‘Hedging’ Your Bets

Expanding the DC menu beyond traditional asset classes.


BY DAVID KUPPERMAN AND SCOTT KILGALLEN

Defined contribution plans are rapidly becoming the primary retirement saving vehicle for most U.S. employees. Currently, 69% of private sector workers have access to DC plans but only 7% have access to defined benefit (DB) plans.[1] Yet, DC plans have not kept pace with DB plans when it comes to investing in alternative investment strategies such as hedge funds, private equity and infrastructure. Such allocations have played an important role in improving the risk/return characteristics of DB portfolios and have contributed to their outperformance of DC plans.

While some of the disparity between DB and DC performance may be attributed to factors such as fees, poor portfolio construction and market timing by participants, we believe the lack of alternative investments is an important factor in DC plan underperformance. And although lack of data makes it difficult to do a proper attribution, studies show that most DC assets are allocated to traditional stocks and bonds, limiting participants' ability to access the potential improved risk/return profile and portfolio diversification from alternatives that their DB counterparts capture.

Potential Benefits of Liquid Alternatives

Today's increasingly volatile and ever-changing market conditions have led some DC plan sponsors to question if the traditional equity and fixed income investment options in their plan are adequately fulfilling their participants' needs. This issue is particularly important when it comes to fixed income. Investors have lived through a nearly 30-year bull market in fixed income and many DC plan participants have come to rely on a heavy allocation to fixed income as they approach retirement. This has spurred interest in liquid alternatives, as DC plan sponsors look for solutions that might help participants in a rising rate environment. Historically, fixed income has performed poorly during periods of rising interest rates, while certain hedge funds strategies have actually benefited from those dynamics.

Against this backdrop, we are beginning to see more plan sponsors looking to broaden their platforms to include alternative investments. Traditionally, alternative investments such as hedge funds were not seen as appropriate for DC plans due to high fees, a lack of transparency, limited liquidity and limits on investor qualification. These issues have now been addressed by liquid alternatives offered through mutual funds registered under the Investment Company Act of 1940 ('40 Act) that employ single or multiple hedge fund strategies.

FIGURE 1

THE ADDITION OF ALTERNATIVES HAS HISTORICALLY BOOSTED DB PLAN PERFORMANCE

Asset Mix and Returns of DB Plans Compared to DC Plans 1997-2013

ASSET CLASS	ALLOCATION (%)		RETURN (%)	
	DB	DC	DB	DC
TRADITIONAL				
Large-Cap Stock	29%	33%	5.8%	6.4%
Small-Cap Stock	6%	8%	7.7%	8.2%
Foreign Stock	23%	7%	5.7%	7%
Employer Stock	0%	18%	n/a	7.9%
Fixed Income	31%	11%	7.4%	6.1%
Stable Value/GICS	0%	19%	n/a	4.6%
Cash	2%	3%	3.5%	3.1%
ALTERNATIVES				
Real Estate, REITS & Other Real Assets	4%	0%	9.5%	0%
Hedge Funds	2%	0%	7.1%	0%
Private Equity	4%	0%	9.5%	0%
TOTAL 100%		0%	7.20%	5.80%

Source: CEM Benchmarking. Asset mix equals the simple average of annual asset mix weights. Returns are the compound average of annual averages for each asset class. Hedge funds were not treated as a separate asset class until 2000, so 60% stock / 40% bond returns were used as a proxy for the period 1997-1999. Based on data observations of 2,465 DB plans and 1,684 DC plans.

At the same time, hedge fund managers have recognized the growth of DC plans and, as a result, more quality funds and solutions are available. In prior years, hedge fund managers were reluctant to deliver their strategies at the lower costs required by DC plans. Now, with the potential size of the opportunity in DC plans, that mindset has changed.

Indeed, the introduction of alternative strategies in publically offered mutual funds has created an opportunity for DC plans to add hedge fund strategies to their platforms.

Fig. 1 demonstrates how a liquid alts fund can meld the benefits of traditional hedge funds with those of a mutual fund in a DC plan-friendly format.

Bridging Hedge Fund and Mutual Fund Benefits

Expanding investment options to a broader universe of strategies, like those in the realm of alternative strategies, can provide participants:

- another solution in pursuit of incremental return and risk management;
- the potential to more effectively manage volatility;
- an opportunity to achieve greater diversification through the addition of a strategy less sensitive to the broader equity and fixed income markets.

Adding Alternatives to the Menu

In our view, DC plan sponsors have two key decisions to make with regard to incorporating liquid alternatives into their offerings. The first is whether to make such choices part of the plan's core investment menu, allowing participants to select how to allocate to them in a portfolio, or alternatively, to offer them in target date or custom balanced funds where the allocation is professionally managed.

The target date approach can be an effective way to incorporate liquid alternatives in a DC plan. Target date funds can allow participants to automatically gain exposure to the previously discussed benefits associated with liquid alternatives. However, not all target date funds include

1 Source: U.S. Department of Labor, Form 5500 Summary Reports through 1998; EBRI Databook 1999-2011.

	TRADITIONAL MUTUAL FUND INVESTING	TRADITIONAL MUTUAL FUND INVESTING
Return Objective	Relative returns	Absolute returns
Benchmark	Benchmark constrained	Unconstrained by benchmark index
Investment Strategies	Limited strategies, long-only, no leverage	Flexible strategies (long and short positions, leverage)
Market Beta	High beta to traditional asset classes	Generally low beta to traditional asset classes
Performance	Dependent on market direction	Often independent of market direction
Management Fees	Asset-based fee only; no performance fees	Generally higher asset-based fee than mutual funds; Performance fees
Liquidity	Daily at NAV	Liquidity restrictions and lock-ups
Investment Size	Minimums as low as $1,000	Large minimums
Investor base	Publicly available	Qualified purchasers
Transparency	High disclosure and transparency	Limited or no position level transparency

Source: Neuberger Berman

BRIDGING BENEFITS

an allocation to liquid alternatives. In general, the target date funds offered in DC plans employ strategies focused on traditional long-only style-box based investments, with minimal, if any, alternative investment exposure. Nonetheless, allocations to liquid alternatives in custom target date funds and some off-the-shelf target date funds are now happening.[2]

Adding liquid alts to a plan's core menu, in our view, is another viable approach to including liquid alts in a DC plan platform. A good portion of participants still use their plan's core menu to build their own portfolio. However, the average DC plan menu of equity funds, complemented by a few money market and core bond funds, may not provide enough options for participants to diversify effectively.[3] This menu design works well for participants accumulating assets, but today the majority of assets in many plans are held by participants nearing retirement. As a result, providing them with investment options that protect from drawdowns and volatility is becoming critically important. The addition of a liquid alternatives option can help participants implement a more robust allocation with diversification across volatility management, growth and income options.

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Participant Education Critical

The general lack of sophistication among participants when it comes to these types of strategies makes participant education critical. Participants will need guidance on how liquid alts might be used as part of broader overall asset allocation based on their specific objectives. We believe it can be helpful to position the DC plan investment menu so that participants think about options in terms of the roles they play in an asset allocation — for example, classifying options as designed for growth, income, volatility management or outpacing inflation.

As DC sponsors look for ways to improve their DC participants' risk/return profile and help them reach better retirement outcomes, look for an increased conviction to add diversifying alternative asset classes to the plan menu. Every plan is different, so there is no single approach to adding liquid alternatives that makes sense for all. But DB plans have demonstrated that including alternative strategies in a portfolio can enhance its risk/return characteristics. We believe this is likely to continue, especially in light of current valuations in the traditional investment marketplace and the potential for rising interest rates.

Additionally, alternatives, once considered inaccessible for DC plans, are now readily available through liquid alternative mutual funds. DC plan sponsors looking to replicate the DB plan experience for their DC participants may want to consider adding liquid alternatives to their DC plan menu.

» David Kupperman is Co-Head of Neuberger Berman, Alternative Investment Management.

» Scott Kilgallen is Head of Financial Institutions Group at Neuberger Berman.

2 Source: Liquid Alts in Target Date Funds, Infovest 21, 2014, Issue 4 and BrightScope.
3 PSCA's 57th Annual Survey of Profit Sharing and 401(k) Plans, 2014.