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Private Equity in Defined Contribution Plans

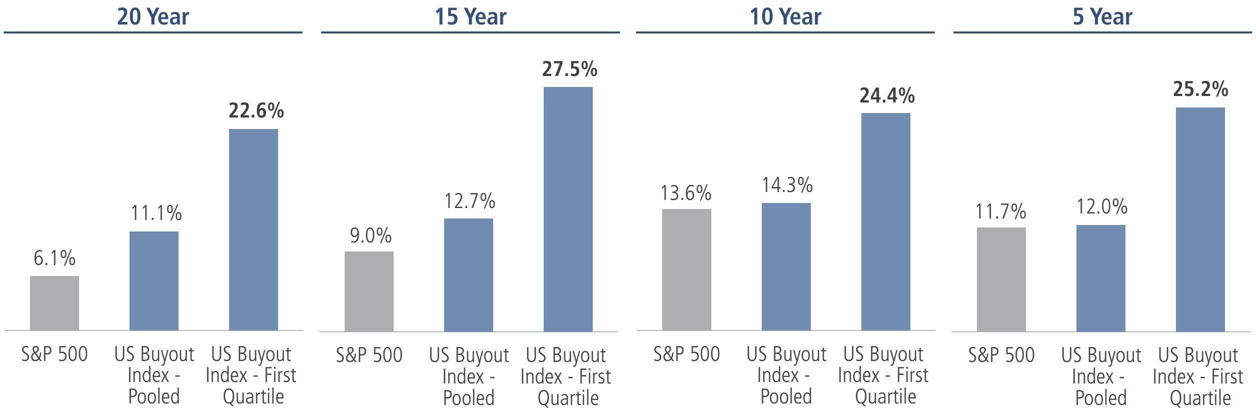
A recent information letter from the DOL may facilitate greater access to private equity for plan participants.

Private equity has long been the subject of interest—if not action—from defined contribution plan sponsors. The asset class' strong performance and low correlation to traditional assets have given it appeal as a source of potential diversified return for defined benefit plans. However, its complexity, valuation uncertainty, fee structures and illiquidity have created challenges within the DC framework. Plan sponsors have also worried that these issues could open them up to liability as fiduciaries. Undeterred, the industry has continued to look for ways to introduce private equity in DC plans where it makes sense in managed asset allocation plan options.

Recently, those efforts received an important shot in the arm from the U.S. Department of Labor in the form of an information letter. Without approving a particular fund or product, the DOL said that, in certain circumstances, it would be open to the inclusion of private equity investments in "designated investment alternatives" such as custom target date, target risk and balanced funds. In the scenario addressed by the letter, a multi-class vehicle would cap its weighting in private equity, with the rest of its assets held in public securities and other liquid investments to manage risk and liquidity needs.

In our view, this is a positive development that is likely to reinforce the perceived benefits of private equity to DC sponsors. A quick review is worthwhile, showing that the asset class has outperformed public equities across multiple timeframes (see display).

PERFORMANCE COMPARISON: U.S. PRIVATE VS. PUBLIC EQUITY



For illustrative purposes only. The benchmark performance is presented for illustrative purposes only to show general trends in the market for the relevant periods shown. The investment objectives and strategies of the benchmarks may be different than the investment objectives and strategies of a particular private fund, and may have different risk and reward profiles. A variety of factors may cause this comparison to be an inaccurate benchmark for any particular type of fund and the benchmarks do not necessarily represent the actual investment strategy of a fund. It should not be assumed that any correlations to the benchmark based on historical returns would persist in the future. Indexes are unmanaged and are not available for direct investment. Source: Cambridge Associates. Represents pooled horizon IRR and first quartile return for the Global All Private Equity Index from Cambridge Associates as of December 2019, which is the latest data available. **Past performance is not indicative of future results.** Please see the Important Valuation and Other Financial Analyses Risk Considerations for details concerning, among other things, COVID-19, including its impact on valuations and other financial analyses.

In our opinion, these figures reflect characteristics inherent to the asset class, including the following:

Information and control. [Private Equity] managers generally have deeper access to information, and more direct and transparent governance control, and thus have the ability to create value through strategic and operational improvements.

Timing. [Private equity] managers often spend months sourcing and completing investments, and can choose a variety of methods to exit their positions, providing them with great flexibility as to the timing of their investments.

Distinct opportunities. Private companies generally avoid the quarterly reporting burden of public companies, and thus may be better able to take on opportunities that may take time to reach fruition.

The latter point is particularly important today, as the pandemic challenges so many sectors and companies. We believe that private equity managers' ability to provide needed capital, and their ability to wait out temporary stresses, could prove particularly beneficial as the global economy moves toward recovery.

A Difference in DC

Even if asset class statistics appear more favorable in general, a key question is whether private equity can make a difference in the context of a target-date fund. Here, the answer appears to be yes. In a 2019 study[1] sponsored by Neuberger Berman, the Defined Contribution Alternatives Foundation and the Institute for Private Capital analyzed a comprehensive sample of 2,515 U.S. private equity funds to create hypothetical simulated portfolios for 1987 – 2017 that invested part of their overall equity allocation in the funds. They found that including the private investments increased average portfolio returns and Sharpe ratios. The results remained robust when accounting for higher fees, as well as randomly selecting a few private funds from each vintage year.

This is not to say that adding private equity to a target-date fund is an automatic decision. As the DOL letter emphasized, private equity introduces a range of additional issues around analysis and oversight, and requires that plan fiduciaries and their portfolio managers have sufficient "capabilities, experience and stability" to effectively run a fund that includes private assets. Creating this exposure has potential benefits, but responsibilities as well.

[1] "Why Defined Contribution Plans Need Private Investments," Defined Contribution Alternatives Foundation and Institute for Private Capital, October 2019.

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