



Alternative Assets Tame A Turbulent Market for Your 401(k) Fund Line-Up

PENSION PLANS, PRIVATE INVESTORS AND FOUNDATIONS HAVE BEEN INVESTING IN ALTERNATIVE ASSETS for years, yet many of these options have never been available in the 401(k) market. If alternatives are appropriate portfolio diversification tools for the most sophisticated long-term investors, why not make them available to 401(k) participants, particularly when they can help flatten a turbulent market's peaks and valleys?

What are alternative investments?

Alternative asset classes and investment options differ from the “traditional, long-only” equity and fixed income funds that are found in a typical 401(k) plan line-up. Alternative investments may include (but are not exclusively limited to): commodities, managed futures, currencies, TIPS, real estate, REITS, private equity and venture capital, as well as the full spectrum of hedge fund strategies, including long-short, 130/30 and market neutral.

Alternative investments may differ from traditional assets as follows:

- a. Low or negative correlation to the returns of traditional assets
- b. The ability to use shorts, leverage and/or other unconventional investment techniques for protective or speculative purposes
- c. Primary goal of “absolute returns” (i.e., measured against inflation) instead of “relative returns” (i.e., measured against the S&P 500)
- d. So-called “lock-up provisions” requiring a long-term investment commitment
- e. Reduced transparency of underlying holdings

- f. Alternate manager compensation structure (such as 2 percent of assets + 20 percent of gains)

How are alternative assets currently used by retirement plans?

Alternative assets generally exhibit low or negative correlation to the returns of traditional asset, which gives them a powerful diversification role in the construction of long-term investment portfolios. Many institutional investors and pension plans have for several years been using alternatives to diversify their long-term investment holdings. Defined benefit pension funds, for example, may add alternative investments to their holdings in order to help ensure that the fund has sufficient total value and liquidity to endure all expected payouts, regardless of the performance of the stock or bond markets at the time of the payout. Alternative investment options each exhibit their own unique series of risks, but when diligently considered and prudently adopted within a balanced portfolio, their use is intended to reduce the overall volatility of the portfolio for the given level of expected performance.



Alternative assets have historically been excluded from 401 (k) plans

Investors in alternative assets have historically been restricted to so-called “sophisticated investors” (private investors with demonstrable investment expertise and/or significant personal assets), institutional pension plans, and other large professionally managed investment bodies. This restriction presumed that the unusual characteristics of alternative assets made them particularly risky investments for the average employee on Main Street to manage independently. These risk characteristics may have included relatively higher volatility (commodities), long-term illiquidity (real estate), and/or a lack of transparency (hedge funds). In addition, successful management of such investments may have required a degree of information access and/or trading expertise unavailable to a private investor of limited time, education or means. Some 401(k) plans offer a brokerage window option whereby participants may purchase assets outside the plan’s sponsored fund line-up; however, otherwise, 401(k) plans have historically been restricted from use as a vehicle for alternative investments.

Why you should consider alternative assets for a 401(k) plan?

It could be argued that no alternatives are appropriate as a stand-alone investment option inside a 401(k) plan because of the inherent and unique risks associated with this asset class. In addition, research has shown that participants may be slow to incorporate new asset categories into their assets allocations and may not use them appropriately.

However, the proper use of alternative assets in a balanced, long-term investment portfolio can enhance returns while reducing overall portfolio volatility. Participants in a 401(k) plan with a long-term investment horizon may benefit from increased diversification, downside protection and/or improved returns via prudent investment in alternative assets.

The market is evolving, and, as new investment products and techniques emerge, additional alternative

“No longer the sole realm of the major players, alternative assets diversify for long term stability.”

investment options are now becoming available to 401(k) plan sponsors. For example, a number of real estate management firms have created mutual funds tied to the returns of their core diversified real estate portfolios, but which tend to hold more cash than prior portfolios in order

to meet liquidity needs typical of 401(k) plans. Commodity-linked mutual funds are becoming available for addition to customized fund line-ups, and hedge fund-like mutual funds are accumulating the historical track records, tenured management teams and dependable cash flows necessary for similar use.

How a plan sponsor can add alternative assets to a 401(k) plan

There are a number of potential methods for making alternative assets available to 401(k) plan participants. A plan sponsor must take a proactive role to ensure that participants simply have access to the same tools used to evaluate, construct and manage alternative assets as those used for defined benefit portfolios. Since the previously discussed characteristics of alternative assets limit this somewhat, the key is to create a 401(k)-compliant and accessible alternative asset fund portfolio.



For all 401(k) plans:

a. Add an alternative fund or funds, which incorporates a number of funds representing different alternative asset classes within the holdings of a single fund

For companies with very large 401(k) plans:

a. Build a customized alternative asset fund through a trust bank or holding entity

b. The trust entity must be willing to customize a portfolio which exhibits daily liquidity features capable of unitization by the 401(k) record keeper

c. This is especially appropriate for companies with an existing defined benefit pension plan which holds or is considering alternative assets

For smaller 401(k) plans:

a. Incorporate select alternative investments into a customized target, lifestyle or age-based portfolio structure

The due diligence required before adding Alternative Assets to a 401(k) fund line-up

In adding alternative assets to a 401(k) plan line-up, the plan sponsor should follow its standard procedure for altering the 401(k) fund selection. The plan committee should add a category outlining these investment options within the Investment Policy Statement, and seek approval from the plan sponsor's governing board, if applicable. The plan committee should give particular attention to the following characteristics of any alternative asset considered for addition to a 401(k) fund line-up:

a. Acceptable degree of transparency
b. Appropriate diversification within the fund
c. Controls on leverage
d. Confirmation of value-added performance (versus "levered up" performance.)

e. Quality managers (consider reputation, tenure and commitment of management team)

f. Acceptable cash flow and redemption rates

g. Reasonable fees

Conclusions

Adding alternatives can be a daunting task for investment committees or plan trustees in the face of time and expertise limitations. As with any new asset class, a high degree of due diligence is necessary when considering the addition of alternative assets to a 401(k) fund line-up. A dedicated, objective consultant may be able to help navigate around the potential pitfalls of alternative assets, and help ensure that 401(k) plan participants have access to the most appropriate resources as they plan and save for retirement. They can also assist by working with the plans record keeper to create customized balanced portfolios using alternatives within the overall asset allocation strategy. In conclusion, it can be expected that even more plans, consultants and record keepers will utilize alternative assets in 401(k) plans, making alternative assets increasingly understood, acceptable, and affordable.