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DEFINED CONTRIBUTION
REAL ESTATE COUNCIL

EVOLVING LANDSCAPE FOR LIQUIDITY WITHIN DC PLANS

Conventional wisdom within the Defined Contribution (DC) industry has held that DC plans must provide only investment options with daily liquidity. This paper will explore how an exclusive reliance on daily liquidity in DC investment options may be evolving alongside the changing DC environment. We will also consider how some types of assets with lower levels of liquidity have developed in ways that could potentially help meet the need for greater levels of diversification within DC plans.

Background

Illiquid investments within DC plans have historically not been part of the investment line-up, whereas within Defined Benefit (DB) plans, illiquid alternative investments such as private real estate, private equity, hedge funds, etc. have been widely accepted as part of the asset allocation. On the DC side, plan sponsors have been reluctant to explore illiquid investment alternatives because of concerns about liquidity. Nonetheless, we believe it is only a matter of time before illiquid investments become more prevalent in DC plans. This is due to the fact that DC plan assets have grown significantly, and allocations to illiquid investment alternatives have been shown to improve participant outcomes. Moreover, liquidity concerns are being addressed, as we will further explain below.

Do DC Plan Participants Actually Move Money Around in Their DC Accounts?

The Covid-19 pandemic crisis that started in February 2020 fueled aggressive selling among stock investors. As a result, the public equity market as represented by the S&P 500 lost about 32% of its value, and publicly traded REITs dropped more than 40% (peak to trough from mid-February 2020 to mid-March 2020). However, the precipitous drop in the equity markets had little longer-term impact on DC plan cash flows as the great majority of participants did not take action, (i.e., sell stock funds to buy bond funds or cash). On average, only 0.046% of 401(k) balances were traded daily in February—the highest rate since August 2011 **(https://www.pionline.com/defined-contribution/covid-19-uncertainty-disturbs-dc-participants)**. Meanwhile, participant phone calls to recordkeepers spiked, but little transaction activity actually resulted from these calls. In 2020, despite the significant increase in market volatility, nearly 9 of 10 participants did not trade, according to Vanguard's analysis of 5 million DC plan participants across their recordkeeping business **(https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/InvComEarlyLookHAS2021)**.

In addition to observable historical participant behavior, the increasing prevalence and growth of Target Date Funds (TDF) should, in theory, limit participant buying and selling activity. TDF managers handle buying and selling for the participants within the fund, and they rebalance the portfolio to a more conservative investment profile as the target retirement date approaches. The basic premise behind the TDF structure is that participants can, and arguably should, invest their DC assets in one TDF for their entire career and into retirement. When investing in a TDF, there is no need for participants to buy and sell throughout their career.

Similarly, white label funds are professionally managed multi-manager portfolios that should also serve to limit DC plan participant buying-and-selling activity, as the fund manager rebalances the investments within the fund. The adoption of white label funds has grown dramatically over the years. This is consistent with the growth in DC plan sizes, and plan sponsors' desire to create more efficient investment options.

It is also widely documented that participant contributions have created a steady stream of inflows over time. Even the year 2020, with its extreme market turbulence, was no exception. Participants are heeding the message from plan sponsors, record keepers, and advisors that they should stay the course on their investment plan regardless of the current stock market volatility. This message of "staying the course" creates consistent inflows of DC contributions, which serve to offset the relatively small percentage of participant outflows during periods of capital market stress.

These points highlight the lack of participant buying and selling inside DC plans, reframing the environment for liquidity issues. This reality of low activity within plans may provide DC plan sponsors, consultants and TDF managers with a potential opportunity to invest in less liquid, more diversified assets such as private real estate. DB plan sponsors have been acting on this opportunity for decades. Most importantly, any improved performance resulting from more diversified portfolios directly impacts participant outcomes.

DC Trends Accommodate Less Liquid Investment Options

Several overarching DC market trends bode well for the DC plan sponsor usage of investment alternatives with lower levels of liquidity, such as private real estate, hedge funds and private equity. These trends include the significant growth in assets, increased use of Target Date Funds, and auto enrollment.

First, the general shift from DB to DC plans is a driving force behind the significant growth in DC plan assets. Most pundits expect this shift to continue with no end in sight. The large and growing DC asset base provides plan sponsors with the opportunity and flexibility to create more efficient investment options for their plan participants through the use of the white label structure. In addition, with improved custodian technology and efficiencies, plan sponsors can create white label funds with fewer assets today than when they originally started to gain popularity years ago.

A second important DC market trend is the use of Target Date Funds. According to Vanguard's "How America Saves Report 2020," 94% of DC plans offer a TDF option today and 78% of all participants use TDFs. TDFs have a multi-asset class, multi-manager structure, making them a natural place to include private real estate (although there certainly are other excellent spots, such as a real asset fund or inflation hedge fund). As mentioned earlier, a DC plan participant can invest his/her entire DC account in a TDF and stay invested in the fund throughout his/her career and into retirement. The TDF provides asset class diversification, and the fund becomes more conservative as the participant approaches retirement. When TDF's are utilized by participants as outlined, the amount of liquidity a TDF manager might need from a private equity or private real estate manager is minimal.

A third DC trend supporting less liquid investment alternatives in DC plans is auto enrollment. Together with auto escalation (collectively, the "auto features"), these plan design features automatically enroll participants in the DC plan and/or automatically increase participant contributions over time. Both features serve to help keep flows into the investment options constant. The constant flow of contributions helps offset any generally small withdrawals, thereby reducing the level of liquidity a plan may actually need.

Growing Number of Daily Priced Private Real Estate Funds

The number of real estate funds that are priced daily has grown significantly in the past 20 years, providing investors with more options to meet their specific needs. The number of funds included in the NCREIF Daily Priced Index ("NFI-DP") has increased from three in 2007 to eleven in 2020, with AUM increasing 114% to $50.2 billion from $23.5 billion during that time period.

The growth in DC plan assets, along with improved efficiency in calculating the daily price of private real estate, has not only increased the number of daily priced real estate investment options but also the ability to customize those funds to meet client needs. While we will focus on the daily liquidity of daily priced real estate funds, we provide a summary below of the common attributes of daily priced real estate funds to provide context for the liquidity discussion.

Common Attributes of Daily Priced Real Estate Products

ATTRIBUTE	COMMON PRACTICES
Fund Structure	Collective Investment Trust, Insurance Company Separate Accounts, and LPs
Investment Allocations	Private Equity Real Estate (75% to 100%); Public REITs (0% to 25%); Cash (0% to 15%)
Real Estate Risk Exposure	Core
Periodic Liquidity Cap	5% to 25% or Specified Dollar Amounts over specified time periods
Pricing Frequency	Daily

SOURCE: DCREC

Real Estate Fund Liquidity Review

Daily priced real estate funds have historically provided a limited amount of daily liquidity, including a periodic liquidity cap commonly between 5% to 25% of a DC plan's investment in the daily priced real estate fund or a specified dollar amount. This daily liquidity allows plan sponsors to flow through participants' contributions and redemptions to their underlying investments, similar to what DC plans do with their public security investments. However, making this liquidity available requires private real estate funds to maintain a range, generally between 5% to 30%, of fund assets in cash and/or publicly traded REITs to accommodate daily liquidity. Access to daily liquidity may add volatility and create dispersion in performance when compared to a pure private equity real estate investment. Due to dispersion of returns and structural changes in DC plans discussed above, plan sponsors may require less liquidity from their illiquid alternative investments in the future. However, as the market has evolved, plan sponsors now have greater choice and more options. This enables them to select the level and frequency of liquidity that aligns with their investment needs.

The amount of daily liquidity offered by daily priced real estate funds has been trending lower over the last decade, with some new offerings only providing quarterly liquidity, like DB plan private equity real estate investments. It's worth noting that even though the amount of daily liquidity offered has been trending lower, some of the funds' allocations to public REITs and/or cash has stayed in a tight allocation band over the last seven years, according to the NFI-DP index. From 2014 to 2020, the equal-weighted allocation to public REITs and cash has been between 10% and 15% of fund gross asset value of the funds in the NFI-DP.

Summary

The increasingly rapid growth and adoption of TDFs and other professionally managed DC plans may reduce the need for daily liquidity in daily priced alternative investments going forward, as professional managers can draw liquidity from liquid investments within the TDF. That being said, a number of daily priced alternative investment funds are now available with varied amounts of daily liquidity. As such, plan sponsors should be able to find a daily priced alternative fund that meets their specific liquidity needs. This is an exciting time for plan sponsors who want to diversify their menu of offerings to include options that incorporate less liquid private investment alternatives, particularly private real estate, given the market's evolution to address defined contribution plans' needs.

About the Defined Contribution Real Estate Council (DCREC)

The Defined Contribution Real Estate Council was formed in 2012 to promote the inclusion of investments in direct commercial real estate and real estate securities, including REITs, within defined contribution plans. Its goal is to improve participant outcomes by furthering education about, advocacy for, and best practices of such investments. Members include many of the leading providers of real estate investment products to the defined contribution marketplace.

More information can found be at www.dcrec.org.