Alternative investing impact on return-seeking portfolios

The role of less liquid assets in a DB portfolio

Russell Investments Research

Mary Beth Lato, CFA, Senior Asset Allocation Strategist

While constructing an asset allocation for a corporate defined benefit (DB) pension plan, the emphasis is often placed on the allocation between the return-seeking portfolio and fixed income, along with the construction of the fixed income portfolio, particularly its ability to hedge pension liabilities. However, it is also important to ensure that the return-seeking portfolio is constructed in a manner that can achieve its targeted return with appropriate levels of risk and diversification.

Alternative investments play a key role in the design of a diversified return-seeking portfolio. In this paper, we focus the discussion on less liquid opportunities such as hedge funds, private real estate and private markets by first addressing the opportunities that they bring and then discussing how a plan's profile, time horizon and liquidity constraints impact the recommended allocation.

Hedge funds, open-ended core private real estate and other less liquid private markets offer unique opportunities for investors. Although core private real estate is considered an investment opportunity within private markets, this paper considers it separately from other less liquid private markets investments due to the liquidity generated by the open-ended investment vehicles through which it is typically accessed. The open-ended investment vehicles allow for investors to have greater periodic liquidity than investing directly in the underlying investments, as the underlying investments themselves are illiquid. All three investment opportunities are similar in that they are less liquid than traditional listed asset classes (e.g., public equities) and rely on the ability to access good managers for successful implementation.

In this paper, we focus the discussion on less liquid opportunities such as hedge funds, private real estate and private markets.

Alternatives are expected to improve risk and reward opportunities

The impact of investing in alternatives on the total portfolio risk and return varies by each underlying investment strategy, as summarized in Exhibit 1. Less liquid private markets are expected to offer returns above those available in the public markets. While hedge funds and core private real estate are not expected to offer a similar level of return premiums, they are both expected to offer diversification and risk reduction within the return-seeking portfolio.

Exhibit 1: Typical less liquid investment strategies

	HEDGE FUNDS	CORE PRIVATE REAL ESTATE	PRIVATE MARKETS
Return expectations	Varies by manager and strategy, but typically below public equity	Between investment grade fixed income and public equity	Above public equity
Typical liquidity classification	Conditionally liquid	Conditionally liquid	Illiquid
Typical liquidity	Quarterly	Quarterly	Illiquid
Controller of liquidity in normal markets	Investor; subject to satisfaction of lock-ups and notification requirements	Investor; subject to notification requirements	Manager[1]
Ability for manager to manage liquidity due to portfolio stress or outsized redemptions	Yes	Yes	N/A

Hedge funds

Hedge funds are a broad category of alternative investment vehicles in which the investment returns are expected to be created by the skill and knowledge of the asset manager. Hedge funds can focus on traditional and/or nontraditional asset classes, and the investment opportunities expand as the targeted liquidity of the vehicle is reduced. Although expected returns and volatilities will differ by strategy, hedge funds are generally expected to have a lower correlation with broad market returns than traditional long-only investments. This is due to the reliance on the skill of the investment manager in delivering the returns. Along with the reliance on skilled managers, commonalities often seen across hedge fund investments are the use of shorting, leverage and a potential lack of transparency. Managers may hold short positions to isolate the impact of skill in generating returns while removing market risk, which is not possible to the same extent in traditional investments. Most hedge fund investments impose initial lock-ups and other liquidity constraints, but the underlying investments can vary in their liquidity and often include daily liquid securities.

> *The impact of investing in alternatives on the total portfolio risk and return varies by each underlying investment strategy, as summarized in Exhibit 1.*

Core private real estate

Core private real estate has historically offered investors strong risk-adjusted returns with low correlations to other asset classes and the potential for a steady income stream. Over the long-term, core private real estate is expected to generate a return below that of public market equities, but above investment grade fixed income, while maintaining low correlations to both asset classes. Along with the diversification benefit from low correlations, core private real estate also serves to reduce risk through its low absolute volatility, which is based on both the economic underpinnings of the asset class and the impact of smoothed accounting valuations. Although the low volatility of returns is partially due to the smoothing nature of lags in appraisal values, it is also due to the long-term nature of leases and rental income that form a sizable portion of the total return and only gradually react to changes in market conditions.

Private markets

Private markets investments are included in the portfolio to capture above-market returns and to provide diversification. The risk reduction from diversification delivered through private markets will depend on the investment type. For all investments, there will be a reduction in the volatility experienced because the valuations of the underlying investments are updated on a lagged and periodic basis leading to a smoothing in the stated quarterly and annual returns. The ability to deliver returns higher than what is available in the public markets allows for more aggressive return requirements to be sought over the long term, or, alternatively, to allow investors to reduce total portfolio risk by allocating a lower percentage of their assets to the return-seeking portfolio without reducing expected returns. Private markets can offer returns above those in the public markets as they are often more focused on value-creation strategies and on providing exposure to market segments and geographies that are less efficient and not available through public markets. Return enhancement can also be generated due to the illiquidity premium and through the structure of, and leverage in, the underlying investments.

The impact of plan characteristics and liquidity needs on the recommended allocations

Many pension plans are concerned about the illiquidity associated with alternative investments; however, we find that most pension plans underestimate the potential liquidity and cash flows within alternative asset classes, and often have the ability to take on more illiquidity than they have chosen to. The typical liquidity parameters of hedge funds, core private real estate and private markets were outlined in Exhibit 1, and, for simplicity in discussing liquidity, we will refer to conditionally liquid and illiquid assets. We also separate investors by their liquidity needs and highlight three broad classifications in Exhibit 2.

Exhibit 2: Pension plan liquidity requirements

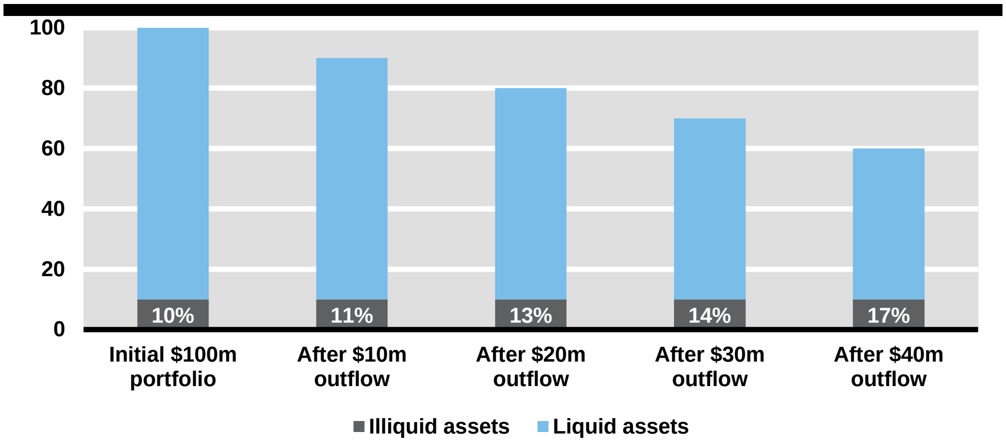
	LOW LIQUIDITY NEEDS	MODERATE LIQUIDITY NEEDS	HIGH LIQUIDITY NEEDS
Growth expectations	Assets and liabilities growing as service cost, contributions and returns expected to outpace benefit payments	Assets and liabilities are expected to be relatively stable or slightly declining through time	Assets and liabilities declining as benefit payments are not offset with new accruals or contributions
Typical plan characteristics	• Open and ongoing	• Recently closed • Underfunded mature closed • Underfunded frozen	• Well-funded mature closed • Well-funded frozen
Time horizon	Long	Medium	Short
Impacted by denominator effect?	No	Possibly	Yes

Often pension plans have unique circumstances that can increase or decrease their expected liquidity needs. Pension plans can also have a tolerance or preference for liquidity that is different than its need for liquidity, which could cause its allocation to less liquid investments to differ from what we recommend based on its plan characteristics.

In addition, an expectation for a trending decline in the asset base is often referred to as the "denominator effect," and reflects a challenge for portfolio rebalancing and the ability to track target asset class weights. The denominator effect is highlighted in Exhibit 3. While the asset base is declining, it is important that the dollar allocation to illiquid assets can also decrease over time to prevent growth in the percentage allocation. Mature plans with de-risking glidepaths would actually be targeting a reduction in the percentage allocation to growth assets through time; thus allowing the denominator effect to increase the percentage allocation to illiquid growth assets would be particularly detrimental. Similar denominator effects may be felt with respect to potentially significant asset declines resulting from market shocks or risk transfer activity.

An expectation for a trending decline in the asset base is often referred to as the "denominator effect," and reflects a challenge for portfolio rebalancing and the ability to track target asset class weights.

Exhibit 3: Denominator effect: Impact of outflows on the percentage allocation to illiquid assets



In normal market environments, the liquidity of conditionally liquid assets accommodates the need to rebalance the portfolio to targets while funding the high benefit payments that many mature and frozen plans have. The liquidity concern that should be accounted for is that conditionally liquid investments allow for the manager to temporarily (i.e., for one to two years) cease all redemptions in a stressed market environment. Although this is unlikely, if this were to occur, it would likely occur as the liquid return-seeking portfolio is also experiencing stress in the form of market losses. Because of this downside liquidity risk, we recommend that pension plans with high ongoing liquidity needs have lower allocations to conditionally liquid investments to ensure that the allocation size is small enough that any potential illiquidity could be tolerated.

> *For under-funded, closed and frozen plans…although the recommended private markets allocation should be moderated, there is no need to eliminate private markets far in advance.*

Although the inability to control the liquidity of private markets investments[2] elevates the concerns that some investors have regarding illiquid assets, liquidity concerns should not deter plans with low liquidity needs from investing in private markets. While some investors imagine that investments in private markets generally provide only minimal cash flows prior to their ultimate payout, cash flows, particularly for a well-constructed and diversified portfolio, actually provide significant liquidity, as discussed in "The liquidity of illiquid assets: A decade in the life of a private funds investor" (Ross). However, due to the lack of control on the timing of when the liquidity is realized, we believe caution is warranted for plans with high liquidity needs and recommend careful consideration of existing private markets positions and any new commitments. For under-funded, closed and frozen plans, the de-risking glidepath to reaching full funding and having hibernation or termination as an expected outcome is likely many years away. Thus, although the recommended private markets allocation should be moderated, there is no need to eliminate private markets far in advance.

Exhibit 4 highlights the recommended allocations to less liquid asset classes based on the plan's liquidity profile.

Exhibit 4: Recommended allocations to less liquid asset classes

PLAN LIQUIDITY CLASSIFICATION	% OF RETURN-SEEKING ASSETS RECOMMENDED		
	HEDGE FUNDS	CORE PRIVATE REAL ESTATE	PRIVATE MARKETS
Low liquidity needs	0-10%	5-15%	5-20%
Moderate liquidity needs	0-10%	5-15%	0-10%
High liquidity needs	0-5%	0-10%	0%

Special considerations for risk transfers

If a plan is preparing to undertake a form of risk transfer, either through full plan termination, partial buy-out or a lump-sum offering, we recommend that it considers the future path of illiquid investment allocations in advance of that event. Plans that are only undergoing a partial risk transfer should determine the expected asset size after the risk transfer and proactively plan the liquidation of conditionally liquid investments so that, after the risk transfer event, the percentage allocated to conditionally liquid investments is at a manageable level. It will not be possible to control the size of any private markets allocation in advance of a partial risk transfer as precisely as for the conditionally liquid investment, but as soon as a partial risk transfer becomes a likely event, the level of commitments made should be adjusted to account for the expected evolution in size of the asset base.

For large plans that are seeking to transfer assets in-kind to insurers, it may be possible to transfer private markets investments, as insurance providers often allocate to private markets in their own portfolios. However, the ability to transfer private markets investments in kind to the insurer will be dependent on the insurer desiring the individual investments that the plan has made. Since this cannot be known until negotiations are underway with the insurer, it would be difficult to plan private markets investments with the expectation that a potential buy-in or buy-out provider would value them in the future.

> *We believe that the illiquidity risk associated with alternative investments is worthwhile given the return enhancement and diversification that they can provide.*

Conclusion

Determining the correct allocation to less liquid assets can be difficult. Although there are many benefits from their inclusion in the portfolio, they contain a new dimension of risk — illiquidity risk. We believe that the illiquidity risk associated with alternative investments is worthwhile given the return enhancement and diversification that they can provide. The most important steps are a proper assessment of the plan's future liquidity needs and the appropriate scaling of the allocation to less liquid asset classes given the unique needs of the plan.

[1] The investor could control liquidity by choosing to buy or sell investments in the secondaries market.

[2] The secondaries market offers investors liquidity if they must liquidate their private markets investments. The growth and maturity of the secondaries market offers investors increased control of liquidity at less of a discount than in the past; however, we would not recommend that investors invest into private markets with the expectation that they will need to liquidate their portfolio through the secondaries market in the future.

References

Ross, L., Mancuso, J. (2011, April). "Structuring a private real estate portfolio". *Russell Investments Research*.

Ross, L. (2011, April). "Structuring a hedge fund portfolio". *Russell Investments Research*.

Ross, L., Deitts, B. (2012, November). "Strategy primer: Private capital". *Russell Investments Research*.

Garcia, E., Larsen, T., Baldridge, J. (2013, August). "Core private real estate, A viable income-generating strategy in a low-yielding environment". *Russell Investments Research*.

Gannon, J., Turner, K. (2013, January). "Structural denominator effects and implications for private market investments in DB pension plans". *Russell Investments Research*.

About Russell Investments

Russell Investments is a global asset manager with a unique set of capabilities that we believe is essential to managing your total portfolio and to meeting your desired outcome. At Russell Investments, we stand with you, whether you're an institutional investor, a financial adviser, or an individual guided by an advisor's personalized advice. We believe the best way to reach your desired outcomes is with a multi-asset approach that combines: asset allocation, capital markets insights, factor exposures, manager research and portfolio implementation.

For more information

Call Russell Investments at **800-426-8506** or

visit **russellinvestments.com/institutional**

Important information

Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

Russell Investments' ownership is composed of a majority stake held by funds managed by TA Associates with minority stakes held by funds managed by Reverence Capital Partners and Russell Investments' management.

Frank Russell Company is the owner of the Russell trademarks contained in this material and all trademark rights related to the Russell trademarks, which the members of the Russell Investments group of companies are permitted to use under license from Frank Russell Company. The members of the Russell Investments group of companies are not affiliated in any manner with Frank Russell Company or any entity operating under the "FTSE RUSSELL" brand.

First used: July 2019 AI-27692-07-22