DO ALTERNATIVE ASSETS HAVE A PLACE IN IMPROVING RETIREMENT READINESS IN DC PLANS?

Defined benefit (DB) plans were designed to provide an outcome: that employees would have the funds they need to retire. In the move from a DB retirement model to a defined contribution (DC) one, the question remains: Will employees have enough money to afford a comfortable retirement? While contributions are one of the drivers to answer that question, plan sponsors may look to make changes to the tools they offer to help their employees achieve their goals.

In the EU, for example, only 37% of employees without a pension feel confident in having enough money for a comfortable retirement, according to the European Insurance and Occupational Pensions Authority.[1]

The situation is similar in the U.S., where more than one-third of 401(k) plan sponsors' top priority is to improve retirement readiness, according to Cerulli Associates research.[2]

"Given participants' key concern about being able to retire, plan sponsors need to take a fresh look at how their investment managers are addressing this issue. They need to evaluate all relevant elements, including investment strategies, advice models, target-date structures and capital preservation options," notes a Mercer whitepaper.[3]

While the challenges and solutions for improving workplace retirement plans are multifaceted, one emerging approach is to offer alternative investments within DC plans. Doing so can provide benefits, such as adding diversification and potentially increasing risk-adjusted returns.

However, adding alternatives to DC plans is not without its fair share of challenges, such as providing sufficient liquidity and timely valuations to satisfy participant needs. Yet increasingly, plan sponsors, asset managers, and other retirement plan stakeholders are finding solutions to ultimately improve participant outcomes.

1 European Insurance and Occupational Pensions Authority. "Consumer Trends Report 2023." Nov. 21, 2023.

2 Cerulli Associates. "Personalized Solutions Help Plan Sponsors Address Retirement Readiness." Oct. 25, 2023.

3 Mercer. "Top considerations for defined contribution plans in 2024."

The Benefits of Adding Alternatives to DC Plans

Investing in alternatives—such as private equity, private debt, real estate and infrastructure—can provide plan participants with several benefits, including increasing diversification, which can also potentially enhance returns.

An analysis by Georgetown University's Center for Retirement Initiatives (CRI), in conjunction with CEM Benchmarking, found that when back-testing returns from 2011-2020, adding up to a 10% private equity sleeve to DC target-date funds, in place of public equities, would increase net returns by 22 basis points per year.[4] Adding up to 10% in real assets, in place of U.S. large-cap stock and core bonds, would net 11 basis points per year. Or, combining these two approaches— i.e., up to 10% alts sleeve with half private equity and half real assets—would have netted these funds an extra 15 basis points per year, even after accounting for all the extra costs of alternatives.

Those higher net returns may in part be due to the diversification that alternatives can provide. Private assets often provide uncorrelated returns to public market assets, and as the CRI research notes, combining uncorrelated assets can either reduce risk or enable investors to allocate more toward higher-returning assets without increasing overall risk.

For example, replacing some portion of public market bonds with infrastructure assets that provide fixed income could potentially yield more while providing a similar feature of returns that are uncorrelated with stocks.

"Adding diversification through alternatives provides another arrow in the quiver in terms of what investment managers and asset allocators can do," said Tom Lauer, Senior Vice President and Defined Contribution Asset Servicing Consultant at Northern Trust.

Related to the benefit of diversification, alternatives can also provide a hedge against inflation. Real estate, for example, tends to increase in value during periods of inflation,[5] whereas other assets like bonds may lose value.

Alternatives can also provide opportunities for plan sponsors to source direct investments, which could improve participant outcomes.

In Australia, for example, superannuation funds have largely already been investing in alternatives, but there's potential to increase and evolve those allocations with more exclusive deals.

For example, superannuation funds can work together in a syndicate and collaborate with local governments to help them identify investment opportunities that support local infrastructure projects, explained Leon Stavrou, Head of Australia and New Zealand at Northern Trust.

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Tom Lauer
Defined Contribution
Asset Servicing Consultant
Northern Trust

4 Georgetown University Center for Retirement Initiatives and CEM Benchmarking. "Has the Lack of Asset Diversification in DC Retirement Plans Been a Costly Missed Opportunity?" June 2023.

5 Urban Institute. "How Higher Mortgage Rates Have Historically Affected Home Prices," May 2, 2022.

"By gaining access that way, it can be beneficial both not only from a community perspective, but also getting access to investments that you might not otherwise," he said.

Overcoming the Challenges of Adding Alternatives to DC Plans

While alternatives can strengthen DC plans, there are undoubtedly some inherent challenges that have held back their usage. For one, alternatives lack the liquidity that public market assets have, and that's trickier for DC participants, considering they typically have the freedom to withdraw assets on their own schedule.

Liquidity challenges also tie into valuation concerns. With less frequent trading, and with the structure of some alternatives, getting accurate quarterly valuations can be difficult, let alone daily NAVs. That, in turn, affects the ability of participants to make withdrawals at fair and accurate valuations.

Fortunately, there are ways DC plans can address these challenges.

In terms of liquidity, one factor for plan sponsors to assess is fund flows. Some plans may be able to manage an illiquid pool of assets by offsetting withdrawals with new inflows, rather than having to sell the underlying assets.

"If you've got a very large, young, growing defined contribution scheme, it might be fine for you to allocate 5% or 10% of that pool to illiquid assets directly, knowing that you've always got positive inflows for the next 20+ years and that your fund is going to continue to grow," said Mark Austin, who leads growth strategy for Northern Trust's Pensions and Insurance business across the EMEA region.

If and when the plan stops growing, ideally at that point those private assets are mature enough to have more liquidity. Still, some of the underlying investments may need to be sold at times, so investing in a diverse range of early- to late-stage private assets can help accommodate withdrawals, without facing as much risk of taking a haircut if exiting highly illiquid positions early.

For example, a toll road infrastructure investment might not have much liquidity as the road is being built, thus the need to have a liquidity buffer. But once that asset matures and starts paying a fixed-income-like return from toll collections, it could be easier to sell that asset if needed, while also being easier to value at that stage.

Another solution is for DC plans to pool liquidity with other plans. For example, by pooling the assets of DB and DC plans, sponsors can net cash flows in the different plans against each other to reduce the need to sell securities.

Investing in alternatives within DC plans could also be more feasible when those private assets are put into a liquid vehicle, such as a target date fund. The target date fund could hold an allocation range to private equity and public equity for example, and if withdrawals necessitate some asset sales, the fund could temporarily dip into the public equity pool while letting the private assets mature.

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In this type of scenario, the exact allocations to traditional versus alternative assets might fluctuate, but plans can get ahead of this issue by communicating it to participants and getting them comfortable with the idea of asset allocation as a narrow range, rather than always as a strict percentage.

That education component doesn't need to be a drastic change, said Lauer, considering plans are already doing much of the work, such as explaining to new hires what a plan's fund menu looks like and how different investing styles can be appropriate for different ages.

As for valuations, technological innovation, such as with AI and machine learning, is making daily fair market valuations more feasible, said Lauer. By analyzing historical data and looking at how different private assets traded under different conditions and assessing that historical information in the context of current fundamentals, it can be easier to obtain a more realistic daily valuation.

Best practices like appointing an independent valuation consultant can help. Plans should also establish clear policies for how they will handle valuations, particularly in times of market stress, like when Covid affected commercial real estate prices, explained Stavrou.

Managing Regulatory Concerns

Regulation can be both a challenge and an opportunity when it comes to alternatives in DC plans.

For example, the Australian Prudential Regulatory Authority came out with Prudential Standard 530 in 2023,[6] which imposes governance standards on superannuation funds, such as around setting a clear valuation framework. While that can increase requirements, it can also provide the structure that plans need to have more comfort in adding alternatives.

To that point, plans in other regions might not have the same regulatory requirements but could be proactive about establishing a strong governance framework for managing alternatives' valuation and liquidity.

But it's also possible that participants will need to get more comfortable with certain investments having different redemption rules. In the UK, the government created the Long Term Asset Fund (LTAF) structure, which allows for the creation of pooled, open-ended funds that do not have to have daily liquidity or valuations. But LTAFs still have a more regulated framework than existing private funds, which can give DC plans more confidence in including these funds in their lineups, according to Austin.

Legal risk is another concern. In the U.S., for example, plans might be concerned they'll face lawsuits for not meeting their fiduciary requirements under ERISA if they introduce higher-cost alternatives into the plan.

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> Head of Australia and New Zealand
> Northern Trust

6 Australian Prudential Regulatory Authority. "Prudential Standard 530." Jan. 2023.

However, said Lauer, the opposite is also worth considering: Will there be ramifications for not offering alternatives? Especially if a company has a legacy DB plan that's investing in alternatives and perhaps achieving better returns, participants could ask why the same is not available in the DC plans.

Moving Toward a More Secure Retirement Future

Alternatives aren't the only new avenue that DC plans are exploring. The use of annuities for the distribution phase is also emerging as a way to help participants gain some of the security that they lack compared to DB participants. In the U.S., for instance, the SECURE Act 2.0 paved the way for the inclusion of annuities within DC plans.[7]

While alternatives and annuities don't always go hand in hand, plan sponsors might consider how alternatives can better support the accumulation phase and annuities can better support the distribution phase, thereby creating better overall retirement outcomes. Some target date funds in the U.S., for example, are starting to offer shareholders the option to buy into annuities in retirement.

Alternatives and annuities can also relate from a liquidity perspective, in the sense that if managed together, plans and their service providers may need to consider how the underlying investments support the steady payments of annuities. In some cases, alternatives might also be used in conjunction with annuities, such as if an insurer holds allocations to mature infrastructure assets that can provide stable returns, like bonds.

In general, though, "what I can see is that in the accumulation phase, you'll have a greater allocation to private assets, and in the decumulation phase or the annuity phase, you'll have a lower allocation," said Stavrou.

Alternatives and annuities on their own won't solve all retirement challenges that DC plans face, and adding these assets does introduce new areas of cost and complexity for plan sponsors. However, when looking at the net benefits, particularly helping employees alleviate their worries about not having enough money to retire and perhaps improving risk-adjusted returns, introducing these assets can be win-win for plan sponsors and participants.

7 Plansponsor. "What Can Annuities Gain From Secure 2.0 Act?" Jan. 30, 2023.

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