UNPACKING THE DEPARTMENT OF LABOR'S GUIDANCE ON PRIVATE EQUITY INVESTMENTS IN 401(K) PLANS

In a surprise announcement, the Department of Labor (DoL) issued an Information Letter in June 2020 that paves the way for investors to access private equity funds via their employer-sponsored retirement accounts.[1] The guidance from the DoL, which governs 401(k) retirement accounts, addresses an inquiry seeking to clarify whether private equity investments can be used as a component of a professionally managed asset allocation fund in individual account plans.

While proponents support the potential to generate higher returns and increase diversification, critics argue the inherent illiquidity and complex fee structures of private equity funds pose unsuitable risks for most retail savers.

Although defined benefit (DB) plans and endowments have invested in private equity for years, defined contribution (DC) plans have largely avoided private investments due to litigation fears under ERISA. The private equity industry has advocated for greater parity between DB and DC investment options and, while the information letter does not provide all out approval, the guidance may serve as a milestone for plan fiduciaries to offer private equity within 401(k) plans.

We unpack the new guidance, including key implications for the alternative investment and defined contribution industries respectively:

- The democratization of alternative investments continues
- Long-term tailwind for private equity firms but litigation fears will likely hinder near-term asset growth
- Regulatory guidance from DoL and SEC in lockstep

KEY IMPLICATIONS

The democratization of alternative investments continues

The broader adoption of alternative investments within retail channels underscores the blurring lines between public and private equity. As companies opt to stay private for longer (e.g., Uber; Airbnb), a significant amount of value creation is occurring ahead of entering public markets. Attractive returns have generated strong demand from institutional and accredited retail investors alike. In response, asset managers have turned their focus to new distribution channels to access the largely underserved retail investor.

Although alternative investments have predominantly been deemed unsuitable for most retail investors, private equity firms have argued that the inability to access alternative assets has put retail clients at a disadvantage. Labor Secretary, Eugene Scalia, supports this sentiment as he believes the action will "help Americans saving for retirement gain access to alternative investments that often provide strong returns."

According to Willis Towers Watson, allocating to a more diversified portfolio with alternative investments improved expected outcomes by 17 percent while also mitigating downside risks.[2] The guidance from regulators coupled with proven better retirement plan outcomes should further augment the growth of alternatives for retail clients in the long-term.

Long-term tailwind for private equity firms but litigation fears will likely hinder near-term asset growth

With assets exceeding $8.8 trillion and coverage provided to more than 100 million Americans, the defined contribution market represents a substantial untapped pool of capital.[3] Private equity managers could unlock as much as $400 billion in new assets according to analysts at Evercore.[4] The strong demand has led to a tremendous influx of capital. According to Preqin, the global private equity industry has seen annual inflows of over $500 billion each of the past four years, bringing the overall market size to more than $4 trillion.[5]

Ahead of guidance from the DoL, Vanguard, one of the world's largest asset managers announced their entry into private equity via a strategic partnership with HarbourVest in Feb. 2020.[5] As the largest provider of target-date funds and boasting $1.3 trillion in DC AUM, Vanguard is well positioned within the DC ecosystem to win new assets.

Although demand is growing, new entrants will face structural challenges as compared to traditional public market investments including capacity constraints, long time horizons, high dispersion between managers, illiquidity, and high fees.

Despite the inflow of funds, private equity firms continue to grapple with broad industry challenges, including intense competition, overpayment for companies and capital deployment issues. As an example, dry powder, or funds waiting to be invested, rose to a new high of $2.5 trillion as of December 2019. Near-term asset growth in employer-sponsored retirement plans will likely be muted as private equity firms work through these challenges.

Regulatory Guidance from DoL and SEC in lockstep

In an effort to better serve retail clients, the regulatory landscape continues to evolve, whereby the DoL and SEC are broadly aligned with their guidance. Accompanying the information letter were statements from both DoL Secretary, Scalie, and Securities and Exchange Commission (SEC) Chairman, Jay Clayton, supporting private equity investments for retail clients.

While remaining in compliance with ERISA, Scalie suggested he is "levelling the playing field" for retail and institutional investors. Clayton commended the DoL's efforts to improve investor choice by "more closely matching the diversified public and private market asset allocation strategies pursued by many well-managed pension funds."

Furthermore, in late August, the SEC voted to expand the definition of accredited investors, a prerequisite for investing in alternative investments. Previously defined as having $1 million in net assets or at least $200,000 in annual income, approximately 16 million Americans met this criteria in 2019.[6] While the SEC did not provide an estimate of the number of people who would qualify under the new rule, the decision will likely generate interest from others to seek accredited investor status. By loosening restrictions, the SEC has opened the door for more retail investors to access private investments.

CONCLUSION

As investors seek enhanced investment returns, allocations to traditional stocks and bonds have been reduced in favor of alternative asset classes. In response to the DoL announcement, we expect this proliferation to continue, albeit at a slower than anticipated pace for retail clients.

Buoyed by strong long-term investment performance and positive sentiment of private market growth potential, the DoL's guidance may serve as a turning point in a broader shift to increasing retail exposure to private investments.

While the private equity industry has successfully influenced the regulatory bodies (e.g. SEC and DoL) in broadening access to private investments, private equity firms and asset managers face structural hurdles ahead of providing private equity investment solutions to plan sponsors. Additionally, a change in the political landscape in November may undo this shift in regulatory direction.

Despite these challenges, we anticipate more strategic partnerships (e.g., Vanguard/HarbourVest) to occur as asset managers and private equity firms look to navigate the defined contribution space effectively.

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AUTHOR

Michael Daly, Senior Consultant
Michael.Daly@capco.com

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