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Private Equity in Defined Contribution Plans

Fiduciary considerations for your plan committee

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Key Takeaways

- The use of private equity in defined contribution plans is permissible under certain circumstances.
- As with any plan investment, a prudent due diligence process is essential for making sound decisions about private equity.
- Plan committees should work with consultants who understand the complexities of this investment.

Does the use of private equity (PE) violate the fiduciary standards of sections 403 (establishment of trust) and 404 (investment duties) of the Employee Retirement Income Security Act (ERISA)?

The Department of Labor (DOL) addressed this question in a guidance letter issued on June 3, 2020. Its guidance focuses on PE within a managed allocation such as a target-date fund, target-risk fund, or managed account—not as a standalone investment option. The purported reason for using PE in managed allocations is to increase diversification and add risk-adjusted excess returns (alpha) to a portfolio over full-market cycles.

According to the DOL, the use of PE, in this context, does not constitute a fiduciary violation as long as:

- You follow a prudent investment process.
- The PE investment is only a portion of the managed allocation fund.
- An investment expert manages the PE allocation.

Despite the apparent green light from the DOL, defined contribution plan sponsors should proceed carefully, starting with understanding what PE is and the associated fiduciary considerations.

What is Private Equity?

Equity simply means ownership. As investors, we're likely more familiar with public equity, such as shares of IBM or Apple. When you buy stock of a public company, you typically trade through an exchange, like the New York Stock Exchange, that regulates the transaction. To be on an exchange, a company has to go through an initial public offering (IPO), which readies the stock for trading amongst investors. IPOs involve many financial, accounting, and legal steps.

PE is similar to public equity, except it doesn't trade on an exchange, which can be both "good" and "bad." Companies that don't trade on an exchange are typically too small or just starting up, giving PE investors access to a unique part of the equity market. However, because these firms don't trade on an exchange, they are not subject to the same processes as public firms. As a result, there may be a lack of transparency and added risk. Also, because access is limited, price discovery (or the establishment of the "right price") by the broader market can be poor, further increasing the risk.

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Why is the DOL Guidance Important?

If you're a fiduciary of an ERISA-governed defined contribution (DC) plan, the DOL letter affects you, whether you're interested in using PE or not. Why? The DOL has historically stated that when you're conducting due diligence on an investment, and particularly a professionally-managed allocation like a target-date fund, you must consider all reasonable facets of that investment. For example, in the DOL's target-date guidance issued in 2013, plan sponsors were instructed to evaluate and consider custom solutions. It's prudent to assume that the question of whether to include PE will become part of the comprehensive due diligence process.

Furthermore, if you think your DC plan may benefit from PE, and want to include it in your managed allocation (and one step further, your qualified default investment alternative (QDIA)), you'll want to make sure you thoroughly understand the investment, document your due diligence process, and communicate effectively to your participants. All of which is no easy task for this type of investment. Below are some key considerations:

Liquidity	• PE is inherently illiquid, meaning that in general, it can be difficult to get the full value of your investment when it's time to sell, especially in periods of market stress. In a DC plan, where benefits must be "responsive" (meaning the ability for participants to transact freely), it may be challenging for PE to stay liquid and provide alpha simultaneously.
Complexity	• The complexity of PE investing means your plan committee must either be an expert in PE due diligence or delegate as appropriate to a 3(21) investment adviser or 3(38) investment manager. You will also have to furnish adequate information to participants so they can make informed decisions.
Higher Fees	• Historically, PE has been criticized for the high fees associated with managing the investment. In a DC plan, these fees must be evaluated through the lens of a fiduciary process. Your plan committee must also believe this investment has the ability to provide added value, net of fees.
Valuation Methodologies	• PE investments require an element of judgment since they often don't have an easily observable market value. You should require and monitor regulatory accounting standards (FASB ASC 820 standards). These standards add a layer of complexity and expertise to the due diligence of these investments.

What Should You Do?

Probably nothing, at least for now. While it may seem appealing to employ this new guidance to potentially enhance your managed allocations, there are reasons to wait and be cautious:

- **PE isn't proven in DC.** Even if we could show that more traditional PE structures have consistently provided alpha, the same results are not a given in a DC context.
- **There's no best practice.** Establishing best practices takes time and involves a process of trial and error, getting new guidance and clarity on previous guidance, and potentially litigation. None of these scenarios is likely to have a positive cost/benefit to your plan.
- **There are virtually no "DC PE" products in the market today.** PE firms haven't had time to develop these products. Many also don't have experience managing these investments inside a managed allocation and for elements like liquidity and time horizon.
- **Fees are still too high.** If PE gains momentum in DC plans, the fee structures for these investments will likely compress.

What's the Bottom Line? Wait and See.

Expanding the investment universe is almost always a good thing—in theory. Additionally, PE is not inherently "bad" despite the negative connotations of some of the issues discussed above. There is a legitimate theory, and observable evidence, that PE can add value in certain circumstances.

It may be prudent for your plan committee to begin thinking about how to incorporate the analysis of PE into its due diligence process. You may also want to assess whether your current plan consultant is qualified to assist with this task, or if you'll need to hire an investment consultant with this expertise. In any event, there is very little "first movers' advantage" in implementing PE soon. We advise patience and prudence when it comes to this investment.

For additional insights, contact a Cerity Partners retirement plan consultant or visit the thought leadership section of ceritypartners.com.

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