SPEAKING OF ALTERNATIVES

S1 EP16: Let’s Talk Defined Contribution

>> Speaking of Alternatives with Keshav Rajagopalan, Managing Director, Head of Product and Strategy at PGIM.

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Defined contribution plans play an important role in today's investment world, opening up opportunities for alternative assets. They also come with their own set of practical considerations. Keshav delves into the world of defined contribution strategies and investing with Josh Cohen, Managing Director of PGIM's DC Solutions business.

>> Welcome to Speaking of Alternatives, the podcast where we dig into the many layers of the alternatives landscape. Today, very excited to be joined by my friend and colleague, Josh Cohen, who's a Managing Director in our DC Solutions business. We're going to dive into everything that's evolving so quickly in the defined contribution landscape and how alternatives may play an increasingly important role in that space. I'm really pleased to also be joined by Josh because he's actually a podcast expert in and of himself. Josh was the mastermind behind PGIM's first podcast series, The Accidental Plan Sponsor. Josh, maybe to start off as we start all of these discussions, tell us a little bit about yourself and how you got into asset management, but more specifically, the DC space, where obviously you have a tremendous amount of expertise.

>> Well, thanks, Keshav. It's so great to talk to you and be on this podcast. And it's funny, harking back to the podcast that I started, Accidental Plan Sponsor, I use that title because the podcast is really an exploration of the evolution and history of retirement plans, primarily in the US, but I also look globally. And I was asking: How did employers in the US, at least, accidentally become this role of a plan sponsor? But what I also found when I was doing the podcast and interviewing guests is many people accidentally found themselves working in retirement plans. It wasn't the plan for many people, and myself included in that. Frankly, how did I get into it in the first place? Well, the only company that offered me a job out of college was a large company called Hewitt Associates out of Chicago that administered retirement plans for large employers, mostly corporate employers. So I got this job. I learned about retirement plans, how they work, how they operate, invaluable experience. But then, after a couple years, I realized I wanted to get back on the investment side. I was an economics major, and

I wanted to get more to that side. So I moved over to investment consulting roles at that firm and subsequent firm. And I would spend my time advising large plan sponsors one of their DC lineups and their plan design. And then eight years ago, I was fortunate to join PGIM. So I'd move to the asset management business. But I continue to work with large plan sponsors and the marketplace on best practices and solutions and capabilities for their DC plans.

>> So, Josh, you've been around this retirement space now for quite some time in many seats, which lends to the many different perspectives you have. What keeps you in it today? Why are you engaged? Why are you interested? And what really drives your passion about the DC space?

>> I think a lot of us who are in the DC space, certainly, we're interested in our roles, our careers, and such. But we also know at the end of the day, we're doing a lot of this for the end worker and saver and retirees. And we know the types of solutions and capabilities and design features that we're working towards for defined contribution plans really has a meaningful impact on their retirement readiness. And so these are our family members, our friends, our fellow citizens. And so I think that really drives me as well as the intellectual interest. I think also when it comes to defined contribution plans specifically, there's a math. What's the right asset allocation? What are the right investments to help people build good portfolios? And some of that we're going to talk about today. But there's also such a human element to it, too, because we have participants in these plans and all their behavioral quirks and such that become more important when it's not a defined benefit plan, when it's all done for them. But it's a savings plan where they have a lot more say on how the investments are allocated, how much they save, etc. And finally, one more thing, Keshav, is the policy element to it. Every country has this need to make sure their population has a secure retirement. That's a very tricky thing. It's such a long-term challenge. It's very expensive when a lot of countries and individuals have more short-term needs financially and otherwise. So how do you build a system that includes Social Security systems and workplace savings systems and personal savings to make sure your population does have a secure retirement? And I find that very interesting as well.

>> The need for individuals to be financially prepared for their retirement is a universal concern. However, each country has its own history and culture, which play a fundamental role in defining how employers and the respective governments approach this challenge.

>> It's interesting. It's someone's needs, wants, their behaviors that drive what they'll eventually need. But then

there is the policy element and also the cultural elements. Each country thinks about this differently based on maybe certain paternalistic features. You and I were recently working on something even in the Middle East, where they're thinking about how to approach retirement. And that is very different than how we may think about it here in the US or in Australia and other parts of the world. So it is fascinating, country to country, how different it can be, but still how important it is at the end of the day.

>> The global perspective is super interesting. I have a whole season of my podcast where I look at other countries beyond the US. And again, a lot of the issues rhyme. The math is actually somewhat similar, but the context, the cultural topics and issues, the providers, the history, the legacy can be very different. The population's needs, etc. So it really is fascinating to look globally at these topics. And again, it's something every country in the world is wrestling with, maybe taking it from different angles, but still, it's a global need.

>> The topic of this podcast is alternatives. So let's create the intersection of DC and alternatives. So if you had a minute to kind of frame this for our audience, what is the case for alternatives in DC plans?

>> Well, Keshav, we know most defined benefit plans, for example, that are trying to meet a liability to meet the retirement needs of their members use all sorts of asset classes to meet those needs. We know defined benefit plans are going away, and this is a global phenomenon in favor of a more defined contribution approach. Yet, this need to have robust portfolios to meet retirement needs doesn't change. Yet, as we look globally, most DC plans haven't kept up. Most of their investments are more simple. Probably one of the big exceptions is Australia with the super funds. But in the US, we recently did a survey of plan sponsors. Seventy-three percent agreed that plans should have within their target date funds, for example, more asset classes to provide diversification. But that's not really happening. Why is a DC plan a great place for this? Because you have professionals looking over these plans. You have professionally managed solutions like target date funds and other multi-asset solutions. You have institutional buying power by the plan sponsors. And these are asset classes that really are well-suited for a retiree's portfolio. They're long-term in nature. These tend to provide inflation protection, which is really important for retirees. So we think DC plans are a great way to provide access to individual participants. These same asset classes that are available to institutional investors, not just DB plans, endowments and foundations, sovereign wealth funds, and high net worth investors.

>> That point now is really timely. We like to unpack a headline in each of these episodes. And this one's about a potential future headline. But there's a lot of buzz right now that the Trump administration is going to issue some

new directives that will actually open up DC plans to alternatives, specifically things like private equity, crypto, gold. What are you hearing, especially in policy circles? What are you hearing about this and how should we begin to think about this?

>> Well, a lot of buzz and interest and activity in the policy circles. And who knows by the time this is released if there will be an executive order or other policy initiatives. Many governments around the world are interested in this topic for various reasons. Sometimes it's to make sure there's enough capital for the local economy and things like infrastructure and other types of investments, but also aligned with what members and participants need to grow their accounts. This current administration is very interested in this topic for various reasons as well. Whether it's an executive order or whatnot, more policy support for fiduciaries, plan sponsors who are interested in adding these types of investments to a plan based on their own research, based on their work with their consultants and advisors, or they think these have efficacy, but many don't tend to do it. And a lot of it's because they are concerned. Particularly here in the US, they recall fiduciary concern, but really, they're worried about getting sued. We have a lot of lawsuits in the US in the ERISA 401(k) space and otherwise. But even globally, there are a lot of plan sponsors who have nervousness about doing something that's innovative. Policies that help ease those concerns, I think, would be most welcome. And we'll see what kind of format that comes in, how helpful that actually is. But we also have to remember, plans can do this today. Many do. Actually, PGIM has for almost 20 years offered private investments in defined contribution plans, primarily through private real estate equity. We've included it in our target date funds for nearly 15 years now. So this isn't new. There are other plan sponsors who have done this. Other plan sponsors have gotten sued for doing this and have actually won in court. Probably, the most recent was Intel, who famously had a lot of private investments in their DC plan.

>> Fiduciary duty, right? The plan sponsor has a fiduciary duty to the plan and, therefore, the participants. So as you think about alternatives and the use case here, what is that next layer if you think about how alternatives could be a building block? What is the intersection of the fiduciary duty there but with the actual bill that needs to happen? So how do you think about it?

>> We can think about what asset classes are. We think about alternatives span a lot of different asset classes, of course. So if we click through a few of the asset classes, again, I mentioned real estate equity. This tends to be core real estate. Very well established. They have really good characteristics in terms of the ability to be in a defined-contribution-friendly format. It provides good risk-adjusted diversification. It provides good inflation

sensitivity. I think private debt is going to be the next area. Again, we actually have clients who have used private debt capabilities, mostly in their stable value capital preservation funds, for a long time. But bringing more and different types of private debt, we're thinking about investment grade, private credit, and real estate debt. ABF is another emerging area. I think the things that will come a little bit later, infrastructure equity, there's a lot of interest there. Certainly in Australia and Canada, and increasingly in the UK, we're seeing more interest there. It hasn't quite come to the US in a big way yet, but that's probably happening. Private equity is actually probably going to take longer. I think given some of the fees, including performance fees, liquidity, J curves, it's going to take probably a little bit more work for plan sponsors to be comfortable with that one. But eventually, it may be coming.

>> While a strong case can be made for the use of alternative assets within employer-sponsored retirement plans, an ongoing obstacle that must be overcome is the fear of litigation if a plan sponsor is seen as breaching its fiduciary obligations.

>> What are some other headwinds, then maybe? If you think about all, it's just the adoption here. You've shared different asset classes. Plan sponsors and executive order could help accelerate some of this. But what are some of the headwinds that we'll just have to overcome?

>> Again, it's not a question of the investment efficacy of these asset classes. It's more some of the other stuff. First and foremost, it's operational complexity. These don't act exactly like a mutual fund or ETF, right?

>> You don't have a daily price. There's not a nav strike that you can quickly see transparency around.

>> Right. Typically, private investments don't have this. Now, again, the real estate industry has figured that out and has vehicles now that do provide estimated daily price. That works very well. And these products can be included in defined contribution plans. Mostly, they're included in things like target date funds. So you need that daily valuation. That's just the way DC plans work, particularly here in the US. And you need daily liquidity often from some of these options. So oftentimes these vehicles will have a liquidity sleeve, something that is more daily value to be able to handle some of the cash flows and trading that are needed for these portfolios. So, again, certain asset classes like real estate have already figured this out. Other asset classes are working towards that. But I would say the biggest headwind is what we talked about before. It's fees, fee sensitivity. Even though many plan sponsors recognize the net fee benefit of a lot of these asset classes, if they didn't, they wouldn't be including them in their defined benefit plans or other strategies. But the headline expense ratio

number tends to be something that defined contribution plan sponsors do focus on, rightly or not. And again, it's because of this fear of litigation, a fear of sticking out, the fear of being a little bit more innovative. Plus, if you start adding asset classes that make you look different than the herd, make you look different than standard target date funds, and you have the Magnificent 7 and an S&P 500 fund driving most of the returns for a short period of time, then you're going to look like an outlier, even if you know these are good investments for the long term. So being an outlier, sticking out is something that, in our environment, rightly or not, plan sponsors worry about, and it has crimped innovation. But, again, this is where hopefully policy initiatives will help address some of those topics as well.

>> Yes, it sounds like in many ways, the issues and some of those headwinds aren't new, and they're probably going to still be there. And as you've pointed out, alts in DC plans isn't new either. But now are we at a new moment where, with some of the policy support and just thinking about it a little differently, will you see an evolution here?

>> Sure. And look, there's just a lot of interest on the supply side. There's a lot of alternative managers who are seeing this $13 trillion pull of assets in the US, and then let alone the trillions of dollars globally that's moving to defined contribution. A lot of these managers are looking at the retail space and the wealth space. And so defined contribution is interesting because it's kind of a mix of institutional and retail and wealth because you have the end participant. So there's a lot of innovation, product innovation or otherwise, to bring some of these private assets to the individual investor. So that work's being done. And then thinking about, well, how can we apply that potentially to the defined contribution space? Now, again, will the supply and the interest from those who provide these products match up with the demand? I think overall, ultimately, it will. It still may take a while because even if we get some regulatory support, I think things tend to move slowly in the DC space. They take time. But I think the direction of travel is definitely to try to incorporate more of these beneficial asset classes to defined contribution portfolios.

>> Alternative assets have a lot of potential to enhance and more broadly diversify portfolios within the defined contribution world. A major consideration is in how to incorporate them optimally.

>> So we like to get questions from our clients. Our PGIM distribution teams are out there listening with their ears to the ground on what our clients are asking about. So a couple of questions, maybe. You've mentioned target date funds. Obviously, target date funds bring that institutionalization to the multi-asset approach. And it's been a

huge beneficiary of flows just because of the ability to have that be a package solution. Could you see alts outside of a target date fund, or is that really going to be how they're incorporated?

>> We think the best application is within some professionally managed multi-asset type of solution. There are examples where alternative investments, maybe as a single asset class or as a portfolio, is available to a member or participant to choose on their own. But that comes with additional complexities around both liquidity and participant education. And do you want to have participants put all of their assets, for example, in one of these alternative asset classes? So we think the best application, in general, for investments across defined contribution plans, but specifically for alternatives, is in multi-asset. And target dates are currently the most dominant multi-asset type of option in DC plans, particularly in the US, but we're seeing that globally as well. Now, that's evolving, too, for other reasons. We're seeing more proliferation and interest in things called managed accounts here in the US. So these -- you can think of more personalized allocations, like a personalized target date fund that looks at more than an individual's age to more craft the portfolio that's right for that individual, based on their specific retirement needs and wants and objectives. There's a great application to include these alternatives in this context as well because it's still professionally managed. It's still overseen by a manager who's determining the asset allocation. It's just being personalized more to the individual. And then increasingly, we're seeing interest in, how do you help individuals decumulate? So there's different types of solutions.

>> Decumulation, or the gradual drawing down of assets to form a reliable income stream from DC retirement plan accounts, presents challenges to plan participants who are not trained professionals.

>> You know, we've figured out pretty well how to help individuals accumulate assets, how to save, how to use automatic features and behavioral finance and inertia to help individuals get into plans, invest in something like a target date fund that works really well for the default investor. But we still need a lot of work. And this is not just a US problem. This is a global challenge. How do you help individuals decumulate? How do they know how to invest? Should they have an annuity or not, and protect some of that income? How much do they need to withdraw every year? And again, many of these asset classes work really well for retirees because they tend to provide more downside protection, more inflation sensitivity, particularly things like real estate and infrastructure. So these are really well designed. So how do you package retirement income solutions, both ones that are guaranteed with annuities, but even ones that are just multi-asset portfolios? Getting these types of asset

classes and those types of solutions as well are going to be increasingly of interest.

>> So maybe the golden question or maybe the elephant in the room, you've talked about how alternatives managers may be licking their lips to think about this opportunity. What is the right size of allocation to alts, right? So what role does it play in the portfolio? And then, therefore, what should be the right size? As you can imagine, it's going to be 100%. So what is it, and how should client sponsors start to think about that?

>> Well, reasonable people can come to different conclusions there. Right now, when we see it, for example, in real estate, in target date funds, we tend to see about a 5 to 6% allocation to private real estate, with some going as high as 10 to 15% when they're including that in, for example, a target date fund. As we broaden the asset classes, then it makes more of a case to increase the allocation. So it's not just one private asset class, but multiple. And I think it will eventually, as this gets embraced, get to maybe the 10 to 15% type range for plan sponsors who really embrace this. It probably won't get to where we are with a lot of defined benefit plans, at least open plans or other portfolios that we see. But I think there's a lot of movement from where we are today to what the potential is.

>> And what is today? You talked about the PGIM approach here. What have we typically done, even in terms of the now couple decades where we've had real estate, private real estate equity in our funds?

>> Yeah. We see about a 5% or so allocation to it today, which sounds small, but it actually can have, particularly in certain environments, really impactful benefits, particularly downside protection and some inflation protection in certain environments. So that's where we tend to see it, and others where our real estate is in someone else's target date funds. It's in a lot of other target date funds, both customized target date funds and off-the-shelf funds. We tend to see it, again, in the five to 10% range.

>> So, Josh, maybe another question as we dig a little deeper. So, of the various alts that could be incorporated into a DC plan, what are the different use cases? How should you think about real estate equity, which we've talked about, versus private equity, real estate debt, other forms of kind of private credit? How do you think about the different use cases here?

>> In the current DC context, we're probably going to start with asset classes that aren't extremely high-end in terms of the fees, just because of that fee sensitivity, even if they have efficacy. We're probably not going to look at the asset classes that have really high leverage that are more close-end type funds. So you need funds that really can have a daily valued estimate and be able to provide sufficient liquidity within the appropriate vehicle.

So we got to start with thinking about those asset classes, at least for the next few years, I think. That's why it tends to look at things like core real estate, investment-grade debt, and such. And again, all of these have different characteristics. Some of these are more growth assets that are more appropriate for someone earlier in their career. That would be in the target date funds, for example, that are in the vintages for younger savers. And others, more like fixed income and certainly more inflation-sensitive assets, are going to be more appropriate for those closer to and in retirement. So I think we need to be careful about just bucketing all alts into one bucket and maybe just have an offering that has all these different kitchen sink asset classes, because they do impact the portfolio differently. So I think it's important not to look at these in terms of a monolithic asset class, but they all have different characteristics that could be important in different parts of someone's lifecycle. And I think that's the way the market's going to evolve.

>> I think that makes sense, and not all alts are created equal. So I think in many ways, trying to get to that next layer will be important, especially from a plan design perspective.

>> I think we can also confuse the buyers a lot.

>> Too much choice in making it so broad. So I think getting specific is going to be important here.

>> Exactly. Maybe a final question on that front. Who's done it right? If you think globally in the US, it sounds like we've done it for some time, but we may be on the precipice of an evolution or a revolution here. What other countries have gotten this right in terms of incorporating alts into their retirement plans?

>> Well, Australia is really held up as the gold standard here. They have such an interesting history. I would encourage your listeners to listen to an episode in Season 2 of my podcast where I focus on the history and evolution of the Australian superannuation funds. It's interesting in so many ways. They actually mandate savings into retirement plans as opposed to other countries where it's more voluntary. And again, they've always, from the beginning, leveraged more liquid and illiquid asset classes in their portfolios, and that's evolved over time. And they've become some of the biggest global investors in private markets now because of that. And their members have seen tremendous growth of their portfolios relative to what they would have seen if they were just in standard asset classes. So I think Australia is the standard that many of us do look at when we look at good examples across the globe. And I think others are trying to move in that direction.

>> Definitely. Listeners should check out that episode to learn more. Well, Josh, this has been a really fascinating conversation. We're on the edge of something very interesting and new here. Again, my takeaway is,

one is it's actually not new. Alts have been around in DC plans for a while now, but we could be in a different moment in terms of how they're incorporated. Two is I think what we just talked about. Not all alts are created equal. So even as you think about and plan sponsors start to examine the incorporation of alts into their DC plans, they really need to think about the use cases of specific alternative asset classes and how they could be incorporated. And three is that customization theme. We talked about targeted funds obviously being so important in terms of a package for a multi-asset approach to DC plans. But as technology has enabled more customization to managed accounts, that combined with incorporating alts will potentially lead to some really interesting and positive outcomes for participants. But, Josh, this has been a fascinating conversation and really enjoyed it. And again, do encourage the listeners to tune in to your podcast to learn more about the DC landscape overall.

>> Really enjoyed it, Keshav, as well. And as I used to say as I was closing my podcast, thanks for listening.

>> Join us next time when your host, Laurie Chan, will discuss alternatives and private wealth with Dominick Carlino and Stuart Parker on Speaking of Alternatives.

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