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The Democratization of Alternative Investments in 401(k) Plans

What should plan sponsors consider when examining alternative investments as an in-plan investment option?



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Key Takeaways


- Historically reserved for institutional or high net worth investors, offering alternative investment vehicles may help democratize a plan by providing plan participants with more choice.
- Alternatives can help mitigate lower-return expectations of traditional asset classes, but they involve complexities that hinder their implementation.
- Today's plan sponsors deserve a modernized ecosystem that facilitates the adoption of alternative investments.

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What's Driving DC Plans' Interest in Alternatives?

Although Defined Benefit (DB) plans have included alternative investments (alternatives or alts) in some form since the 1970s, Defined Contribution (DC) plan investment options typically have included more traditional investments, such as mutual funds and collective investment trusts (CITs) composed of public companies' stocks and bonds. DC plan participants have had little opportunity to gain exposure





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to alternatives, which include an array of asset classes, such as private equity (PE), private real estate, hedge funds, and newly emerging cryptocurrencies. While some mega plan sponsors may provide exposure to alternatives within target date funds (TDFs) or managed [accounts](#), a large part of the 401(k) market has been left on the sidelines when it comes to alternative investing.

With the number of alternative asset classes growing, more plan fiduciaries are reviewing DC plan menu options and examining the merits of adding investments outside of publicly available mutual funds in hopes of improving participants' retirement security prospects. And studies show that alternative asset classes may help improve retirement outcomes by diversifying a participant's portfolio beyond traditional equity or fixed income.

For example, a 2021 Willis Towers Watson review found that private market investments outperformed public equities by 5.9% per annum since 2000.¹ Similarly, a Georgetown Center for Retirement Initiatives study found that allocations to alternative investments could potentially improve DC plan participants' investment outcomes in a TDF by 11% to 17%.²

Driving the interest in alternative investments in 401(k) plans may be the potential to augment and diversify future growth opportunities.

Additionally, the number of public companies has decreased and represents a smaller portion of the U.S. economy. As investors, participants need diversified

exposure to the broader market and economy to reduce their overall risk.

Recognizing these fundamental shifts in markets, a Defined Contribution Institutional Investment Association (DCIIA) paper argued for consideration of alternatives to help mitigate lower-return expectations for traditional asset classes post-COVID-19.³

Challenges Hindering the Adoption of Alternatives

In spite of some potential benefits, interest in alternative investments hasn't translated into plan sponsor adoption. Offering alternatives to DC participants is challenging, even for fiduciaries with the resources needed to properly analyze and implement their use. "Very few plans give participants the ability to invest directly in an alternatives strategy. It's just very difficult from a structural standpoint," says Sean Murray, Head of Retirement Solutions, Envestnet. "Generally, the larger the plan, the more advanced an investment lineup might be. In these plans you could see alternative investments in custom target date funds, custom models, or managed solutions. In the largest end of the marketplace, companies may have their own internal due diligence team, or consultants, who have leveraged alternatives in their corporate cash or in their pension plan. In that type of structure, it's easier to complete the due diligence needed to implement alternatives products in-plan." 4

Some of the complexities involved in adding alternatives to a DC plan menu include:

- **Daily valuation/liquidity:** Many alternatives are not publicly priced or traded, proving them difficult to value and easily liquidate. Plan participants need both daily valuation and liquidity.

- **Benchmarking:** Alternatives such as private equity, private real estate, and hedge funds are often not publicly traded on any exchange, making benchmarking problematic.
- **Cost:** Alternative investments are typically more expensive than traditional asset classes and can involve complex fee structures.

Even professionally managed multi-asset funds, such as risk-based funds or TDFs, which may have more viable implementation structures for inclusion of alternatives, still have a low take-up rate. A 2020 DCIAA survey found across \$312 billion in custom target date funds, only 11% of assets were in private real estate, 2% in hedge funds, and 1% in private equity. 5

Alternative Investments: A Brief Guide

Alternatives as a category can encompass a broad range of investment types. The following table describes some of the common alternative investment categories, and how they are currently positioned for potential use in DC plans.

	Private Equity	Private Real Estate	Hedge Funds	Cryptocurrency
Description of Type	A form of financing where investors pool their capital for ownership stake in a private company.	Commercial real estate, the third largest asset class in the U.S. beyond equities and fixed income.	Actively managed funds pursue high-risk/high-return strategies including leverage and shorting.	Digital or virtual currency with no central regulating authority.
Current Landscape for 401(k) Plan Sponsors	Minimal in-plan exposure today, mostly by mega plans or accredited investors.	May be poised for enhanced benefits in a post-COVID-19 cycle. Established track record for liquidity management over time. REIT structure may be seen in some plans already.	Increase in DC-friendly vehicles tracked by Morningstar.	The Department of Labor (DOL) has essentially thrown cold water on this due to instability and perceived risk. Fidelity Investments, however, recently announced it will make bitcoin available to its 401(k) plan sponsor clients based on requests.
Potential Benefits	Potential for excess returns and access to wider range of companies to invest in.	Historically, low correlation to traditional asset classes.	Flexibility in return streams can be uncorrelated to traditional asset classes.	Accessibility, potential liquidity, user privacy.

The DOL has Taken a Cautious Stance

Historically, the DOL has had a cautionary view on making alternative investments available in DC plans. “The DOL’s main concerns are that these investments are hard to value, have liquidity issues, and can have costly or exotic fee structures,” says Thomas E. Clark Jr., an ERISA expert and a partner at Wagner Law Group.⁶ The Biden administration has maintained the Department of Labor’s guidance that confirmed plan fiduciaries may offer certain private equity strategies without running afoul of ERISA (Employee Retirement Income Security Act). But interestingly, Clark

points out, it singled out that large plan fiduciaries with experience in evaluating private equity (PE) investments may be better suited to evaluate the use of PE alternatives over plan-level fiduciaries of smaller plans.

In the case of cryptocurrency, DOL has cautioned plan fiduciaries to exercise “extreme care” before they consider adding such an option to a 401(k) plan's investment menu for plan participants. Nonetheless, interest in crypto is so high that Fidelity Investments recently announced its intent to offer a [Bitcoin](#) option for its workplace retirement plan sponsor clients, should they choose to offer it.

What Does This Mean for the Future?

Plan fiduciaries understandably are questioning what to do next. “Looking around and benchmarking what other plan sponsors are doing helps you meet the ‘prudent man’ standard under ERISA,” says Thomas E. Clark Jr. “So, some might say ‘if I look around and see that everyone is adding this, well then, maybe I ought to as well.’ But the truth is, no one is doing this yet.” He adds: “DB plans and accredited investors have the access, which is great. But no plan fiduciary should fear that they are behind the eight ball adding alternatives to a 401k plan lineup, because they’re not.”

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So where does that leave us for now? Some experts say alternatives should be included within managed solutions with “guardrails” that address the liquidity concerns. “Alts should be part of a diversified, long-term portfolio and professionally managed,” says Jonathan Epstein, president of the Defined Contribution Alternatives Association. “We’re not advocating for standalone private equity on DC fund menus, but rather as an allocation within a target date fund or something similar,” he says.⁷

DCIAA suggests that implementing alternatives within multi-asset fund vehicles can help manage liquidity within the context of the fund's broader portfolio allocation and periodic rebalancing. Further, limiting allocations to clearly defined percentages may help establish a risk threshold for that portion of a portfolio.

Industry Innovation is Needed

Some experts argue the onus for change to ease adoption of alternatives should not rest on the shoulders of plan sponsors. "When you think about it, we have plan fiduciaries responsible for trillions in DC plan assets, with greater aggregate bargaining power than that of accredited investors, who have access," says Thomas E. Clark Jr. "Plan fiduciaries should think about this conversation differently, in our view. Maybe it's not that the DC world should live in the world of accredited investors. One could argue they deserve an entirely new ecosystem, one that's built expressly for them and designed to address these issues."

Angela Antonelli, Executive Director of the Center for Retirement Initiatives at Georgetown University adds "Now is not the time to reverse course and make it more difficult for plan fiduciaries to consider options that help to achieve the best risk-adjusted returns and deliver the best retirement income outcomes for their employees." ¹

Organizations such as DCIAA, the ERISA Industry Committee (ERIC), Defined Contribution Alternatives Association, and the Committee on Investment of Employee Benefit Assets (CIEBA) are all said to be exploring this issue. As more research is done, and innovation advances, it will be important for plan sponsors and consultants to carefully evaluate what's in the best interest of their plans' participants, and how alternative investments may have a role to play.

Drew Oringer, a partner at Dechert LLP's ERISA and Executive Compensation group agrees, adding: "There may be a number of different ways to potentially do this, but it's tricky. Ideas are percolating out there. The challenges are formidable, but not insurmountable." He says: "To move forward, we'll have to overcome the technical hurdles in terms of the law and also navigate the tonal differences expressed by the different administrations." ⁸

"I would expect the trend to be toward opening alternative investments up to 401(k) plans and making them a part of an otherwise carefully vetted, solidly constructed investment menu," says Drew Oringer. "It's not going to happen overnight, it needs to be done very carefully, but I suspect it will happen over time." ⁸

He concludes: "Ultimately it comes down to this, once you solve the gating issues in terms of the law and the technicalities, you're always going to need the plan fiduciary to decide that this is a good idea for the plan in question." ⁸

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