Observations & Opinions

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ROLE OF ALTERNATIVE INVESTMENTS IN 401(K) PLANS

Alternative investments and strategies are the "topic du jour" for institutional and high net worth investors alike. With capital market pundits expecting a low inflation, low return environment going forward and investment managers continually asking for leeway to broaden their sources of alpha, new products – which are much more complex than your traditional long-only equity and bond mix – are constantly coming to market. But how do such investments fit into defined contribution plans, where even emerging market equity funds are rarely found in the investment fund line-up?

In this installment of *Observations & Opinions* we will begin with an overview of Callan's ideal 401(k) plan structure and use that ideal as a springboard for discussing the potential role of alternative or non-traditional asset classes.

Ideal 401(k) Plan Structure

Callan employs a three-tiered framework to depict a defined contribution plan's fund choices and to evaluate the overall plan investment structure. This approach is designed to address the varied needs of each different constituency in a population of participants. We would recommend this structure for a new plan unconstrained by existing options, participant account balances, and service provider arrangements.

Tier I - Asset Allocation Options

Callan has a strong preference to include asset allocation options as the prudent baseline or default option in a defined contribution plan. Asset allocation funds are good alternatives for participants lacking the knowledge, interest, or time to manage their accounts directly. (Many industry observers assert that such individuals constitute the majority of plan participants.) Asset allocation funds offer:

1. Professional management to provide well-diversified exposure to major asset classes and styles;
2. Automatic rebalancing when the allocations to the asset classes and styles stray too far from their target allocations; and,
3. A turnkey solution that allows participants to delegate investment decision-making.

Tier II - Core Options

Tier II is geared to provide 401(k) participants with an array of core investment options. These core options are the primary building blocks needed to create a diversified portfolio that suits a participant's personal investment needs from a risk/reward perspective. Tier II inherently caters to participants who want to be more actively involved in the construction and on-going maintenance of their investments. However, Tier II should also be structured in a way that recognizes that even many do-it-yourself DC participants can be overwhelmed by too many investment choices. Tier II should be designed to offer access to a manageable set of major asset classes and styles: capital preservation, fixed income, domestic equity, and international equity. Equity asset classes can be broken into capitalization and style categories. Within this construct, it is important that participants have access to a spectrum of choices that encompasses small to large capitalization equities, including value, core, and growth styles. Tier II should be comprised of as few as six to as many as ten different funds in order to provide sufficient diversification opportunities without overwhelming choice. The more esoteric asset classes being discussed in today's marketplace do not belong in Tier II.

Tier III - Specialty Options

Tier III of the 401(k) framework is the specialty tier, and includes investment options that are not considered to be one of the "core" primary building blocks. These specialty options constitute an opportunity set that is geared towards more sophisticated participants who are interested in further diversifying into specific areas of the capital markets. Tier III options include company stock, socially responsible strategies, REITs, TIPS, high yield bonds, global equity, emerging markets equity, international fixed income, concentrated or all-cap equity, and mutual fund or self-directed brokerage windows. Tier III is the area of a 401(k) structure where non-traditional, alternative strategies should be housed for direct access.

Callan generally does not recommend the adoption of specialty options. For one thing, adopting a Tier III set of funds puts the burden of selecting the strategies and monitoring the funds squarely on the shoulders of the sponsor. It becomes very difficult to determine how many Tier III funds are enough and what strategies should be included. The presence of Tier III options may add "heft" to the investment fund line-up, while also increasing the potential confusion factor for even sophisticated plan participants. Research has shown that 401(k) participants who consider themselves savvy investors, in reality have very poorly-defined investment preferences.[1]

We recognize that there are many reasons why a plan sponsor may wish to include funds that may not be considered part of the Tier II core options. A primary reason for offering a 401(k) plan for many plan sponsors is to attract and retain workers. If demand is high for certain fund types, plan sponsors may wish to accommodate participants' desire for certain non-core investment vehicles.

The balance of this article will examine which alternative investment strategies work in a 401(k) environment, as well as the challenges to such funds' implementation. Outside of logistical issues, we will examine the pitfalls that might be encountered by offering these strategies to participants on a direct basis through a 401(k) plan.

What Does the Term "Alternative Strategy" Encompass?

Within the defined contribution plan environment, "alternative investments" often encompass everything from TIPS to socially responsible strategies to emerging market equities, and self-directed brokerage windows. The list of alternative investments is very different within traditional DB plans and endowment/foundation (E/F) structures. Below is a partial list of the alternative strategies that are being utilized and considered for DB and E/F structures today:

- Direct real estate
- Private equity
- Hedge funds
- Global tactical asset allocation (GTAA)
- 130/30 (130% long equities, 30% short)
- Commodities
- Timber
- Infrastructure
- Currency
- Managed futures

Challenges to Implementation

The key challenge to the inclusion of alternative investments within the DC plan structure are the need for daily valuation and daily liquidity. The further an investment moves away from public markets of traditional stocks and bonds, the more difficult it becomes to achieve a dependable, accurate valuation on a short-term basis

1 "How Much Is Investor Autonomy Worth?" Journal of Finance, August 2002, Vol. 57.4, pp. 1593–1616.

while also being able to meet the liquidity needs of entering and exiting participants.

Still, given the importance of 401(k) plans going forward (read: assets will grow), there is considerable focus by investment managers to provide new products in an attempt to address these daily value and liquidity issues. However, when we examine the available strategies today in more detail it appears that some concession is typically necessary to make them viable in a 401(k) environment. One example is real estate, specifically direct versus exposure through REITs. Several investment managers have developed, or are developing, direct real estate vehicles like those used in other institutional frameworks that could be offered in a daily valued 401(k) environment. Indications are that the nuances are still being worked out to ultimately adapt to daily values and liquidity.

Direct real estate differs from public REITs, which are publicly traded companies that own and manage real estate properties. The performance patterns of direct real estate and REITs are very different given the valuation lag of traditional direct real estate. REITs have a high correlation to small cap value equities due to their frequent valuations and dividend requirements which are quite different from direct real estate investments. Despite this fact, 401(k) plan sponsors are adding REITs to their structures at a rapid rate. According to the Profit Sharing/401(k) Council of America, in the last five years the percent of plans with a real estate fund (REIT) has grown from 9% to 19%. The strong returns from the asset class undoubtedly have been a factor in this demand growth along with the fact that many DC participants view real estate-based investments more intuitively than other asset classes.

The general appeal of non-traditional investments (beyond stocks and bonds) has also been a strong influence in pursuing their inclusion, but it does appear to vary asset class by asset class. For example, an allocation to TIPS can play a meaningful diversification benefit in a portfolio that is heavy on fixed-income. In fact, many DB plans have been adding strategic allocations to TIPS as a diversifier and inflation hedge recently. In contrast, DC plans that have added TIPS as an alternative strategy in Tier III show very low utilization rates. While the risk of chasing returns in TIPS is low since they are fixed-income, their inclusion in a DC line-up as an alternative strategy and diversifier provides its own challenges for appropriate use by participants.

Unlike real estate and TIPS, daily valuation and liquidity issues do not appear to be readily solvable in other recently popularized alternative strategies. For example, private equity programs involve a fifteen to twenty year time horizon with capital calls and net distributions at periods set by the manager, not the investor. Most popular hedge funds have lock-up periods and limited opportunities for contributions and redemptions. In response we have seen mutual fund managers instead develop products which use hedge fund-like tools in their portfolios while still providing daily valuation and liquidity. However, access to the most successful hedge fund managers, and their multitude of underlying techniques and strategies, will seemingly never occur in a 401(k) environment. The most common tool that can be tapped, however, is short selling stocks. The degree to which short-selling is used varies from opportunistic, where the shorts are a small portion of the portfolio, to a more consistent percentage which attempts to mimic a market neutral strategy. One of the significant differences between institutional hedge funds and these mutual funds is the number and types of strategies that can be employed within a portfolio. So again, similar to REITs versus direct real estate, with hedge fund-like options for DC plans we observe a clear trade-off or concession in order to offer them in a daily valued and liquid environment. The ability to gain the same institutional strategy exposure is curtailed by the DC requirements.

Asset Allocation Strategies: A Potential Home for Non-Traditional and Alternatives in a DC Plan

Presuming that liquidity and other DC-related issues can be resolved, the fact remains that the typical 401(k) participant struggles to understand the role of stocks versus bonds in their portfolio. Requiring such individuals to determine the optimal allocation to alternative investments may not be very realistic. Research shows, for example, that participants who use emerging market equity funds are prone to select them based on performance rather than diversification potential, and they tend to over-allocate to such funds.[2] Given the liquidity concerns and the potential misuse of alternative investments by DC participants, the most promising role of such investments may lie within Tier I asset allocation strategies. As part of an asset allocation strategy, it is up to the manager of the asset allocation strategy to determine the appropriate proportion to invest in alternatives—not the participant. Meanwhile liquidity concerns can be handled to some extent through the more

2 Hewitt Associates research report: *401(k) Participant Allocations to Emerging Market Equity Funds.*

liquid investment components of the asset allocation funds. (Although daily valuation remains an issue even in this construct.)

Conceptually, the idea of including alternative investments in asset allocation funds is very appealing. Asset allocation funds can be viewed as DB-like strategies with set risk parameters. The potential to pursue diversified sources of alpha through alternative or non-traditional asset classes would seem to be a natural outgrowth of this structure. Furthermore, plan sponsors who have DB experience and also offer a DC plan to their participants may want to leverage their knowledge, experience and due diligence within alternative strategies for an asset allocation fund. To date we have not seen off-the-shelf products from investment managers incorporate the more esoteric strategies into their proprietary asset allocation funds. Our belief is that these strategies will be incorporated in due time. Many Tier III-type asset classes are already being used including REITs, international small cap, emerging markets, high yield, commodity-linked notes, and TIPS. Furthermore, a degree of tactical asset allocation is employed by some asset allocation strategies. Notably, Tier III-type asset classes can be incorporated into a customized asset allocation offering while not being presented as a stand-alone option to participants. Customized asset allocation options are primarily based on the core line-up of options but can tactically include allocations to what would otherwise be Tier III asset strategies.

Conclusion

The appeal of various alternative or non-traditional asset classes resonates with institutional investors. The appeal stems from a strong diversification and return potential which, if used appropriately, can benefit all investors from institutions to individuals. The trend of DC plans as the primary retirement security source combined with statistics that show average DC participants severely lag institutional program returns suggest that introducing alternative strategies would benefit participants. Given all the opportunity, obstacles remain however. The requirements of daily values and daily liquidity in most 401(k) plans diminish the possibility of non-traditional asset classes and strategies becoming prevalent one-off options for participants. Further, direct access to these oft-misunderstood approaches involves too much uncertainty and risk for plan sponsors. Sufficiently educating participants about how to best use non-traditional strategies when they have direct access will pose significant challenges. The probable home for alternatives and non-traditional strategies is within asset allocation funds. Sophisticated investment managers and plan sponsors are seriously exploring the opportunities and working through the logistics. We should expect to hear increasing discussion on the topic going forward.

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This newsletter offers Callan's observations and opinions on a variety of topics pertaining to the defined contribution industry.
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