

Innovations in DC Investment Options

Including non-traditional asset classes in defined contribution plans can provide diversification and help craft better outcomes



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As defined contribution plans take advantage of the lessons learned from many years of investment experience at their defined benefit brethren, one important area has not been plumbed significantly: non-traditional investments such as private real estate and private equity. In this roundtable, Matthew Soifer, managing director and head of BlackRock's institutional distribution for defined contribution, Robert Collins, managing director and head of the U.S. defined contribution practice at Partners Group, and David Skinner, executive director and defined contribution practice leader at PGIM Real Estate, explain how a range of strategies are being retooled specifically to meet the needs of the DC market, where plan sponsors are looking for ways to help participants achieve better results in a world of mediocre returns from traditional asset classes.

P&I: Why are plan sponsors looking to include non-traditional asset classes in DC plans?

David Skinner: Non-traditional asset classes, when combined with traditional asset classes, can provide enhancements to portfolio construction and improve investment outcomes.

With respect to private real estate, adding the asset class can increase a portfolio's diversification, provide downside protection and generate a consistent income stream. Ultimately, how non-traditional asset classes are incorporated depends on the particular outcome a DC plan sponsor is seeking for their participants. For example, if the DC plan sponsor is seeking inflation protection, they would then look to incorporate an asset class like private real estate.

Matt Soifer: I see DC plans as being where corporate DB plans were 10 years ago. So we have a real opportunity in the DC space to deliver more risk-efficient portfolios using that knowledge. Beta has served DC plans well — the historical returns have been pretty good. But given where asset pricing is today, where GDP growth domestically and globally is, retirement savers may be in a much tougher position going forward.

So we need to consider ways to provide more diversification in the DC lineup, rather than relying

predominantly on economic growth to determine outcomes for participants.

Robert Collins: I agree 100% from the sponsor's fiduciary perspective. They need to do everything they can to achieve required outcomes for their employees. The expected returns for traditional asset classes, speaking primarily to equities, are going down. And the risks are going up.

Traditional solutions don't address all the challenges that participants face, such as inflation risk and longevity risk. The fact that many traditional public equity strategies are implemented passively presents additional challenges to sponsors.

Soifer: The place where non-traditional asset classes can make sense is in a target-date fund. It can be structured to offer flexibility in terms of liquidity when using hedge funds, private real estate or private equity. One approach can be to pair alternative asset classes with less expensive beta. That can help allow the plan sponsor to control for fees.

P&I: Should non-traditional asset classes be used as standalone options in the lineup, or should their use be confined to professionally managed solutions?

Collins: We think private markets — private real estate, private equity — should be part of a multi-asset solution,

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~ Robert Collins, Partners Group

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such as a white-label fund in the core menu of a target-date fund. We see plan sponsors trying to open up the architecture of their target-date funds to customize them to not only best fit the unique demographic needs of their workforce but also access the most flexible set of asset classes and investment techniques.

Soifer: Our primary focus is on helping to improve investment outcomes through the target-date fund, because that is where many participants are defaulted. We see a perfect storm coming where participants aren't

saving enough and future returns for traditional assets may be lower than in the past. Using alternatives may allow plans to target a tighter distribution of outcomes while seeking to reduce risk.

Skinner: Over the last 10 years, there has been a trend with DC plans moving the investment decision-making away from participants toward professionally managed solutions. Today, approximately 15% to 20% of DC assets are professionally managed. Over the next 10 years, we anticipate that the size will double to 30% to

40%. Professionally managed structures provide a means for non-traditional asset classes to be more efficiently incorporated into DC plans.

P&I: Is the use of non-traditional asset classes part of a larger change in overall DC plan design?

Soifer: We are seeing plan sponsors taking action. In the last five years, plans have been focused on simpler plan design. Multimanager white-label structures are becoming a more common part of lineups, and adoption of custom

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The first question that plan sponsors ask today is not about liquidity or daily valuation, but about how the asset class can help them maximize outcomes for their participants in the most efficient way.

~ David Skinner, PGIM Real Estate

target-date funds continues to grow. Some plans at the large- and mega-plan end of the market are starting to use alternatives within these structures. It's early days, but the structures are in place and becoming more common to facilitate the use of alternatives.

Collins: Plan sponsors are looking at how their professionally managed options are constructed. They want a more optimal plan design structure and are using levers such as auto-enrollment and auto-escalation to reach better outcomes. They also need to evaluate the changes and quantify the benefits. So that may be what we are seeing today.

P&I: What non-traditional asset classes are plan sponsors using and how are they incorporated?

Skinner: There are many types of non-traditional asset classes that plan sponsors are using to meet their investment objectives. From a real estate perspective, publicly traded REITs have been used by DC plans for more than 10 years. More recently, plan sponsors have been increasingly allocating to private real estate to further diversify their portfolios.

We have seen the use of both public and private real estate in white-label, professionally managed, outcome-driven solutions such as real assets strategies, inflation-protected strategies and income strategies, just to name a few.

Collins: We look at private equity first because it has been the most important driver of returns and equity diversification in portfolios in other institutional investment settings — for defined benefit plans and endowments and foundations. We see a great deal of interest in private equity from DC plan sponsors because it addresses many of the challenges that fiduciaries face when trying to achieve good outcomes for their employees.

The reason why private equity hasn't been embraced yet by the DC market is because the solutions haven't been

there. Traditional asset managers working in DC don't necessarily have the requisite private equity expertise and experience to develop solutions. And not many private markets asset managers have been focusing on creating innovative solutions for what they may consider to be non-core client segments; however, this is changing and viable private equity solutions do exist today.

Soifer: It's really hard to argue with some of the characteristics that private equity, or alternatives broadly, can add to a portfolio. We see acceptance of alternatives as an evolution that will take time.

One place to start may be in the beta space. As most participant portfolios are focused on capitalization-weighted indexes, we know that a more diversified portfolio has exposure to a variety of different factors, not just economic growth. This could be through alternatively weighted indexes like minimum volatility or exposure to factors like size or momentum. Or even risk parity. I'm somewhat surprised that we haven't seen greater adoption of risk parity products in DC.

P&I: Unlike DB and endowment and foundation investors, DC plan sponsors live in a daily priced world where liquidity is important. How are investment managers addressing the liquidity and daily valuation issues?

Skinner: To a certain extent, real estate managers have been at the forefront of developing products with liquid components that can be incorporated into DC plans. For example, real estate managers have created hybrid products that combine publicly traded REITs and private real estate to address the liquidity needs of DC plans. The first generation of these products had as much as 40% allocated to REITs. More recently, as plan sponsors have experienced the benefits of using real estate in target-date funds, they have re-evaluated the need for liquidity from a real estate investment. And so as a result, the second generation of products has a 5%-15% allocation to publicly traded REITs.



A focus on cost alone may push some sponsors disproportionately toward passive investments, which may have the effect of limiting diversification. This may result in particular portfolios that are more exposed to market and inflation risks.

~ Matthew Soifer, BlackRock



In addition, over the past decade, daily valuation methodologies have evolved to address some of the key requirements of DC plan sponsors, including transparency, independence and a repeatable and documented process.

Collins: There are some pretty simple portfolio construction techniques that you can utilize to build a more liquid private equity portfolio. You can use an integrated approach, combining investments directly into both the equity and debt of operating companies, with a portfolio of mature assets bought on the secondary market, while also making primary commitments to new

funds. That makes it easier to get invested in a more efficient manner. It also mitigates the J-curve effect that typically occurs when an entire portfolio is constructed of primary fund commitments.

This process also produces an entirely different liquidity profile than a standalone fund or a fund of funds. By using portfolio construction in a thoughtful fashion, you can develop a private equity portfolio that does have liquidity.

Skinner: The first question that plan sponsors ask today is not about liquidity or daily valuation, but about how the asset class can help them maximize outcomes for their

participants in the most efficient way. So what we see is plan sponsors adding private real estate to those options where it can be a diversifying asset class or can be used to provide income.

In a target-date fund or a multi-asset structure, about 90% of the portfolio is liquid, so adding an illiquid asset class like private real estate or private equity is achievable. The key is to weigh the investment attributes of the structure against the liquidity needs of the plan.

Collins: Certainly Dave is right, the private real estate managers have trail-blazed this hybrid approach, which

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is now being applied across many illiquid investments, private equity, infrastructure, some hedge funds. There's been an enormous amount of innovation behind the scenes to develop a viable way for DC plans to add these assets to target-date or white-label funds.

P&I: Are there any asset classes that aren't appropriate for DC investors?

Skinner: I would never suggest eliminating any one asset class. All asset classes can be implemented, but the important point is to ensure that the asset class fits into the outcome that the plan is seeking. I view asset classes as interchangeable building blocks that can be mixed and matched as necessary to achieve a desired outcome.

Soifer: We think the target-date structure is the most appropriate place to use these solutions. We don't think having potentially volatile asset classes, such as commodities or emerging markets, as stand-alone options makes as much sense for most participants. We'd generally prefer to see high-yield bonds packaged into a core-plus mandate, or emerging markets packaged into a broad international mandate. But certainly the plan sponsor's knowledge of their participant population should be considered when making these types of decisions.

Collins: You need to embed these diversifiers in a professionally managed setting, but then ask all the traditional investment selection questions about whether the investment will add value to the portfolio net of fees, whether the team has a track record, whether the investment is scalable. In this way, the investment manager can determine whether the strategy is appropriate and how much is appropriate within the overall portfolio.

P&I: How do liquid alternatives fit into this conversation?

Soifer: Liquid alts may be a step in the right direction in that managers are trying to improve investor access to investments that may not have been previously available. But for me, and Rob and Dave, we want to make sure that we can deliver one of the strongest institutional-quality solutions. That could mean going farther than some of the liquid alternatives strategies have gone — to take advantage of the broadest universe of strategies available.

Collins: There is a great deal of heterogeneity in that market. The appeal of what are commonly known as liquid alternatives is that they make what was inaccessible, accessible. But to Matt's point, it's worth considering whether the constraint of the mutual fund structure impinges on the ability to run the strategy as it has been run in other settings.

Skinner: Liquid alternatives can be another means to

improve investment outcomes. One challenge that we have seen is that the term tends to be a catchall for a wide variety of alternative strategies and structures that are difficult to evaluate relative to an index. Also, because of their complexity, liquid alternatives can be difficult for managers to evaluate and properly perform due diligence.

P&I: Many non-traditional asset classes have a reputation for charging high fees. And given the focus on fees, fee disclosure and litigation, how can plan sponsors think about the costs of adding these asset classes to their target-date or multi-asset class options?

Soifer: Cost is only one of many factors that plan sponsors may consider in selecting an investment menu. Plans may also consider the value they are paying for, as well as an investment's risk and return characteristics.

A focus on cost alone may push some sponsors disproportionately toward passive investments, which may have the effect of limiting diversification. This may result in participant portfolios that are more exposed to market and inflation risks.

Collins: It's true that certain regulations have been misinterpreted. Fiduciaries should not be focusing on the least expensive option, rather they should be looking to find strategies that — net of fees — create value and best help their employees reach their desired outcomes.

Skinner: We like to encourage plan sponsors to look at the situation holistically. If the net return is ultimately enhanced due to the addition of certain asset classes, then we believe the fee should become less of a focal point.

P&I: The cost discussion seems to lead to the passive vs. active question. Are you seeing a reversal of the trend toward passive that picked up speed after the financial crisis?

Skinner: DC plans can have active and passive, traditional and non-traditional asset classes because the blending of those asset classes can improve outcomes. Plan sponsors can access and allocate more into passive equities and fixed income, and this can bring down the overall cost of the target-date fund, allowing them to add a more expensive asset class. Some plan sponsors focus on the top-level fee alone, but others focus on the bottom line or net number. It's the difference between a fee budget — top level — and the net return after fees — bottom level.

Collins: One of the challenges of purely passive investing, particularly in equities, is the dramatic change in the makeup of the market. In the last 15 to 20 years, the number of public companies in the U.S. has fallen by half. That leads to an increasing concentration

in the public markets. So we think that to develop equity diversifiers, you need to look at the hundreds of thousands of private companies in the U.S., not just the 3,000 or 4,000 public ones.

P&I: Let's talk about who is using alternatives in DC plans. Is there is more talk than actual use?

Collins: Yes, but that is changing. There's been a significant amount of adoption of private real estate funds within professionally managed solutions. Private equity is close behind, with a tremendous amount of interest and talk in the last three or four years. But it wasn't until last year that the industry really responded. There are now two private equity managers with live solutions, and others in various stages of product development.

Skinner: Corporate, public and union plans are using alternatives in their DC plans. We are also seeing asset managers with target-date and real asset collective

investment trusts include alternatives as well. As we have discussed, the trend in the DC marketplace is moving from stand-alone options toward professionally managed structures, with target-date funds being the most prevalent.

P&I: What can managers do to make it easier for plans to consider using non-traditional asset classes and other innovative DC solutions?

Collins: As an industry, we need to challenge each other on issues such as communication and fees. Because these questions will always be there. Communicating the advantages of private equity may be easier because everyone is conversant with equities.

We know that this is the beginning of a journey for some plans. There is a great deal of enthusiasm for adding private market strategies because it has been the most important non-traditional allocation

within institutional portfolios.

Skinner: Many DC plan sponsors talk about mirroring what has been successful on the DB side. But it takes time and it takes education. Private real estate is becoming more familiar, so there's less talk and more action.

We're seeing sponsors using the asset class in target-date funds, but they are also adding it into white-label fixed-income funds as a diversifier because bonds aren't performing as they need them to. Incidentally, they are also looking at both private real estate debt and equity.

Soifer: One of the most important benefits that alternatives can bring is the potential to mitigate on the downside. Of course, everyone wants to participate in the upside, but non-traditional asset classes open up the tool kit to potentially offer some downside protection as well, with the ultimate goal of more certainty around outcomes. ❖



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