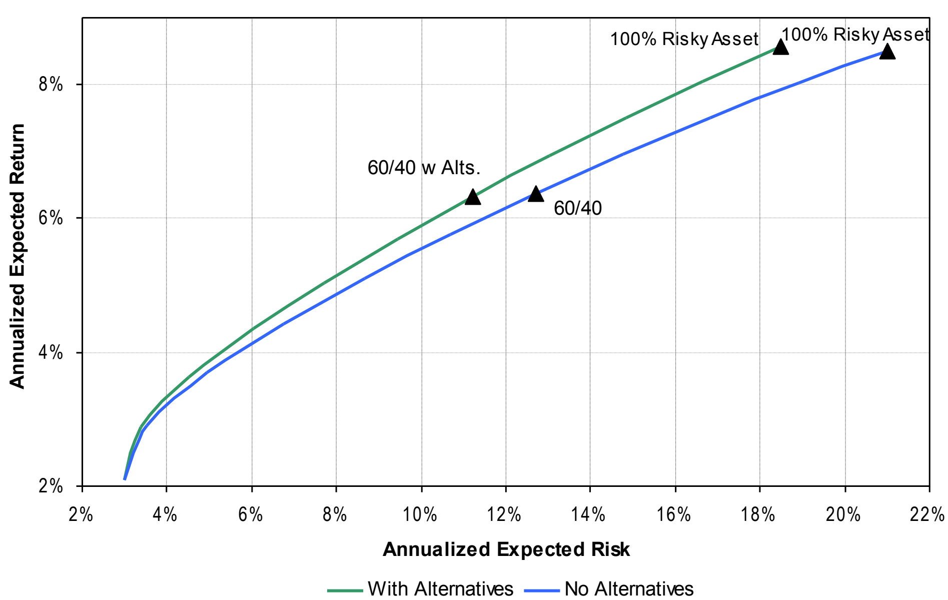
The exhibits on the following page illustrate how alternatives could have helped make "total return"-seeking portfolios more efficient over the past 10 years—and how they may achieve similar positive results over the next 10 years.

Efficient Frontier (Historical --10 Years)



Source: Hewitt EnnisKnupp[4]

Efficient Frontier (Forward-Looking 10 Years)



Source: Hewitt EnnisKnupp[5]

CONSIDERATIONS FOR ALTERNATIVES IN DC PLANS

When evaluating how to incorporate alternatives into their plans, DC plan sponsors need to take a variety of considerations into account, including the following:

- ***QUALITY OF ALTERNATIVES MANAGERS:*** While some aspects of evaluating both strategies and managers for alternatives may be similar to current DC plan practices, there are other aspects that may initially be new to DC plan sponsors. DC plan sponsors may, therefore, seek to add incremental skill sets when pursuing and evaluating alternatives managers. In doing so, plan sponsors may be able to take advantage of the institutional knowledge of their DB counterparts. Alternatively, they may select target date funds that include alternative asset classes. Plan sponsors will need to dedicate significant time to both the initial search for a manager within each category of alternatives, and to ongoing evaluation of the chosen managers. As with all strategies, taking steps to ensure a quality, repeatable investment process is critical.
- ***LIQUIDITY:*** Some alternatives can be relatively illiquid. Private securities, for example, will certainly be illiquid for a period of time. A plan sponsor should evaluate the liquidity of any alternative being considered, as the liquidity of these products can vary from periods of months to, in some cases, over 10 years. Plan sponsors should pay particular attention to any restrictions on exiting the investment during a period of market distress.

  While it has been market practice to provide daily liquidity in DC plans, it is legally permissible within ’40 Act funds to include up to 15 percent illiquid investments. The manager of such funds can effectively manage the portfolio around these illiquid alternatives in the same manner that DB plans and other institutional investors historically have done. In order to provide better outcomes for plan participants, it also may be appropriate to consider relaxing “the daily liquidity requirement,” thereby expanding the potential universe of alternatives that can be added directly to a plan menu, or used within an asset allocation or managed-account solution.
- ***FAIR VALUE:*** Due to the illiquidity features of some alternatives, daily fair market value may not currently be available in offerings that report periodic net asset values (NAV). Various valuation methodologies can be used to establish adjusted daily fair value with third-party validation. DC plan sponsors should understand how the periodic or adjusted daily NAV is determined, and provide for appropriate disclosures.
- ***LEVERAGE:*** Leverage is a complex element in some alternative strategies (e.g., swaps, structured notes, options and futures/forwards), especially those of the absolute-return variety. In other alternatives strategies, leverage is simply a means of optimizing the capital structures in underlying companies that constitute the investment portfolios. Plan sponsors should understand the different forms of leverage; they may want to consider adopting guidelines that optimize the amount of leverage a particular strategy can use.
- ***TRANSPARENCY:*** Managers of some alternatives strategies, in particular, may limit information shared with investors, in order to reduce the likelihood that others will mimic their approach. Plan sponsors need to be comfortable with the amount of information disclosed, and confident that they have established skill sets to evaluate the strategies.
- ***FEES:*** Many alternatives managers charge a percentage of investment gains or “carried interest” as part of their fee structure. Such fees can often best align the managers’ interests with those of the plan’s participants. This practice may not, however, fully conform to the traditional DC objectives, which seek to explicitly quantify, in disclosure documents, all fees borne by investors. Plan sponsors may, therefore, prefer performance-based fees that are structured in a manner that clearly define breakpoints, in order to simplify the quantification and meet fee-disclosure objectives. We are seeing some movement in the marketplace to make fee structures in the alternatives space more palatable to the needs of those in the participant-directed space. Plan sponsors should be aware that alternatives managers and fund structures may have multiple levels of fees.

- ***PARTICIPANT EDUCATION:*** Most DC plan participants will not be familiar with these strategies. Educating them will be important. While alternatives may not be familiar to plan participants, multi-asset class managers are well-positioned to make portfolio-construction decisions, and to develop appropriate education materials. Indeed, some target date funds are already including some of the less traditional asset classes, such as Treasury Inflation-Protected Securities (TIPS) and REITs.
- ***FIDUCIARY RESPONSIBILITY:*** Plan sponsors assume fiduciary responsibility in the selection of plan investment offerings. As noted previously, their lack of familiarity with alternative strategies makes it vital to expand due diligence capabilities for some alternatives in order to fully evaluate them or to obtain expert advice. After diligence is completed, the proper disclosures are straightforward. To the extent that alternatives are embedded in multi-asset managed strategies, the fiduciary responsibility can be shared with other parties.
- ***LEGAL DOCUMENTATION:*** Many alternative investment strategies will be available through vehicles other than a '40 Act fund, expanding the required legal documentation and process. Documentation for separate accounts, commingled pools or limited partnerships may require review by plan attorneys, as well as negotiation between the plan sponsor/consultant and investment manager. While the alternatives' legal review may be different from the review to which DC plans are traditionally accustomed, many attorneys and service providers are experienced in these areas and can facilitate the process.
- ***BENCHMARKING:*** In order to fully evaluate an investment opportunity, it is important to have a relevant benchmark available for comparison. While traditional asset classes tend to have well-recognized benchmarks, some alternative strategies will have more asset-class specific benchmarks that may not be adequate for broad-based performance evaluations. That said, benchmarking alternatives to traditional public equity benchmarks can serve as a useful comparison. For example, some DB plans have been using public equity benchmarks plus an incremental percentage (e.g., Russell 3000 + 3%, or CPI + 5%) to adequately benchmark some alternative asset classes. Using a consultant that specializes in non-traditional asset classes, as other institutional investors have done for years, can assist with these comparisons.
- ***INTEGRATION WITH FINANCIAL ADVICE TOOLS:*** The use of advice engine based portfolios has become more prevalent in DC plans. Most of these advice engines have been developed based on the assumption that the "opportunity set" will be limited to traditional asset classes; the integration of alternatives should, therefore, be discussed with the advice engine providers.

LOOKING AHEAD

The historical performance gap between DC plans and DB plans suggests that DC plan participants are missing out on the diversification and performance benefits available to DB plans. The strategic incorporation of alternatives into DC plans can play a role in closing this performance gap, as plan sponsors, investment managers and intermediaries innovate to bring solutions to DC participants.

In summary, DCIIA supports the consideration of alternative investments in DC plans. This stems from the diversification and performance benefits that non-traditional asset classes and alternative strategies offer to a plan participant's asset allocation. Further, we maintain that the best way to incorporate these types of investments into a DC plan is through either an asset allocation solution, such as a target date fund, or through a bundled alternative-assets portfolio. In doing so, we believe plan sponsors can meet their fiduciary duty to provide better potential outcomes for their plan participants.

FOOTNOTES:

[1] *The Callan DC Index represents the aggregate performance of over 80 DC plans with collectively over $100 billion in assets. The DB comparison set represents the performance of 260 corporate DB plans with collectively over $635 billion in assets. Performance is gross of fees. Source: Callan Investments Institute, "DC Observer", Fourth Quarter 2011.*

[2] *Based on the simple average of annual returns for 1997-2011 of 2,465 DB plans and 1,684 DC plans. Source: CEM Benchmarking.*

[3] *Asset mix equals the simple average of annual asset mix weights for 1997-2011. Returns are the compound average of annual averages for each asset class for 1997-2011. Hedge funds were not treated as a separate asset class until 2000, so 60% stock / 40% bond returns were used as a proxy for the period 1997-1999. Based on data observations of 2,465 DB plans and 1,684 DC plans. Source: CEM Benchmarking.*

[4] *Without alternatives, the frontier consists of 60% global equities (MSCI ACWI IMI) and 40% fixed income (Barclays Aggregate Bond), respectively "risky assets" and "non-risky assets." With alternatives, the frontier allocates 20% of the "risky assets" to alternatives (1/3 hedge funds, 1/3 private equity & 1/3 real estate) with 80% to global equities; "non-risky" assets consists of core fixed income. Hedge funds are represented by HFRI Fund of Fund Index, Real Estate is represented by the NAREIT index (public real estate), and Private Equity is represented by the S&P 500 Index adjusted to reflected higher expected volatility (S&P 500 return x 1.36). Source: Hewitt EnnisKnupp.*

[5] *Based on Hewitt EnnisKnupp's 10-year capital market assumptions. Asset classes included are global equity, core fixed income, hedge funds (FOF), core real estate & private equity. With alternatives, the frontier allocates 20% of "risky assets" to alternatives (1/3 hedge funds, 1/3 private equity, 1/3 real estate) with 80% to global equities; "non-risky" assets consist of core fixed income. Source: Hewitt EnnisKnupp.*

ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of American workers. Toward this end, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution plan design. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants. For more information go to: http://www.dciia.org.