INVESTMENTS & WEALTH
REVIEW
Elevating the Practice of the Advice Professional

A reprinted article from
MAY /JUNE 2025

A Safer Way: How Target-Date Funds May Solve for Diversification, Professional Manager Selection, and Holding Periods

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HOW TARGET-DATE FUNDS MAY SOLVE FOR DIVERSIFICATION, PROFESSIONAL MANAGER SELECTION, AND HOLDING PERIODS

BY STEVE NOVAKOVIC, CAIA®, CFA®

WHETHER ONE AGREES or not that it's a positive trend, retail investors are gaining increased access to private markets. As an example, the U.S. Securities and Exchange Commission just recently further lowered the "velvet rope," removing the accredited investor requirement for certain private market-oriented interval funds. Meanwhile, we have new funds (including exchange-traded funds) with blended allocations to liquid and illiquid assets that are launching regularly. This trend shows no signs of reversing, so it is critical to consider how to best educate and inform this evolving investor base.

But housing illiquid securities within vehicles that promise regular liquidity can be complicated. In our view, the mismatch in liquidity represents the most significant risk in this new world of retail alternatives. Indeed, it may not be a matter of if but rather when such a mismatch will lead to a meaningful market failure.

That said, we believe private market access can be beneficial to retail investors despite the risks. The key lies in setting realistic expectations, particularly around return expectations, diversified exposure, dispersion across managers, and individual holding periods.

Investors inspired by the strong returns reported by sophisticated institutions may mistakenly view an allocation to alternatives as a cure-all for portfolio underperformance (see table 1).

According to NACUBO, large endowments allocate more than 50 percent of their portfolios to alternative investments, thanks to a perpetual time horizon.[1] Retail investors would be ill-advised to assume similar levels of illiquidity risk or to attempt to replicate institutional portfolio allocations, or to expect similar returns.

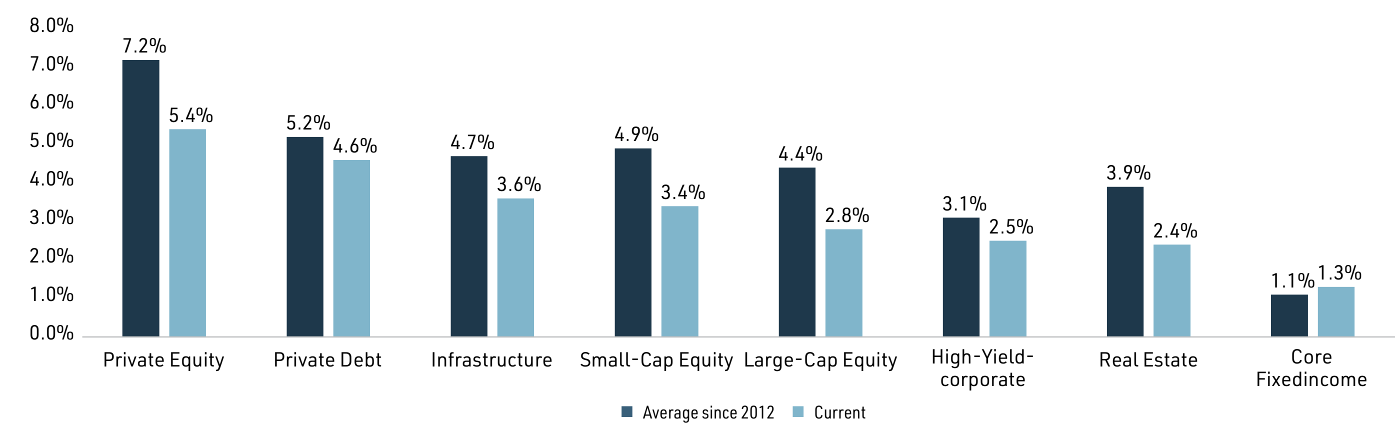
This does not mean that retail investors cannot benefit from private market exposure. Historical and projected long-term

TABLE 1 Annualized Returns as of June 30, 2024

	3-YEAR	5-YEAR	10-YEAR
NACUBO Endowments $5B+	12.2%	9.4%	9.1%
60%Russell 3000 / 40%Bloomberg Agg	3.7%	8.5%	8.0%

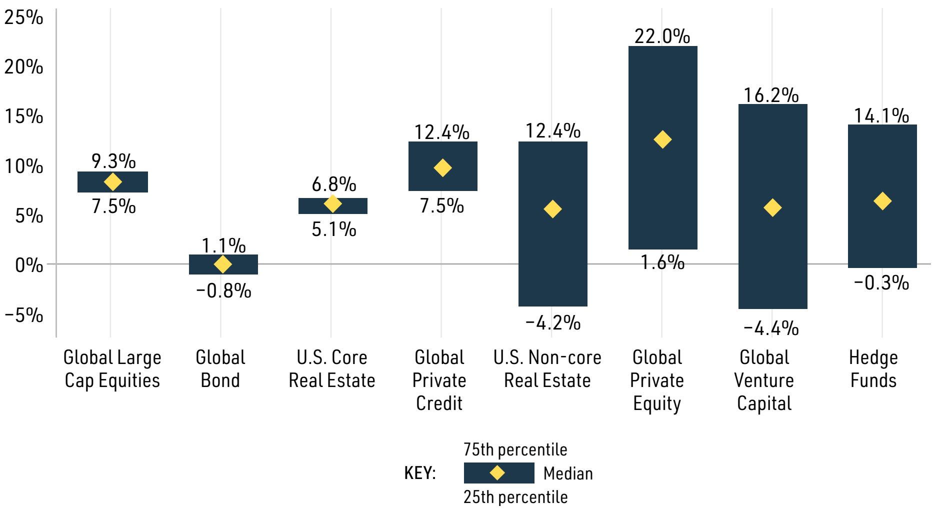
Source: Morningstar, NACUBO

FIGURE 1 10-Year Expected Risk Premiums



Note: Private debt average since 2019, due to data availability.
Sources: Pitchbook, Horizon Actuarial–Geography: US, as of August 2024.

FIGURE 2 **Manager Dispersion**
Based on returns from Q4 2014–Q4 2024



Source: Burgiss, NCREIF, Morningstar, Pitchbook PivotalPath, J.P. Morgan Asset Management

risk premia are highly favorable for private market investments (see figure 1). Hence, it would be understandable to expect even modest allocations, earning the median return, to be accretive.

However, capturing these median returns is far from straightforward. There are no passive index funds that offer broad-based exposure to private markets. Achieving proper diversification requires investors to diversify across managers and strategies as well as across vintages—a challenge that demands significant capital and resources. Institutional investors lacking resources or expertise solve this challenge through funds of funds. Unfortunately, these vehicles are largely inaccessible to retail investors and come with their own drawbacks, most notably a double layer of fees, placing a drag on returns and eroding alpha.

For retail investors, target-date funds may offer an analogous solution. Although they do not eliminate the fee concern,[2] they may solve the diversification challenge. If the allocations are managed such that investors are getting diversified exposure across holdings and time, this can be a good outcome for investors. Target-date funds are not illiquid vehicles, generally speaking, but investors tend to buy and hold these funds rather than trade in and out.[3] Further, the composition of the portfolio should have sufficient liquidity to manage any rebalancing or early withdrawals.

Long-term investment vehicles such as target-date funds, defined contribution plans, and other retirement accounts represent the most appropriate mechanisms for delivering private market exposure to retail investors. As noted, another challenge with these vehicles is whether they are able to deliver top-quartile alpha in addition to capturing the beta of the private markets. The impressive returns delivered by large endowments come from capturing private market risk premia and also from enhanced returns via superior fund selection.

Numerous other vehicles purport to offer retail access to private markets, and perhaps these vehicles are better suited to capture alpha. Again, it comes down to setting and managing clear expectations. We've established that any single fund investment will lack the appropriate diversification to reasonably provide an expectation of a median return or an index-like return. This would suggest that investors might reasonably expect enhanced returns, i.e., alpha, through focused security selection.

One means of measuring alpha is through evaluating dispersion of returns. Figure 2 highlights manager dispersion (as represented by the first and third quartiles) across public and private strategies over the past decade. In public markets, dispersion is relatively small, consistent with the understanding that alpha is difficult to come by in these markets. When investing in one or two public market funds, there is a reasonable chance the outcome will be within 1–2 percent of the median return (and similarly the passive index return). For private market investors, this is decidedly not the case. The difference between first and third quartiles can be as wide as 20 percentage points.

This level of dispersion makes it nearly impossible to set any reasonable expectation. Institutional investors may have greater confidence in expecting above average returns, due in large part to their distinct advantage in manager selection. In addition to having greater experience and resources for due diligence, they often enjoy access to top-tier managers. For example, many top-performing fund managers are either closed to new investors or do not have products available for retail investors. This does not mean that all retail-accessible funds are subpar, but it is reasonable to assume that the average quality available to retail investors is likely lower than that available to institutional investors.

Again, going back to endowment returns, if retail investors buy into a new fund offering exposure to private markets and are surprised when it underperforms the median drastically, shame on them. Similarly, expecting to generate first-quartile returns with any kind of consistency is a recipe for disappointment. In fact, I believe there is an even greater risk for retail investors to earn below-median performance, and therefore reduce or eliminate any benefit from capturing the enhanced risk premium, i.e., beta, of private market investments.

Where does this leave us? Focus on investing in funds that are designed for long-term holding periods, e.g., target-date funds, that provide diversified exposure to private markets. For the broader universe of offerings,

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I would urge caution. A fund advertising 30-percent exposure to private markets may sound appealing, but what is that allocation almost certain to provide? Higher fees and, potentially, more variability of performance.

What about illiquidity risk? Even if private holdings are capped at 30 percent of a liquid fund's assets, this does not eliminate the fundamental mismatch between asset and vehicle. Private assets are illiquid and infrequently marked to market. Consider this: In the first five months of 2025, 12 of the 102 trading days saw the S&P 500 move more than ±2percent. On one day the index dropped 6 percent and another day the index rose by 9.5 percent.

Now imagine a liquid fund offering daily liquidity with 30-percent exposure to private markets. If the market surges 9.5 percent in one day, and the private holdings are not immediately revalued, new investors could be purchasing units at an unfair discount—diluting existing shareholders. Conversely, if the market plunges 6 percent and private assets are not marked down immediately, investors may receive an inflated redemption value, again harming remaining shareholders.

Interval funds, tender-offer funds, and other semiliquid funds address some of these challenges by allowing only periodic liquidity windows and, ideally, aligning redemptions with updated valuations. Realistically, there may still be some issues with lagged prices and longer periods before new valuations are provided.[4]

We can remain supportive of thoughtful exposure to alternatives, but advisors should harbor serious reservations about the proliferation of retail access. For those intent on gaining exposure, the focus should be on long-term, diversified fund offerings. Avoid assuming that liquid structures with alternative allocations will deliver the same benefits that are earned by endowment portfolios. And importantly, temper return expectations. Don't assume the interval fund you've been eyeing is likely to produce first-quartile returns. Clear, realistic communication up front is the best way to avoid the inevitable disappointment of those who mistakenly believe they can replicate the experience of large, well-resourced institutions.

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ENDNOTES

1. "2024 NACUBO-Commonfund Study of Endowments" (February 12, 2025), https://www.nacubo.org/Research/2024/NACUBO-Commonfund-Study-of-Endowments.
2. "Should Ordinary US Retirement Accounts Be Investing in Private Assets?" *Financial Times* (May 28, 2025), https://www.ft.com/content/d1358846-70c8-4249-b32d-8de4e2452bf7.
3. J. Ptak, "Vanguard Target-Date Fund Investors Bought (and Sold) Themselves an Extra $23 Billion," Morningstar (June 3, 2025), https://www.morningstar.com/funds/vanguard-target-date-fund-investors-bought-sold-themselves-an-extra-23-billion.
4. For example, real estate holdings are typically only appraised on an annual basis.

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