



Defined Contribution

Institutional Investment Association

Alternative Investments in Defined Contribution Plans

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Introduction and Overview

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ALTERNATIVES IN DC PLANS: INTRODUCTION

- The June 3, 2020 Information Letter from the DOL on the use of Private Equity in defined contribution (DC) plans is an important development in the broader conversation around the inclusion of alternatives in DC plans. See the DCIIA publication (authored by Groom Law), “Considerations for Offering Private Equity in Defined Contribution Plans,” July 2020.
 - The DOL issued a Supplemental Statement to the Information Letter on December 21, 2021, but did not change the terms of the letter.
- The information presented here builds on that development and updates DCIIA’s September 2015 publication, [“Capturing the Benefits of Illiquidity,”](#) which outlines how different types of alternatives can be used in a defined contribution plan.
- The types of alternative investments discussed are: Private Real Estate, Hedge Funds and Private Equity, with a focus on:
 - What’s new in terms of the offerings available for each type of alternative?
 - How can each type of alternative add value as an investment in a DC plan?
- This presentation also details current thinking as to the Benefits, Considerations and Challenges of offering alternative investments in DC plans.
- Potential next steps are provided for fiduciaries considering implementing alternatives in their plan.
- The summary assessment includes a look at current usage as well as possible future usage of alternative investments in defined contribution plans.

ALTERNATIVES IN DC PLANS: OVERVIEW

- Alternatives—namely, private real estate (RE), hedge funds (HF), and private equity (PE)—can provide a range of benefits that complement traditional equities and fixed income when included as part of defined contribution (DC) multi-asset portfolios.
- Benefits vary by alternative asset class. Depending on the asset class, these benefits may fill varying roles within multi-asset portfolio construction such as:
 - Diversification: Reduced correlation to traditional equity and bond markets
 - Income: Stable yield
 - Stability & downside protection: Reduced overall portfolio volatility
 - Return enhancing: Potential for additional returns versus traditional public market
 - Absolute return: Absolute return potential unrelated to market performance
- Defined benefit (DB) plans have benefited from including alternatives since the 1970's, and some DC plans have included alternative sectors for over 30 years.
- These benefits have historically supported stronger investment outcomes, which could be especially relevant to mitigate lower return expectations for traditional asset classes, post-COVID.
- The inclusion of alternatives presents a range of considerations for DC sponsors that, depending on the alternative asset class, includes cost, valuation, liquidity, benchmarking and participant communication.

ALTERNATIVES IN DC PLANS: OVERVIEW OF CHARACTERISTICS BY TYPE

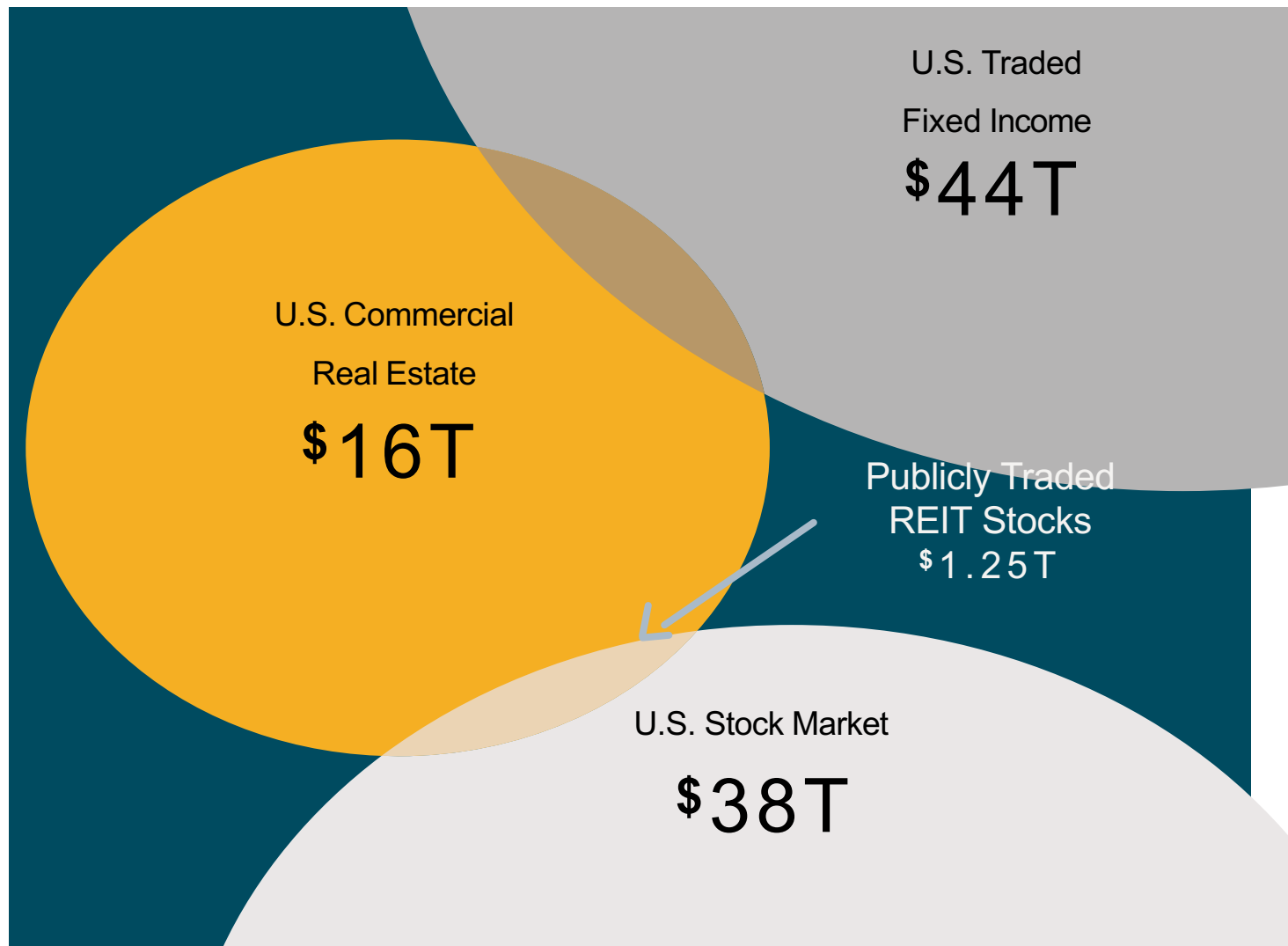
	Private Real Estate	Hedge Funds	Private Equity
Potential Benefits for DC plans	Diversification, stable yield, enhanced risk-adjusted returns, downside protection, and potential for inflation protection	Investment flexibility, diversification, enhanced risk-adjusted returns, downside protection	Greater investment universe for equity asset class, enhanced risk-adjusted returns
Where Commonly Implemented in DC Plans	Multi-asset strategies: target date funds (off-the-shelf and custom), white label funds (real assets, risk-based), income funds/retirement tier, standalone	Multi-asset strategies: target date funds (off-the-shelf and custom), standalone – using liquid alternatives funds	Multi-asset strategies: target date funds (off-the-shelf and custom)
Vehicles Commonly Available	Mutual Fund / '40 Act Fund, CIT, Fund of Funds, Insurance Separate Account, LPs, LLCs providing access to direct real estate or blended private/public funds	Mutual Fund / '40 Act Fund, CIT, Fund of Funds, LPs, LLCs	Mutual Fund / '40 Act Fund, CIT, Fund of Funds, Separately Managed Account, LPs, LLCs
Common Fee Structure	Varies by structure. Management fee with AUM breakpoints is common	Varies by structure. Can range from under 100 bps to 2% plus a performance fee	Varies by structure. Normally includes management fee and performance fee
Typical Benchmark	NCREIF ODCE, Custom private/public blend	CPI + HFRI Index	S & P 500, MSCI World
Liquidity	Daily/Quarterly (Varies by structure)	Daily/Monthly/Quarterly (Varies by structure)	Daily/Monthly/Quarterly (Varies by structure)
Valuation	Daily/Monthly/Quarterly (Varies by structure)	Daily/Monthly/Quarterly (Varies by structure)	Daily/Monthly/Quarterly (Varies by structure) (detailed valuation provided annually per K-1)

Investment Case: Private Real Estate

PRIVATE REAL ESTATE AS AN ASSET CLASS

3rd Largest Asset Class

Commercial real estate is a major industry and a significant asset class in size and scale when compared to the U.S. Equities and Fixed Income markets.



SOURCE: Federal Reserve, Bureau of Economic Analysis, NAREIT, SIFMA, World Bank, Economy.com and LaSalle Investment Management. Based on data through 2019.

WHAT'S CURRENT?

There is strong support in the market for daily-valued private real estate offerings, with DC plans' interest in them and utilization of them growing

- Expanded choice with 16 daily-valued solutions totaling approx. \$50B available and additional launches expected
- \$7B¹ in multi-asset solutions, including target date, risk-based and white label funds
- Retirement tier/income solutions evolving to include private real estate
- Emerging interest in private real estate debt
- Fees, valuation and liquidity:
 - Fees have compressed, management fees tiered by AUM typical
 - Broader standardization around valuation and liquidity
 - There's an established track record for liquidity management over time

¹ Source: NCREIF

WHAT'S CURRENT?

Private real estate is positioned to potentially offer enhanced benefits in a post-COVID cycle:

- Greater expected market volatility, along with desire for yield/ income and total return driving interest in private asset diversifiers
- As demonstrated in the chart, private real estate may offer inflation protection without increasing overall portfolio volatility²

Inflation Hedge REAL ESTATE INCOME CONTINUES TO EXCEED INFLATION



Based on CPI Inflation. Real Estate Income is same-store NOI growth.
Sources: Bureau of Labor Statistics, NCREIF. Data as of Q2 2020.

Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue.

² Net income growth doesn't reflect investment management fees that would be charged for a real estate investment

THE CASE FOR PRIVATE REAL ESTATE IN DC PLANS

- Real estate is a prevalent asset class for institutional investors and offers many benefits that could strengthen retirement outcomes.
- Potential benefits of private real estate include:
 - Diversification/low correlation to traditional equities and fixed income (*see slide 12*)
 - Enhanced risk-adjusted returns (*see slide 13*)
 - Downside protection
 - Income-driven returns
- Given write-downs across private real estate valuations during 2020, current valuations may present trough pricing, which could support stronger absolute returns during the next cycle, particularly relative to equities and fixed income.
- As a result, in a post-COVID cycle private real estate may offer return-enhancing benefits in addition to the long-term strategic benefits noted above.

BENEFIT: LOWER CORRELATIONS TO TRADITIONAL ASSET CLASSES

Private real estate provides enhanced diversification when combined with traditional asset classes

Reflects 15-year historical time period ending Q2 2021³ (net of fees)

Asset Class	Core Private Real Estate	Large Cap Stocks	Corporate Bonds	REITs	T-Bills
Core Private Real Estate	1.00	--	--	--	--
Large Cap Stocks	0.16	1.00	--	--	--
Corporate Bonds	-0.17	-0.21	1.00	--	--
REITs	0.19	0.77	0.02	1.00	--
T-Bills	0.16	-0.09	0.16	-0.08	1.00

- Core private real estate has shown a low correlation with traditional asset classes and may offer enhanced diversification within multi-asset portfolios.
- Private and public real estate investment trusts (REITs) present structural and tactical differences that have resulted in dissimilar risk-return profiles, and REITs have demonstrated a higher correlation with equities over shorter time periods.
- As a result, private real estate and REITs often play different/complimentary roles in overall portfolio construction.



³ Meketa Investment Group 2021 Capital Market Expectations. Core private real estate: NCREIF-ODCE index net; Large cap stocks: S&P 500; Corporate bonds: U.S. Agg.

BENEFIT: ENHANCED RISK-ADJUSTED RETURN

Core private real estate versus other asset classes *(statistics are net of fees)*

Historic: Reflects 15-Year period ending 2Q 2020

	Average Annual Total Return	Standard Deviation	Sharpe Ratio
Core Private Real Estate	7.0%	7.3%	0.79
Public Real Estate	6.9%	23.0%	0.25
Corporate Bonds	5.5%	5.8%	0.75
Large Cap Stocks	8.8%	16.4%	0.46
T-Bills	1.2%	0.8%	-

Forward Looking: Next Cycle⁴

Projected Annual Returns
5.9%
6.5%
2.5% ↓
4.1% ↓
0.4%

- Private real estate can provide an attractive absolute return profile with significantly lower volatility than equities over the same time period.
- Therefore, adding private real estate to a multi-asset class portfolio can support an improved overall risk return profile for the total portfolio.

Sources: Core Real Estate: NCREIF ODCE; Public Real Estate: NAREIT Equity REITs; Large Cap Stock: S&P 500; Corporate Bonds: Citigroup Investment Broad Investment Grade Bond Index; Standard deviation is based on quarterly returns. The methodology represents the return profile that investors recognize in their portfolios. Private real estate represents serial correlation as an appraisal-based private market asset class. The industry presents a range of methodologies to measure volatility. Risk free rate is 3-month T Bill. Data as of 2Q 2020.⁴ JPMorgan Long Term Capital Market Assumptions as of November 2020.

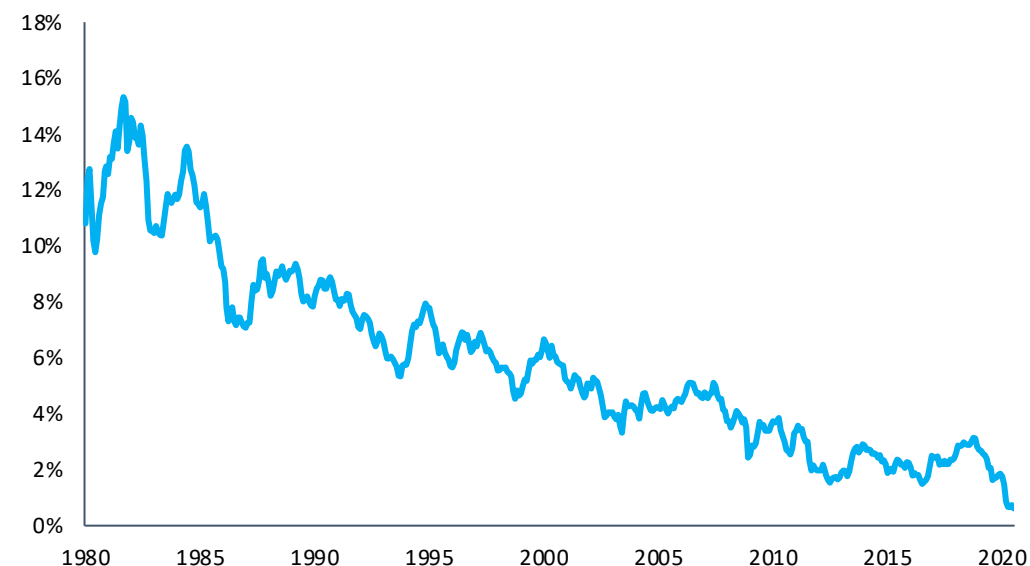


Investment Case: Hedge Funds

WHAT'S CURRENT?

- Low interest rates may make hedge funds an attractive diversifier.
 - With interest rates near historic lows (*see chart at right*), and markets pricing in low rates for the foreseeable future, hedge funds may offer a more attractive way to add diversification and manage volatility than traditional fixed income funds.
- Over the last 5 years, we have seen an increase in DC friendly vehicles with an increase in the number of liquid alternatives tracked by Morningstar.
- Over the same period, there has been more muted growth in hedge funds than in liquid alternatives, but there still has been an expansion in the number of options available.
- Within a multi-asset/multi-manager implementation (e.g., target date funds, target risk funds, etc.), mutual fund and collective fund vehicles are typically used. Limited Partnerships may also be used but they may come with increased administrative and operational considerations.

Federal Reserve Economic Data, Federal Reserve Bank of St. Louis
10-Year Constant Maturity Treasury Note



THE CASE FOR HEDGE FUNDS IN DC PLANS

- Hedge funds are investment pools that can offer greater flexibility than more traditional investments like equity or fixed income funds.
- The greater flexibility relates to their investment tools (derivatives, leverage and short selling), eligible investments and objectives.
- Benefits include:
 - Flexibility that may lead to return streams uncorrelated to traditional stocks and bonds.
 - Uncorrelated absolute returns that may enhance returns or mitigate risk in a full portfolio context.

HOW CAN HEDGE FUNDS ADD VALUE?

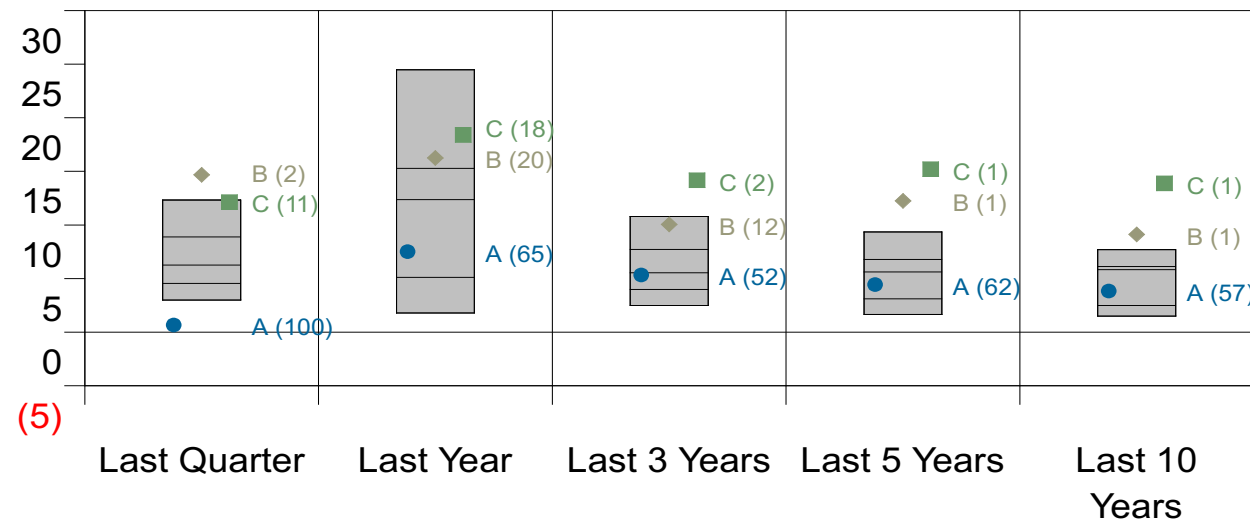
- Hedge funds are able to offer versatile investments that can be used to achieve a wide range of investor objectives.
- Hedge funds can be selected to enhance return, to reduce total portfolio volatility, to provide exposure to under-represented sources of return or to mitigate potential draw down risk, among other objectives.
- There are a variety of hedge fund choices in the market. These come with different levels of volatility, expected returns, and risk mitigation characteristics.
- The following slides show the return of hedge funds in the HFRI Fund of Funds Composite Index⁵, their relatively low volatility and the low level of down-market capture versus relevant indices.

⁵ All fund of funds hedge funds are included in the HFRI Fund of Funds Composite Index® which is equally weighted. To be eligible for inclusion in the HFRI Funds of Funds Indices a hedge fund must: Report monthly returns, Report Net of All Fees Returns, Report assets in USD, be open to new investment, and Meet the AUM minimum eligibility criteria of:
a) Having at least \$50 Million USD under management on the last reported month prior to the annual rebalance, or
b) Having at least \$10 Million USD under management on the last reported month prior to the annual rebalance and have been actively trading for at least twelve (12) months

RETURNS FOR HEDGE FUNDS⁶

- Over the long term (10+ years), performance has often looked more akin to fixed income (as measured by the Bloomberg Aggregate Bond Index) than global equity (MSCI ACWI).
- Volatility has been roughly half that of the S&P 500 Index, but about double that of the Bloomberg Aggregate.

Returns
for Periods Ended December 31, 2020
Group: HFRI Fund of Funds Composite Group

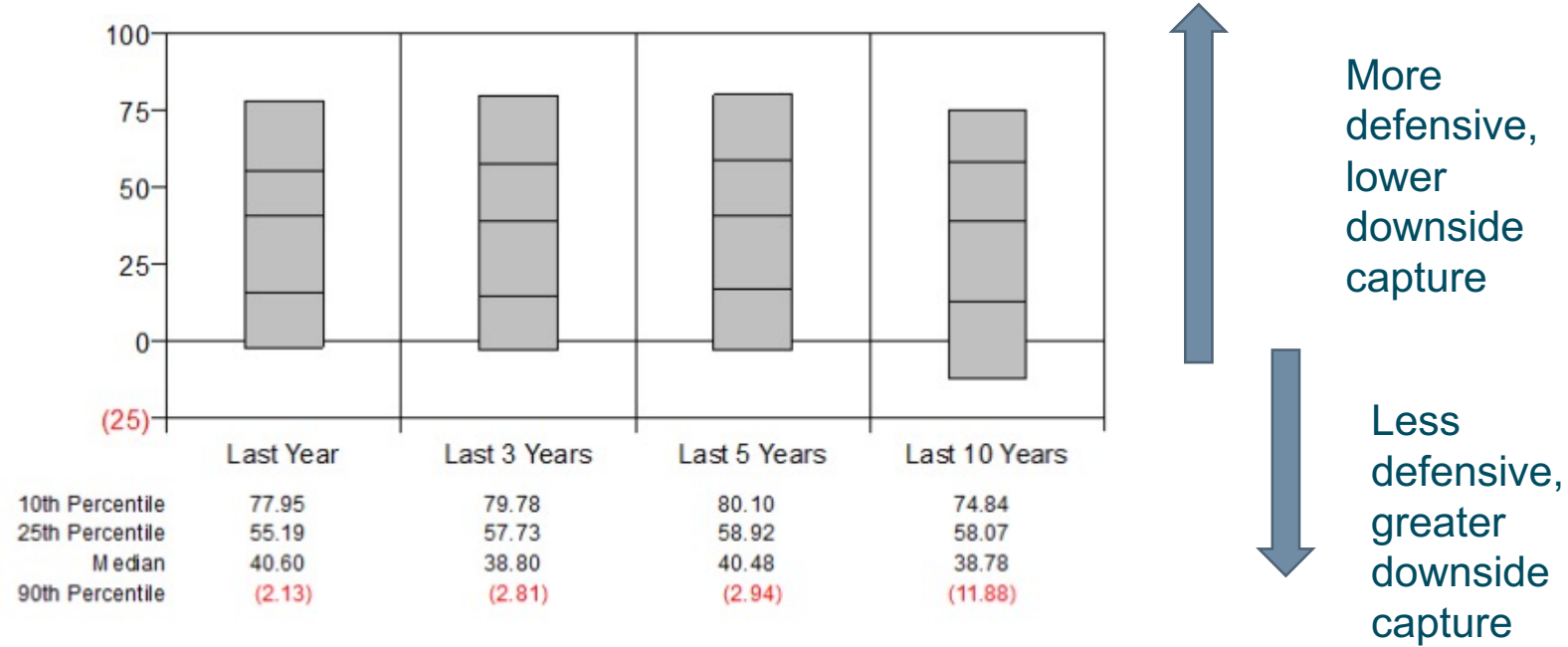


	Last Quarter	Last Year	Last 3 Years	Last 5 Years	Last 10 Years
10th Percentile	12.33	24.48	10.80	9.35	7.70
Median	6.27	12.37	5.55	5.62	5.83
90th Percentile	2.99	1.80	2.49	1.65	1.50
Bloomberg:Aggregate	0.67	7.51	5.34	4.44	3.84
MSCI:ACWI	14.68	16.25	10.06	12.26	9.13
S&P:500	12.15	18.40	14.18	15.22	13.88

⁶ Individual fund performance and volatility can vary from HFRI composite benchmark. All returns are net of fees.

DOWN MARKET CAPTURE RELATIVE TO MSCI:ACWI

FOR THE PERIOD ENDED
SEPTEMBER 30, 2020
(NET OF FEES)



- Within the HFRI Fund of Fund Composite, historically managers have provided down market protection relative to global equity performance. The median manager has regularly provided a downside capture of about 40% of global equities.
- If a manager captures less than 100% of the declining market, it is said to be "defensive." Thus, the smaller the down-market capture number, the more defensive the manager was, i.e., the fund went down less than the index.
- Down Market Capture is determined by the index, which has a Down-Capture ratio of 100% when the index is performing negatively.

Source: HFRI Fund of Funds Composite Group

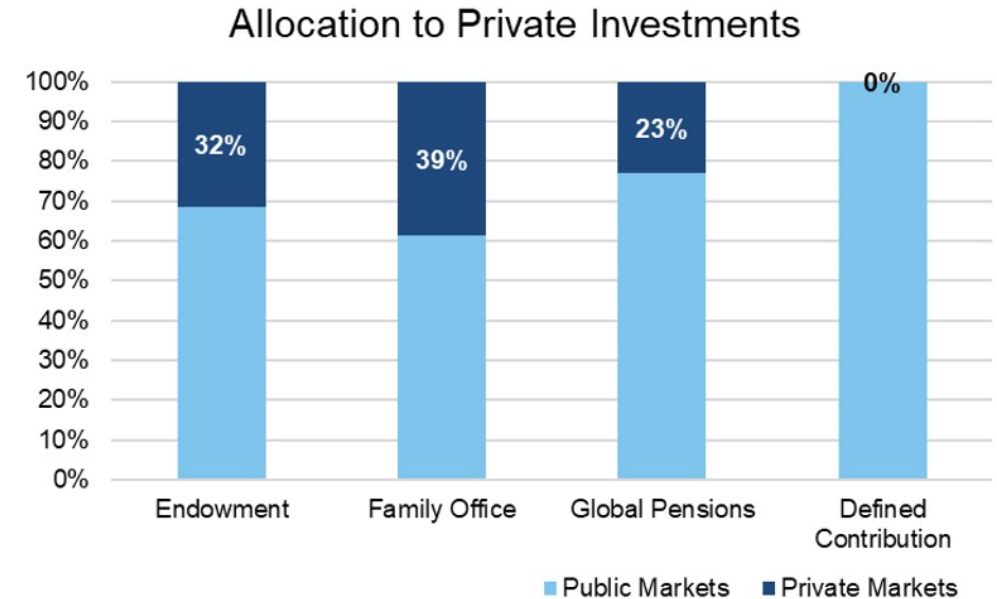
Investment Case: Private Equity

WHAT'S CURRENT?

- DOL Information Letter, issued June 2020:
 - Confirms that ERISA does not prohibit making private equity available in a DC plan
 - PE can be considered as part of a managed asset allocation--not as a stand-alone investment option
 - Fiduciaries are allowed to explore adding PE if it provides better net-of-fee outcomes for participants
 - Provides a framework, or roadmap, for fiduciaries considering PE
- On December 21, 2021, the DOL issued a Supplemental Statement to the June Information Letter clarifying its position that PE investments are permissible in DC plans but that they didn't necessarily endorse or recommend them and they reiterated the plan fiduciary responsibility regarding these investments.
- Jay Clayton, Chair of the SEC when the Information Letter was issued, has commented on the lack of opportunity for DC plans in using only the public equity market.
- Daily valued products already exist today; several additional products are in development.
- Some states that have used PE in their DB plans (i.e., the state of Washington) have moved to include an allocation to PE within their DC asset allocation funds.

THE CASE FOR PRIVATE EQUITY IN DC

- Private equity encompasses equity investments in companies not listed or traded on any stock exchange.
- **Benefits include:**
 - Potential for excess returns
 - Access to a wide range of investment strategies, including a focus on sector specialists, turnarounds, growth capital, venture capital, and buyouts.
- **How does private equity add value?**
 - Private equity has historically outperformed on a consistent basis (net of fees): conventional public equity, fixed income, and cash assets⁷.
 - Private equity funds have outperformed public equity (MSCI World TR) by 4.2% over a 10-year period ending June 30, 2020, net of fees⁸
 - Adding private equity can help diversify plan offerings and may enhance returns. Yet compared to other institutional investors, DC plans still have insignificant allocations to this asset class (<1%).
See chart on right.



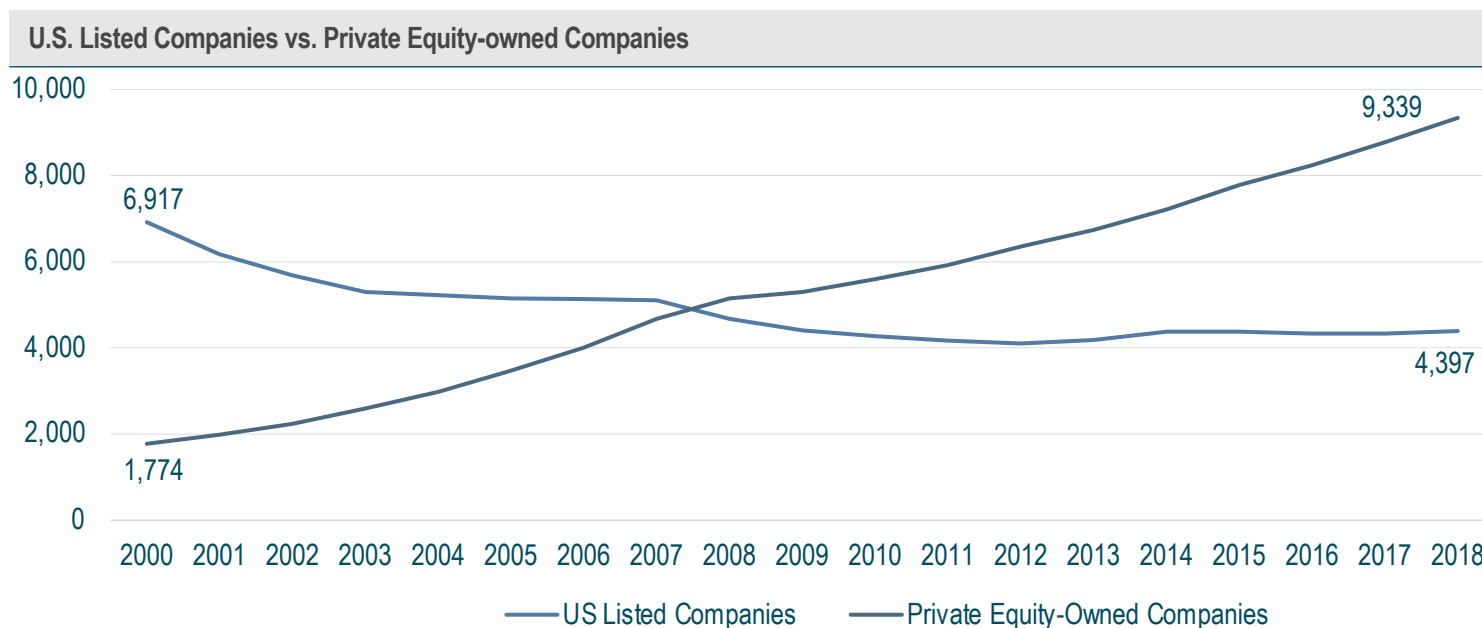
^{7 & 8}: Source: Partners Group, Cambridge, MSCI, S&P
Chart Sources: 2019 NACUBO Study of Endowments,
UBS/Campden Global Family Office Report, Global Pension
Asset Study 2020



THE CASE FOR PRIVATE EQUITY IN DC PLANS

Including Private Equity in DC Plan Investment Offerings Can Broaden the Opportunity Set for Investing

- The number of private equity owned companies has been increasing. Currently, they outnumber publicly listed companies in the US by more than 2 to 1.⁹
- This trend is expected to continue, as private companies may stay private or delay public offerings.¹⁰



⁹ & ¹⁰ Neuberger Berman Insights,
Private Equity Outlook, January 2020

Chart Source: PitchBook and World Bank,
Data as of December 2019, the most
current available data from the World Bank



HOW CAN PRIVATE EQUITY ADD VALUE?

Simulated Risk and Return Statistics of Target Date Funds with Private Equity Allocations Show Positive Results (*net of fees*)

This analysis utilizes a comprehensive sample of 2,515 U.S. private equity funds to create simulated portfolios for 1987-2017 that invest part of their overall equity allocation in these private equity funds.

	All Public Equity Benchmark	With Buyout Funds (2)	With VC Funds (4)	Buyout and VC Funds (6)
Return (annual)	8.59%	8.91%	9.89%	9.49%
Standard Deviation (annualized)	9.62%	7.77%	9.79%	8.74%
Standard Deviation (adjusted, annualized)	10.37%	8.42%	12.04%	9.99%
Sharpe Ratio	0.65	0.85	0.78	0.82
Sharpe Ratio (adjusted)	0.61	0.78	0.63	0.72
Semi-Deviation (adjusted, annualized)	10.76%	9.13%	10.22%	10.02%
Skewness	-0.52	-0.63	0.36	-0.18
Kurtosis	0.45	0.72	4.02	2.01
Average Allocation Fixed Income	40.0%	39.7%	39.6%	39.6%
Average Allocation Public Equity	60.0%	40.6%	40.6%	40.7%
Average Allocation Private Equity		19.7%	19.8%	19.7%
Average Deviation from Target		-0.3%	-0.2%	-0.3%
Std. Dev. (PE allocation - PE target)		3.4%	7.0%	4.7%

Table presents mean values for the results of 1000 simulations targeting a constant allocation of 20%. All reported moments are annualized. Furthermore, this report is adjusted standard deviations and Sharpe ratios following the approach outlined in Getmansky et.al. (2004) to account for smoothed reporting of NAVs. Moments of the return distributions and measures of risk are reported for the steady state period. In addition, this report provides the average allocation to each asset class in the steady state and the percentage of simulations that outperformed the base case benchmark (portfolio with 60% public equity and 40% fixed income allocation). Specifications (1) and (2) report results with US buyout funds only, (3) and (4) report results with US venture capital funds only, and (5) and (6) report results where equal allocations are made to both buyout and venture capital funds. Specifications (1), (3), and (5) allocate 4% of total portfolio value annually to private funds. In contrast, specifications (2), (4), and (6) over-allocate such that the target allocation is closer to the 20% target, on average.

Source: DCALTA/IPC Research, 2019, [DCALTA/IPC Research Paper - Why DC Plans Need Private Investments](#)

Opportunities, Considerations and Challenges when Including Alternatives in DC Plans

ALTERNATIVES IN DC PLANS: OPPORTUNITIES SUMMARY

Potential Benefits	Private Real Estate	Hedge Funds	Private Equity
Potential for additional returns versus traditional public markets	Moderate	Moderate	High
Diversification: Reduced correlation to traditional equity and bond markets	High	High	Low
Reduced overall portfolio volatility and downside protection	High	High	Moderate
Absolute return potential unrelated to market performance	Moderate	High	High
Stable income yield	High	Low	Low

- Benefits vary by alternative asset class, which supports varying roles within multi-asset portfolio construction.
- Individual manager performance and strategy focus can vary, which may provide enhanced or reduced benefits and performance versus the information provided in the table above.

OPPORTUNITY

Alternatives are well-positioned to benefit multi-asset portfolios in a new business cycle

- The global pandemic of 2020 precipitated the sharpest recession on record and the fastest ever rebound.
- As the economy begins to move toward a new business cycle, the downward shift in traditional asset class return expectations, in addition to the risk of inflation and continued volatility, creates new challenges for participants to reach retirement goals.
- Private real estate, private equity and hedge funds may offer a range of benefits, including a source of enhanced returns that could help investors mitigate the impact of macro challenges and support stronger retirement outcomes over the next cycle.
- Benefits of including Alternatives over the next cycle may include:
 - Source of enhanced returns
 - Source of yield
 - Enhanced portfolio diversification/ reducing volatility
 - Natural inflation hedge



CONSIDERATIONS & CHALLENGES: COST

CONSIDERATION	DESCRIPTION	POTENTIAL MITIGATION
<p>COST</p>	<p>Investment management</p> <ul style="list-style-type: none"> • Alternative asset classes (Alts) are typically more costly than traditional asset classes in DC plans. • Fee impact varies across real estate, private equity and hedge funds. <ul style="list-style-type: none"> ○ Real estate generally presents flat fee structure; private equity and hedge funds present base fee plus performance fee. • For certain Alts, strategies such as newly created private equity funds, J-curve effect might be present. <ul style="list-style-type: none"> ○ Management fees are calculated on committed capital (not invested); thus, fees can cause performance in early years to be negative until capital is invested; turns positive when distributions are earned. <p>Administrative - plan may incur additional expenses related to:</p> <ul style="list-style-type: none"> • Administrative (custodial) services • Need for investment advisers to help evaluate and monitor investments 	<ul style="list-style-type: none"> • Fees have compressed over recent years, e.g., DC private real estate supported by aggregation discounts. • Modest allocations can limit impact on fees while maintaining meaningful impact of Alts in multi-asset portfolios. • Adjusting active/passive portfolio mix can provide "funding" for higher cost Alts. • Portfolio construction/diversification will be critical in managing J-curve. <ul style="list-style-type: none"> ○ This includes the total allocation to the alternative investment and considers open-ended funds, secondary funds, and co-investments that are already fully invested and expected to return capital in the near future.¹¹ • Document rationale for inclusion and regular reviews of cost/benefit analysis. • Fees can be analyzed in connection with expected and historical performance (i.e., risk-adjusted return net of fees).

¹¹ Also, providers are working on solutions that may be in various stages of development. An example includes using multiple vintages within an Alts sleeve in a CIT, which manages the risk.

CONSIDERATIONS & CHALLENGES: DAILY VALUATION

CONSIDERATION	DESCRIPTION	POTENTIAL MITIGATION
<p>DAILY VALUATION</p>	<ul style="list-style-type: none"> • Except in the case of certain listed real estate funds/REITS, private alternatives are typically not exchange-traded securities, and therefore generally not priced daily via public markets. • Real estate, hedge funds and private equity solutions have developed a range of systematic methodologies to deliver daily NAVs. • Alternative investments provide periodic reporting, with frequencies ranging from monthly to annually. 	<ul style="list-style-type: none"> • Alts may offer established track record of daily NAVs (varies by sector). • Independent third-party valuation services may appraise investments. <ul style="list-style-type: none"> ○ Frequency varies by investment, and ranges from daily to quarterly. ○ Third-party valuation services may not be available for all investments. • Implement trading guidelines for alternatives to reduce transactions not supported by credible valuations.

CONSIDERATIONS & CHALLENGES: LIQUIDITY

CONSIDERATION	DESCRIPTION	POTENTIAL MITIGATION
<p>LIQUIDITY</p>	<ul style="list-style-type: none"> • Frequency of liquidity varies, but Alts solutions typically lack daily availability unless solution includes liquidity sleeve or other mechanism. <ul style="list-style-type: none"> ○ Solutions have tended to include a small allocation of liquid assets to support daily liquidity needs. ○ Liquidity from private market Alts component vary by sector, e.g., monthly or quarterly. ○ Secondary markets may offer liquidity, but alternatives typically lack a highly liquid secondary market for selling investments. ○ Certain Alts may have restrictions on selling securities. ○ New liquidity solutions are coming to market. • Liquidity constraints/limitations may be heightened during periods of market dislocation or corporate actions affecting the plan and could impact the ease and ability to rebalance a multi-asset portfolio. 	<ul style="list-style-type: none"> • Implement within fund vehicles, such as TDF and multi-asset funds that can manage liquidity within the context of the fund’s broader portfolio allocation and periodic rebalancing. • Limit allocations to manageable percentages within the plan’s multi-asset fund. • Understand the size of your investment in an Alts fund vs. total AUM of all investors in that fund. <ul style="list-style-type: none"> • Smaller percentage investments can reduce liquidity issues. • Define Alts allocations in terms of percentage ranges to provide flexibility and establish what happens if thresholds are exceeded. • Assess plan-specific liquidity challenges based on participant exchange activity and potential events such as divestitures and reductions in force. • If anticipated that liquidity may be insufficient, implement trading guidelines and/or restrictions to help manage liquidity availability.

CONSIDERATIONS & CHALLENGES: OPERATIONS

CONSIDERATION	DESCRIPTION	POTENTIAL MITIGATION
<p>OPERATIONS</p>	<ul style="list-style-type: none"> • Alternatives have complex investment structures that may present challenges for recordkeepers on platforms. <ul style="list-style-type: none"> ○ Requires custodian for custody and administrative services to handle cash flows, rebalancing, unitization of the custom fund, valuation services and custom fact sheets. ○ May add additional administrative expenses. 	<ul style="list-style-type: none"> • Ensure Trustee/Custodian capable and experienced in alternatives. • Ensure capability to monitor participant investment and exchange activity so liquidity needs can be anticipated and managed. • If in a sleeve, liquidity can be handled at the fund level, which requires administration. • Review structural and operational appropriateness of solutions.

CONSIDERATIONS & CHALLENGES: LEGAL

CONSIDERATION	DESCRIPTION	POTENTIAL MITIGATION
<p>LEGAL</p>	<ul style="list-style-type: none"> • Fee lawsuit claims: <ul style="list-style-type: none"> ○ Benchmark availability varies by alternative asset class. ○ Return performance against other investment options. ○ Prudence of fees against other traditional investment options. • Regulatory investigations: <ul style="list-style-type: none"> ○ Process incomplete or inconsistent with IPS. ○ Participant knowledge: <ul style="list-style-type: none"> ○ Participant understanding of features, risks and limitations of investment alternative. 	<ul style="list-style-type: none"> • Ensure participant communications explain investments included in plan, including any exchange restrictions that may apply and expense ratios resulting from adding alternatives. • Review role of alternatives for each fund in consideration and document process of review. Review and negotiate alternatives fund documents for ERISA considerations. • Document historical and expected performance net of fees. • Evaluate how underlying fees appear in a fund’s expense ratio. • Ensure governance documents and IPS are up to date and consider recent DOL guidance. • Consider recent related legal cases such as the <i>Intel</i> dismissal. <ul style="list-style-type: none"> ○ Intel Litigation: In January 2022, District court again – and with prejudice - dismissed claims holding that plaintiffs had not sufficiently explained why the target date funds they considered peer funds (passively managed funds) provided a meaningful benchmark for comparison to target date funds that contain alternative investments. This Court has previously said it is not per se imprudent to include alternatives in a DC plan. Plaintiffs may attempt to appeal to the 9th Circuit Court of Appeals.

CONSIDERATIONS & CHALLENGES: BENCHMARKING

CONSIDERATION	DESCRIPTION	POTENTIAL MITIGATION
<p>BENCHMARKING</p>	<ul style="list-style-type: none"> • Individual alternative solution/fund: <ul style="list-style-type: none"> ○ Benchmark availability varies by alternative asset class. Ask manager for suggested benchmark. ○ Benchmarks may change over time due to changes in peer group and investment objectives of the alternative investment. • Fund/portfolio level: <ul style="list-style-type: none"> ○ Benchmarking at the overall portfolio level varies over time horizons with the understanding that performance vs peers may deviate significantly during a market cycle. 	<ul style="list-style-type: none"> • Evaluate benchmarks to ensure their appropriateness. Ensure benchmark reflects underlying investments in strategy. • Monitor benchmarks to ensure continued appropriateness.

CONSIDERATIONS & CHALLENGES: OVERSIGHT

CONSIDERATION	DESCRIPTION	POTENTIAL MITIGATION
<p>OVERSIGHT</p>	<ul style="list-style-type: none"> • Most DC plans are governed by the Benefits Committee, which may not have the necessary investment expertise, bandwidth, or willingness to evaluate and monitor alternative investments in the DC plan. 	<ul style="list-style-type: none"> • Assess committee member capability and willingness to oversee alternative investments. • Consider independent third-party consultant, oversight or outsourcing solutions: <ul style="list-style-type: none"> ○ 3(21) Arrangement – consultant advises plan fiduciaries and makes recommendations, but plan fiduciaries maintain decision-making control ○ 3(38) (OCIO) Arrangement – consultant assumes fiduciary responsibility and full discretionary control over evaluation, selection, and monitoring of alternatives. OCIO role can be limited to alternative investments or extended to full plan. • Ensure investment consultants have sufficient background and expertise in the types of alternatives being utilized.

CONSIDERATIONS & CHALLENGES: TERMINATING INVESTMENTS

CONSIDERATION	DESCRIPTION	POTENTIAL MITIGATION
<p>TERMINATING INVESTMENTS</p>	<ul style="list-style-type: none"> • Potential challenges unwinding positions if needed or desired, driven by: <ul style="list-style-type: none"> ○ Plan terminations ○ Corporate actions, such as divestitures ○ Changes to plan’s fund lineup • Some alternatives may have restrictions on sales/divestitures. 	<ul style="list-style-type: none"> • Termination is generally a “known event,” which allows for advance notice to support liquidation. • Ensure concerns are properly considered early during corporate actions that may impact DC plan. • Maintain and adjust allocations based on projected liquidity needs. • Target investments with liquidity that align with plan liquidity needs. • Consider independent third-party transition management or secondary/off-market solutions.

CONSIDERATIONS & CHALLENGES: PARTICIPANT COMMUNICATION

CONSIDERATION	DESCRIPTION	POTENTIAL MITIGATION
<p>PARTICIPANT COMMUNICATION</p>	<ul style="list-style-type: none"> • Industry focus has mostly been on educating participants at the multi-asset strategy level rather than the individual component level, given that alternatives are generally implemented in this way in DC plans. Information on the objectives and desired outcomes for the overall strategy need to be included. • If alternatives are implemented as a standalone investment offering, new fund fact sheets and fund descriptions need to be developed. • Adopting registered fund summary prospectus disclosure principles may be useful. • In general, consider if communications should provide info regarding investment objectives, underlying allocations, risk disclosures and potential trade restrictions. <ul style="list-style-type: none"> • Expense ratios may require special attention if investments are subject to complex fee structures, such as a performance-based fee. • Annual 408(b)2 fee disclosures and 404a-5 participant disclosures should also be considered, including for direct and indirect fees associated with a custom TDF or multi-fund/multi-asset class investment option. • Consider if changes to underlying manager will require participant notice or not, or change in performance reporting or fund fact sheets. It may not if change is not material and does not alter overall risk/return characteristics and objective of custom fund. 	<ul style="list-style-type: none"> ▪ Carefully review communications for completeness and clarity. ▪ Prepare talking points to address participant questions likely to arise. ▪ Obtain legal review prior to releasing communications.

Next Steps when Considering Implementing Alternatives in DC Plans

POTENTIAL NEXT STEPS FOR FIDUCIARIES INTERESTED IN IMPLEMENTING ALTERNATIVES

- Plan fiduciaries interested in implementing alternatives in their DC plan should assess the specific alternative benefits, in addition to the interests and concerns of the various stakeholders in their plan.
- Stakeholders may include:
 - Participants
 - Administrator/recordkeeper
 - Custodian/trustee
 - Investment consultant/manager
 - Legal counsel
 - Managed Accounts provider

POTENTIAL NEXT STEPS FOR FIDUCIARIES INTERESTED IN IMPLEMENTING ALTERNATIVES

Plan Fiduciaries should assess and compare alternative asset class benefits and challenges with plan objectives and requirements in order to identify appropriate implementation and strategy:

- Assess objectives for implementing alternatives and potential benefits of inclusion, such as increased diversification, reduced volatility, uncorrelated returns, stable income or potential for enhanced return.
- Assess risk appetite of fiduciaries and internal capacity/willingness to monitor and evaluate options.
- Assess liquidity needs and challenges for your plan based on participant exchange activity and other events that may affect liquidity.
- Assess what allocation ranges fit with your objectives, liquidity needs and risk appetite.
- Assess external/service provider capabilities:
 - Current investment advisor/consultant
 - Administrator/recordkeeper
 - Custodians and trustees
- Assess potential cost impact to funds.
- Assess participant communication strategy.

KEY CONCEPTS OF GOVERNANCE FOR IMPLEMENTATION

- **Investment Policy Statement:** identify and formalize the objectives and constraints governing the investment options and establish guidelines for the implementation of the investment strategy.
- **Asset Allocation Policy:** reflect the return and risk objectives, which are dictated by expectations for capital market behavior. The Asset Allocation Policy is typically expressed as percentage allocation targets for each underlying fund exposure or asset class, including the ranges around which the allocations may vary without requiring rebalancing.
- **Rebalancing Policy:** given the nature of cash flows in DC plans and liquidity constraints in alternatives, a rebalancing policy will need to be determined to manage cash flows and for exposures to remain within asset allocation target ranges.
- **Manager Selection:** each investment manager fulfills a distinct and necessary role. Plan sponsors should ensure that allocations are sized appropriately, and that the overall success of the multi-fund option is not disproportionately impacted by the outcome of a single manager.
- **Risk Management:** the process of identifying risks, analyzing those risks, and deciding what to do about them.
- **Operational Oversight:** working closely with the custodian to ensure the asset allocation and rebalancing policies are followed, cash flows are managed efficiently, unitization and valuation services are being accurately provided, and managers are adhering to the stated investment guidelines.

Summary

ALTERNATIVE INVESTMENTS IN DC PLANS: SUMMARY ASSESSMENT

- Alternatives can provide benefits beyond those available from traditional equities and fixed income in terms of both diversification and return generation.
- Professionally managed multi-asset funds, such as risk-based funds or target date funds, may be more viable implementation structures for inclusion of alternatives.
- DCIIA RRC's 2020 Custom Target Date Survey looked at the holdings of \$312 billion in custom target date funds across 14 fund managers and found that as of year-end 2018:
 - 11% of the assets were in private real estate, 2% in hedge funds and 1% in private equity
- Callan's DC Index¹² shows that 3.5% of plans offer some type of alternative as of Q1 2021.
- Alternative investments present a range of considerations and challenges depending on the asset class, including cost, valuation, liquidity, benchmarking and participant communication. Various measures and guidelines are available to manage the exposure while providing access to the benefits of the alternative sectors.



¹² Callan DC Index tracks performance, asset allocation, and cash flows of more than 100 large defined contribution plans representing approximately \$350 billion in assets.

ALTERNATIVE INVESTMENTS IN DC PLANS: SUMMARY ASSESSMENT

- As for near-term predicted usage by asset managers, Cerulli's 2020 DCIO Asset Manager Survey shows that:
 - 16% will consider adding private real estate and 15% will consider adding private equity to their funds that may serve as the plan's QDIA, if they are approached by consultants, advisors or plan sponsors.
 - 15% are still in the fact-finding stage for considering the inclusion of private equity in their QDIA funds and 3% for private real estate.
 - 3% do plan to add private real estate to their QDIA funds in the next 24 months.
- Plan fiduciaries will need to determine if alternatives are a good fit for their plan(s) and, if so, how they can be effectively implemented and managed over the longer term.