



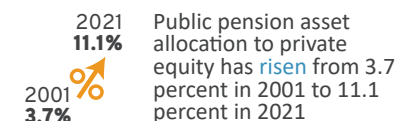
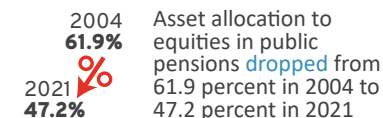
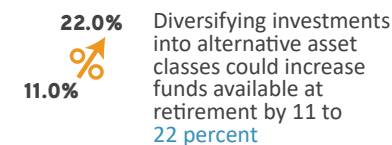
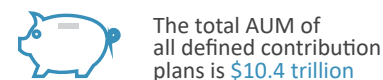
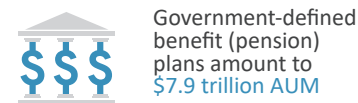
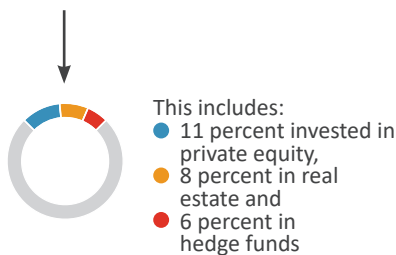
Free markets. Real solutions.

EXPLAINER

401(k)s and Private Company Investments—Open the Door

August 2022

State Pensions Already Invested in Alternatives



Summary

Alternative investment asset classes, such as private equity, hedge funds and real estate, have traditionally been viewed as investment vehicles exclusively available to wealthy and institutional investors. State pension plans and private defined benefit plans also include investments in these alternative asset classes, allowing their plan holders greater diversification, leading to superior long-term returns. But these asset classes have traditionally been off limits for defined contribution 401(k) plans—the dominant retirement income source in the country. The tens of millions of 401(k) plan holders should have the opportunity to access superior returns and wealth building enabled by including alternatives in their plans.

The Problem

In the retirement savings universe, traditional defined benefit pensions are dwarfed by defined contribution 401(k) plans. Defined contribution 401(k) plan assets under management (AUM) are \$7.4 trillion, more than twice the \$3.3 trillion in private defined benefit plans. What can Congress do?

The Numbers

Year	Private Defined Benefit Plan AUM (in \$B)	401(k) Plan AUM (in \$B)	Annual Contributions to Defined Benefit Plans (in \$B)	Annual Contributions to Defined Contribution Plans (in \$B)
1975	186	74	23	13
2019	3,274	7,433	103	570

Source: Department of Labor, Private Pension Plan Bulletin Historical Tables and Graphs 1975-2019, September 2021.

Defined benefit plans often include alternative asset classes such as private equity funds, hedge funds and real estate, whereas defined contribution 401(k) plans are largely restricted to stocks and bonds. Yet funds with higher-performing alternative investments have delivered superior long-term returns compared to funds that hold only stocks, bonds and cash. Thus, if 401(k) funds included more alternative asset classes in their portfolios, individuals could begin retirement with more money in their 401(k)s. Alternative asset classes are underrepresented in 401(k) plans due to fears of litigation and because of safeguards established by the Employee Retirement Income Security Act (ERISA). We believe that appropriate controls should be put in place, and 401(k) holders should have the ability to benefit from higher returns by allocating a portion of their savings to alternative asset classes.

The Argument

Reduced Availability of Public Company Investments

The number of publicly traded companies is shrinking, whereas capital in privately held companies is growing. The number of publicly traded **companies** in the United States declined from its peak of 8,000 in 1996 to approximately 5,000 in 2020. Aggregate enterprise value of private companies has been **estimated** to be far greater than the total valuation of publicly traded companies. The decline in publicly traded companies—combined with the trend for companies to buy back their stock—limits the availability of stocks for purchase by institutional pension fund managers.

Superior Returns

A National Bureau of Economic Research (NBER) **paper** found that private equity likely outperformed public markets in the 1980s, 1990s and 2000s, with annual returns more than 3 percent higher than if the same funds were invested in the Standard and Poor's 500



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index. The NBER research also found that average U.S. venture capital funds outperformed public equities in the 1990s but have underperformed public equities in the 2000s.

Another [study](#) found that alternative assets—including private equity, real estate and hedge funds—can increase target date fund performance by 22 percent in best-case scenarios and 11 percent in worst-case scenarios.

[Other research](#) demonstrates the benefits of including private investments in diversified portfolios. One group [concluded](#) “Private markets investments have outperformed public equities by 5.9% per annum since 2000.”

Supporting the Broader Economy

Prohibiting defined contribution plan holders from investing in alternatives dampens retirees’ nest eggs and income-generating potential, restricting plan holders from participating in trillions of investment targets in growing private businesses and real estate. Private equity has long been a tool to grow the wealth of individuals with enough capital to make large investments. Allowing Americans to pool their retirement assets and collectively invest in such alternatives enables access to assets not otherwise available to those in low-to-moderate income tiers.

The Counterarguments

Resistance to the inclusion of alternative investments centers on the potential for litigation, higher fees and lower liquidity. ERISA [mandates](#) that, as fiduciaries, pension fund managers must “discharge [their] duties with respect to a plan solely in the interest of the participants and beneficiaries.” The higher complexity of alternative investment classes may lead to increased exposure to errors and omissions for pension fund managers.

[Fees](#) for private equity investments are typically about 2 percent, in addition to a percentage of the profits. This is more than double the expense ratio for [equity](#) mutual funds, which are approximately 1 percent.

In addition, some alternative investments—such as hedge funds and real estate—may have periods of higher [volatility](#), which depresses fund performance.

Recent Developments

On June 3, 2020, the Department of Labor (DOL) issued an [Information Letter](#) regarding private equity investments in defined contribution plans. In the letter, the DOL asserted that pension fund managers wishing to add or maintain private equity investments in their funds must exercise a heightened level of review and diligence.

On Dec. 21, 2021, the DOL published a [Supplemental Statement](#) focusing on a Securities and Exchange Commission (SEC) “Risk Alert” issued shortly after the 2020 Information Letter was released. In the alert, the SEC raised several compliance concerns, which included conflicts of interest, fees and policies on material nonpublic information.

The Way Forward

Retirees and investors should have access to greater retirement wealth accumulation in their 401(k) plans by participating in private company growth. Unfortunately, 401(k) plans are unnecessarily deprived of this wealth-building opportunity by overly cautious DOL rules. As the wealth of privately held companies grows—and the number of publicly traded firms shrinks—plan managers should have the ability to enhance 401(k) returns with some allocation to alternative investments. The DOL should explore this wealth-expanding opportunity.