INVESTMENTS
& WEALTH MONITOR

A reprinted article from November/December 2024

The Complex Case of Integrating Private Markets in Retirement Plans

By Aaron Filbeck, CAIA®, CFA®, CFP®, CIPM®, FDP®, and Claire Sawyer

INVESTMENTS & WEALTH INSTITUTE®

© 2024 Investments & Wealth Institute®. Reprinted with permission. All rights reserved.

The Complex Case of Integrating Private Markets in Retirement Plans

By Aaron Filbeck, CAIA®, CFA®, CFP®, CIPM®, FDP®, and Claire Sawyer

In this article, we will summarize the arguments for and against including private market strategies in defined contribution plans. We will explore the investment rationale for incorporating private markets, as well as arguments against inclusion, such as concerns about investor sophistication and the variability of performance outcomes at the fund level. Additionally, we will highlight legal precedents that may shed light on this ongoing debate. We finish this article with a few recommendations and paths forward as this debate continues.

THE STATE OF DB AND DC PLANS

According to the Investment Company Institute (ICI), $38 trillion in assets is held in some form of a retirement plan in the United States as of 2023. Approximately two-thirds of these assets are held in a 401(k), individual retirement account (IRA), or another defined contribution (DC) plan (see figure 1). As of 2023, nearly $10.5 trillion of these retirement savings vehicles are dedicated to some form of an employer-sponsored retirement plan, e.g., 401(k), 403(b), 457 plans, thrift savings plans, etc. That's quite a large swath of the U.S. investment market, and it's almost entirely new ground in terms of alternative private market investment exposure.

Figure 1 shows that the proportion of defined benefit (DB) plans continues to shrink and is now a minority in terms of assets held in these retirement schemes. These figures should not be surprising, as our corporate culture has become far more mobile, and many organizations have closed down or stopped offering DB benefit plans for new entrants. An exception may be those who work in the public sector.

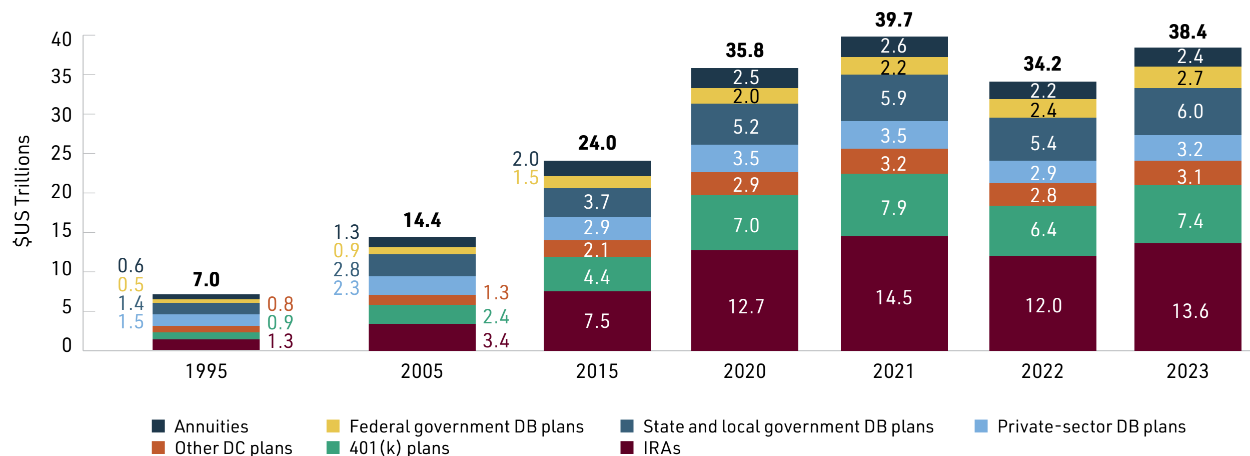
ALLOCATIONS IN DB PLANS

During the course of the 2000s and 2010s, the average allocation of a DB pension plan changed significantly.[1] This is illustrated in figure 2.

From 2000 to 2023, allocations to alternative investments went from approximately 10 percent to 35 percent of pension assets, respectively. This came at the cost of exposure to equities and bonds, which came down by 20 and 10 percentage points, respectively, to make room for the alternative appetite. During this period, most of the growth in alternative investments was driven by growing allocations to private equity, real estate, and hedge funds.

Figure 1

RETIREMENT PLAN ASSETS IN THE UNITED STATES

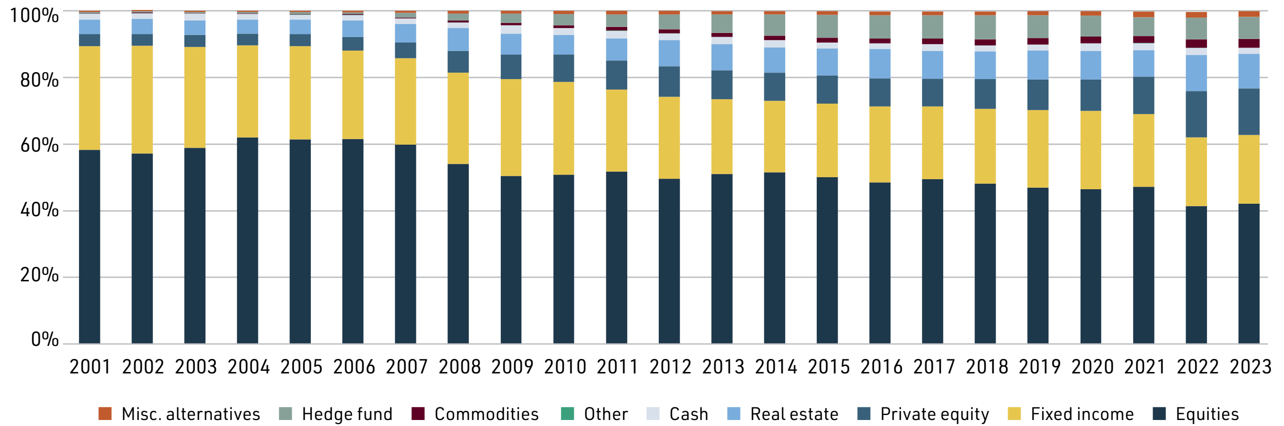


Source: Investment Company Institute.

© 2024 Investments & Wealth Institute. Reprinted with permission. All rights reserved.

Figure 2

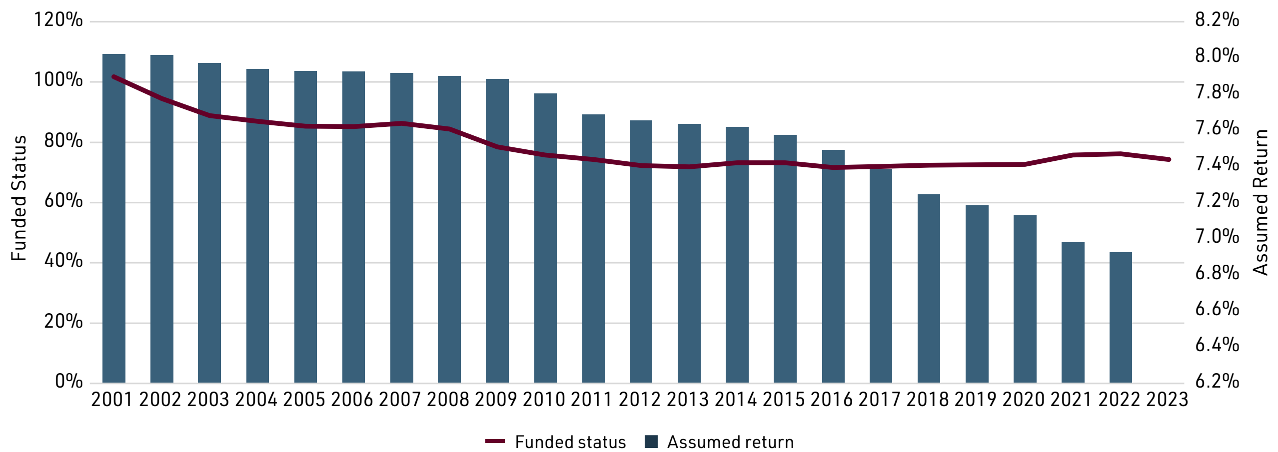
AVERAGE DB PLAN ALLOCATION



Source: Public Plans Database (July 2024).

Figure 3

FUNDED STATUS VS. ACTUARIAL RATE ASSUMPTION



Sources: Public Plans Database, PENDAT, Census of Governments.

There are many reasons for this, most importantly a pronounced change in interest rates. As interest rates decreased, the present value of liabilities increased, driving up plan liability and driving down funded levels (see figure 3). The punishment is exacerbated by decreasing forward-looking returns. As a result, many pension plans have looked for higher, and alternative sources, of return to account for declining funding ratios—hence the rise in private market alternative allocations.

ALLOCATIONS IN DC PLANS

DC plans, on the other hand, have not seen such a dramatic reallocation between traditional and alternative investments.[2] This is mostly because, with a few exceptions, alternative investments are unavailable to plan participants in the first place.

In general, 401(k) plan participants have much higher allocations to equities. According to Vanguard, roughly 74 percent of Vanguard DC assets are in public equities, factoring in the underlying allocations of balanced and multi-asset funds (see figure 4). In 2024, this is approximately 30-percent higher than the average allocation to public equities in DB pension plans. Meanwhile, there's about zero in private equity.

Similarly, savers have skewed much more toward target-date retirement funds during the past decade, as these investment options have become more widely available.

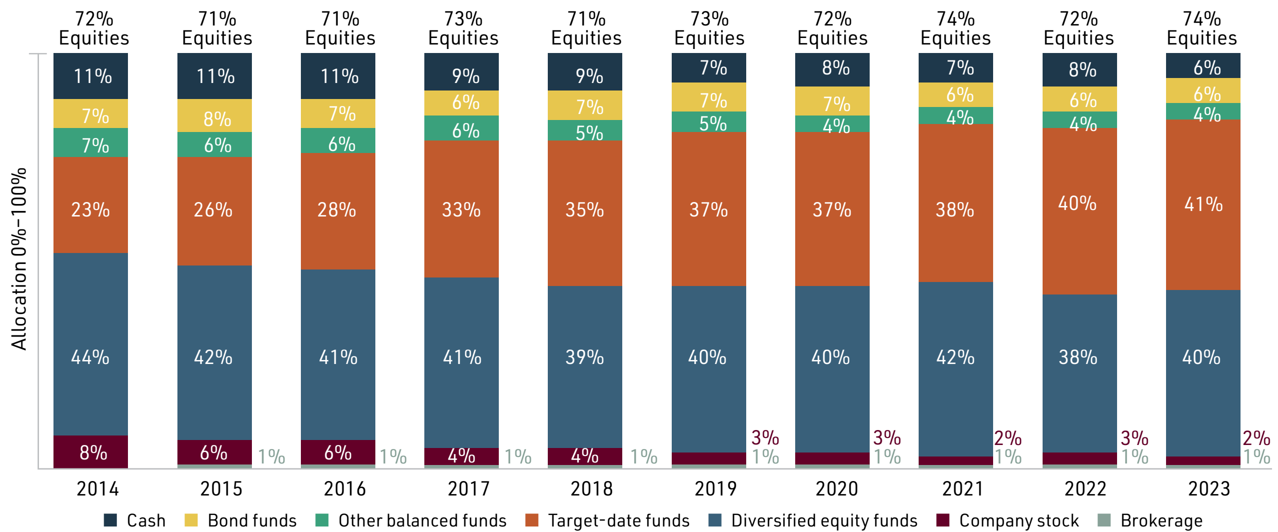
There are a few reasons for both trends, including:

1. 401(k) participants tend to skew younger than DB plan participants, because many companies no longer are offering pensions to workers.
2. Target-date funds increasingly have become the qualified default investment alternative for 401(k) plans, meaning that if the participant selects nothing, contributions

© 2024 Investments & Wealth Institute. Reprinted with permission. All rights reserved.

Figure 4

PLAN ASSET ALLOCATION SUMMARY



Source: Vanguard, "How America Saves 2024."

automatically are invested in a target-date fund instead of cash.

BRIDGING THE GAP: PRIVATE MARKETS IN DC PLANS

Since the Global Financial Crisis, there has been an increased call for including different types of investment options in DC retirement plans via target-date funds. Until now, mutual funds have been the predominant fund vehicle for plan participants to own. However, arguments for exchange-traded funds (ETFs), collective investment trusts, registered non-traded closed-end funds, and limited partnership structures in retirement savings vehicles have all become topics of debate.

For the remainder of this article, we will focus on the debate around including private markets, which largely impacts limited partnerships and registered non-traded closed-end fund structures. We will introduce some of the landmark legal precedents that may influence future outcomes, summarize arguments on either side, and propose a potential path forward.

THE CASE FOR PRIVATE MARKETS IN RETIREMENT PLANS

There are several cases for integrating private markets into DC retirement plans. We will focus on three common ones:

1. Changes in capital formation
2. Outdated regulatory requirements
3. Portfolio benefits

The first argument for including alternative investments, in particular private assets, in these plans is that it better allows everyday retirement savers to access an increasingly significant portion of the global economy that no longer is accessible through public equity and debt markets. This is especially true in the United States, where much of this discussion is taking place. According to the World Bank, there are nearly 48,000 listed companies in the world, and the United States represents just 4,700.[3] Although it accounts for just under 10 percent of all public companies, the United States represents more than half of the global market capitalization.[4] However, despite the prominence of the United States' market-cap representation in global markets, the number of publicly traded companies has declined considerably since reaching a peak of approximately 7,800 in the late 1990s.

Similarly, there are approximately 2,800 and 18,000 companies with annual revenues of more than $100 million each that are publicly traded or privately held, respectively. The latter represents a significant and growing proportion of the economy that is not found on public exchanges.[5] Of course, a counterargument comes back to the market-capitalization differences between public and private markets—the number of companies is split roughly 90-percent private, 10-percent public, but actually is 10-percent private and 90-percent public when adjusted for market cap.[6] Even so, the argument for private markets is less about sizing and more about where value is being created. In the same period during which the number of public companies has been declining, the length of private companies' lifecycles has increased. In fact, from 1999 to 2020, the average age of a new public technology company jumped from 4.5 to 12 years.[7] The initial public offering (IPO) market has changed as well. Private companies are staying private longer, and often they elect not to go public at all. The number of IPOs in the United States has experienced a secular decline, with some cyclical increases, since the late 1990s—dropping from a peak of 677 in 1996 to 54 in 2023.[8]

Similarly, the debt markets are changing tremendously, and options for lending to new companies and sectors in the economy increasingly are being made available to investors that previously were

© 2024 Investments & Wealth Institute. Reprinted with permission. All rights reserved.

restricted to banks. Unlike equities, where private markets increasingly are cutting into public markets, private debt is increasing access to companies. During the past 20 years, non-bank lenders, e.g., private investors and funds, have become the dominant lender of choice for small and medium-sized businesses, comprising more than two-thirds of corporate loans as of 2022.[9] For companies, these lenders fill a financing gap left by banks post-Global Financial Crisis. For investors, these loans offer attractive nominal yields (before any defaults).

For DB plans, these changes in capital formation are important to consider but less of a hurdle because many plans already either have exposure to private markets or can gain exposure if they choose. The same cannot be said for DC plan participants, who currently have little to no exposure to these types of investment options on plan menus. The reality is that DB plans and DC plans today have very different portfolios, and DB plans (in the United States) skew toward an older demographic. These differences could lead to very different outcomes for participants. The inclusion of private markets in DC plans would offer the average individual investor access to opportunities that historically have been reserved for large institutions and affluent individuals. Although such opportunities come with additional considerations and risks, and may not be appropriate for all investors, increased access could contribute to more equitable long-term outcomes as markets continue to evolve.

A second argument is that the United States currently restricts access to private markets in an antiquated way. Skinner (2023) makes the argument that wealth is a poor proxy for sophistication and that regulation has been slow to adapt to changing capital market dynamics and product creation. For instance, other high-risk investments, such as concentrated sector funds, cryptocurrencies, and levered funds technically are available for individual investors today. So why is private equity being held back? Of course, retirement plans carry additional considerations, but screening the appropriateness of these investments is the responsibility of the plan sponsor or advisor, not the regulator.

A third argument focuses on the benefits of incorporating alternative investments into portfolios because there is a presumed benefit of higher total returns relative to their publicly traded equivalents. This argument isn't specific to the DC structure but is an important question to consider—is it worth it in the end? As discussed above, a big difference among the DC participants, high- and ultra-high-net-worth individuals, and institutional asset owners, is the level of sophistication. Generally, the latter two groups benefit from professional investment advice and/or discretionary management. However, the investment risk for DC participants is on them, and so is fund selection, even if from a curated menu.

Just as there are strong arguments for including private markets in DC plans, there also are strong arguments against the idea.

Brown et al. (2019) address this concern by simulating multiple portfolios using a random assortment of funds and found that even a randomly simulated portfolio that included different private equity funds (buyout and venture capital, specifically) created better outcomes. This exercise also incorporates the reality that dispersion exists among managers, a fact that often is ignored in illustrations. They concluded:

> *In 100% of simulations, the returns with private funds outperform the public-only benchmark. This suggests that despite the wide dispersion of returns in private funds, the ability to diversify by investing in multiple funds is sufficient to have nearly guaranteed superior returns historically.*

THE CASE AGAINST PRIVATE MARKETS IN RETIREMENT PLANS

Just as there are strong arguments for including private markets in DC plans, there also are strong arguments against the idea. Here, we will outline a few of the most common arguments against integrating private markets into DC plans, including:

1. Private market fund fees
2. Participant sophistication, liquidity, and manager selection
3. Regulation and ongoing legal challenges

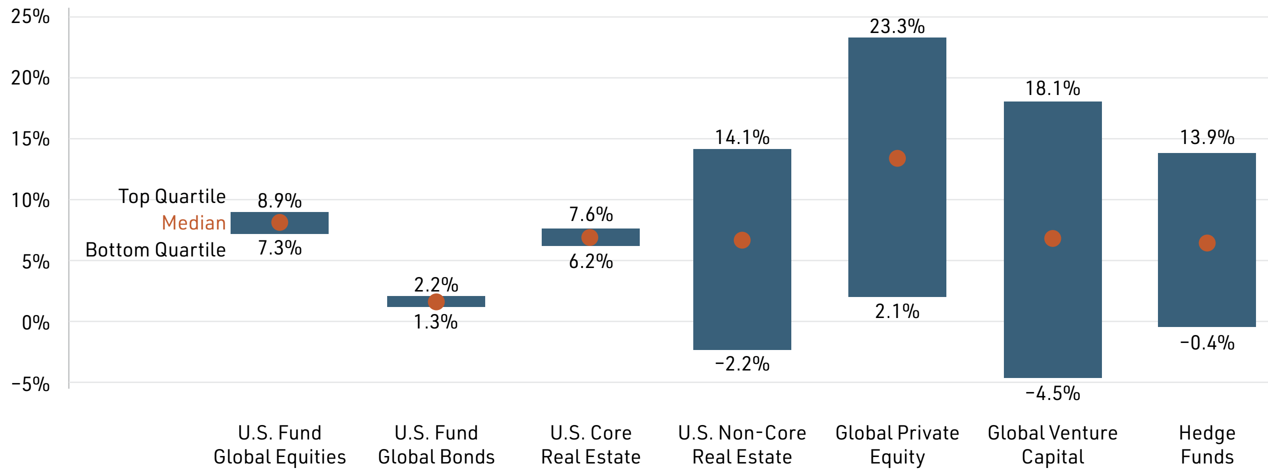
FEES

In almost all cases, alternative investments have higher fees than traditional investments. Although all investors generally are fee-sensitive, plan sponsors in the DC space are even more fee-sensitive—and not just with traditional versus alternatives. In fact, according to ICI,[10] the asset-weighted average expense ratio for equity mutual funds in 401(k) plans was 0.77 percent and 0.39 percent in 2000 and 2020, respectively. Fees in isolation tell only part of the story, but it's important to note that the broader industry asset-weighted average fee was 0.52 percent at the end of the same period.

The early 2010s brought a significant acceleration of the move to low-cost, index-based investments, and assets under management in index-based mutual funds and ETFs surpassed those in actively managed mutual funds and ETFs. As investors voted with their dollars, so did plan sponsors and their advisors, who incorporated many more index funds into plan menus. Of course, some of this was driven by growing evidence that, net of fees, the majority of public long-only actively managed equity and debt funds have generated

© 2024 Investments & Wealth Institute. Reprinted with permission. All rights reserved.

Figure 5 PUBLIC AND PRIVATE MANAGER DISPERSION



Source: JPMorgan Asset Management.

negative excess returns relative to their respective index benchmarks.[11] These trends, combined with a strong fiduciary culture (or a fear of being sued) driven by the Department of Labor, have only accelerated.[12]

Introducing private markets would, therefore, increase investment fees charged to participants, a reversal of the trends of the past decade-plus. A traditional limited partnership private fund will charge higher management fees and also introduce incentive-based fees (known as "carried interest"). Regulated funds, such as interval funds, tender-offer funds, non-traded real estate investment trusts, and non-traded business development companies may not charge carried interest but still charge higher management fees.

PARTICIPANT SOPHISTICATION

The second argument against integrating alternatives into 401(k) plans is that most plan participants are not sophisticated investors and, therefore, may not make prudent investment decisions on their own. There are two levels to this argument: the sponsor or advisors who select and/or approve the fund menu and the participants that invest in them.

To start with the latter group, this is a broader challenge outside the context of investments. According to the World Economic Forum,[13] fewer than 50 percent of adults are considered financially literate. Although these estimates are based on survey data and questionnaires, the questions asked are basic financial concepts surrounding compound interest, inflation, and diversification.

Similarly, surveys during the past several years indicate that of those who have access to a 401(k) plan, only a little more than half actually contribute. There are several reasons for this, but the United States still faces challenges when trying to encourage participants to begin saving in the first place.

Therefore, the idea of introducing complex investments such as private equity, private credit, hedge funds, real estate, etc., often is met with resistance from regulators and even plan sponsors. Most DB plans are managed by investment professionals, and the investment risk is on the institution. This is obviously not the case with DC plans.

The former group, plan sponsors or advisors, are just as important, because these are the decision-making bodies responsible for approving and selecting funds on a plan menu. Investment selection in private markets is difficult, and poor manager selection can lead to poor results and potential legal headaches. As shown in figure 5, the difference between top- and bottom-quartile fund performance[14] is far wider in private markets than in public markets. Of course, past performance is no indication of future results, although there is evidence of slight performance persistence among private market funds.

Those who argue against including private markets in DC plans make a valid point that even supposed experts select bottom-quartile managers. Aside from identifying the best funds, plan sponsors and advisors must be able to access them in the first place. Some of the top general partners in the world are closed off to new investors, and others may require high minimum investments to gain access. Finally, a common worry is that sponsors and participants may not fully understand the risks and other considerations, such as illiquidity and ongoing monitoring costs.

LEGAL CHALLENGES

The third argument, and one that is highly correlated to the previous two, is legal concerns. There is a history of class action lawsuits against plan sponsors as the 401(k) market has grown, particularly focused on fees. In fact, more than 50 percent of plans with assets of more than $1 billion have been sued for

© 2024 Investments & Wealth Institute. Reprinted with permission. All rights reserved.

"excessive fees" alone, and such cases continue to be brought before the courts. In 2023, plaintiff law firms filed 48 new cases related to excessive fees and poor performance, 32 of which targeted plans with assets greater than $1 billion. Seventeen of these cases included complaints of excessive investment fees, and 28 included complaints of excessive recordkeeping fees. Settlements in excessive fee cases reached an all-time high of 42 in 2023, totaling $353 million.[15] For additional context, let's discuss some of the legal precedent surrounding DC plans.

ERISA requires that fiduciaries show the "care, skill, prudence, and diligence" of a prudent person to "minimize the risk of large losses." In other words, the matter of most importance under ERISA is the process, not necessarily the outcome.

A HISTORY OF LEGAL PRECEDENTS AND CHALLENGES

Litigation surrounding DC plans has fallen mainly into three categories of complaints: imprudent investment options, excessive fees, and self-dealing (the latter usually being linked to one or both of the former). The basis for most of this litigation and subsequent legal precedent is the Employee Retirement Income Security Act of 1974 (ERISA).

ERISA'S FOCUS

By nature, ERISA is not prescriptive about specific investment options or the reasonableness of fees. Rather, it articulates the standards and obligations of plan fiduciaries, who are trusted to implement their expertise and act in the best interest of plan participants. Specifically, ERISA requires that fiduciaries show the "care, skill, prudence, and diligence" of a prudent person to "minimize the risk of large losses." In other words, the matter of most importance under ERISA is the process, not necessarily the outcome.[16]

LITIGATION: PROCESS VS. OUTCOME

Despite this, much of the litigation around 401(k) plans has pertained to the alleged inappropriateness of investment options, often due to poor performance or a lack of performance history.

During and immediately following the Global Financial Crisis, there was a strong trend toward accusing employers of imprudently including their own stock in 401(k) plans, resulting in large losses for plan participants. This changed in 2014 following the Supreme Court decision in *Fifth Third Bancorp v. Dudenhoeffer*, which held that, barring certain special circumstances, plan fiduciaries would not be liable for failing to predict stock performance. The ruling was based on several prior decisions that collectively argued that public markets presumptively are efficient, and it would therefore be unreasonable to hold a fiduciary liable for failing to outsmart them, even in the presence of insider information.[17]

These rulings narrowed the scope of potential performance-related litigation around public markets and upheld the importance of prudent investment and due diligence processes. However, given that the rulings were predicated on the assumption of market efficiency, the potential implications for private market assets are uncertain. Private markets inherently are less efficient than public markets and, due to their opacity and relatively limited disclosures, are more challenging to assess from a performance standpoint. This presents complications for one of the key tenets of fiduciary duty under ERISA, articulated in *Tibble v. Edison Int'l* in 2015: Fiduciaries are required to monitor every investment option offered in a DC plan and eliminate those that are no longer prudent within a reasonable time period.

Considering this decision, how might plan participants view poor performance in the context of something like a traditional drawdown fund, which often has a negative internal rate of return during the early years of the fund due to its J-curve, and to what extent would fiduciaries be subject to increased scrutiny and litigation for the inclusion of such funds in DC plans?

A more recent decision in *Foreman v. TriHealth, Inc.* seems to err on the side of the fiduciary's discretion, stating:

> *Disappointing performance in the near term and higher costs do not by themselves show 'deficient decision-making, especially when we account for competing explanations and other common sense aspects of long-term investments.' … side-by-side comparisons "of how two funds performed in a narrow window of time, with no consideration of their distinct objectives, will not tell a fiduciary which is the more prudent long-term investment option.*

Although this argument is promising, the risk of litigation and its associated costs for plan fiduciaries remains.

LITIGATION AND FEES

Potential allegations of excessive fees are another area of continued concern. Although ERISA does not hold that higher fees necessarily are imprudent, there still has been extensive litigation on these grounds. The courts generally have held that fiduciaries need not offer the cheapest possible investment options, but rather that fees must be reasonable relative to similar offerings and must be regularly evaluated to determine whether they continue to be reasonable.[18]

In other words, an actively managed fund with higher fees is not necessarily an imprudent investment option simply because passively managed funds with lower fees exist.[19] As recently stated in *Smith v. CommonSpirit Health*:

© 2024 Investments & Wealth Institute. Reprinted with permission. All rights reserved.

> *It is possible indeed that denying employees the option of actively managed funds, especially for those eager to undertake more or less risk, would itself be imprudent … The actively managed funds need to charge higher fees, because they must hire management teams to actively select investments to buy and sell, whereas index funds require less management and less upkeep.*

At first glance, these arguments appear to set the stage for defending the higher fee structures often seen in private markets. After all, diversification and the potential for higher returns often are cited as benefits of investing in private markets, and navigating their increased complexity and inefficiency requires a high level of expertise and active management. One could argue that these factors are a sound justification for higher management and incentive fees. Simply alleging that fees are too high or that performance is too low on an absolute basis also has been considered insufficient in the eyes of *Meiners v. Wells Fargo & Co.*: "… a plaintiff must provide a sound basis for comparison—a meaningful benchmark."

But therein lies the rub. Given the opacity and lack of disclosures characteristic of private markets, establishing a meaningful benchmark is deceptively difficult. Although courts previously have dismissed complaints because plaintiffs failed to establish such a benchmark,[20] would the same standard apply if plaintiffs' ability to do so was inherently limited by the characteristics of the investments in question? Further, it's not sufficient for a fiduciary to simply offer a reasonable array of options and expect participants to find the best among them, i.e., fiduciaries cannot justify the continued inclusion of a fund with higher fees solely on the basis that they also are offering lower-cost alternatives.[21] As stated earlier, fiduciaries must take the additional step of removing the imprudent investment options from the plan, and failure to do so may open them to litigation.

Although Congress' motive of protecting plan participants via ERISA is evident, whether recent waves of class action litigation are of actual benefit to said participants is less clear. Given the sheer number of fee-related lawsuits we already see around 401(k) plans, it's likely that the higher fees and limited disclosures characteristic of private market assets would invite an even larger wave of litigation. Although fiduciaries ultimately may be able to justify the inclusion of these options by demonstrating a prudent investment process, whether it's worth the legal headache to push that frontier is another question entirely. One could argue that plan sponsors and fiduciaries are being consistently forced into a defensive position that will stifle innovation and dissuade them from including more diversified plan offerings. In the (understandable) effort to reduce liability and avoid arguably frivolous litigation, sponsors may opt to maintain the status quo and keep pace with their peers rather than pursue new strategies that may, in the long term, be more beneficial for plan participants.

In other words, sponsors have a strong case for not including higher-cost funds with a higher probability of disappointing returns given the immense legal pressure to prioritize lower-cost options.

THE PATHS FORWARD

As previously discussed, there are strong arguments for and against including private market funds into DC plans in the United States. Any inclusion should be thought through carefully, both at a broader regulatory level and the specific plan level. Alternative investments are not right for everyone, and any potential benefits they could provide should be weighed against the risks, costs, and mistakes that could be made.

THE PROBLEM WITH THE U.S. DC MODEL

The DC system in the United States is one that puts the investment risk on the participant rather than on a trained professional. It makes sense to approach inclusion with caution because, as discussed in prior sections, the average plan sponsor and/or participant does not have the expertise to select individual funds.

In many ways, we believe there should be a broader discussion around the structure of the DC system in the United States. Many other developed (and even developing) nations have sought balance by putting the savings risk on the individual and keeping the investment risk with a professional. One of the most popular examples of this model is the Australian Superannuation Fund, which allows for all the portability benefits of a DC plan with the benefits of professional management found in a DB plan. Similarly, the Chilean DC retirement system follows a DC model with a professionally managed fund lineup. Both models have variations found all across Latin America, Asia, and Europe. Under both models, contributions are either voluntary or fall under a Social Security tax-like mandate, creating an automatic savings rate for citizens. Further, variations of these models allow for participants to gain access to private markets without having to manage the portfolio themselves. Of course, whether private markets are in these plans depends on the system. For example, Australia's superannuation is a heavy allocator to private markets whereas the Chilean pension system is just getting started.

THE REALITY OF TODAY'S CAPITAL MARKETS

Assuming the likelihood that the United States cannot solve this structural dilemma in the short term, the conversation must then turn back to the investments. These are not markets that can be ignored anymore. Alternative investments represent $22 trillion in assets under management,[22] and they account for approximately 50 percent of total industry revenues.[23] It's incumbent on sponsors, regulators, and advisors alike to at least consider a path forward, and we should be finding

© 2024 Investments & Wealth Institute. Reprinted with permission. All rights reserved.

ways to give individuals better access to all parts of the economy.

Structurally, DC plans probably are one of the best mechanisms to utilize longer-dated, more illiquid investments for individual investors. Young participants have multiple decades before they'll ever touch their hard-earned savings, and participants across all ages typically are "set it and forget it" investors.

TARGET-DATE FUNDS: THE PATH OF BROADEST BENEFIT

Despite all of this, the bottom line is that non-investment professionals, and even smaller advisory firms, are at a disadvantage relative to the large pools of capital found in endowments, foundations, and pension funds. Until this disadvantage is mitigated, we believe the best path forward to helping individual investors gain access through their DC plans would be for the asset management community to begin integrating private markets into their multi-asset funds, most notably target-date funds.

Depending on the study, target-date funds are a large and/or increasing proportion of 401(k) assets. According to the Employee Benefit Research Institute and ICI, 68 percent of 401(k) participants hold target-date funds, which represents about 38 percent of assets.[24] Research also has found that target-date fund investors tend not to actively trade in their plans, benefit from dollar cost averaging, and often earn returns equal to or greater than the average fund's return.[25]

This approach would mitigate many of the arguments against inclusion—fees could remain lower on average, manager selection is left to professional money managers instead of the advisor or plan sponsor, and private markets would be part of a more broadly diversified portfolio. Of course, most target-date funds are offered as mutual funds, regulated by the Investment Company Act of 1940, which has restrictions on investing in limited partnerships and limits illiquid assets to 15 percent of overall assets. However, the growing popularity of collective investment trusts, typically found in larger plans, may be a way around these restrictions. Either way, target-date funds might be a good entry point to get sponsors, participants, and regulators more comfortable with private markets.

This move would leave out a large population of do-it-yourselfers who prefer to manage their own portfolios. Instead, the industry should build up its capabilities in the target-date fund space, which are managed by professionals, and start small. In a recent article, Cambridge Associates suggested starting with small allocations to private equity and private credit earlier in the glide path and utilizing secondaries to mitigate the J-curve and provide immediate and diversified exposure to private markets.[26]

SUPPORTING PARTICIPANTS IN THIS SCENARIO

Assuming all of this were to happen, important educational issues still would need to be addressed for plan participants. Two items to be addressed would be to reinforce the long-term nature of retirement savings vehicles and education around the investments owned in those vehicles. Regarding the former, there are an increasing number of mechanisms for participants to withdraw funds from their accounts, including hardship distributions and/or loans. Regardless of whether private markets are part of the fund lineup, sponsors should continue to discourage these practices, but it becomes even more important when the underlying assets are illiquid. The alignment of time horizons should not be interrupted. Regarding the latter, it's important for all parties of the relationship to be educated, from the advisor/consultant to the sponsor to the individual participant. As discussed above, financial literacy already is a challenge faced by most individual investors in the United States. Because these strategies are complex and illiquid, the need for foundational and continuous participant engagement is elevated even more.

CONCLUSION

Although private markets and other alternative investments can benefit an overall portfolio, they aren't without their risks. Particularly when it comes to members of society with more to lose than the average institution or ultra-high-net-worth individual, we should be cautious when it comes to introducing some of these risks. We believe there is still a lot of discussion to be had on this topic and, once again, it should be thought through carefully. Not every long-only public market mutual fund on a plan menu is appropriate for a participant, just as not all participants need or require alternative investments in their portfolios.

Aaron Filbeck, CAIA®, CFA®, CFP®, CIPM®, FDP®, is managing director of global content strategy at CAIA Association. He is a member of the Investments & Wealth Monitor *editorial advisory board. He earned a BS with distinction in finance and a master of finance from Pennsylvania State University. Contact him at afilbeck@caia.org.*

Claire Sawyer is associate director of content development at CAIA Association. She earned a BA in legal studies from University of California, Berkeley, has earned the sustainability and climate risk certificate (SCR), and is a Level II candidate in the CAIA Program. Contact her at csawyer@caia.org.

ENDNOTES

1. For this article, we will focus on state and local public plans, which we believe serves as a good proxy for the average participant around the country. Similarly, the label of "alternative investments" in this article will refer to any investment that is not public equities or fixed income. This will include investments such as private equity, private credit, real estate, commodities, and hedge funds.
2. Unlike public pension plans, DC plans are more difficult to aggregate to gain a holistic view of portfolio allocations across participants—both because they are private and because every plan has a slightly different lineup. However, we still can gain insight into trends and preferences.
3. World Bank. Data as of December 31, 2022.
4. As measured using the MSCI All Country World IMI Index.

© 2024 Investments & Wealth Institute. Reprinted with permission. All rights reserved.

5. "Private Market Investing: Staying Private Longer Leads to Opportunity," Hamilton Lane (April 14, 2022), https://www.hamiltonlane.com/en-us/insight/staying-private-longer.
6. D. Rasmussen, "Sizing Private Equity Allocations," Verdad Weekly Research (2024), https://mailchi.mp/verdadcap/sizing-pe-allocations?e=39e07564b4.
7. Jay Ritter IPO Data, https://site.warrington.ufl.edu/ritter/ipo-data/.
8. Ibid.
9. "Understanding Private Credit: Sponsored vs. Non-Sponsored Financing." Brookfield Oaktree (September 2023), https://www.brookfieldoaktree.com/sites/default/files/2023-05/Understanding-Private-Credit-Sponsored-Vs-Non-Sponsored-Financing.pdf.
10. "Costs Continue to Fall for 401(k) Investors," Investment Company Institute (July 31, 2020), https://www.ici.org/video/200731_fof_401kfees.
11. S&P Global SPIVA as of December 31, 2023. Also, note that many of these studies do not adjust performance for risk or measure alpha; these simply are excess return measures.
12. "Understanding Retirement Plan Fees and Expenses," Employee Benefits Security Administration (December 2011), https://www.dol.gov/sites/dolgov/files/legacy-files/ebsa/about-ebsa/our-activities/resource-center/publications/understanding-retirement-plan-fees-and-expenses.pdf.
13. M. Meineke, "Can You Answer These 3 Questions About Your Finances? The Majority of US Adults Cannot," World Economic Forum (April 24, 2024), https://www.weforum.org/agenda/2024/04/financial-literacy-money-education/.
14. Note that most return comparisons are made using internal rate of return, which is a highly flawed performance metric. However, the vast majority of proponents for private markets use this metric and therefore it is being used here for illustrative purposes.
15. D. Aronowitz, "Summary of 2023 Excess Fee and Performance Litigation," Encore Fiduciary (January 8, 2024), https://encorefiduciary.com/summary-of-2023-excess-fee-and-performance-litigation/.
16. See *Tussey v. Abb, Inc.* and *Braden v. Wal-Mart Stores, Inc*.
17. See *White v. Marshall & Ilsley Corp.*, *Summers v. State Street Bank Trust Co*., *Nelson v. Hodowal*, and *Basic Inc. v. Levinson*, among others.
18. See *Hecker v. Deere & Co*.
19. See *Braden v. Wal-Mart Stores, Inc., Davis v. Wash. Univ. in St. Louis,* and *Davis v. Salesforce.com, Inc.*
20. See *Matousek v. MidAmerican Energy Co*.
21. See *Hughes v. Northwestern University.*
22. "Innovation Unleashed: The Rise of the Total Portfolio Approach," CAIA Association (2024), https://caia.org/total-portfolio-approach-2024.
23. Boston Consulting Group. "The Tide Has Turned: Global Asset Management Report 2023," https://www.bcg.com/publications/2023/the-tide-has-changed-for-asset-managers.
24. S. Holden, S. Bass, and C. Copeland, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2022," *EBRI Issue Brief* (April 30, 2024), https://www.ebri.org/docs/default-source/pbriefs/ebri_ib_606_k-xsec-30apr24.pdf?sfvrsn=1f43072f_1#:~:text=year-%20end%202007.-,•,a%20small%20share%20take%20them.
25. "Mind the Gap: A Report on Investor Returns in the US," Morningstar, https://www.morningstar.com/lp/mind-the-gap.
26. H. Gallary, "Better Alternative(s): Private Investments May Improve Outcomes for Defined Contribution Participants," Cambridge Associates (March 2024), https://www.cambridgeassociates.com/insight/better-alternatives-private-investments-may-improve-outcomes-for-defined-contribution-plan-participants/.

REFERENCES

Brown, G., W. Hu, and B. Kuhn. 2019. Why Defined Contribution Plans Need Private Investments: The Benefits of Private Equity and Venture Capital in Diversified and Time-varying Portfolios. DCALTA/IPC Research Paper. https://docs.wixstatic.com/ugd/1bf9e3_fb7d9a710db9472a8e002b3c2fec2621.pdf.

Skinner, C. P. 2023. Private Equity for the People. *University of Pennsylvania Law Review*. Forthcoming. The Wharton School Research Paper. https://www.ssrn.com/abstract=4649735.

CONTINUING EDUCATION
To take the CE quiz online, go to www.investmentsandwealth.org/IWMquiz

© 2024 Investments & Wealth Institute. Reprinted with permission. All rights reserved.

5619 DTC Parkway, Suite 600
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org

© 2024 Investments & Wealth Institute®. Reprinted with permission. All rights reserved.

INVESTMENTS & WEALTH INSTITUTE® is a registered mark of Investment Management Consultants Association Inc. doing business as Investments & Wealth Institute. CIMA®, CERTIFIED INVESTMENT MANAGEMENT ANALYST®, CIMC®, CPWA®, CERTIFIED PRIVATE WEALTH ADVISOR®, RMA®, and RETIREMENT MANAGEMENT ADVISOR® are registered certification marks of Investment Management Consultants Association Inc. doing business as Investments & Wealth Institute.