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Summary:

A primer on private investments in defined contribution plans

Historically, U.S. defined contribution (DC) plans have offered plan participants access predominantly to publicly available investment options such as equity and bonds. As U.S. DC plans continue to progress towards being the primary source of retirement savings for U.S. workers, plan fiduciaries may wish to consider the merits of offering access to private investments.

Private investments have long been utilized in defined benefit plans due to their return potential, diversification and risk benefits. However, many issues have presented a hurdle for DC plans considering offering these investments, including but not limited to administrative and operational complexity, higher and multifaceted fee structures, and the expertise required to evaluate private investments.

Another significant barrier has been litigation risk, particularly fee litigation, which has become more pervasive in the DC industry. However, we have seen the successful implementation of private investments in DC plans outside of the U.S. Shifts in the U.S., such as the growing availability of pooled employer plans and the evolution of investment vehicles to make private investments more readily available to a wider investor base, may warrant a fresh look at private investments for DC plans.

As a first step, we suggest that DC plan sponsors consider educating themselves on what private investments entail and gain an understanding of how to solve for various complexities.

If pursued, Mercer believes that for most DC plans private investments are likely most appropriate when offered through a multi-asset vehicle that is professionally managed, such as a target date fund.

Figure 1

Private markets

Private market investments encompass any assets which are not tradeable on a public exchange. Instead, the purchase and sale of private market assets are privately negotiated.

Private equity

Private equity broadly refers to investing in privately owned companies through a negotiated process. Most strategies involve a transformative, value-add active strategy.

Private debt

Private debt broadly refers to a privately negotiated lending agreement between a lender and a borrower obtained outside of the public market, sometimes known as “Direct Lending”.

Real assets

The real asset universe consist of a spectrum of sub-asset classes: Real Estate, Infrastructure, and Other Real Assets. Differences exist in economic drivers and size of regional opportunity sets.

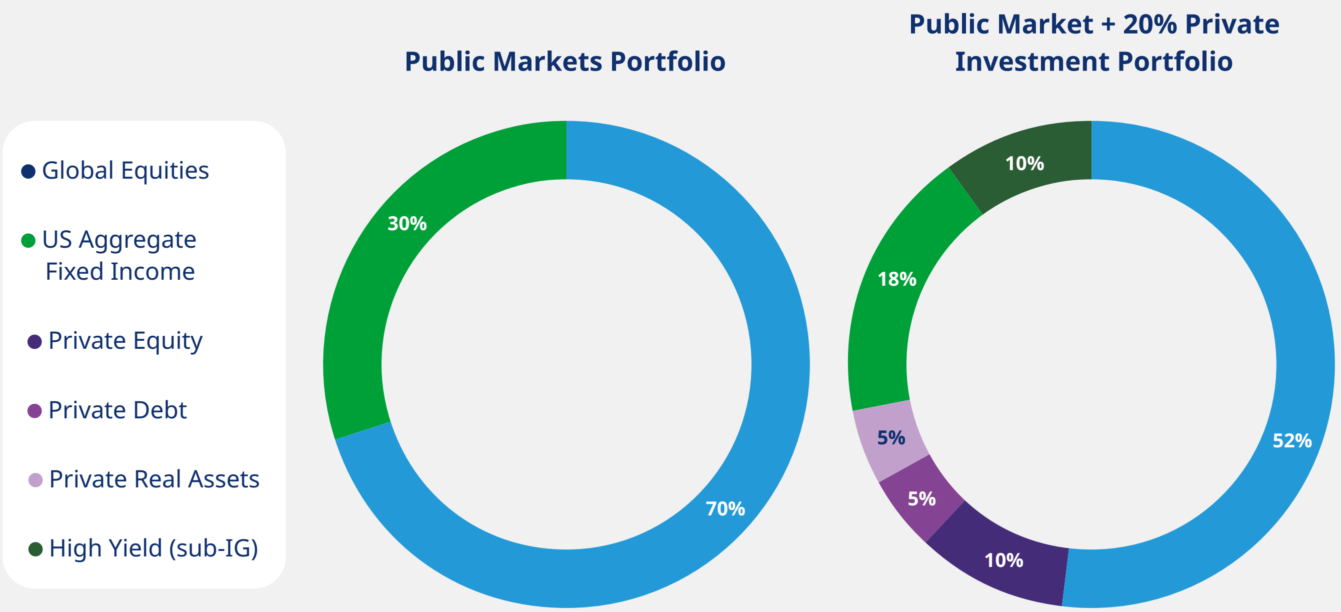
- **Real estate:** Real estate broadly refers to an equity or debt interest in tangible property consisting of land, buildings and the improvements of those. The four major sectors are office, residential, industrial, logistics and retail. Strategies by increasing risk and return: core, core-plus, value-add and opportunistic.
- **Infrastructure**: Infrastructure broadly refers to the basic physical and organizational structures needed for the operation of a society or enterprise.

In the following we explore, some of the potential benefits of private investments and how to solve for some of their associated challenges that DC plans may encounter. In this brief, non-exhaustive exploration, we assume that private investments would be deployed through a multi-asset portfolio (e.g., target date fund).

Potential Benefits of Private Investments

- May provide a more efficient risk-return profile compared to only a portfolio of publicly available securities (e.g., equities and bonds)
- May enhance diversification, which has the potential to improve return consistency[1]
- Provides direct exposure to hard assets (e.g., real estate, infrastructure, etc.) which may provide for lower volatility and correlation to publicly traded equities

Figure 2



	Public Markets Portfolio	Public Market + 20% Private Investment Portfolio
Expected Risk (%)	13.1%	13.1%
Expected Return (%)	6.1%	7.1%

Figure 2 is provided for illustrative purposes only and does not constitute a portfolio recommendation. There can be no assurance that these results can be achieved. Actual results are likely to vary. Expected risk reflects annual standard deviation and expected return reflects asset-class only (no alpha) expected returns for traditional asset classes and includes alpha assumptions for private investments for a 20-year forward-looking period using Mercer's Capital Market Assumptions as of January 2024. Calculations performed by Mercer are as of 02/29/2024 and were performed on 03/08/2024. Asset class expected returns are hypothetical, shown for illustrative purposes at the general-market level only. This is not meant to represent Mercer's performance or any actual portfolio.

1. Diversification does not guarantee a profit or protect against a loss

Potential Challenges and Considerations for Private Investments

Challenge vs public markets	Considerations
Less liquid: Private investments are not daily valued or traded because they are not listed on exchanges and often deploy capital over a long period of time (multiple years)	• Limiting overall allocations to private investments within a portfolio with majority liquid assets • Embedding liquidity sleeves to manage cash flows in a multi-asset fund • Using pooled, multi-investor fund structures customized for DC plans
Higher and complex fees: A private market investment fee often reflects a higher investment management fee due to the experience and capital intensity required. In addition, most private investments may also have a preferred return and carried interest fee or profit-sharing component.	• Limiting private market investments to a small allocation of an investment portfolio • Utilizing a fee budget within a multi-asset fund • Trading off a fee budget with passive, publicly traded investments where markets are efficient
Complexity: Private investments require additional and unique resources and expertise involved in the placement and administration of these investments compared to publicly traded portfolios	• Private market managers are starting to provide communication support and educational collateral, in addition to vehicle structures that provide for daily pricing and more frequent liquidity. It is important to assess whether these "DC friendly" vehicle features erode the benefits of the investment. • Engaging with external experts, such as an OCIO (outsourced chief investment officer) otherwise known as an ERISA 3(38) investment fiduciary, may provide notable resources and knowledge around operations, administration and placement.

The decision to include private investments in a U.S. DC plan portfolio is complex and dependent on the specific circumstances of each plan sponsor. There are notable investment, administrative and operational hurdles and complexities that require careful consideration, in addition to the ever-present risk of DC litigation. However, as the private investment landscape continues to evolve and as DC plans provide for an increasing amount of U.S. worker's retirement savings, fiduciaries should thoughtfully consider this often-underutilized component of capital markets.

To learn more about various possible implementations and more details around fiduciary considerations, see our paper: **Looking to the future: The evolution of private investments in DC plans.**