Including Alternatives in TDF Glide Path Design

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The search for higher returns and diversification potential in retirement plans has led many defined contribution (DC) plan sponsors down the path of considering alternative assets and private fund structures in DC plans such as 401(k)s.

However, high fees, lack of transparency and lock-ups of committed capital make plan sponsors and participants rightfully tread with trepidation. For example, alternative investments such as private equity (PE) may require multi-year lockups. Typical PE fee structures involve management fees representing 1.5–2.0% of committed capital, plus performance fees representing 20% of aggregate fund profits[1] — known as "carried interest" — which potentially result in annual average fees of more than 5%.[2] By comparison, average annual fees for target date funds (TDFs) stood at around 37 basis points (bp) as of 2020.[3]

Plan sponsors and target date fund managers have an obligation to make an allocation to alternatives only where the portfolio stands to benefit from return streams that cannot be accessed through traditional sources, and at a fee level that is in line with the potential value added.

At Voya, we have developed an approach that examines the benefits of incorporating alternatives in target date funds by integrating the following critical elements within glide path design — risk premia, skill premia and excess returns relative to fees.

Risk Premia and Skill Premia

Alternative investments represent a collection of market beta, risk premia and skill premia. Risk premia in alternative investments may be traditional, e.g., equity risk premia in the case of private equity; or alternative, e.g., insurance premia in volatility. Skill premia refer to the magnitude of excess returns due to the skill of the alternative managers utilized.

In traditional asset classes, the dispersion of returns from manager skill is generally muted relative to alternative asset classes, where selecting top quartile managers can have greater impact on portfolio returns than allocating to the asset class.[4]

Skill premia are scarce and hard to access. Plan sponsors with decades of alternative investing experience through their defined benefit plans, and well-established relationships with specialized managers, may be better able to access skill premia. For such plan sponsors, providing their DC participants with access to these specialized funds through their target date program may add incremental value.

[1] Source: Shah, Kunal, An Explanation of Private Equity Fees, iCapital Network, October 2019. https://www.icapitalnetwork.com/insights/private-equity/an-explanation-of-private-equity-fees/.

[2] Source: Stafford, Erik, Replicating Private Equity with Value Investing, Homemade Leverage, and Hold-to-Maturity Accounting (September 18, 2020). Available at SSRN: https://ssrn.com/abstract=2720479 or http://dx.doi.org/10.2139/ssrn.2720479.

[3] Trends in the Expenses and Fees of Funds, 2020 (ici.org).

[4] Source: McKinsey Global Private Markets Review 2019. https://www.mckinsey.com/~/media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/Private%20markets%20come%20of%20age/Private-markets-come-of-age-McKinsey-Global-Private-Markets-Review-2019-vF.ashx.

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The potential benefits of alternatives must be compared with the potential added value from asset allocation and manager selection.

Identifying skill is difficult in private markets — typical metrics such as internal rate of return do not offer appropriate comparisons in a multi-asset framework. Voya uses alternative measures such as public market equivalents (PMEs), excess value and replication of returns via public market factors. These measures help us understand private market returns and enable us to better identify manager skill and persistence.

Given the scarcity of skill premia, which raises their cost, an intelligent alternatives portfolio would have to balance limited access to skill premia with additional sources of returns such as alternative risk premia; and potentially at lower cost, replicating the median returns of private equity funds using public equities.

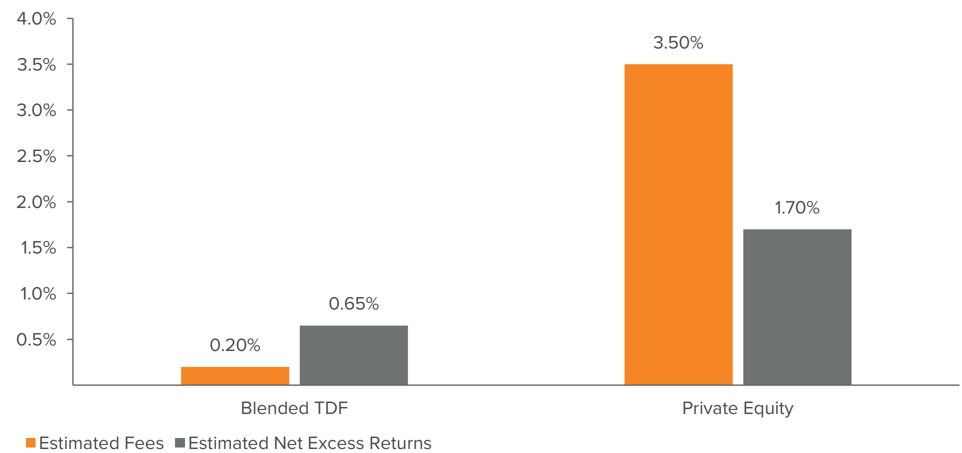
Excess Return Relative to Fees

Investment management fees play an important role in determining the appropriate alternatives approach in target date funds. With the industry average for target date fund fees around 37 basis points (footnote 2), the additional value from alternatives needs to be considered in relation to fees paid.

In the context of TDFs, the additional value from alternatives must be viewed in comparison with the additional value that can be obtained from other sources such as asset allocation and manager selection. Specifically, the excess returns from alternatives should be evaluated against the excess returns from an active allocation to a diversified portfolio of traditional assets (Figures 1 and 2).

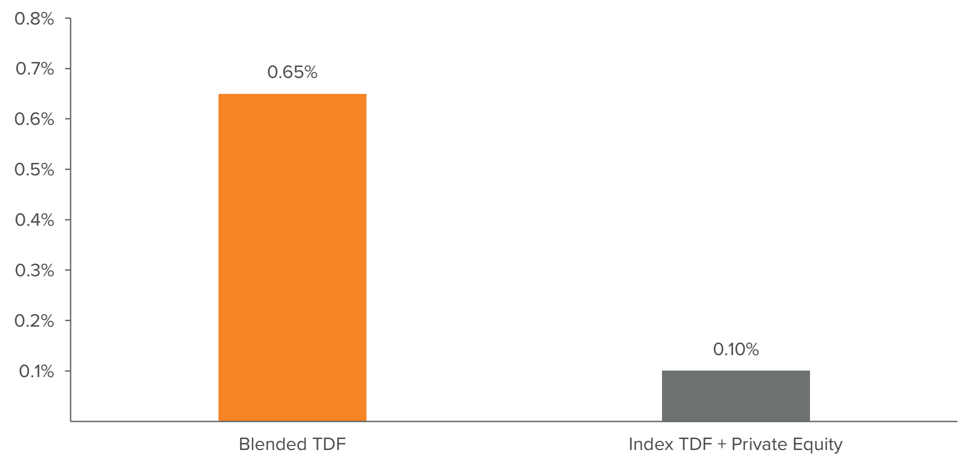
Figure 1. Higher fees present a hurdle to inclusion of private equity in TDFs

Excess returns relative to fees paid



Source: Voya Investment Management. Fees: for blended TDF assumed fees represent estimated average fees for actively managed TDF over passive TDF. For private equity, assumes 1.5% management fee and 2% carried interest (3.5% per annum combined). All fees are annualized. For blended TDF, 50 bp assumed excess returns over a static 60/40 MSCI ACWI/Barclays Global Aggregate index, based on Voya's capital market assumptions; plus assumed 15 bp return from active manager selection. For private equity, represents the excess returns over MSCI ACWI based on Voya's capital market assumptions. Results using historical data are similar. All performance shown in this report is hypothetical and is for illustrative purposes only. For more information on performance methodology, please see "Investment Excellence" in the disclosure section below.

Figure 2. For the same level of fees, private equity may fail to provide an improvement in expected returns



Source: Voya Investment Management. This figure compares the excess returns over an index target date fund between two approaches. The first approach is to utilize a blended TDF that is assumed to cost an additional 20 bp over an index TDF, but is expected to deliver 65 bp of excess returns over the index TDF. The second approach assumes that 5.6% of an index TDF is allocated to private equity; at 5.6% allocation, the fees of the second approach are expected to match the fees paid in the first (blended) approach. All performance shown in this report is hypothetical and is for illustrative purposes only. For more information on performance methodology, please see "Investment Excellence" in the disclosure section below.

Private equity has generated value for investors. Additionally, as discussed earlier, top quartile private equity funds have been able to offer net of fee returns well in excess of public markets. However, the message from Figures 1 and 2 is that a target date fund program cannot add value by simply making an allocation to private equity. Such an approach likely would increase costs without a meaningful improvement to the target date program. Therefore, a more thoughtful approach is needed.

Contours of a More Thoughtful Approach

A more thoughtful approach would reframe an alternatives allocation into one that balances fees paid against additional diversified returns. This can be achieved by allocating to an alternatives portfolio that balances risk premia and skill premia.

Skill premia

Skill premia may be worth paying for, but are you convinced your TDF can access enough of them? If an allocator or TDF manager has demonstrated the ability to access highly skilled private equity funds, then a concentrated allocation to a select group of top quartile managers may result in accessing valuable skill premia from private markets.

For such an allocation, however, PE manager selection is extremely important and the plan sponsor or TDF manager must have a high degree of conviction in both the PE managers and his or her ability to select top-performing managers. The abilities to source deals, secure co-investment opportunities and negotiate terms are specialized skills, without which investors risk diluting their returns and paying excess fees for average performance.

By definition, such skill premia are scarce resources. Therefore, the amount of skill premia may not be sufficient or meaningful enough to complete an alternatives allocation — the skill premia of private asset managers may need to be augmented by other sources of uncorrelated returns. We refer to these uncorrelated return sources as risk premia.

Risk premia

Various studies have demonstrated that the median returns of traditional PE can be replicated by applying private market investment styles to public markets. Such an approach, known as replicated private equity (RPE), would allow target date funds to approximate the risk premia embedded in private equity without paying the high fees of PE funds. Also, the greater liquidity of replication strategies compared to PE strategies may be attractive within a TDF program.

Alternative risk premia strategies harvest returns from sources that are distinct from traditional equities, rates and credit. These strategies are used by large pension plans, sovereign wealth funds and hedge funds to generate returns — from equity, currency, commodity, volatility, rates and credit markets — that are distinct from typical equity and bond returns.

Balancing these sources of risk premia along with skill premia, where available, may result in TDF programs with higher returns but without a meaningful increase in fees. We call this approach (of combining active high conviction PE managers with replication and alternative risk premia) “intelligent alternatives.”

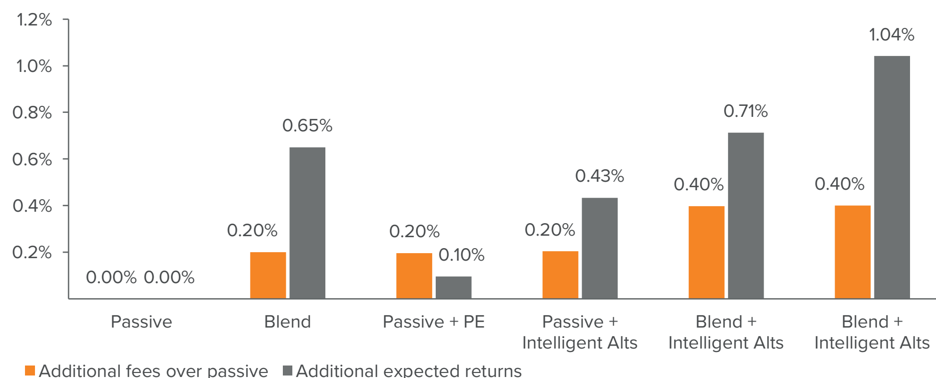
Figure 3 compares various hypothetical TDF allocations to highlight the trade-offs between fees and excess returns. As discussed in the previous section, a traditional blended TDF approach offers higher excess returns for the same amount of incremental fees paid, e.g., 65 bp of additional returns versus 10 bp for private equity (PE) and 43 bp for intelligent alternatives given an assumed 20 bp fee budget over passive.

A blended TDF with intelligent alternatives is likely to provide the best trade-off between fees and expected returns. Assuming a TDF investor is willing to pay additional fees (let’s say 20 bp) over a blended approach in order to obtain the benefit of alternatives, then combining a blended TDF approach with intelligent alts potentially can result in 100 bp of excess returns over a passive approach.

It is important to note that the fees and expected returns used here are estimates for illustrative purposes only and to highlight the relative merits of various approaches. Actual fees will vary by target date program and actual investment returns will differ from expected returns. There can be no assurance that any blended approach will perform as expected.

Voya believes that target date fees and transparency matter to plan sponsors and consultants. The value of this “thought experiment” therefore is to help decision makers compare the potential benefits of various approaches through a fee-constrained lens.

Figure 3. A blended TDF with intelligent alts is likely to provide the best trade-off between fees and expected returns



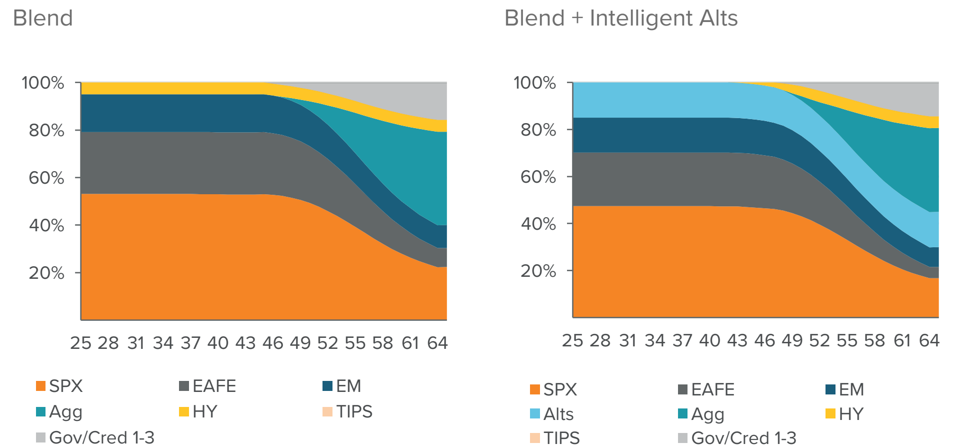
Source: Voya Investment Management. Passive assumes a passive TDF program allocated to global equities and bonds. Blend assumes a blended TDF program with active asset allocation and blend of active and passive managers. PE assumes an allocation to a diversified portfolio of PE managers. Intelligent alternatives assumes an allocation to a portfolio of high conviction active PE funds, PE replication and alternative risk premia. For each scenario, the portfolio allocations are calculated such that the fees paid across each hypothetical TDF program are similar. Additional fees over passive assume blended TDF costs 0.2% above passive TDF. Assumes PE fees of 3.5%. Assumes intelligent alts fees of 1.5%. Expected net of fee returns above passive are assumed to be 65 bp, 170 bp and 310 bp per annum, respectively, for blended, PE and intelligent alternatives. All analysis based on Voya’s capital markets assumptions. All performance shown in this report is hypothetical and is for illustrative purposes only. For more information on performance methodology, please see “Investment Excellence” in the disclosure section below.

Illustrative Glide Path Design

An holistic approach to alternatives seeks to balance potential returns while addressing the needs of participants at a reasonable cost.

Figure 4 illustrates a hypothetical glide path constructed utilizing our stochastic glide path model to simulate various income replacement ratio scenarios at retirement for blended target date fund allocation, with and without an “intelligent alternatives” allocation. We used a 15% allocation to intelligent alternatives for the illustration.

Figure 4. Hypothetical TDF glide paths without and with diversified alternatives



Source: Voya Investment Management. Allocations are subject to change.

Conclusion

In a low return and uncertain environment, increasing potential sources of long-term return can be beneficial to individuals saving for retirement. However, a simplistic allocation to high cost alternative investments may not be the right answer.

Instead, a target date program that incorporates alternative investments needs to take a holistic view and incorporate risk premiums, skill premiums and fees paid to obtain these premiums, amongst other considerations. By balancing returns against these dimensions, a TDF can be more effective in addressing the needs of participants at a reasonable cost.

Such an approach requires going beyond conventional investment analysis, and requires a more intelligent approach to alternative investments. We welcome the opportunity to discuss how our approach to glide path design and intelligent alternatives may help sponsors better meet their obligations to plan participants.

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