IPA

Institute for Portfolio Alternatives

May 21, 2020

Preston Rutledge
Assistant Secretary
Employee Benefits Security Administration
200 Constitution Avenue, NW
Suite S-2524
Washington, DC 20210

Dear Mr. Rutledge:

The Institute for Portfolio Alternatives ("IPA") writes to encourage the Department of Labor (the "Department") to issue guidance to help defined contribution plan fiduciaries as they consider adding portfolio diversifying investments to their defined contribution plans. While defined benefit plans have long used diversifying investments like real estate or private equity, litigation risk has chilled the adoption of such asset classes that could help generate better retirement outcomes for defined contribution plans. We understand that the Department has a pending request related to the inclusion of a professionally managed and diversified portfolio of alternative assets as a modest component of a multi-asset class fund, such as a target date fund, within a defined contribution plan's investment options. We encourage the Department to quickly issue guidance as greater diversification helps investors most during periods of extreme volatility, and the COVID-19 crisis has caused unprecedented volatility.

The IPA represents predominantly SEC-registered non-listed[1] investment vehicles that provide alternative portfolio diversifying investment ("PDI") products for main street investors that have low correlation to the equity markets and were historically available only to institutional investors. Over the last 20 years, private real estate as measured by the NCREIF Fund Index – Open-end Diversified Core Equity[2] (NFI-ODCE) has had a low correlation of .20 to the S&P 500 according to Morningstar, Inc. For over 30 years, the IPA has raised awareness of PDI products among stakeholders and market participants, including investment professionals, policymakers and the investing public. We support increased access to alternative investment strategies through public, non-listed real estate investment trusts, business development companies, and interval funds.

The Department should encourage defined contribution fiduciaries to expand investment choices beyond mutual funds and to consider asset classes like private equity and real estate. Defined contribution plan participants should have the benefit of investment strategies that have been successfully used by defined benefit plan fiduciaries for the past 45 years. We have already seen products like publicly-listed REITs gain acceptance among defined contribution plan fiduciaries. However, these

[1] The shares are not listed on a national securities exchange; however, because the shares are registered with the SEC, they are freely tradable.

[2] The NFI-ODCE typically reflects lower risk investment strategies utilizing low leverage and is generally represented by equity ownership positions in stable U.S. operating properties diversified across regions and property types.

publicly-listed REITs are subject to market volatility akin to the broader equity markets and may not, especially during periods of crisis, reflect the underlying value fundamentals of direct property ownership. Litigation risk has slowed the adoption of other asset classes that could provide participants with enhanced diversification. If the Department provides a framework that fiduciaries can follow and document when evaluating, selecting, and monitoring asset classes like private equity, public non-listed REITs, and interval funds, plans would likely provide participants with better tools to navigate economic downturns.

After the enactment of ERISA, real estate was one of the first asset classes that plan fiduciaries used for diversification.[3] As early as 1980, 22% of defined benefit plans invested in real estate.[4] Since then, defined benefit plans have increased their allocation to real estate and have nearly $800 billion invested today. Defined benefit plans have used real estate as a way to diversify their portfolios and to inoculate plans from some of the volatility seen in daily-traded stocks and bonds, particularly with the long investment horizons that are characteristic of many retirement investors. Further, today defined benefit plans have access to the U.S.'s $17 trillion commercial real estate market, but defined contribution plans, if they have access at all, are only able to diversify using the $1 trillion that is traded in the public equity market. Morningstar has reported that stocks, as indicated by the S&P 500, have experienced volatility (standard deviation) of 15.9% over the last 20 years while private real estate as measured by NCREIF NPI (standard deviation) has been 8.55%.

The Department should be concerned that fiduciaries use one set of products in defined benefit plans and an entirely different suite for their defined contribution plans. The Department should encourage plan fiduciaries to give defined contribution plan participants access to the same set of tools that the fiduciaries use to manage defined contribution plans. In particular, we hope that the Department will describe a safe harbor process that could help plan fiduciaries demonstrate that they have followed a prudent process when evaluating investment products that may seem more complex than traditional mutual funds.[5]

In its current guidance project, the Department has asked, “What factors would a prudent plan fiduciary focus on when evaluating a complex product like a private equity fund?” Based on our experience with defined benefit plan fiduciaries who use real estate (a similar asset class), we agree with other commenters that understanding and documenting the following six factors would ensure a prudent process.

[3] Ellen Beckett Brown, The Evolution of Pension Fund Investment in Real Estate, 1991.

[4] Id. at 19.

[5] In many ways, REITs are simpler and easier to understand than mutual funds as more individuals are familiar with the concept of real estate appreciation (through home ownership or rent) than they are with the movement of equity securities on an exchange.

- Liquidity
  - Plan fiduciaries should consider the impact of potential illiquidity and the advantages and disadvantages of liquidity.
  - Greater liquidity provides participants with more frequent opportunities to reallocate, redeem investments, and roll assets out of plans. However, greater liquidity also limits the ability of defined contribution plan participants to achieve greater returns through the "illiquidity premium" or mitigate risk through non-correlated assets, and it also leaves participants vulnerable to the human instinct to sell when markets go down. Full liquidity may be unnecessary as most participants rebalance infrequently. The current extreme volatility caused by the ongoing pandemic highlights how participants can instinctively lock in losses as they seek to take advantage of immediate liquidity, but they act only after markets have already sunk.
  - Plan fiduciaries should consider moving further down the liquidity spectrum to a point where the tradeoffs better match the investment horizon of most defined contribution plan participants. The products IPA members offer can meet a broad range of liquidity needs.
  - We encourage the Department to provide a statement or other guidance signaling that limited liquidity may be in a participant's best interest. Retirement plans are designed for long-term investing. To the extent a participant has a long investment horizon, we hope that the Department could acknowledge that a participant may benefit from an illiquidity premium and that less tradeable investments may reduce the risk of churning.
  - In the real estate space, plan fiduciaries should be encouraged to consider whether more real estate related products with structures that allow for direct access to real estate should be included to provide greater diversification even if such options only have limited monthly or quarterly liquidity.
- Time Horizon
  - Plan fiduciaries should consider the long investment horizon of retirement savers and consider whether participant investment needs could be better served by offering investments that are designed to be held for various periods. When including these products, a plan fiduciary should understand how participant gains/losses can be affected if participants are provided liquidity in a secondary market.
  - For example, exchange-listed REITs may provide real-time liquidity, but they do this by trading at the price that an individual is willing to buy or

sell REIT shares for which can be different from the value of the underlying real estate holdings. NAV REITs provide liquidity by buying back shares at a price based on the underlying asset values. Public non-listed REITs and interval funds may offer less liquidity, but they periodically offer to buy back a percentage of the outstanding shares at the fund's objectively determined value, and most NAV REITs offer a percentage of the fund's NAV as liquidity either daily or monthly.

  - While real estate product time horizons may look different from private equity time horizons, a prudent fiduciary should be encouraged to consider a broad range of diversifying asset classes with different time horizons.

- Valuation
  - We hope that the Department could provide guidance encouraging plan fiduciaries to understand valuation. For different asset classes or strategies, fiduciaries should expect to see different models, standards, and methodologies.
  - For example, in the real estate space, defined benefit plans have developed an array of prudent valuation standards that have been utilized for long periods of time. Most standards that have developed generally encourage:
    - Third-party appraisal of each asset, at least annually
    - Objectivity in valuation; many real estate products utilize independent third-party valuation firms
    - Timely recognition of material events
    - If there is daily valuation, either:
      - Capture the daily accrual of net income, or
      - Intra-quarter value adjustments to appraised property values
    - Verifiable and consistent transparent processes
    - Property level debt valuation
    - Valuation of partnership interests and other assets and liabilities
    - Clear roles for parties involved in valuation (e.g., independent director oversight and independent valuation advisor involvement)
- Fees
  - Plan fiduciaries should understand the entire fee structure to assess the potential impact of fees on the returns on alternative investments. We note that private equity, real estate funds, or any other actively managed portfolio diversifying investment may bear higher fees than passive

solutions or traditional mutual funds. However, prudence should require consideration of the potential for risk-adjusted returns net of fees when compared to other similarly diversifying investments. While some funds may have incentive allocations, carried interest, or other performance-based compensation, others do not. And incentive fees may align shareholder interests more effectively with fund sponsors as both benefit or suffer together.

  - Offering documents for publicly registered real estate funds, such as public non-listed REITs and interval funds clearly disclose annual asset manager fees, performance fees, and up-front sales charges.
  - Many publicly registered real estate funds have multiple share classes, including share classes for institutional investors, that could be appropriate for defined contribution plans.
  - Real estate investments are able to provide greater transparency than many other illiquid asset classes. Understanding real estate fee structures may be as simple to understand as the fees of a mutual fund as all such fees impact the net asset value and returns in a similar manner.

- Management
  - As with any other asset class, plan fiduciaries should assess the capabilities of the party or parties that will be responsible for asset management. Factors to consider include (i) track record, including historical investment returns, (ii) staffing and resources, and (iii) investment philosophy and strategy.
- Legal Structure
  - Plan fiduciaries should understand the implications of the vehicle being used. Different structures trigger different regulatory schemes. For example, mutual funds are regulated differently than collective investment funds, and business development companies are subject to different rules to private funds. And public non-listed REITs are regulated differently than exchange-listed REITs.
  - The Department should remind plan fiduciaries that there is not one “right” legal structure, and that it is important to understand the tradeoffs.

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We respectfully urge the Department to issue guidance on this important issue. We appreciate your consideration of this request during this challenging time. If it would be helpful, we would be happy to meet with you and answer any questions you or your team may have.

If the IPA may be of any assistance, please do not hesitate to contact me or Anya Coverman, IPA's Senior Vice President, Government Affairs and General Counsel, at (202) 548-7190.

Sincerely,

Anthony Chereso
President & CEO, Institute for Portfolio Alternatives