PGIM

PART 2

THE EVOLVING DEFINED CONTRIBUTION LANDSCAPE

ALTERNATIVES & ESG AS LONG-TERM SOLUTIONS FOR LONG-TERM CHALLENGES

ALTERNATIVE AND ESG INVESTING IN THE DC SPACE

An introduction

In a world of aging populations, changing demographics and issues of inequality, it's imperative that the average US worker has access to quality investments to help them build and maintain their wealth, particularly when it comes to retirement. Unfortunately, the typical defined contribution (DC) participant doesn't have access to the same types of investment strategies currently available to institutional investors and high-net-worth individuals, such as private equity, hedge funds and direct real estate.

Given the long-term nature of retirement savings, some investors believe they can also benefit from other diversification tools such as responsible and sustainable investments. Indeed, an increasing number of investors feel that environmental, social and governance (ESG) factors can materially affect the long-term success of a company and the returns of its securities.

PGIM recently completed a survey of more than 130 DC plan sponsors in an effort to capture insights about the current landscape related to the implementation of alternative investments in DC plans. Our research also examined the use of ESG investments. Here we offer our findings. (Part 1 of our research series, focusing on the expanding role of OCIOs, can be read here.)

How we conducted our research

PGIM canvassed more than 130 DC plan sponsors to learn about the current trends in the DC market. The research was conducted by Greenwich Associates using an online, quantitative approach with DC plan sponsors who have at least one 401(k) plan and a minimum of $100 million in 401(k) assets. See an explanation of our methodology at the conclusion of this report.

USE OF ALTERNATIVES IN DC PLANS

BY THE NUMBERS

Sophisticated investors of all kinds understand the benefits of unique investment strategies to grow wealth and manage risk. Given that plan sponsors and consultants have the ability to bring this approach to the typical participant, at institutional pricing, there is a compelling case to be made that they try and do so. But do they?

Our proprietary research shows that most DC plan sponsors do not offer alternatives as part of their target date funds (TDFs). Indeed, within TDF arena just 5% of plans say they currently offer or are considering offering hedge funds to their participants via their target date fund, while 7% currently offer or are considering offering private equity. Real estate private equity has the support of 11% of plan sponsors.

The lack of alternatives use is at least in part a function of sponsors believing that, because most participants are novice investors, they should not have exposure to more "sophisticated" investments that other institutional investors often use. But if there are suitable investment options available it seems all participants should have access. To the extent it is operationally feasible, DC sponsors should look to portfolios of their institutional counterparts as guidance when designing investment options.

This is the second in a three-part series from PGIM taking a deep dive into key trends in the DC space in the United States and contains analysis specific to the United States.

Bringing institutional solutions to individual participants

Plan sponsors should look to portfolios of their institutional peers when designing investment options, most notably around extended credit sectors, alternatives and private assets.

As an example, private real estate has historically been a strategic allocation in institutional portfolios and also relied upon by individuals in building and growing their wealth.

In analyzing private real estate's impact on retirement outcomes, we have found that a modest allocation in multi-asset portfolios results in a meaningful reduction in both the magnitude and range of projected portfolio drawdowns.

The benefits of this effect can be significant in reducing sequence of return risk around retirement and keeping plan sponsors committed to their investment selections.

CURRENTLY USING ALTERNATIVES AS PART OF TARGET DATE FUNDS

	Real estate private equity	Real estate private debt	Hedge funds	Private equity	Liquid alternatives
Currently using	9%	5%	4%	4%	4%
Considering using	2%	1%	1%	3%	4%

CONSIDERING USING ALTERNATIVES AS PART OF TARGET DATE FUNDS

THE ROLE OF TDFs

EASY, BUT NOT SIMPLE

The objectives of investors often differ, as will their investment solutions, and it is the institutional approach taken by these investors that can improve the success of defined contribution plans. And the need for simple-to-use solutions like target date funds does not necessarily mean the underlying investments must be simple.

As an example of an institutional approach, alternative asset classes such as private real estate have historically been a strategic allocation of institutional portfolios. But individuals also rely on investments in property to build and grow their wealth, highlighting the importance of consideration for inclusion in DC menus.

According to National Real Estate Investor, 62% of high-net-worth individuals hold average allocations to real estate of 5-25%. Typical American workers are not accredited investors and therefore can't access many of these strategies on their own, but it can be done within a DC plan.

Our research reveals that more larger plans are offering TDFs with alternative investment options embedded in their offerings, and real estate is a main component. Of the plans surveyed with between $1 billion to $5 billion in AUM, 19% say real estate private equity are offered within their TDFs.

ALTERNATIVES AS PART OF 401(K) PLAN - TDFs

	Currently offer	Considering adding	Not considering adding
$100m - $249m			
Real estate private equity	12%	0%	88%
Real estate private debt	3%	0%	97%
Hedge funds	3%	0%	97%
Private equity	3%	0%	97%
Liquid alternatives	3%	0%	97%
$250m to $499m			
Real estate private equity	0%	2%	98%
Real estate private debt	0%	5%	95%
Hedge funds	2%	2%	95%
Private equity	5%	0%	95%
Liquid alternatives	5%	5%	90%
$500m to $999m			
Real estate private equity	10%	3%	86%
Real estate private debt	7%	0%	93%
Hedge funds	7%	0%	93%
Private equity	7%	3%	90%
Liquid alternatives	3%	3%	93%
Over $1B			
Real estate private equity	10%	2%	88%
Real estate private debt	8%	0%	92%
Hedge funds	4%	0%	96%
Private equity	2%	6%	92%
Liquid alternatives	4%	4%	92%

RISKY BUSINESS?

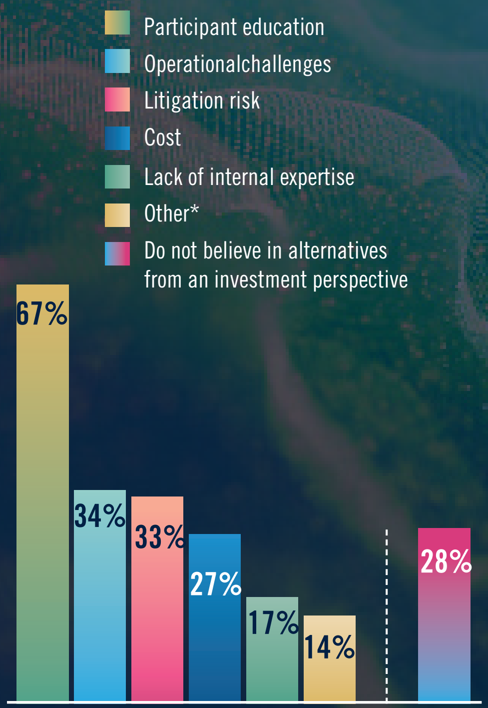
TO OFFER OR NOT OFFER ALTERNATIVES

One of the biggest drivers of the trend toward the simple approach in DC plans has been perceived litigation risk by plan sponsors. Ironically, one could argue that the trend of moving towards simpler and cheaper investment menus actually creates more legal risk by putting sponsors' interests ahead of participants' interests. Importantly, the Department of Labor's (DOL) stance on the use of private equity in DC plans has changed, giving plan fiduciaries the opportunity to take a more innovative approach.

To be sure, the DOL's recent information letter was not a safe harbor, nor was it a new regulation. The DOL merely stated its view that the inclusion of private equity is not inherently improper. The letter did provide some special considerations a plan sponsor should evaluate given the unique nature of this asset class. Whether it's private equity, other alternative strategies or any investment strategy, a fiduciary should be able to go through a process and rely on their own expertise and the expertise of their advisors to evaluate whether they believe a strategy will benefit their participants.

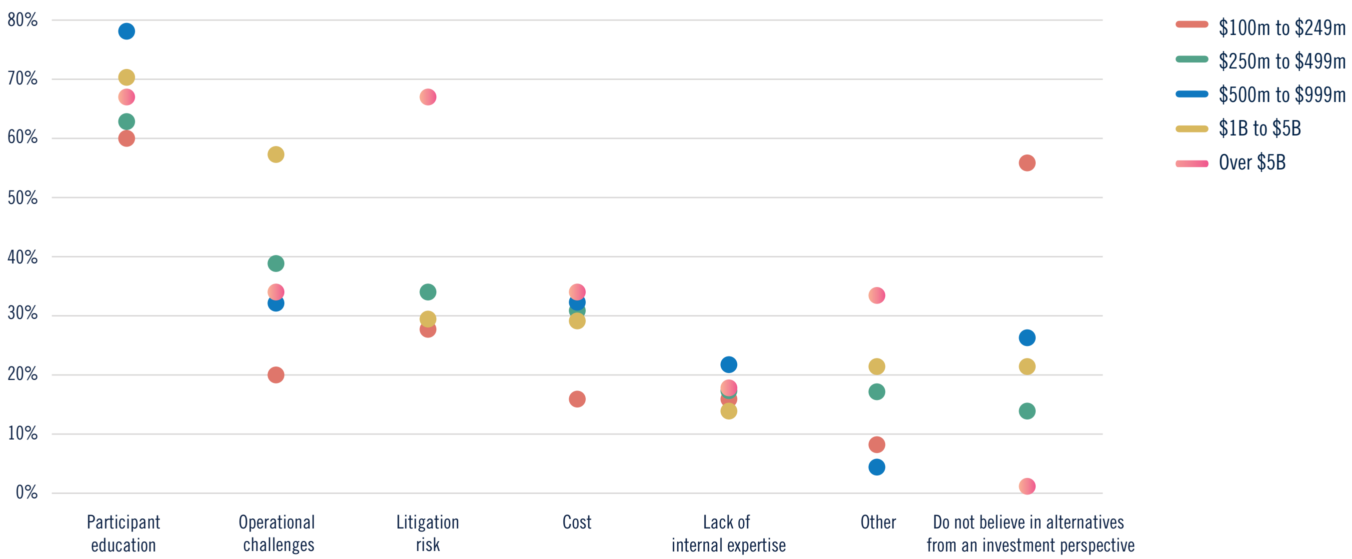
The most common reason cited in our research for not considering adding alternatives is the need for enhanced participant education, followed by the operational challenges presented by using alts and litigation risk. What's more, 28% of respondents said they don't believe in alternatives from an investment perspective.

REASONS FOR NOT CONSIDERING ADDING ALTERNATIVES TO INVESTMENT MENU OR TARGET DATE FUND - TOTAL



*Other includes liquidity risks, mismatch with fiduciary expectations, complexity for non sophisticated investors, Covid-19 circumstances, limited demand from participants.

REASONS FOR NOT CONSIDERING ADDING ALTERNATIVES TO INVESTMENT MENU OR TARGET DATE FUND BY TOTAL AUM IN 401(K) PLAN



A MIXED BAG

ESG INVESTING IS OF CONTINUED INTEREST FOR INVESTORS

As part of our research, we also asked plan sponsors about their ESG use. ESG investing is of continued interest for investors in the US and around the globe - it's an evolving area with varying views, differing definitions, and where new research is being unearthed on a regular basis.

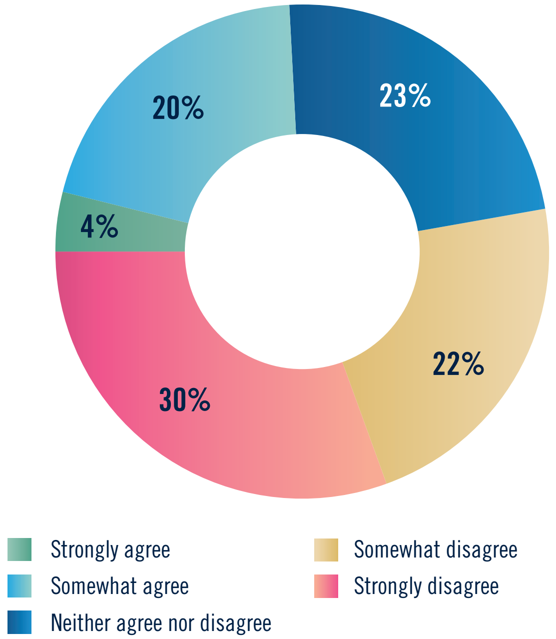
In our survey, almost a quarter of plan sponsors (4% who strongly agree and 20% who somewhat agree) said they have taken action to incorporate ESG approaches into their 401(k) plan over the last 1-3 years, while 52% (30% who strongly disagree and 22% who somewhat disagree) said they have not, with the remaining respondents on the fence.

Late last year, the DOL issued its final rule outlining its stance on ESG investing. The ruling requires plan fiduciaries to select investments based on pecuniary factors – that is, any factor that a responsible fiduciary prudently determines is expected to have a material effect on risk and/or return of an investment.

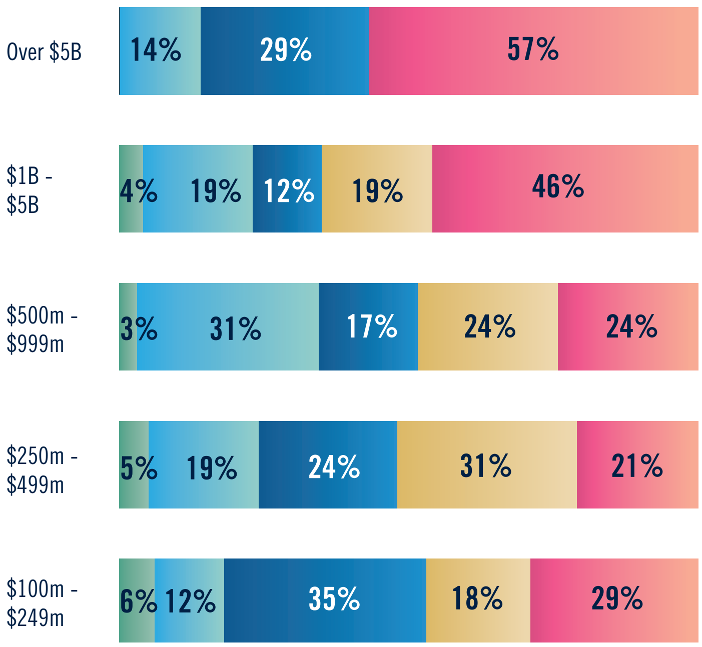
Some in the industry may invest in an ESG strategy purely for social reasons, but doing so for an ERISA plan would be impermissible. But many also believe it's important to consider ESG factors when investing because doing so may result in better long-term performance. While the DOL doesn't forbid ESG investing, the proposed regulations and pronouncements around it seem to be skeptical that this approach has investment merits. The regulation would make it critically important for fiduciaries to follow a prescribed set of standards in order to be able to justify ESG investments. The remaining question is whether plan sponsors who believe in ESG investing will take the necessary steps or will instead forgo such investments out of fear of perceived fiduciary risk. We also expect the Biden administration to revisit the current policy.

We asked, "To what extent do you agree with the following statement. Over the last 1-3 years, we have taken action to incorporate ESG (Environmental, Social and Governance) approaches into our 401(k) plan."

INCORPORATION OF ESG IN 401(K) PLAN TOTAL



BY TOTAL AUM IN 401(K) PLAN



CONCLUSION

RAISING THE BAR IN THE DC SPACE

Defined contribution should have access to the same types of investment strategies currently available to institutional investors and high-net-worth individuals, including alternatives and ESG investments to address their long-term investment challenges. Starting with alts, the DC market is an obvious place to focus on, the result of:

Fiduciary Oversight:

There is no higher fiduciary standard than ERISA, and participants in a DC plan have a fiduciary that needs to ensure their best interests are served.

Institutional Pricing:

Employers can use their scale to bring certain institutional investments to the average American worker at a price they could not have achieved on their own.

Professional Management:

In a DC plan, certain alternatives can be incorporated in professionally managed solutions like TDFs, overseen by knowledgeable investment professionals.

Long-Term Time Horizon:

Many alternative investments are illiquid and require a long-term holding period to pay off. Saving for retirement can be a half-century or more proposition, making certain alts an investment option for less liquid investments with a longer-term payoff.

Broadest Access:

For most middle-income Americans, the bulk of their wealth is in housing and their retirement plans. If we want to provide access to alternative investments to a majority of Americans, DC plans are where this can best happen.

What's more, as investors look to diversify their portfolios with responsible and sustainable investments, they will require more than one-size-fits-all strategies to meet their changing needs and shouldn't be faced with compromised returns. While there is no "right way" to approach ESG investing, as the DC space continues to evolve workers should have made available to them more investment options that are aligned to their ESG preferences and that meet fiduciary standards of appropriateness.

There is a fairness case to be made to democratize investment opportunities and allow more American workers access to the types of strategies that only institutions and wealthy Americans currently utilize. While many plan sponsors have fiduciary concerns in adding these to DC plans, there are similarly fiduciary concerns of not making these investments available given the compelling case to do so.

For more info contact Josh Cohen, Head of Institutional Defined Contribution, PGIM Institutional Relationship Group at josh.cohen@pgim.com or learn more at pgim.com/dc

APPENDIX

METHODOLOGY

- The research was conducted by Greenwich Associates from March 5th to July 17th 2020, using an online, quantitative approach with DC plan sponsors in the United States who have at least one 401(k) plan and at least $100m in 401(k) assets.
- The research was conducted on an unsponsored/blind basis with no mention of PGIM as the study sponsor.
- Participants were incentivized to participate with a summary of the research findings as well as a charitable donation to the American Red Cross or AMEX gift card ($100).
- Respondents had the option to determine whether to disclose their participation and/or individual responses.

Figure A1: Most DC plan sponsors do not offer alternatives in their investment menu or as part of their TDF; liquid alternatives and real estate private equity most common

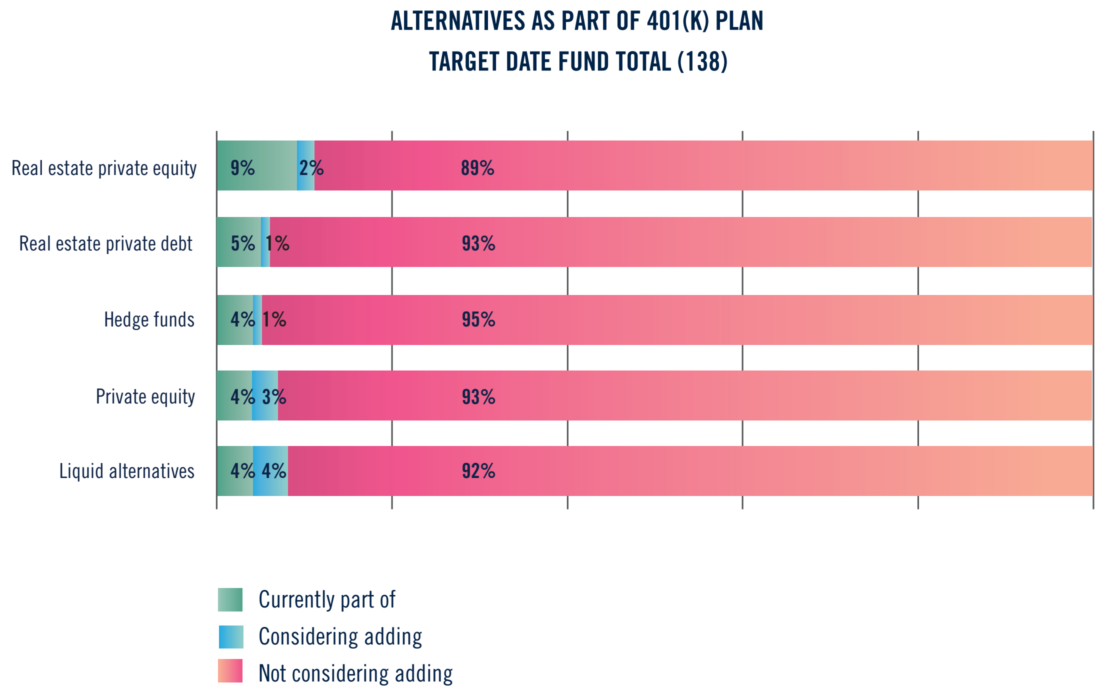


Figure A2: More larger plans are offering TDFs with alternative investment options embedded in their offerings

ALTERNATIVES AS PART OF 401(K) PLAN

TARGET DATE FUND
BY TOTAL AUM IN 401(K) PLAN

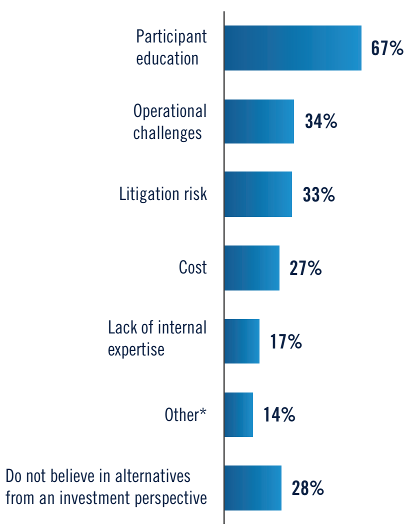
	Over $5B (7)			$1B to $5B (26)			$500m to $999m (29)			$250m to $499m (42)			$100m to $249m (34)		
	CPO	CA	NCA	CPO	CA	NCA	CPO	CA	NCA	CPO	CA	NCA	CPO	CA	NCA
Real estate private equity	0%	0%	100%	19%	4%	77%	10%	3%	86%	0%	2%	98%	12%	0%	88%
Real estate private debt	0%	0%	100%	15%	0%	85%	7%	0%	93%	0%	5%	95%	3%	0%	97%
Hedge funds	0%	0%	100%	8%	0%	92%	7%	0%	93%	2%	2%	95%	3%	0%	97%
Private equity	0%	0%	100%	4%	12%	85%	7%	3%	90%	5%	0%	95%	3%	0%	97%
Liquid alternatives	0%	0%	100%	8%	8%	85%	3%	3%	93%	5%	5%	90%	3%	0%	97%

CPO = Currently Part Of
CA = Considering Adding
NCA = Not Considering Adding

Figure A3: The most common reason for not considering adding alternatives is the need for enhanced participant education; over a quarter do not believe they are appropriate

REASONS FOR NOT CONSIDERING ADDING ALTERNATIVES TO INVESTMENT MENU OR TARGET DATE FUND

TOTAL (93)

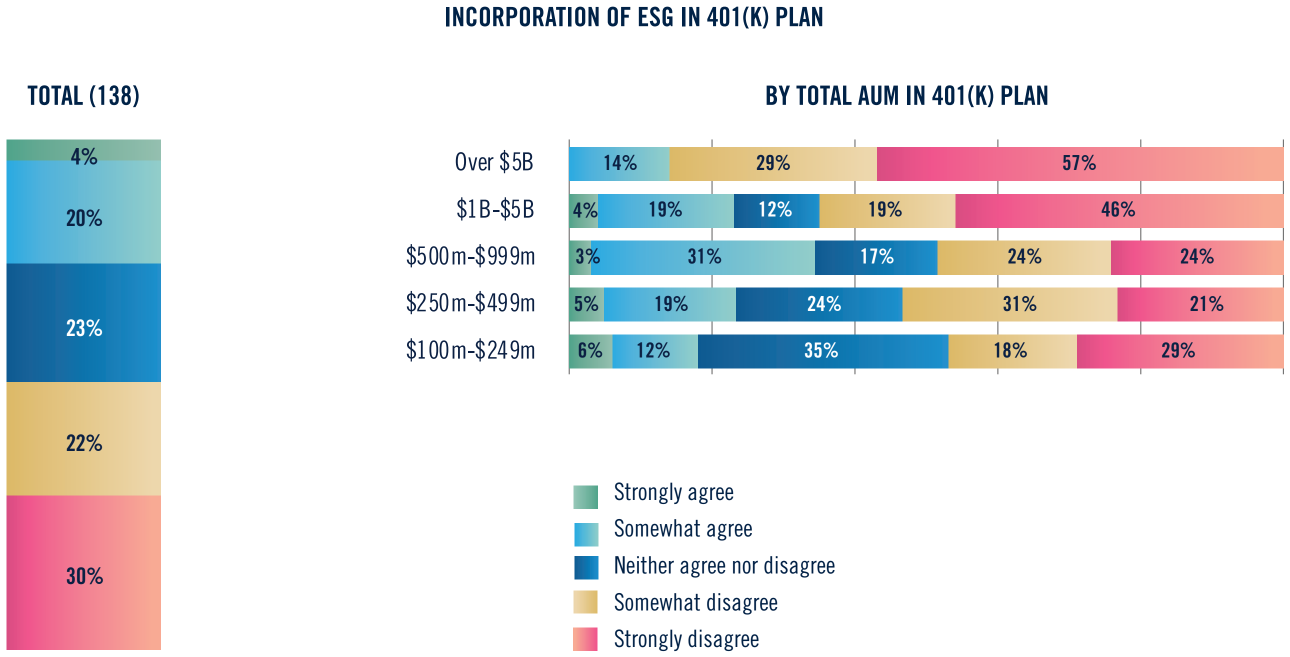


BY TOTAL AUM IN 401(K) PLAN

By Total AUM in 401(k) Plan				
Over $5B (6)	$1B to $5B (14)	$500m to $999m (19)	$250m to $499m (29)	$100m to $249m (25)
67%	71%	79%	62%	60%
33%	57%	32%	38%	20%
67%	29%	32%	34%	28%
33%	29%	32%	31%	16%
17%	14%	21%	17%	16%
33%	21%	5%	17%	8%
0%	21%	26%	14%	56%

*Other includes liquidity risks, mismatch with fiduciary expectations, complexity for non sophisticated investors, Covid-19 circumstances, limited demand from participants.

Figure A4: Almost a quarter of plan sponsors have taken action to incorporate ESG approaches into their 401(k) plan over the last 1-3 years; slightly more common for those using an OCIO



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