Amid concerns over inflation and market volatility, more plan sponsors are looking at adding alternative investments to their defined contribution (DC) plans. Here’s what to consider.

The recent financial crisis has prompted plan sponsors to consider alternative investments as a way to add diversification and dampen volatility. In some cases, plan participants—prompted by fears over inflation and market volatility—are prodding their employers to add Treasury Inflation-Protected Securities (TIPS), commodities and real estate investment trusts (REITs) to their investment line-up.

But there are some common myths that plan sponsors may come across as they consider adding alternatives to their DC plans. We address—and debunk—some of the biggest misconceptions.
1. Participants may see alternatives as complicated, scary investments. Why add them?

Broadly speaking, alternative investments can include hedge funds, private equity and direct real estate vehicles—investments that investors typically characterize as complicated and illiquid. While there are appropriate ways to include these strategies, the most common alternative investments within the DC universe include commodities, high yield bonds, emerging market debt, REITs and TIPS. Although these asset classes must still be used in the right context and proportions by participants, they often have a liquidity and transparency advantage over the aforementioned asset classes.

In addition to the ease of implementation, these asset classes can be used to add greater levels of efficiency to a well-diversified portfolio. In other words, you can expect greater levels of return for the same risk levels, or vice versa. In a traditional 60% stocks/40% bonds portfolio, the 60% equity position typically accounts for about 90% of the portfolio’s risk. Adding alternatives can diversify away some of that equity risk—resulting in a smoother ride for participants and a better outcome at retirement.

Alternatives can also enhance returns during participants’ working years, resulting in more income in retirement.

Say an investor allocated 60% of a $300,000 portfolio in the S&P 500 Index and 40% in the Barclays U.S. Aggregate Bond Index in March 2001. Fast forward ten years to March 2011 and that portfolio would have increased to about $450K, according to J.P. Morgan Asset Management’s Global Multi-Asset Group. However, that same investor would have earned an additional $50K in real returns to about $500K—even after the volatility of recent years—if the asset allocation had been diversified to include extended assets across equity and fixed income, such as small-cap, mid-cap, international equities, emerging markets equities and debt and high yield bonds.

From a strategic asset allocation perspective, alternatives can be used as either an equity or fixed income substitute depending on the vehicle. A global tactical asset-allocation manager, for example, might be viewed as an equity alternative since investors will reap equity growth but benefit from more diversification since the investment won’t be perfectly correlated with equities. On the other hand, an absolute return strategy whose returns are measured against a conservative benchmark is likely to be considered a fixed income alternative.

2. TIPS are the single best way to hedge inflation.

Given concerns over inflation, some plan sponsors have turned to TIPS to protect participants’ portfolios against inflation’s deteriorating effects. After all, not only are TIPS designed to keep pace with inflation, but they also have perceived safety as Treasury securities. Other plan sponsors may take comfort in the fact that about 20% of plan sponsors are now offering TIPS as a standalone option in their plan.

But because of timing and trading issues, TIPS may not necessarily provide investors with enough inflation protection when they need it the most.

While traditional hedges, such as TIPS and commodities, have tended to outperform during inflationary periods, they also perform differently, depending on the time period. Commodities, for example, tend to lead when inflation is rising, while TIPS tend to correlate more closely with the actual CPI releases as inflation works its way through the system. TIPS’ principal, for example, is only adjusted after the CPI numbers are released. This is not necessarily an issue until we see a rise in "real" interest rates in the economy. A sharp decrease in inflation expectations will have a deteriorating effect on a TIPS portfolio. Additionally, that effect tends to be magnified by the longer duration of TIPS relative to some other fixed income sectors.

According to research from J.P. Morgan Asset Management, a diversified basket of inflation-sensitive assets that can perform well in different inflationary environments outperforms a single bet on any one inflation-sensitive asset over the long term. This diversified basket may be especially helpful for those closer to retirement who can benefit by holding a more diversified portfolio that results in potentially greater returns.

3. The best way to add alternatives is through standalone options.

While some plan sponsors today offer alternatives as an option in their

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1 For illustrative purposes only. The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 Index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index. The Barclays Capital U.S. Aggregate Index represents securities that are SEC registered, taxable and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. This U.S. Treasury Index is a component of the U.S. Government index. The diversified portfolio consists of the following breakdown: 30% Russell 3000 Index; 30% Barclays Capital U.S. Aggregate Index; 20% MSCI ACWI (All Country World Index) Index; 5% J.P. Morgan EMBI Global Index; 5% Russell 2000 Index; 5% Barclays Capital U.S. Corporate High-Yield Index; 5% HFRX Fund of Funds Composite; and 5% NCREIF Property Index.

investment line-up, adding them as standalone funds can be a challenge from a portfolio management and communications perspective since plan sponsors need to ensure that participants understand the risks.

For one, the risks associated with extended asset classes—liquidity, transparency, volatility and, in some cases, leverage—can become magnified if investors use them inappropriately. Take, for example, a 25-year-old who—after reading the headlines about rising gas prices—allocates a significant portion of his or her portfolio to a TIPS fund when he or she would likely be better off holding mostly equities.

So unless the standalone options come with guidance that set “reasonableness” and “concentration” limits, it may make more sense to implement alternatives as part of a managed account or multi-asset portfolio. By bringing alternatives together in a packaged solution, the portfolio manager may be able to manage assets to enhance the portfolio’s asymmetric return patterns—that is, capture more of the returns in up markets, while losing less in down markets. From a portfolio construction perspective, that can help amplify positive returns because managers are able to accumulate excess returns while trimming some of the losses in drawdown periods.

Keeping in mind that plan sponsors wishing to slim down their investment line-up in favor of broader mandates may look at these diversifiers as packaged products. And while many target date funds also include an allocation to alternatives, some plan sponsors may look to add a multi-asset alternatives portfolio to complement existing options in the plan.

Also, since alternative assets, such as commodities, natural resources, equities and TIPS, can trade differently in different environments, a manager who can invest across those assets—and make the correct calls—can mean the difference between a positive return and a negative one depending on the investment time horizon.

4. **Since alternatives are complicated, we need a new process to evaluate them.**

Plan sponsors may think that because alternatives can be more complicated vehicles, they need a different evaluation process than the process they already have in place to evaluate their core options.

But the reality is that the process is largely the same. Plan sponsors still evaluate alternatives’ performance against their relevant benchmarks and peers and consider the experience and track records of the managers.

Plan sponsors, however, do need to have a clear understanding of how to use alternatives and—from a strategic allocation perspective—the role that alternatives are supposed to play in the portfolio either as an equity or fixed income replacement. For plan sponsors, the key is to understand what the alternative product is, how it behaves and how much it can change over time.

5. **Telling my participants about alternatives requires an extra layer of communication.**

Similarly, communicating the information and benefits of alternatives to plan participants is relatively straightforward. Just as with stock and bond funds, for example, investors can evaluate performance by looking at alternatives’ fund fact sheets, which detail holdings and key statistics, such as turnover ratios. The underlying securities still get rolled up into the stock-bond-cash allocation. In the same way, investors can see a list of the underlying managers and holdings in a multi-manager product—the main difference is that the list of managers is likely to be longer and broader in a multi-managed product.

Incorporating alternatives as part of a managed solution can simplify the communication challenges in part because plan sponsors won’t necessarily have to walk participants through a tutorial or correlation matrix that illustrates how different asset classes perform in a variety of economic conditions.

Overall, alternatives can play a critical role in improving retirement outcomes for participants. But because of their potential risks—including the risks that participants use them inappropriately—extended asset classes are most appropriate as part of a packaged solution where professional managers have the ability and resources to construct a portfolio that will amplify returns in positive markets, while limiting the risks and losses in down markets. ☐