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Center for Retirement Initiatives

Use of Alternative Assets in Target Date Funds:

Challenges, Strategies, and Next Steps

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Executive Summary

Target date funds (TDFs) are intended to be an investment option that eliminates the need for retirement savers to worry about what their asset mix should be (e.g., equities, bonds, etc.) or how to adjust that asset allocation over time. TDFs are designed to gradually adjust participants' investments away from growth-oriented investments to investments focused on income and capital preservation as savers near retirement age.

The simplicity of this approach has made TDFs one of the most-common investments in today's defined contribution (DC) plans. Since the U.S. Department of Labor (DOL) allowed TDFs to be used as a default investment option for participants who do not select their own investment options for their retirement plans, almost 90% of DC plans now offer a TDF,[1] almost half of all DC plan participants are solely invested in a TDF,[2] and TDFs receive 49% of new plan contributions, compared to 8% in 2007.[3]

To improve retirement income outcomes for plan participants, DC plan fiduciaries are exploring strategies to enhance their potential investment returns in TDFs. Is it possible to build a better target fund? The answer is yes. One strategy for accomplishing this looks beyond the traditional equity, fixed income, and cash asset classes, and invests TDFs in alternative asset classes more commonly used in defined benefit (DB) plans, such as private equity, hedge funds, and real estate. This strategy has the potential to boost the retirement income of DC plan participants, and some plan fiduciaries are beginning to examine how they can include alternatives within the TDFs they offer.

If we look to other countries around the world, there already has been a significant move toward using alternative assets in DC plan investment strategies. However, fiduciaries for domestic DC plans have not yet widely adopted portfolio allocations to alternative asset classes. One reason for this may be a lack of clarity about fiduciaries' duties under the Employee Retirement Income Security Act of 1974, as amended (ERISA).[4] The DOL could help alleviate some of these concerns by providing guidance about the use of alternative assets in DC plans, including incorporation into TDFs.

This report describes the potential benefits that allocations to alternative asset classes could offer to a TDF's investment portfolio, including enhanced retirement income for participants. Next, it identifies and explains the unique challenges a fiduciary should consider when deciding whether to include alternatives in a TDF, as well as potential strategies a fiduciary may use to apply appropriate due diligence. Finally, to support and encourage this innovation, the paper recommends that the DOL take

[1]Callan Institute, 2019 Defined Contribution Trends, p. 22, available at https://www.callan.com/wp-content/uploads/2019/04/Callan-DC-Trends-Survey-2019.pdf.

[2]Vanguard, How America Saves 2019, p. 4, available at https://pressroom.vanguard.com/nonindexed/Research-How-America-Saves-2019-Report.pdf.

[3]Georgetown University McCourt School of Public Policy Center for Retirement Initiatives, *The Evolution of Target Date Funds: Using Alternatives to Improve Retirement Plan Outcomes* (June 2018), p. 8, available at https://cri.georgetown.edu/wp-content/uploads/2018/06/WTW71824_WHITE-PAPER_Georgetown-CRI-Target-Date_Jun-18_Final.vs2_626.pdf.

[4]ERISA protects the participants in and beneficiaries of private sector employee benefit plans, including retirement plans (defined benefit and defined contribution). ERISA does not cover federal, state, or local governmental plans. 29 U.S.C. §1001, et seq.

administrative action to clarify a fiduciary's responsibilities when considering including alternatives in TDFs.

I. Why Look at Alternatives in Target Date Funds?

Alternative asset classes have long been available to institutional and wealthy investors.[5] Moreover, alternative investments are well-established and routinely form a significant portion of the investment portfolios of defined benefit (DB) plans.[6] However, DB pension plans and the secure retiree income provided by such plans are becoming a thing of the past. With the migration from DB to DC plans, the investment risk and reward has shifted to plan participants. When taking this into consideration, it is important to examine whether there are best practices from DB plans that can be imported to DC plans.

Historically, DC plans present more of a challenge with investments than DB plans. DC participants have more control and freedom to determine the underlying funds to meet their objectives, which can result in money moving in and out of funds frequently, meaning liquidity needs can be greater. DB plan investments, on the other hand, are directed by fiduciaries with a focus on generating long-term guaranteed income, which requires less liquidity. In part because of this difference, DB plans have been able to invest in alternatives, which can offer exposure to assets with higher returns while diversifying against the risk of large losses. However, complexities related to liquidity and pricing would have to be addressed to include such assets in DC plans.

TDFs are attractive to consider because they have several attributes that make them a natural entry point for alternatives in DC plans. First, participants invested in TDFs tend to reallocate their asset mixes at a lower rate than participants invested in other DC plan investment options.[7] This means the capital in TDFs tends to be more stable over time. Second, because TDFs are allocated to multiple asset classes, most of a TDF's assets will still be able to satisfy daily liquidity and fund alternative investments. Third, similar to a DB plan's investment portfolio, a TDF is designed to be diversified among multiple asset classes that are selected by a plan fiduciary. Therefore, participants

TDFs are attractive to consider because they have several attributes that make them a natural entry point for alternatives in DC plans.

[5]Prequin, *Investor Outlook: Alternative Assets H1 2019*, available at https://docs.preqin.com/reports/Preqin-Investor-Outlook-Alternative-Assets-H1-2019.pdf (stating institutional investors' target allocation to private equity is 9.9%).
[6]Letter from Dennis Simmons, Executive Director, Committee on Investment of Employee Benefit Assets, to Preston Rutledge, Assistant Secretary, Employee Benefits Security Administration, Department of Labor, 2 (July 19, 2019), available at https://www.cieba.org/assets/Comment_Letters/CIEBA%20Alts%20in%20DC%20Plans%2007-19-19fnl.pdf; State Street Global Advisors, How Do Public Pension Funds Invest?, (April 2018), p. 5, available at https://www.ssga.com/investment-topics/asset-allocation/2018/inst-how-do-ppfs-invest.pdf.
[7]Vanguard, How America Saves 2019, p. 4, available at https://pressroom.vanguard.com/nonindexed/Research-How-America-Saves-2019-Report.pdf, p. 95. While 12% of DC participants made a portfolio trade during 2018, only 2% of single-fund TDF investors did so.

would not be allowed to select specific asset class weightings or specific alternative funds.[8] For these reasons, TDFs tend to be a better home for alternative investments, which are generally less liquid, because they require more time to convert to cash than other daily-valued investments common in DC plans.

A fiduciary might consider a number of alternative investment asset classes, each with the potential to provide compelling benefits to a TDF's investment portfolio. The private equity asset class offers access to privately held portfolio companies that experience their growth stages before becoming publicly traded or that do not become public at all.[9] Private equity managers purchase control over portfolio companies and use their skills to improve the companies' management and governance, or to identify new opportunities or efficiencies. After creating new value in the portfolio companies, private equity managers sell their investments to obtain a return. The main benefit of private equity is the potential to capture investment returns that exceed returns that may be obtained in the public equity markets.

Other potential alternative investment classes include hedge funds and real estate. Hedge funds comprise a wide variety of active management strategies with the potential to add diversification to a TDF investment portfolio, with low correlation to the performance of public equity and credit markets. Thus, hedge funds potentially provide protection, or a hedge, in changing markets. Real estate generally derives income from the use of physical assets, physical goods, or services derived from those assets, which can include high-quality, income-generating buildings. The benefit of exposure to the real estate asset class is that, historically, it has experienced lower volatility than other asset classes. Because it offers both an income and capital appreciation component, it may be expected to reduce risk without a decrease in expected return.

Private equity, hedge funds, and real estate might be described as "illiquid" asset classes because the underlying investments these asset classes provide exposure to are not readily traded on a public market.[10] However, real estate funds have been available as investment options in DC plans for at least 25 years.[11] Some of these real estate funds already use the strategies discussed here to overcome illiquidity challenges. For example, some real estate funds invest a portion of their assets in liquid investments that can readily be sold to satisfy participant redemption requests. Therefore, these challenges are not at all new. The experience with real estate shows that they can be addressed successfully.

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[8]This paper is not intended to address the merits of "standalone" alternative investment options that might allow a participant to invest all of a DC plan account in alternative asset classes.

[9]There has been a 50% drop in publicly listed companies between 1996 and 2016 and a rise in privately held companies. This makes it increasingly difficult for investors to get diversified exposure to the U.S. economy, and to have real economic value creation, without tapping private equity. *See* National Bureau of Economic Research, *NBER Reporter* 2018, Number 2, *The Shrinking Universe of Public Firms: Facts, Causes, and Consequences*, available at https://data.nber.org/reporter/2018number2/stulz.html.

[10]The underlying investments in hedge funds may be liquid, but the fund manager may impose liquidity restrictions to ensure stability in available assets.

[11]Pension Real Estate Association, Private Real Estate Fund Options for Defined Contribution Plans (October 2004) (on file with authors).

In 2018, the CRI released a study examining the impact that allocations to the private equity, hedge fund, and real estate asset classes would have upon participants' retirement income.[12] The study found that a TDF's allocation to alternatives would increase a participant's annual retirement income by 17% in an expected or average scenario. Even in a down-market, worst-case scenario, the study found that an allocation to alternatives would increase a participant's annual retirement income by 11%. In addition, investing in alternatives can decrease the chances that participants outlive their retirement savings. The study found that, assuming participants retain their investment in a TDF allocated to alternative investments through retirement, the allocation to alternatives can increase participants' chances of retaining their savings after 30 years of retirement by 9% (assuming a 4% annual spending rate) or 15% (assuming a 5% annual spending rate). These results are possible because allocations to alternatives have the potential to increase the TDF's inflation-adjusted returns while reducing risk over time.

> A recent Georgetown University study found that a TDF's allocation to alternatives would increase a participant's annual retirement income by 17% in an expected or average scenario and 11% in a down-market, worst-case scenario.

The CRI's study noted that, despite the great opportunities that alternative asset classes may provide, potential fiduciary concerns about their unique aspects may be preventing wide adoption. However, the application of fiduciary obligations to alternative asset classes can be managed through a careful and prudent process focused on enhancing potential outcomes for participants. This includes addressing concerns such as liquidity and pricing, benchmarking, fees, and governance related to incorporating alternative investments into TDFs.

II. What Are the Operational Challenges of Including Alternatives in Target Date Funds?

Although alternatives have potential to strengthen the ability for TDFs in DC plans to deliver better retirement outcomes, fiduciaries must understand and address unique complexities and challenges. Those challenges are discussed below. Section III describes a framework for a prudent process to address the challenges, and Section IV provides case studies of DC plan fiduciaries who have, *in fact*, addressed the challenges and operationalized alternative asset classes.

[12] Georgetown University McCourt School of Public Policy Center for Retirement Initiatives, *The Evolution of Target Date Funds: Using Alternatives to Improve Retirement Plan Outcomes* (June 2018), available at https://cri.georgetown.edu/wp-content/uploads/2018/06/WTW71824_WHITE-PAPER_Georgetown-CRI-Target-Date_Jun-18_Final.vs2_626.pdf.

A. Governance and Oversight

A fiduciary's standard of care under ERISA is the same regardless of the type of investment being made. However, that standard of care may require a higher degree of knowledge and care depending on the complexity of the asset class being considered. Fiduciaries should recognize that the complexities and challenges inherent to alternative investments will require the adoption of processes or policies governing, among other things:

Although alternatives have potential to strengthen the ability for TDFs in DC plans to deliver better retirement outcomes, fiduciaries must understand and address unique complexities and challenges.

- The percentage of each TDF portfolio that will be allocated to alternative investments;
- The search for and due diligence of potential alternative investment fund candidates;
- Negotiation of investments, including legal review;
- Quarterly and annual reporting providing detailed performance and risk attributions, as well as in-depth qualitative research on each manager; and
- Authority to direct the custodian and managers on intra-trust asset transfers and transfers out of trust to fund mandates and pay expenses.

Fiduciaries are not required to undertake each action personally, but may instead delegate responsibilities and obtain advice and recommendations. There are benefits and considerations to both in-house and outsourced or co-sourced models.

In-house	Co-sourced/Outsourced
Sponsor has the ability to retain internal knowledge	Firms with a global scale leveraged across all clients
Internal objectives can be adhered to more closely because the internal team works directly with the investment committee	Additional support from asset class specialist teams — support with top-down views and portfolio construction philosophies
Internal team allows for more control over the portfolio	Shared fiduciary responsibility under the discretionary outsourced management relationship
	Dedicated operational due diligence team to evaluate non-investment risks
	Potential to access a more-mature portfolio, which may lessen some of the early-stage return issues with some private investments

For example, a plan fiduciary might use an internal team of employees with investment expertise to assist with selecting and monitoring an investment portfolio. An internal team allows for more control over the portfolio and for internal objectives to be adhered to more closely. On the other

hand, a plan fiduciary might delegate this activity to or receive recommendations from an investment consultant or investment advisory firm. This model may provide the benefit of leveraging the global scale of the firm, as well as its expertise in alternative asset classes. Outsourcing or co-sourcing may also provide the potential to access a more-mature portfolio to work through the "J-curve," which occurs if the investment begins with a brief initial negative return that shifts rapidly to increasing positive returns, as discussed in greater detail in Section E. Nonetheless, fiduciaries must develop or have sufficient expertise to monitor the performance of delegated responsibilities. For example, fiduciaries should be able to ask key questions to understand the reasoning behind delegates' decisions and advisors' recommendations.

B. Liquidity and Pricing Requirements

TDFs generally must be managed to satisfy daily withdrawals or redemptions by participants. Moreover, to satisfy daily participant-initiated withdrawals or redemptions, the value of a TDF must be determined on a daily basis. Most investments in the traditional equity, fixed income, and cash assets classes permit daily liquidity and pricing. However, alternative investment funds do not generally permit investors to withdrawal any part of their investments on a daily basis. Many alternatives are only valued on a monthly or quarterly basis. For example, hedge funds might only permit redemptions of investors' interests on a monthly or quarterly basis, and private equity funds generally do not permit investors to redeem their interest at will, meaning interests are only fully liquidated after several years. Some DC funds available today allocate to real estate, which estimates pricing in-between formal building appraisals within their fund structures to determine a fair value where the funds transact.

Therefore, fiduciaries must consider the extent to which alternative investment allocations affect liquidity and whether it will be possible to value the TDF on a daily basis. Fiduciaries can balance illiquid alternative investments with other liquid investments that may be used to satisfy requests for participant-initiated withdrawals or redemptions. As part of this analysis and as previously discussed, TDFs experience less-frequent redemptions and represent a comparably more-stable source of funding for alternative investments, due to the inherently passive nature of investing in TDFs.[13] Today, plan fiduciaries have access to newly developed liquid alternative strategies that could mitigate the illiquidity risk when including alternative in TDFs. For example, a liquid alternatives portfolio is a combination of hedge funds and/or alternative betas. Most hedge fund and alternative beta strategies offer monthly or quarterly liquidity, which is more than sufficient to be categorized as liquid for the average institutional investor, especially when compared with many private market strategies.

In addition, fiduciaries, or their chosen investment manager(s) and trustee(s), can adopt guidelines for the estimation of the value of alternative investments on a daily basis. The focus of the guidelines would be to determine whether it is necessary to adjust any monthly or quarterly valuations

[13] Plan Sponsor, 2019 Target-Date Fund Survey (September 18, 2019), available at https://www.plansponsor.com/research/2019-target-date-fund-buyers-guide/2/#Industry%20Snapshot.

provided by the managers of the underlying alternative investment funds. Factors that may suggest the valuations should be adjusted may include, among other things:

- Known intra-period cash flows, including sales and acquisitions at known transaction prices;
- Estimated expenses, and management and performance fees, applied linearly;
- Quoted market transactions or market fluctuations of similar securities or properties; and
- Any other known material events.

Fiduciaries may also want to consider running simulations to confirm whether their TDFs will have adequate liquidity in the event of extreme economic conditions, such as a recession or depression. That typically involves running stress tests simulating significant market downturns and, as discussed in Section IV, is a practice utilized by some current TDF managers today.

C. Fees

Alternative investments bear more-complicated fee structures than more-traditional DC plan investment vehicles such as mutual funds or collective investment trusts.[14] Alternative investment fees may include management fees, charged based on a percentage of invested or committee capital, and incentive fees, charged based on a percentage of any positive performance results. Moreover, on an absolute level, the fees that alternative investment bear are generally higher than traditional DC plan investment vehicles. Fiduciaries may find fee issues to be especially acute because, over the past years, a large number of lawsuits have been filed against DC plan fiduciaries challenging the investment and administrative fees paid under such plans.[15] As recommended in Section V, the DOL could issue guidance that places fees in the proper context when considering alternative investments. This guidance would quell concerns that alternative investments are impermissible *per se* as a result of fees.

Fiduciaries must understand the fee structure of the alternative investment funds they select, or, in other words, how the managers of the funds they select will be compensated, and alternative investment fees should not be considered in isolation. In this respect, since alternative investments will only constitute a portion of a TDF portfolio, fiduciaries should consider what effect alternative investment fees will have on the fee profile of the TDF as a whole. Most importantly, a participant's retirement outcome will not be based on fees alone, but rather will contemplate the potential for alternative investment to deliver returns net of fees. Therefore, a fiduciary's ultimate determination should be based on the potential of alternative investments to increase a TDF's performance net of

[14]Collective investment trusts, also known as commingled funds, collective investment funds, or collective trust funds, are investment vehicles maintained by banks or trust companies for investment by tax-qualified retirement plans. See, generally, Office of the Comptroller of the Currency: *Comptroller's Handbook, Collective Investment Funds* (May 2014), available at https://www.occ.treas.gov/publications-and-resources/publications/comptrollers-handbook/files/collective-investment-funds/pub-ch-collective-investment.pdf.

[15]Mellman and Sanzenbacher, *401(k) Lawsuits: What are the Causes and Consequences?*, Center for Retirement Research at Boston College (May 2018), available at http://crr.bc.edu/briefs/401k-lawsuits-what-are-the-causes-and-consequences/.

fees.[16] This determination forms part of a prudent process, including consideration of potential investment performance, fees, and fund managers' experience.[17]

There is no fiduciary requirement to implement the lowest cost option available, and it should not be controversial to point out that participant outcomes are improved as long as the net-of-fee value proposition is positive. Nevertheless, fiduciaries should be mindful of the perception participants might have about fees and make an effort to communicate and inform investors. It is possible that if they see a fee that they interpret as too high, they could avoid the investment. Fiduciaries should remain mindful of how fee information, or lack thereof, could possibly affect participant behavior.

D. Benchmarking

Key to monitoring a TDF's performance is identifying and comparing against a benchmark. Although benchmarking almost always poses challenges, there may be many potential other TDFs on the market to serve as benchmarks for TDFs invested only in traditional asset classes. However, to use TDFs allocated only to traditional asset classes as a benchmark for a TDF allocated to alternative investments would risk comparing "apples to oranges" by comparing funds with different investment strategies and risk levels.[18] As an alternative, fiduciaries could consider reviewing the overall glide path of the TDF while also benchmarking the underlying portfolios (*e.g.*, using asset-specific benchmarks for each underlying portfolio to assess performance from a return, risk, and risk-adjusted standpoint).

E. The J-Curve

The "J-Curve" refers to a trend applicable to private equity and other alternative investment funds that draw down capital for investments over time. The value of these funds may decline moderately during the first phase of the fund's term, due to the accrual of investment-related fees and expenses before any investment gains occur, which temporarily reduces the value of the plan's investment. During later stages of the fund's term, the fund's underlying portfolio investments should gain value, which would increase the value of the plan's investment, and then be sold. The initial markdowns on the principal committed, followed by potential gains, follow the shape of the letter "J."

The impact of the J-Curve tends to be more pronounced when an alternative investment program begins (since all investments are new) but, over time, it tends to be less noticeable at the portfolio level as gains on older investments offset the "fee drag" from newer investments. A fiduciary also may use several strategies to mitigate the impact of the J-Curve, including, for example, making investments in more-mature private equity or real estate funds through a secondary market. By

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[16]*See, e.g., Taylor v. United Techs. Corp.*, 2009 WL 535779, at *10 (noting that the "selection process [for actively managed mutual funds] included appropriate consideration of the fees charged on the mutual fund options, and of the returns of each mutual fund net of its management expenses"); *Laboy v. Bd. of Trustees of Bldg. Serv.*, 2012 WL 3191961, at *2 (S.D.N.Y. Aug. 7, 2012) ("[I]t is performance net of fees rather than mere fees that courts have used to find that a claim for breach of fiduciary duty had been stated").

[17]*Taylor*, 2009 WL 535779, at *5 and 10.

[18] *Sacerdote v. New York Univ.*, 328 F. Supp. 3d 273, 314 n.114 (S.D.N.Y. 2018) (comparison of funds with different investment strategies is impermissible "apples to oranges" comparison).

investing in funds with a diversity of vintage years, the overall asset portfolio may receive consistent payouts over time while minimizing the percentage impact of the J-Curve on the overall portfolio.

One means of gaining exposure to funds with a diversity of vintage years is to access alternative asset-class investments through a fund-of-funds. As discussed in Section IV, one plan fiduciary used a different strategy: allowing plan participants to invest in units of a defined benefit plan. Because the DB plan holds a mature portfolio of alternative investments, including funds with a diversity of vintage years, the J-Curve would not have a material impact on individual DC plan participants.

F. Legal Risks

ERISA imposes duties on fiduciaries of loyalty, prudence, prudent diversification, and acting in accordance with the documents governing the plan.[19] ERISA's duty of loyalty requires that a fiduciary act for the exclusive purpose of providing benefits to plan participants and beneficiaries, and defraying the reasonable expenses of the plan.[20]

> Many plan fiduciaries – even those strongly supportive of private asset investing- are reluctant to include alternatives assets in their TDFs because of the perception of increase litigation risk.

The prudence rule requires acting as a "prudent expert" would act under similar circumstances.[21] Under ERISA, a breach of fiduciary duty can give rise to a fiduciary's personal liability for losses resulting from the breach, or for other equitable relief.[22] A fiduciary's duty of prudence generally requires that the fiduciary undertake an appropriate diligent process prior to making a decision on behalf of the plan.[23] DOL has stated that a fiduciary's obligation to carry out its duties "prudently" generally is met when fiduciaries follow a "procedurally prudent" process by gathering relevant information, considering all available courses of action, consulting experts where appropriate, and making a reasoned decision based on all relevant facts and circumstances.[24] The process must be tailored to the complexities of the decision under consideration.[25] A fiduciary who does not possess the knowledge or skills necessary to conduct an adequate investigation of particular courses of action must acquire that knowledge or skills or seek outside assistance.[26] Therefore, engaging an investment expert or consultant supports the thoroughness of the due diligence and a finding of prudence.[27] A fiduciary's decisions should generally be documented in writing.

[19]ERISA § 404(a).
[20]ERISA § 404(a)(1)(A).
[21]ERISA § 404(a)(1)(B).
[22]ERISA § 409.
[23]*Brock v. Robbins*, 830 F.2d 640, 648 (7th Cir. 1987); *Donovan v. Mazzola*, 716 F.2d 1226, 1232 (9th Cir. 1983).
[24]DOL Field Assistance Bulletin 2003-02 (May 7, 2003), available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2003-02.
[25]*See* DOL Info Ltr. to Eugene Ludwig, (March 21, 1996).
[26]*Martin v. Feilen*, 965 F.2d 660, 670-71 (8th Cir. 1992).
[27]*Gregg v. Transp. Workers of Am. Int'l*, 343 F.3d 833, 841 (6th Cir. 2003); *Bussian v. RJR Nabisco Inc*., 223 F.3d 286, 299 (5th Cir. 2000).

The next section of this paper discusses a framework for a potentially prudent process in connection with a fiduciary's decision to allocate a portion of a TDF portfolio to alternative investments. Although a strong fiduciary process can greatly reduce a fiduciary's litigation risk, the federal government could do a lot to support plan fiduciaries who want to modernize DC plan investments. Many plan fiduciaries — even those strongly supportive of alternative assets investing — are reluctant to include an alternative assets allocation in their TDFs because of a perception that it could increase the risk of litigation. The DOL could provide more legal certainty by explicitly stating that DC plan fiduciaries can prudently include an allocation to alternative assets investments in their TDFs and provide a list of issues fiduciaries should consider.

III. What Are the Steps for Enhanced Due Diligence for Illiquid Alternatives?

A fiduciary would be required to exercise prudence in connection with a series of related steps, including (a) decisions about whether to allocate TDFs to alternative investments, and what percentage of the funds should be allocated to each alternative asset class; (b) the selection of individual alternative investment managers and negotiation of the investments, including legal review; and (c) monitoring alternative investments.

A. Initial Decisions Regarding the Allocation

More than 40 years ago, the DOL promulgated a regulation under ERISA that clarifies the application of the prudence standard to investment decisions and incorporates modern portfolio theory.[28] Under the regulation, the prudence of an investment is to be judged based on an analysis of all the pertinent facts and circumstances related to the investment.[29] A fiduciary must take certain factors into consideration, such as the investment's position in the plan's overall portfolio (or the portfolio over which the investment professional exercises discretion), risk of loss associated with the investment, opportunity for income, and the investment's impact on the diversification of the plan's portfolio and the plan's liquidity and cash flow needs.

Accordingly, in determining whether to allocate TDF portfolios to alternative investments, and deciding what the extent of the allocations should be, fiduciaries should consider how alternative investments would affect the risk, return, diversification, and liquidity characteristics of a TDF portfolio as a whole. This consideration might include analysis of the unique aspects of, for example, the private equity, hedge fund, and real estate asset classes. For example, a plan fiduciary may consider the potential for private equity to deliver above-market returns, ability of hedge funds to provide

[28] Preamble to ERISA Section 404 Prudence Regulation, 44 Fed. Reg. 37221, 37222 (June 26, 1979).
[29] 44 Fed. Reg. at 37225.

diversification, and potential for real estate to lower the volatility of an investment portfolio. A fiduciary might also consider the demographics of the plan's participant population, including age and compensation, to determine whether the alternative investment allocations would fit the needs of the plan's specific participants. These considerations might be documented in a report or memorandum that describes the potential impact (either historical or forward-looking) of allocations to alternative investments.

Fiduciaries might solicit advice from investment consultants or investment managers in making these decisions, and the TDF allocation (or a range of potential allocations) might be documented in the plan's investment policy statement. As previously discussed, there are advantages and considerations in delegating to an investment manager or receiving advice from an investment consultant.

B. Selection of Specific Alternative Investment Funds

A fiduciary should establish and initiate policies and procedures for selecting individual alternative investment funds or managers and negotiating the investments. A fiduciary's review of candidates might encompass quantitative and qualitative factors, such as their:

- Historical investment returns;
- Capabilities of the candidate to manage the investment, including its staffing and other resources that may be relevant;
- Investment philosophy and/or strategy;
- Experience with or understanding of TDFs;
- Willingness to work with plan sponsors to address DC-specific issues, particularly related to pricing, liquidity, and the disclosure of fees; and
- The alternative investment fund's fee structure.

Diligence steps include reviewing various due diligence documentation (e.g., offering memorandum, limited partnership agreements or articles of association, or audited financial statements), onsite discussions with key operational staff, creation of operational due diligence reports and manager ratings, and ongoing monitoring. Fiduciaries should also engage legal counsel to conduct a legal review of the documents governing the alternative investment fund. Legal review can help identify terms that would harm the plan, its participants, and beneficiaries. Further, many alternative investment funds grant rights through negotiation that would not be obtainable by default.

Notably, fiduciaries may delegate the selection of alternative investments funds to an investment manager or receive advice from an investment consultant. To the extent they delegate authority to an investment manager, the fiduciary should monitor the activities of the manager on a regular basis.

C. Monitoring Alternative Investment Funds

ERISA's prudence standard requires that fiduciaries monitor a plan's investments at regular intervals.[30] While the courts or the DOL have not articulated a specific schedule, it is general practice that quarterly monitoring, unless there is an emergency requiring immediate attention, is sufficient. As noted above, the establishment of a benchmark to measure the performance of individual alternative investment funds, as well as the TDF portfolio as a whole, will play a significant role in performance monitoring. Fiduciaries should also periodically monitor whether the factors considered upon the initial review of the alternative investment fund (such as investment philosophy or staffing) have changed.

IV. Case Studies

Despite the challenges discussed above, both plan sponsors and fund managers have begun to incorporate alternative investments in their TDFs. The following case studies[31] illustrate how this is being done today.

A. Plan Sponsor Perspective

This public plan sponsor acts as a fiduciary investment manager for more than a dozen retirement plans, both defined benefit and DC plans, covering public employees, teachers, school employees, law enforcement officers, firefighters, and judges.

For over three decades, the sponsor has been committed to making significant private market investments (i.e., private equity, real estate, and tangible assets) for the defined benefit plans it manages. It believes that having private market exposure is beneficial to increasing long-run returns while helping reduce risk through diversification. Over the years, the plan's investment returns have been well above average, which it believes is due, in large part, to the fact that its private market investments allow the plans to capture an "illiquidity premium" (i.e., additional yield because an investment cannot be readily sold at its fair market value).

This public plan is somewhat unique in that it already includes an allocation to private markets in investment funds offered to certain participants who direct their own investments. In the 1990s, the state created a new hybrid retirement plan that has both a DB and DC component. Participants are able to select their own investments from a lineup with their DC portion of the plan. A group of plan participants encouraged the plan to find a way to include private market investments in one of the options available because they wanted the opportunity to benefit from an allocation to private market investments.

[30] *Tibble v. Edison Int'l*, 135 S. Ct. 1823, 1828 (2015).

[31] These case studies are intended to provide real world illustrations of potential approaches. To retain a focus on generally applicable strategies, the authors have elected to not specifically identify the organizations discussed.

In response, the plan developed an investment option that has essentially the same portfolio construction and discipline as the defined benefit component. This option has a single investment allocation for all investors, but participants who elect to use it get the benefit of exposure to the same private market investments as those available in the DB plan. Starting in 1995, the plan began to implement this new investment option. In 1996, the state approved this as a default option for participants in the hybrid plan. With assets of approximately $8.5 billion, the new investment option is now the largest investment in the hybrid plan and more than 60% of participants invest in it.

The plan believes that participants have benefited from this new investment option and having exposure to private market investments. In fact, the private market investments have materially outperformed public equity investments over the past one-, three-, five-, 10- and 20-year periods. For example, its private markets investments have outperformed its public equity investments by 2.8% over the previous 20-year period.

Given the positive outcomes for participants, in 2016, the plan began exploring the possibility of making an allocation to private market investments in the TDFs available to certain governmental employees in the state. To do that, the plan has been engaging in a comprehensive review and planning process that takes into consideration the unique operational and legal challenges inherent in incorporating private market investments into TDF portfolios, which have age-dynamic glide paths (as opposed to the uniform allocation in newer default investment options).

> The plan believes that participants have benefited from having this new investment option and exposure to private market investments.

In particular, the project team is taking investment issues into consideration, including the proper allocation throughout a TDF's glide path, as well strategies for managing a plan's liquidity needs. The plan is also carefully considering operational issues, including pricing and recordkeeping methodologies. The plan has been particularly focused on developing, refining, and implementing procedures to ensure that private market investments are properly valued. At the same time, the plan's legal department is conducting a thorough analysis of the fiduciary issues associated with the investment decision, potential legal risks, and need for any additional legislation to implement the change.

In addition to addressing operational and legal challenges, plan staff also recognize the importance of communicating the benefits of the TDF changes to stakeholders clearly and successfully. Thus, the plan anticipates that any changes to the TDF investment strategy will be accompanied by a robust public relations campaign that will include providing education to plan participants about how incorporating a private markets allocation could affect their retirement savings and discussions with lawmakers.

B. TDF Manager Perspective

> A critical challenge is communicating the new strategy to plan fiduciaries and participants in a way that helps them understand that incorporating alternative assets into their TDFs is a prudent investment for plan participants.

This nonprofit recordkeeper and asset manager was established more than four decades ago to help public sector employees build retirement security. It has more than $57 billion in assets under management and administration, and serves participants and plans across the country. The organization primarily serves public sector retirement plans (e.g., 401, 457, and 403(b) plans), but recently began offering certain investments to private sector retirement plans as well.

The investment team manages a suite of TDFs intended to provide investors with exposure to multiple asset classes in a single strategy. The funds gradually adjust the asset mix as investors draw closer to their retirement dates. The funds historically invested primarily in public equities and bonds but did not have an allocation to alternative investments.

Several years ago, the team began to investigate strategies to improve performance and diversification for the TDFs in public DC plans. After an extensive review of the economic data, the investment team concluded that DC plan participants could achieve better investment results by having exposure to longer-duration, less-liquid investments, including private equity, real estate, and private debt. That would not only give participants broader diversification, but would also capture the illiquidity premium, similar to many DB plans and other institutional investors.

Although the concept was clear, the firm's investment team had to address a number of operational challenges including alternative investments in their TDFs. In particular, the team had to create new TDF glide paths that incorporate an allocation to alternative investment but recognize that participants need more liquidity once they retire and begin drawing on their retirement savings. They also had to optimize a specialized investment vehicle to hold the alternative investments and create a mechanism to fund expected and unexpected redemptions. That involved conducting stress tests of the model to ensure adequate liquidity in the event of, for example, severe market downturns. It also focused on developing a strategy for phasing in the allocation to alternative investments over time through a laddering process that avoids having an over-commitment to any particular vintage and helps manage the J-Curve. They also established robust procedures to ensure that alternative investments are properly valued, including processes for vetting and back-testing valuations.

A critical challenge that remains is communicating the change to plan fiduciaries and participants. Although the team believes the new TDF allocation to alternatives will improve

performance, they still need to ensure that stakeholders understand the changes and that fiduciaries have sufficient information to conclude that the TDFs are prudent investments for plan participants.

C. International Experience

DC retirement systems have grown in popularity around the world, particularly as countries have been forced to address financial challenges. As those systems have matured, many managers have considered the best ways to construct investment portfolios that help improve retirement outcomes for participants. In several countries, that has included a move to incorporating alternative asset classes.

- ***Australia***. Australia has established a system of superannuation funds, which pool DC assets for purposes of investment.[32] Similar to the DOL's regulations, Australian law provide for default superannuation funds, some of which are permitted to operate in a manner similar to TDFs.[33] The superannuation funds commonly invest in alternative investments, and AustralianSuper, the largest Australian Superannuation DC fund provider, offers funds with an allocation of more than 20% of their assets to real estate, private equity, and other alternatives.

- ***Chile***. Chile was one of the first countries to implement a DC pension system when it put pension system reforms in place in 1980. To improve retirement outcomes, Chile issued regulations that permitted direct investment in alternative assets effective in 2017. Within just the first year, managers invested approximately 2.7% of the assets in alternative asset classes.

- ***Malaysia***. Malaysia has established a compulsory retirement savings plan for Malaysian citizens working in the private sector. It is a DC program that is managed by the Malaysia Employees' Provident Fund, commonly known as EPF. EFP has incorporated real estate into its investment strategy and currently has a 10% strategic allocation to that asset class. It also makes some investments in private equity.

- ***Mexico***. Since 1997, Mexico has provided retirement benefits through a DC system that lets participants select between pension fund managers. The system is known as Administradores de Fondos para el Retiro (AFOREs) and is responsible for managing individual accounts and making investments. Mexican regulations have permitted AFORES to invest in alternative assets since 2007, and as a result, approximately 8% of the total assets have been invested in alternatives, including infrastructure, energy, real estate, forestry, and private equity. Investments in alternative assets are expected to grow in the future.

- ***United Kingdom (UK).*** The UK has a diversified retirement system composed of several types of retirement plans. For DC programs in the UK, the consideration of integrating alternative assets

[32]Australian Tax Office, Your Superannuation Basics (accessed on November 13, 2019), available at https://www.ato.gov.au/General/Other-languages/In-detail/Information-in-other-languages/Your-superannuation-basics/.
[33]Superannuation Legislation Amendment (MySuper Measures), Regulation 2013 (Austl.) § 7.9.07N.

is growing in popularity.[34] The government and regulators are considering changes to programs, including UK NEST[35], that will allow for investment in alternative assets.

V. Recommendations

Despite the significant benefits that alternative investments might bring to TDF investment portfolios, there is still significant uncertainty about whether making exposure to alternative investments in TDFs available through a DC plan is consistent with a fiduciary's duty of prudence. This uncertainty is exacerbated by widespread litigation challenging the investment and administrative fees paid under DC plans. The litigation even includes one case currently working its way through the courts in which participants alleged that fiduciaries breached their fiduciary duties by allocating balanced funds and TDFs to invest in private equity funds and hedge funds.[36] These cases have produced a chilling effect, causing some fiduciaries to believe that they will incur significant risk if they make any investment available other than passively managed index funds.[37]

Although a strong fiduciary process can greatly reduce a fiduciary's litigation risk, the federal government could do a lot to support plan fiduciaries who want to modernize DC plan investments.

This state of affairs is unfortunate because, in contrast to the *legal* uncertainty, many plan fiduciaries are certain of the significant real-world benefits that allocations to alternative investments may provide to a TDF portfolio. Many DC plan fiduciaries are already familiar with alternative investments because they manage DB plans with significant allocations to alternatives and there is increasing interest to begin using alternatives in TDFs. If the legal uncertainty could be addressed, a greater number of DC plan fiduciaries would be ready to modernize the their TDFs by incorporating alternative investments.

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[34]One investment manager announced it will allocate 15-20% of the assets of the default investment fund it manages to infrastructure, property, private debt and private equity. Universities Superannuation Scheme to Add Private Markets to DC Plan, Pensions & Investments (Jan. 22, 2020), *available at* https://www.pionline.com/defined-contribution/universities-superannuation-scheme-add-private-markets-dc-plan.

[35]In 2019, the UK Department of for Work & Pensions issued a consultation (*i.e.*, a request for information) on defined contribution funds' investment in illiquid assets, including private equity. Investment Innovation and Future Consolidation: A Consolidation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution Schemes (Feb. 2019), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/776181/consultation-investment-innovation-and-future-consolidation.pdf. See also Georgetown University McCourt School of Public Policy Center for Retirement Initiatives, *CRI Policy Blog: The Next Generation of NEST Program Reforms in the UK: Anticipating Some Challenges Will Strengthen the Foundation for Continued Success* (November 2018), available at https://cri.georetown.edu/the-next-generation-of-nest-program-reforms-in-the-uk-anticipating-some-challenges-will-strengthen-the-foundation-for-continued-success/ which discusses the UK NEST's consideration of alternative investment approaches, including procuring access to private credit. Nest announced in September 2019 two fund managers it will partner with to enable its members to invest in private credit. Nest Corporation, Nest puts private markets in the hands of its savers (September 13, 2019), available at https://www.nestpensions.org.uk/schemeweb/nest/nestcorporation/news-press-and-policy/press-releases/Nest-puts-private-markets-in-the-hands-of-its-savers.html.

[36]*Sulyma v. Intel Corp. Inv. Policy Comm.*, No. 15-cv-04977 (Compl. filed April 26, 2016).

[37]*Brotherston v. Putnam Investments*, LLC, 907 F.3d 17, 39 (1st Cir. 2018) (stating that fiduciaries may "easily insulate" themselves from liability if they select "low-fee and diversified market index funds").

For this reason, it would be appropriate for regulators to step in to provide clarity. One DOL official has stated, in a public setting, that the same ERISA fiduciary duties apply to private equity and hedge funds as other typical DC plan investments.[38] However, the DOL has never explained the application of these fiduciary duties to alternative investments, with the result that uncertainty remains. The DOL should issue an advisory opinion, information letter, or field assistance bulletin that provides clarity to fiduciaries and analyzes ERISA's fiduciary requirements in a substantive manner. The guidance should make it clear, by providing a list of factors to consider, that ERISA does not prohibit alternative investment in DC plans *per se*, and therefore that a fiduciary could, if it follows a prudent process, decide to allocate a portion of a TDF portfolio to alternative investments.

[38] Testimony of Louis Campagna, Chief of the Division of Fiduciary Interpretations, Office of Regulations and Interpretations, Advisory Council on Employee Welfare and Pension Benefit Plans, Hedge Funds and Private Equity Investments, at 26 (November 2011), available at https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/about-us/erisa-advisory-council/2011-hedge-funds-and-private-equity-investments.pdf.

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