DCALTA
Defined Contribution
Alternatives Association

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Daily Valuation of Alternative Assets in DC Plans

A Framework for Plan Sponsors and Industry Stakeholders

Executive Summary

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Letter from DCALTA

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At the end of the first quarter 2023, employer-sponsored U.S. defined contribution (DC) plans contained $9.8T in assets.[1] In contrast to the rapid growth of alternative investments by institutional investors and broad adoption by defined benefit plans and endowments, DC plans have largely foregone the diversification and return potential of alternatives because of technical and legal uncertainties, arising in part from ERISA[2] conditions. On June 3, 2020 and December 21, 2021, the Department of Labor published statements that provide clarity on important ERISA issues for DC plans seeking to offer the benefits of alternative assets to their participants.

With this legal foundation now established, DCALTA has focused on the critical operational topics to be addressed by DC plans seeking to incorporate alternative assets. To assist plan fiduciaries and practitioners, we are releasing a series of whitepapers exploring these issues. Our first whitepaper set out a consensus framework for daily valuation of private assets in DC plans. In this second whitepaper, we put forward a liquidity framework that draws from the deep experience of the DCALTA membership to address real-world considerations of plan sponsors and fiduciaries. As before, we use position statements throughout the paper to create a practical roadmap for sponsors and their consultants.

DCALTA's mission is to enhance and secure participant outcomes through education, research, and advocacy on the benefits of including private equity and other alternative investments within a defined contribution framework. Our members represent every aspect of the U.S. retirement investment ecosystem, and we seek to be the industry's collective voice on both policy and operational topics. These whitepapers are designed to facilitate plan sponsors and other constituents move toward inclusion of alternatives in DC plans with greater technical certainty.

Jonathan Epstein

Executive Summary

For the full whitepaper, please visit our website www.dcalta.org

American DC plans have evolved to offer 'daily trading' and 'next day withdrawals' as standard plan facilities in a competitive market. On the one hand, inclusion of alts can allow DC plans to keep investment performance on par with institutional grade investment portfolios, such as endowments and sovereign wealth funds. But on the other hand, maintaining a participant-facing 'daily' liquid experience when a portion of the underlying assets are illiquid presents an operational challenge.

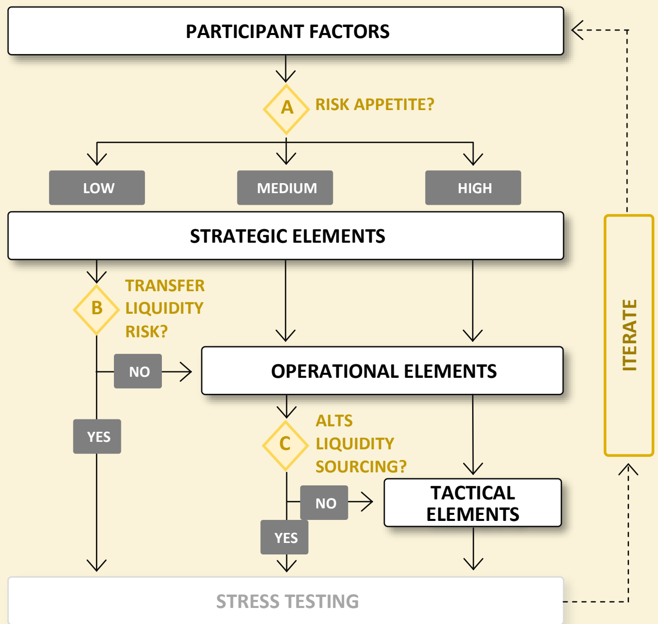
Liquidity management is at the center of this challenge. In recognition of this, DCALTA has called on its members – which include plan sponsors, asset managers, professional service providers, and valuation technology specialists – to contribute to a unique, industry-inclusive discussion on liquidity considerations. The DCALTA Liquidity Framework is the product of those discussions.

The Framework identifies a range of variables that give shape to DC plan liquidity, and steps through them in a logical, telescoping sequence. Participant demographics and the sponsor's characterization of their own risk appetite are positioned appropriately at the forefront of the Framework to inform subsequent decision-points. These decisions – spanning strategic, operational and tactical elements – define how a plan implements alts. Throughout the paper we discuss options and trade-offs through a liquidity management lens, taking positions where necessary, to explain that:

- Liquidity risk is configurable to align with the risk appetite of plan sponsors.
- Value is still achievable from investment products designed to absorb a portion of liquidity risk.
- The DCALTA Liquidity Framework may be used to review risk appetite periodically.

Importantly, the Framework is not prescriptive. With its unique sponsor-defined risk appetite 'factor', the Framework allows sponsors and consultants to design a custom solution through an iterative 'design, stress-test, tweak' process. In this way the Framework serves to enhance the specificity of stress testing rather than replace it.

1. Investment Company Institute, www.ici.org/statistical-report/ret_23_q1
2. Employee Retirement Income Security Act of 1974, as amended.
3. See, for example: Brown, G., Kuhn, B., and Hu, W. (2019). "Why Defined Contribution Plans Need Private Investments."; Antonelli, A. (2018). "The Evolution of Target Date Funds: Using Alternatives to Improve Retirement Plan Outcomes."



DCALTA Liquidity Framework

The framework is presented as factors that affect liquidity, to be considered in sequence, then stress tested and tweaked iteratively to maximize the opportunity for return given the risk appetite of the plan. Participant factors are both the logical starting point and overarching consideration of the framework because they inform all elements of the process. Within the sequence are three key decision points:

[A] Considers four plan conditions to establish a baseline qualitative understanding of its risk appetite (related to alts liquidity management).

[B] Considers how liquidity risk of the alts component is delegated. A fully outsourced solution would remove consideration of operational and tactical elements (as identified herein) for the plan fiduciaries.

[C] Considers the fiduciary framework – whether responsibility is distributed to external managers or fully in-house.

NOTE:
Stress testing examines the effect of market, corporate, and product lifecycle events on PIO liquidity. It is a well-researched quantitative component of risk management and is outside the scope of this framework. The framework is *not* intended to replace or limit quantitative testing in any form.

DCALTA Positions

1. Default pathway products may help cultivate conditions favorable to the liquidity of participant investment options that include alts.
2. A maintained data set descriptive of the participant population and their asset transfer and withdrawal activity over time is helpful to determining sponsor risk appetite and optimizing liquidity related decisions.
3. Targeted participant education and ongoing communication is helpful to align participant behavior with plan liquidity management.
4. Alts products may transfer sources of risk – including liquidity risk – from participant investment options to compensated third parties and still provide net value to participants.
5. The alts component is of modest size as defined by the sponsor, consistent with the guidance of the U.S. Dept. of Labor, that optimizes the expected net value added of the alts component against the sponsor's risk appetite.
6. A mix of products along the liquidity spectrum can exert a stabilizing effect on liquidity dynamics of the alts component in alignment with a sponsor's risk appetite.
7. Moderately liquid asset allocations within a professionally managed multi-asset class portfolio may be used to efficiently source and store alts-related liquidity.
8. The fiduciary framework sets the scope (and efficiency) of liquidity pathways, which can be adjusted by the plan as risk appetite evolves.
9. Similar to stable value funds, plan driven redemptions from commingled, multi-asset funds with alts (like TDFs) can be carefully managed to minimize any potential liquidation impact on the TDF's continuing investors and the redeeming plan's participants.
10. A thoughtful rebalancing strategy that acknowledges the long-term and illiquid nature of alts may further enhance participant outcomes.
11. Unitized products (found to the left of the liquidity spectrum) can provide a ramping alts component exposure to alts within defined timeframes that plans can use to mitigate cash drag.
12. The secondaries market is an unsuitable source of liquidity for the day-to-day operational purposes of most plans.
13. Tactical responses to liquidity events should involve an alts valuation procedure that is tested and reliable under market volatility.

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The positions stated in this document are those of DCALTA and may not be the positions of the individuals or organizations listed above.

DCALTA welcomes new members.

Founded in 2015, DCALTA is a 501(c) non-profit organization representing the collective voice of the defined contribution retirement savings plan ecosystem. Our 40-plus members include plan sponsors, alternative investment firms, consultants, asset servicers, recordkeepers, technology providers and other stakeholders.

In addition to regular member events, we engage in education, research, and advocacy to:

- Address operational, educational and regulatory matters related to the uptake of alternatives investments in DC plans.
- Provide information to the DC plan and Alts communities, including regulators and legislators, without bias.
- Better define how the inclusion of alternatives investments in DC plans may contribute to enhanced participant outcomes.
- Advocate for prudent modernization of the relevant laws and regulations through a collective industry voice.

Please visit our website, www.DCALTA.org to learn more about member benefits.