The Case for Liquid Alternatives in Defined- Contribution Plans

David Kupperman and Scott Kilgallen
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Defined-contribution (DC) 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. Yet, DC plans have not kept up 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.

The landscape is starting to shift, however, as more DC plan sponsors are considering alternative investments as a way to address potential underfunding on the part of employees as they reach retirement. In the market decline of 2008, many retirees and near retirees experienced severe declines in their savings, causing plan sponsors to look for ways to offer more diversified investment options. Meanwhile, the availability of alternative investments has gradually expanded, as they have become increasingly available, not just in private vehicles but in publicly traded vehicles as well. In our view, these “liquid alternatives” (or liquid alts) are a portfolio tool that can help dampen total portfolio volatility and improve a participant’s potential retirement outcome.

We define liquid alts for the purposes of this article as mutual funds registered under the Investment Company Act of 1940 (‘40 Act) that employ single or multiple hedge fund strategies. This definition of liquid alts is a bit more limited than those used commonly by others, who may incorporate global allocation funds, long-only strategies focused on real estate investment trusts (REITs) and commodities. The inclusion of those and other more illiquid strategies, such as private equity, in DC plans is a separate topic that we will not address here. Our discussion provides an overview of the liquid alts market, what we believe fiduciaries should consider before including these investments in a DC plan, and several implementation strategies.

ALTERNATIVE ADVANTAGES

In recent decades, the numbers of traditional hedge funds and the assets they manage have grown at a dramatic rate, as shown in Exhibits 1 and 2; assets have exceeded pre-2008 levels as investors have sought investment vehicles that are designed to address high volatility and low yields in the marketplace.

Much of this long-term growth is a result of DB plans broadening their investments beyond U.S. stocks and bonds to construct more-diverse portfolios. Starting with commercial real estate in the 1980s, private
equity, venture capital, foreign securities, hedged strategies, and structured credit instruments have all made inroads to many DB plans. In doing so, they have reduced their allocations to more-traditional investments in U.S. stocks and bonds.

This decision appears to have proven beneficial to performance. Traditional long-only investing, based on the “style box,” limits a portfolio's diversification; which, in our view, is a key factor in generating attractive long-term risk-adjusted results. As a case in point, from 1997 to 2011, the average DB plan outperformed the average DC plan by 140 bps annually.² Exhibit 3 compares the average allocations and returns of DC and DB plans. Although some of the disparity between DB and DC performance may be attributed to such factors 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.

The addition of hedge fund strategies to a DC plan can help diversify DC participant portfolios, which may reduce volatility versus long-only investments, typically by utilizing hedges and short positions to reduce the level of market exposure in typical long-only portfolios. Hedge fund strategies have been historically less volatile than broader markets and have outperformed on a risk-adjusted basis during periods of higher volatility for broader markets.³ From January 1990 through September 2014, for months when the VIX (CBOE’s Market Volatility Index, measuring equity market volatility)⁴ closed above its historical average, the HFRI Fund Weighted Composite Index outperformed the S&P 500 Index by 76.5%, cumulatively. During the same period, when the

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**Exhibit 1**

Number of Hedge Funds

<table>
<thead>
<tr>
<th>Thousands</th>
</tr>
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<tbody>
<tr>
<td>1000</td>
</tr>
</tbody>
</table>

**Exhibit 2**

Hedge Fund Assets Under Management

<table>
<thead>
<tr>
<th>$ Trillions</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.5</td>
</tr>
</tbody>
</table>

*Source: Hedge Fund Research, Inc. [2014].*
The Addition of Alternatives has Historically Boosted DB Plan Performance

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Allocation (%)</th>
<th>Return (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DB</td>
<td>DC</td>
</tr>
<tr>
<td>Traditional</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large-Cap Stock</td>
<td>29%</td>
<td>33%</td>
</tr>
<tr>
<td>Small-Cap Stock</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td>Foreign Stock</td>
<td>23%</td>
<td>7%</td>
</tr>
<tr>
<td>Employer Stock</td>
<td>0%</td>
<td>18%</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>31%</td>
<td>11%</td>
</tr>
<tr>
<td>Stable Value/GICS</td>
<td>0%</td>
<td>19%</td>
</tr>
<tr>
<td>Cash</td>
<td>2%</td>
<td>3%</td>
</tr>
<tr>
<td>Alternatives</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate, REITS &amp; Other Real Assets</td>
<td>4%</td>
<td>0%</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>2%</td>
<td>0%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>4%</td>
<td>0%</td>
</tr>
<tr>
<td>TOTAL 100%</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

Notes: 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 1997–1999 period. Based on data observations of 2,465 DB plans and 1,684 DC plans.

Source: CEM Benchmarking.

MOVE (the fixed-income equivalent of the VIX) closed above its historical average, the HFRI Fund Weighted Composite Index outperformed the Barclays Aggregate Bond Index by 47.6%, cumulatively.³

Hedging seeks to reduce the effects of a negative market but may limit performance in an up market. In the current environment, this concept has been akin to fixing the roof while the sun is shining. We believe DC plan sponsors should take the time to understand how adding a hedge fund investment strategy can help their participants build better risk-adjusted portfolios.

LIQUID ALTERNATIVES: KEY TRENDS

There are a variety of reasons that DC plans have not added alternative investments to their platforms and have remained heavily weighted in favor of domestic equities and traditional style-box orthodoxy. First, there is the question of education and helping plan sponsors who are unfamiliar with such strategies to reach a better level of comfort. Second, there are few liquid alternative mutual funds with meaningful track records. For example, there are only 35 funds with a track record of at least five years in the multi-alternative category. In contrast, there are 2,900 long-only equity funds (including U.S. international and sector equity) with five-year track records.⁶ Third, the costs of many solutions have made them less attractive in the highly fee-sensitive DC world. Exhibit 4 emphasizes the sizable allocation of DB plans to alternatives, and Exhibit 5 shows the asset class allocations of DC plans. As a result, DC plans have fallen behind DB plans when it comes to providing a modern portfolio with investment options for today’s more-complex markets.

Amid increasingly volatile and ever-changing market conditions, however, DC plan sponsors are finding that traditional investments are not adequately fulfilling their participants’ needs. 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 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 alts. Part of the reason for this interest is the expansion of the liquid alts market, which is being driven by hedge fund managers seeing the opportunity to be part of the DC space. As a result, we are seeing more quality funds and solutions become available. In prior years, hedge fund managers were reluctant to

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deliver their strategies at the lower costs required by DC plans that are focused on investing in the mutual fund space. 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. Exhibit 6 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.

In addition, we believe adding liquid alternatives to DC plan menus offers several investment advantages, including the following:

• providing another solution in pursuit of incremental return and risk management;
• the potential to more effectively manage volatility;

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**EXHIBIT 5**
DC Plans Lack Meaningful Allocations to Emerging Markets, International and Alternative Strategies

Notes: The average asset allocation for a DC plan is derived from the Callan DC Index, which is an equally weighted index tracking the cash flows and performance of nearly 90 defined contribution. Asset allocation as of September 30, 2014.

Source: Callan Associates.

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**EXHIBIT 6**
Hedge Fund Structures: Traditional Partnerships vs. Liquid Alternatives

<table>
<thead>
<tr>
<th>Traditional Mutual Fund Investing</th>
<th>Traditional Hedge Fund Investing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return Objective</td>
<td>Absolute returns</td>
</tr>
<tr>
<td>Benchmark</td>
<td>Unconstrained by benchmark index</td>
</tr>
<tr>
<td>Investment Strategies</td>
<td>Flexible strategies (long and short positions, leverage)</td>
</tr>
<tr>
<td>Market Beta</td>
<td>Generally low beta to traditional asset classes</td>
</tr>
<tr>
<td>Performance</td>
<td>Often independent of market direction</td>
</tr>
<tr>
<td>Management Fees</td>
<td>Generally higher asset-based fee than mutual funds; Performance fees</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Liquidity restrictions and lock-ups</td>
</tr>
<tr>
<td>Investment Size</td>
<td>Large minimums</td>
</tr>
<tr>
<td>Investor base</td>
<td>Qualified purchasers</td>
</tr>
<tr>
<td>Transparency</td>
<td>Limited or no position level transparency</td>
</tr>
</tbody>
</table>

Source: NB Alternatives.
• an opportunity to achieve greater diversification through the addition of a strategy less sensitive to the broader equity and fixed-income markets.

Expanding investment options to a broader universe of strategies, like those in the realm of alternative strategies, may also improve the outcome for DC plan participants. In a 2011 article, the Defined Contribution Institutional Investment Association (DCIIA [2011]) counseled DC plan sponsors to consider adding investment offerings that provide better risk balance, in an attempt to enhance returns and reduce the volatility that the typical plan participant experiences.

This issue is particularly urgent today. 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 alts, as DC plan sponsors look for solutions that might help participants in a rising rate environment. In fact, we observed a noticeable uptick in investor interest in liquid alts following the “taper tantrum” in 2013. Although rates have subsequently fallen from their 2013 peak, given mixed economic data and geopolitical issues, the Federal Reserve has made clear its intention of beginning the process of normalizing rates in 2015.

Although no guarantee of future results, since 2000, hedge funds have posted strong results during periods of rising interest rates.7 This has been partially because of their ability to short, hold cash, allocate among different asset classes, and move across different sub-strategies. In addition, rising rate environments have created attractive opportunities for specific types of managers, including fundamental equity long–short, credit arbitrage and event-driven managers. We believe this gives DC plan sponsors another reason to consider liquid alts, as long-only fixed income investments could bear the brunt of a rising rate environment.

THE EXPANDING LIQUID ALTS MARKETPLACE

As discussed earlier, until recently, hedge fund managers were averse to the notion of creating liquid alt products. The robust asset-raising environment allowed them to charge management and performance fees of typically 2% and 20%, respectively. As such, many hedge fund companies dismissed the idea of offering portfolios that charged a relatively modest, flat management fee. They also preferred having the ability to lock up investors, even if the terms were more onerous than the actual liquidity of their portfolios. Additionally, they were hesitant to become more transparent and reveal their holdings, particularly short positions. Finally, with minimal knowledge of the ‘40 Act guidelines, they were mostly unaware that it was possible to construct portfolios that would provide substantially the same exposures and be managed in substantially the same manner as their existing products.

However, times have changed. In response to the challenging asset-raising environment, hedge funds with less than $1 billion in assets under management (AUM) and, especially, those with less than $500 million in AUM, are now more willing to negotiate fees and terms, making them more willing to manage liquid alternative products. What’s more, hedge fund managers usually do not have the infrastructure to launch, operate, and most importantly, distribute a mutual fund. Partnering with a larger asset manager with these capabilities enables them to raise capital in markets they could not access directly, such as DC plans.

Furthermore, hedge fund managers have been drawn to the “sticky assets” that are typically associated with retirement accounts. According to one study, only 10.7% of DC participants changed the asset allocation of their current account balances in 2013.8 Over the last decade, these trends have contributed to the rapid growth of liquid alternative products, which has more than quadrupled in number, with assets of more than $400 billion. (See Exhibits 7 and 8.)

IMPLEMENTATION STRATEGY

In our view, DC plan sponsor have two key decisions to make with regard to incorporating liquid alts 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 to offer them in target date or custom balanced funds where the allocation is professionally managed. The second key decision is whether to use a single-manager strategy or multi-strategy funds.

We believe a target date approach can be an effective way to incorporate liquid alts into a DC plan. Target date funds have increasingly become the Qualified Default Investment Alternative (QDIA) of choice for DC plan
sponsors. Target date funds with an allocation to liquid alts allow participants to automatically gain exposure to the previously discussed benefits associated with liquid alts. However, few target date funds now include an allocation to liquid alts. In general, the target date funds offered in DC plans today employ strategies focused on traditional long-only, style-box-based investments, with minimal, if any, alternative investment exposure. Nonetheless, a number of custom target date funds and some off-the-shelf target date funds have incorporated certain alternative strategies, albeit not hedge funds but long-only funds investing in commodities and REITs.9

A target date fund’s glide path allows the manager to weight allocations to reflect the age and risk tolerance of participants at different phases of retirement investing. As the space matures, we expect to see more single-strategy solutions incorporated in target date funds as managers look to use different hedge fund strategies for different participant life stages (i.e., structuring equity hedge and event-driven allocations for younger participants but employing a more balanced approach for older participants). Given the attractive portfolio characteristics of liquid alts and the growing availability of strategies, we anticipate that more target date funds will incorporate liquid alts in the future.
Plans that offer custom balanced funds as the QDIA or simply as an additional asset allocation choice can also incorporate liquid alts into those professionally managed offerings. Similar to target date funds, such funds that utilize open architecture for manager and asset class selection can tailor the liquid alts exposure to meet the investment objectives of each fund.

Adding liquid alts to a plan’s core menu, in our view, is also a 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. The general lack of sophistication among participants when it comes to these types of strategies makes a strong education effort critical. Participants will need guidance on how liquid alts might be used as part of broader overall asset allocation based on their specific objectives.

In addition, plan sponsors must decide whether to use multi-manager or single-manager liquid alts funds. In both cases, this process often involves conducting extensive due diligence, including a rigorous evaluation of potential managers, investment structures, pricing, and fees.

There are several reasons why sponsors may want to offer access to liquid alts through a multi-manager ’40 Act fund. In doing so, they are essentially hiring a fund-of-hedge funds manager to

- oversee the investment and operational due diligence associated with the initial manager selection process;
- develop a diversified portfolio of managers using various complementary alternative strategies (e.g., long–short equity, long–short credit, event-driven, and so on);
- build a robust operational infrastructure that includes hiring third-party service providers to, among other things, take custody of the assets of the underlying managers, review all positions in the portfolio, and monitor all trading activity on a daily basis;
- conduct daily compliance monitoring, including ensuring that the underlying managers are adhering to portfolio exposure limits and liquidity requirements and are not exhibiting style drift;
- adjust the manager and strategy line-up as deemed necessary given changing market cycles;
- implement independent robust risk management of the overall portfolio.

These points take on added importance when one considers the increasing number of liquid alternative products available today and the limited experience that most DC plan sponsors have in investing in such strategies at this time. Exhibit 9 reinforces the value of manager selection, given the wide variation in performance

**Exhibit 9**
Dispersion of Manager Returns by Strategy

![Dispersion of Manager Returns by Strategy](image)

*Sources: NB Alternative Investment Management and Morningstar.*
between top- and bottom-decile managers across individual hedge fund strategies.

Typically, alts managers do not invest relative to a benchmark (or care about tracking error). As a result, two managers may, for example, both employ “macro” strategies but wind up with very different portfolios. A multi-manager fund selects differentiated managers, combines them, and monitors them so that the fund can adapt to changing market conditions, providing DC plan sponsors an additional layer of oversight.

CONCLUSION

As demonstrated by DB plans, 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. Although alternatives were once considered inaccessible for DC plans, the expansion of the liquid alts market has made them a viable asset class. As DC plan sponsors look to replicate the DB plan experience for their DC participants, the comfort level with alternative investing should increase.

In our view, the most appropriate way for DC plans to add liquid alts to their platform, in the near term, is through the use of multi-manager funds. In doing so, DC plans can benefit from independent due diligence, access to a wide range of strategies, continual oversight, and proactive portfolio adjustments, leaving the “heavy lifting” to the investment manager. As DC sponsors look for ways to improve their DC participants’ risk–return profile, we expect to see increased conviction to add diversifying alternative asset classes, including liquid alts.

ENDNOTES

The authors would like to thank Michelle Rappa and John Geer for their help in putting together this review of liquid alts in the defined-contribution plan market.

2DCIIA [2013] and CEM Benchmarking.
3Source: Bloomberg.
4The VIX is often described as the “fear index.” The higher the index, the higher the volatility of the equity markets.
5Sources: NB Alternatives, HFR, and Bloomberg.
6Source: Morningstar.
7Source: Neuberger Berman.
8Source: Holden and Schrass [2013].
9Sources: “Liquid Alts in Target Date Funds” [2014] and BrightScope.

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