November ▪ 2014

John Hancock INVESTMENTS

Deepening diversification in defined contribution plans: the rise of liquid alternatives

Leo M. Zerilli, CIMA
Head of Investments
John Hancock Investments

"As asset allocators are continuing to develop more advanced target-date funds, alternatives to stocks and bonds are playing an increasingly more prominent role in these portfolios."

Key takeaways

- For more than 60 years, alternative investments have provided differentiated sources of return and ways to hedge market risk beyond those available through traditional stock and bond strategies.
- Once limited to high-net-worth and institutional investors, alternatives have become more popular among individual investors through the mutual fund structure, a response to greater market volatility in recent years.
- Initially slow to adopt alternatives, many defined contribution (DC) plan sponsors are now refining legacy lineups of funds by incorporating liquid alternative investments into professionally managed asset allocation options—and fulfilling their fiduciary obligations to plan participants in the process.

Executive summary

Since the middle of the last century, what we now call alternative investments have provided capital market participants with unconventional sources of potential return along with risk management techniques beyond those available through stocks and bonds alone. Once exclusive to sophisticated institutional investors and wealthy individuals, alternative investment strategies have recently drawn a much broader following through liquid and easily accessible vehicles such as 1940 Act mutual funds. While traditional defined benefit pension plans have made extensive use of alternatives for years, plan sponsors of participant-directed DC plans have been slow to adopt these nontraditional investment styles, even in their most liquid forms. However, if implemented properly, one can make a strong case for the fiduciary merits of access to alternative investment exposures within a DC plan. Indeed, many plan sponsors are now refining legacy lineups of funds to address concerns about volatility, low yields, and high correlations by incorporating liquid alternative investments within professionally managed asset allocation options, including target-date retirement funds.

Traditional vs. alternative investments: some generalizations for DC plans

Traditional investments	Alternative investments
Limited to long stock and bond positions	Can include derivatives, short sales, and leverage
Deliver a wide range of possible results	Aim for a target range of outcomes
Return oriented	Risk controlled
Underscore the magnitude of returns	Emphasize consistency of returns
Market return dominates the result	Manager skill dominates the result

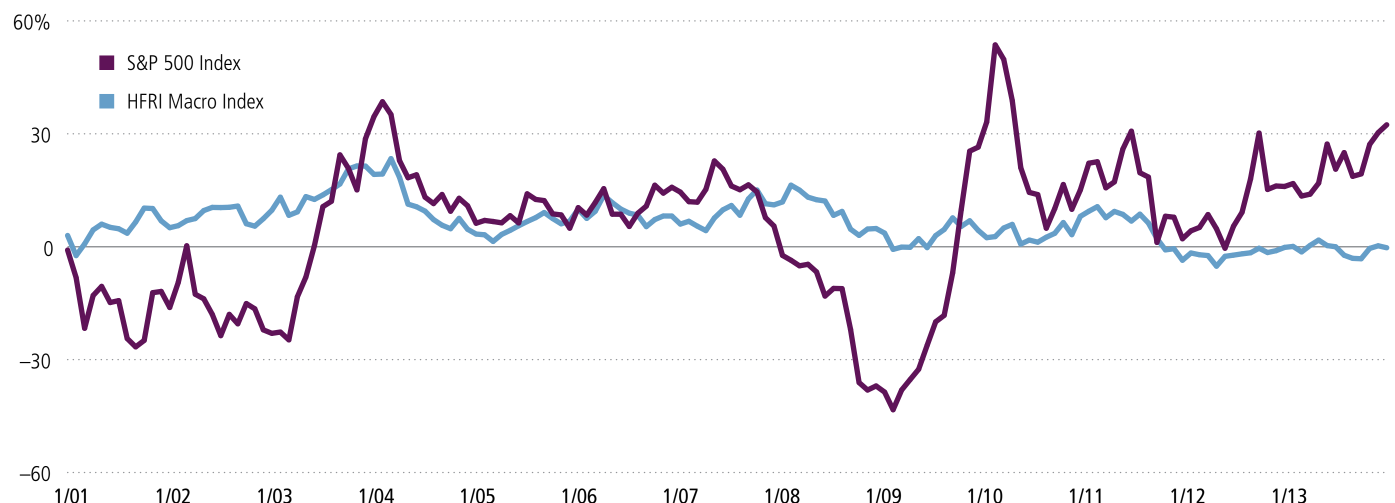
Alternatives for DC plans: more tortoise than hare

At their most basic descriptive level, alternative investments are strategies other than long-only stock and bond funds. The chief virtue of alternatives is that they do not necessarily move in sync with the traditional investments that dominate most portfolios. Because alternatives tend to behave differently than traditional stock and bond styles, they are typically used as portfolio diversifiers. There are, of course, exceptions, but for our purposes here, most alternative managers seek to hedge or limit certain market risks and therefore emphasize risk control and consistency of returns rather than attempting to amplify returns. If the traditional investment manager is the proverbial hare, then our alternative manager is the tortoise, pursuing success through the compounded effect of a steady, low-volatility return stream over time.

Alternatives to long-only stock and bond investments are not new. The hedge fund traces its roots to 1949, when Alfred Winslow Jones formed an investment partnership that included leverage and short selling, techniques designed to generate returns while lessening market risk. Jones was ahead of his time; these types of private partnerships, which sought total return while hedging the risks of market declines, didn't gain much

Alternatives have displayed a different pattern of returns

Rolling 12-month return



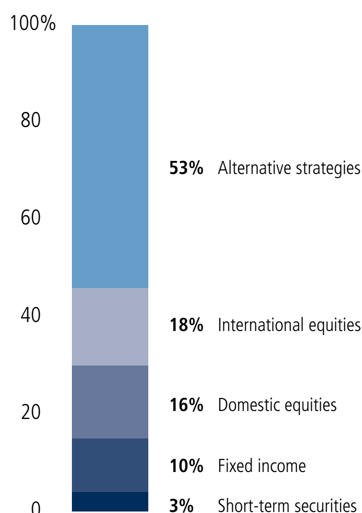
Source: Morningstar, as of 12/31/13. For illustrative purposes only. The HFRI Macro Index is a benchmark designed to reflect macro hedge fund industry performance by constructing equally weighted composites of constituent funds, as reported by the hedge fund managers listed within HFR Database. Macro investment managers trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed-income, hard currency, and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches, and long- and short-term holding periods. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Past performance does not guarantee future results.

traction until the 1980s. The popularity of hedge funds initially grew within circles of wealthy individuals, what today one would call the high-net-worth market. Other early adopters of alternative investments included charitable foundations, defined benefit pension plans, insurance companies, and other institutional investors.

Already enthusiastic, university endowments' appetites for alternatives grew even more following the 2000 publication of *Pioneering Portfolio Management*, by David Swensen, Yale's chief investment officer. Swensen argued that an endowment—designed to support the scholars of today and tomorrow with intergenerational neutrality—has an inherent advantage over other types of investors. Endowments can invest with a time horizon extending into perpetuity. This makes it possible for Yale and its peers to fund large allocations to alternatives, including illiquid assets such as private equity, venture capital, and real estate. Such investments offer the potential to capture an illiquidity premium, which compensates an investor for holding an asset that lacks an active trading market. Investing in alternatives proved an enduring trend in higher education. Today, the average university endowment has the majority of its assets allocated to alternative strategies.

Endowment asset allocation in 2013

Survey of 831 universities



Source: National Association of College and University Business Officers, 2014.

Unlike a university endowment, the average person has a finite investment time horizon, and a prolonged lockup period is not a viable option. Fortunately, not all alternatives rely on an illiquidity premium to drive their returns. Opportunities to introduce alternatives into the portfolios of the everyday investor have expanded in recent years with the emergence of high-quality managers in the mutual fund universe.

The rise of liquid alternatives

As we know from financial market movements in 2008, traditional stock and bond asset allocation has not always provided investors with sufficient insulation against market volatility. During the global financial crisis, correlations of security prices across asset classes surged as all but the safest investments dropped sharply. The breadth, scale, and speed of capital destruction prompted many investors, particularly those approaching retirement, to question age-old assumptions about diversification. While 2008 may have been an extreme anomaly, taking a multidecade view of the market's behavior reveals that big moves within a single trading session have been on the rise for some time.

The elevated volatility of recent years has made it more difficult for the average investor to stick to an investment plan. Studies have shown that long-term investors respond to sharp market drops by switching among their investments. Emotion often dominates investor behavior, and research suggests that the fear of further losses often motivates investors to sell near market bottoms, turning temporary bouts of market volatility into permanent portfolio losses. Fund researcher DALBAR, Inc. publishes an annual study that puts the average holding period for stock and bond mutual funds at little more than three years. The result of all this buying and selling is that investors, on average, underperform broad market indexes.

Recognizing an unfulfilled need for risk-reducing strategies in the wake of the global financial crisis, a number of talented hedge fund managers and mutual fund families began working in partnership to offer alternative investments to individual investors. Today, many liquid versions of strategies that were successful within hedge fund structures are now available to a broader audience of investors through 1940 Act mutual funds.

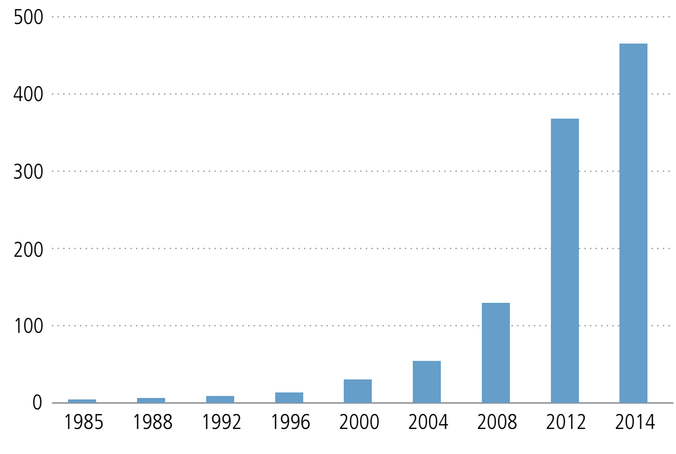
Managers of these liquid alternative investments are able to execute hedge fund-like strategies without many of the risks inherent in hedge funds such as lockup periods, a lack of transparency, little regulatory oversight, excessive leverage, and illiquid holdings. Alternative styles that lend themselves well to mutual funds include those with a volatility-dampening bent such as absolute return, currency management, global macro, and long/short equity strategies and listed infrastructure assets.

As the U.S. equity market hits new record highs, and with 2008 still a vivid memory, mutual fund investors are taking notice. In fact, the alternatives category is the fastest-growing segment of the mutual fund market today, with several hundred unique alternative investment mutual fund offerings now available. In 2008, alternative mutual fund asset levels were negligible; today, liquid alternatives are approaching an aggregate $300 billion in assets across the alternative categories that Morningstar tracks.[1] Citing Morningstar, the *Wall Street Journal* reported net inflows of over $40 billion in 2013, up from less than $15 billion the previous year.

Industry researchers Cerulli Associates and Strategic Insight both predict substantial growth in liquid alternative assets over the next several years. According to Strategic Insight, liquid alternatives may reach $490 billion by 2018. Cerulli's estimates suggest alternative mutual funds may represent 14% of the industry's assets within the next decade, up from the current 2%–3%.

Growth of liquid alternative funds over three decades

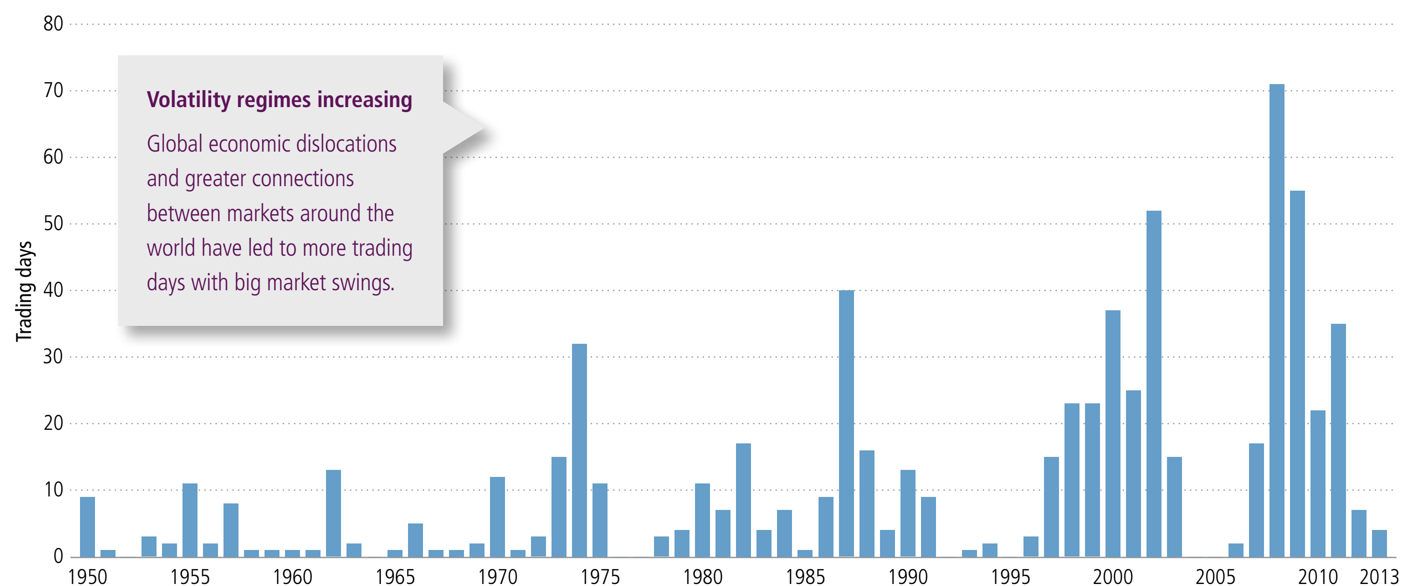
Number of alternative mutual fund offerings



Source: Strategic Insight, Forward, and Morningstar, as of 6/30/14.

Stock market volatility has become more prevalent in recent years

Number of trading days per year with returns +/– 2% (S&P 500 Index), 1995–2013



Source: Morningstar Direct, 2013. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Past performance does not guarantee future results.

Alternatives offer potential to help plan sponsors meet fiduciary responsibilities

DC plan sponsors have been slow to adopt alternative strategies in their plan lineups, instead relying primarily on the diversification potential of long-only stock and bond funds. According to *Pensions & Investments*, only $14 billion in DC plan assets are currently invested in asset classes other than equity, money market, and domestic fixed income.[2]

Historically, one of the perceived hurdles of incorporating alternative investments into a DC plan pertained to federal regulations governing participant-directed retirement schemes. That's less of a challenge today. The statutes setting the ground rules for DC plans haven't changed much in that regard; rather it's the vehicles in which alternative investments have become available that have changed over time.

ERISA, the Employee Retirement Income Security Act of 1974, set standards of conduct for fiduciaries, those who manage and oversee employee benefit plans and their assets. At ERISA's core is the requirement that plan sponsors act solely in the best interest of the plan participants. Fiduciaries owe participants the duty of loyalty, acting for the exclusive purpose of providing benefits to participants, and the duty of prudence, acting with the care, skill, and diligence that a prudent expert would use under the prevailing circumstances.

ERISA does not specify the types of investments a plan sponsor must offer participants. Fiduciaries have broad latitude in selecting, removing, and replacing investments. The main requirement is that plan sponsors select investment options through a prudent process that applies in prevailing investment industry practices. Alternatives have been a part of the prevailing practice for high-net-worth individuals and institutional investors for years. With the growth of liquid alternatives, the prevailing industry practices are now changing for the average individual investor as well.

In the DC arena, plan sponsors must provide a lineup of fund options giving participants adequate tools—that is, a "broad range of investment alternatives"—to help them access or build diversified portfolios.[3] Rather than attempting to judge the merit of a particular strategy in a vacuum, the U.S. Department of Labor (DOL) advises fiduciaries to "consider each plan investment as part of the plan's entire portfolio."[4] This more holistic view supports the inclusion of alternatives, which may reduce portfolio risk for participants because of its complementary features.

In acting solely in the interest of plan participants, fiduciaries have a clear obligation to keep expense ratios low. While liquid alternatives tend to carry higher fees than traditional mutual funds, certain distinguishing traits of alternative mutual funds may merit a higher fee. For example, when contemplating alternative exposures for a defined contribution plan, sponsors should

Mutual fund vs. hedge fund structures

Structure	Mutual funds	Limited partnership hedge fund
Liquidity	Daily	Varies—lockups are common
Typical fees	1%–2%	2% + performance incentive
Transparency	High	Low to none
Regulation	High	Low
Investment minimums	Low	Often high
Accredited investor	No	Yes
Leverage	Lower	Unrestricted
Taxes	Form 1099	Schedule K-1

consider the likelihood of an investment helping participant portfolios achieve one or more of a number of goals, including:

- Lowering a portfolio's correlation to the stock market
- Improving portfolio performance potential in a rising interest-rate regime
- Reducing manager concentration risk
- Weathering macroeconomic or geopolitical shocks with resilience

The DOL acknowledges that higher expenses "may be for … access to special investments that can smooth returns in uncertain markets, and may be worth it …"[5] Most liquid alternatives have substantially lower fees than their hedge fund counterparts. The scale of a DC plan can create further fee advantages for participants.

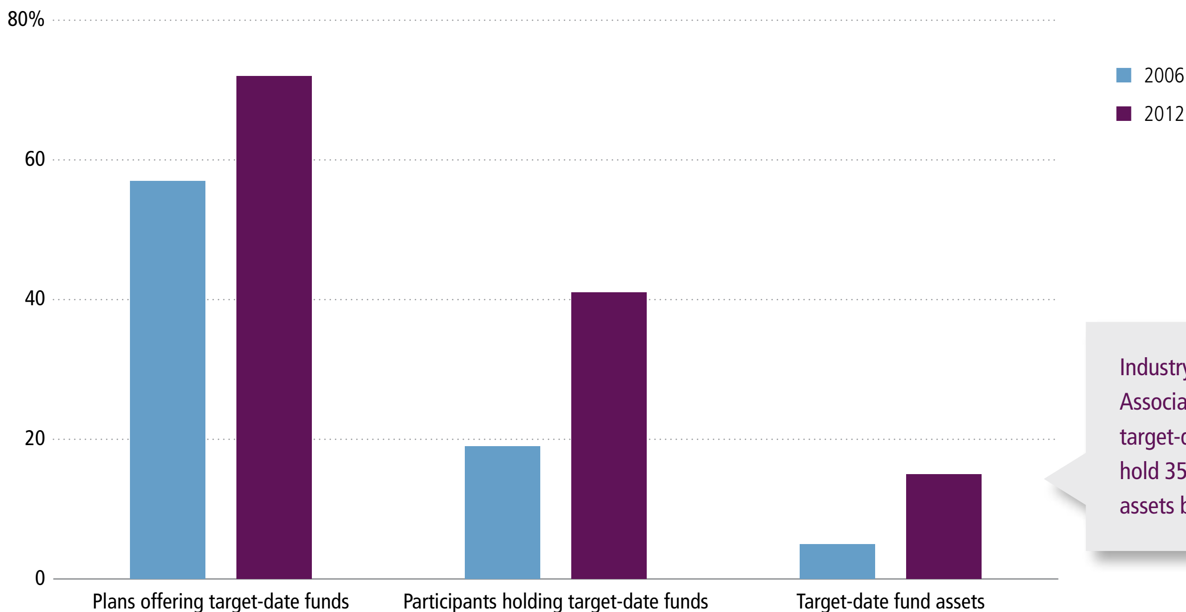
The bundled solution: alternatives in asset allocation portfolios

If alternative investments serve an important role in deepening the diversification of a portfolio, what is the best way for most DC plan participants to benefit from them? Simply adding stand-alone alternative funds to a plan's investment lineup may be problematic; employees may already find the list of investment options overwhelming and be unsure about how to use them. Fortunately, sponsors can increase both the simplicity and the sophistication of their plans' investment lineups by giving participants an opportunity to incorporate alternatives prudently with either multi-alternative offerings packaging various niche or nontraditional investment strategies together or with more diversified multi-asset portfolios, such as target-date funds, that blend both traditional and alternative investments together. Driven by developments in Washington, broadly diversified target-date retirement funds have enjoyed a surge in popularity over the last few years.

In the summer of 2006, the U.S. Congress passed the Pension Protection Act (PPA), the most significant reform of the country's pension laws since ERISA's enactment in 1974. Prompted by the increasing deficit of the Pension Benefit Guaranty Corporation, much of the PPA addressed defined benefit pension plans, but there were significant implications for DC plans as well. For many DC plan sponsors, the most important part of the law was its explicit green light giving employers the ability to implement

Target-date funds represent a growing share of 401(k) plan assets

Percentage of total 401(k) market at year end, 2006 and 2012



Industry researcher Cerulli Associates projects that target-date funds could hold 35% of all 401(k) assets by 2018.

Note: Funds include mutual funds, bank collective trusts, life insurance separate accounts, and pooled investment products.

Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project, *ICI Research Perspective*, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2012," December 2013.

automatic plan enrollment for their employees. Plans meeting certain conditions in automatically enrolling employees could now enjoy a safe harbor from nondiscrimination testing. As one of the requirements, plan sponsors opting for automatic enrollment had to choose a suite of default investments for participants failing to register a preference themselves. This paved the way for plan sponsors to add target-date funds, which automatically adjust their asset allocations, becoming more conservative over time, without any action required on the participant's part.

According to the Investment Company Institute (ICI), at year-end 2012, target-date funds accounted for 15% of 401(k) assets, up from 5% at year-end 2006. In 2013, target-date funds enjoyed net inflows of $53 billion, finishing with $618 billion in assets, a 28% increase relative to 2012. Today, industry researcher Cerulli Associates projects that target-date funds are on pace to receive 63% of all 401(k) contributions and could hold 35% of all 401(k) assets by 2018.

In 2013, the DOL issued guidance to plan fiduciaries choosing among target-date strategies that highlighted the diversification benefits of portfolios populated with multiple managers, an approach we have taken at John Hancock Investments in asset allocation portfolios for nearly two decades.

Target-date mutual fund growth

Year	Total net assets ($ billions)	Net cash flow ($ billions)	Number of funds
2013	618	53	491
2012	481	53	430
2011	376	42	412
2010	340	44	377
2009	256	43	379
2008	160	42	338
2007	183	56	245
2006	115	33	184
2005	71	22	127
2004	44	13	84
2003	26	7	45
2002	15	4	25

Source: *2014 Investment Company Fact Book*, ICI, 2014.

While the trend in recent years has been to simplify DC plan investment lineups by offering fewer investment options, the sophistication of the remaining offerings has been on the rise. As asset allocators are continuing to develop more advanced target-date funds, alternatives to stocks and bonds are playing an increasingly more prominent role in these portfolios. Indeed, the asset allocation mix of some bundled fund solutions for DC plan participants are coming closer to resembling their defined benefit (DB) pension fund counterparts, a trend the industry has dubbed the "DB-ization" of DC plans. In recent years, allocations that have made their way into target-date funds include absolute return, currency, buy-write and long/equity, and commodities.

Conclusion

Alternative investments have provided unconventional sources of return and unique ways to manage market risks beyond those available through the traditional portfolio staples of stocks, bonds, and cash. Once limited to institutions and wealthy families, alternative strategies have become popular with everyday investors through liquid vehicles, such as 1940 Act mutual funds. While initially slow to adopt alternatives, plan sponsors are beginning to turn to them for help in carrying out their fiduciary responsibilities to plan participants.

The PPA of 2006, the financial crisis of 2008, and the migration of talented hedge fund managers into the mutual fund world have made DC plan fiduciaries more open to refining legacy lineups by incorporating alternatives into the plans' mix. In our view, the most appropriate way to approach alternative investments is with an asset allocation mindset.

1 Josh Charney, alternative investments analyst at Morningstar, *Ignites* exclusive interview, 6/19/14.
2 *Pensions & Investments,* survey of defined contribution plan assets in mutual funds, 6/30/14.
3 Employee Retirement Income Security Act (ERISA) of 1974.
4 *Meeting Your Fiduciary Responsibilities,* U.S. Department of Labor, February 2012, p. 3.
5 "Target Date Retirement Funds—Tips for ERISA Plan Fiduciaries," U.S. Department of Labor, February 2013, p. 2.

Diversification does not guarantee investment returns and does not eliminate the risk of loss. Standard deviation measures performance fluctuation, may not be indicative of future risk, and is not a predictor of returns.

Absolute return funds are not designed to outperform stocks and bonds in strong markets. There is no guarantee of a positive return, of the fund achieving its objective, or that volatility-reducing strategies will be successful. The use of hedging and derivatives could produce disproportionate gains or losses and may increase costs. Fixed-income investments are subject to interest-rate and credit risk; their value will normally decline as interest rates rise or if an issuer is unwilling to make principal or interest payments. Illiquid securities may be difficult to sell at a price approximating their value. Currency transactions are affected by fluctuations in exchange rates. Investments in higher-yielding, lower-rated securities include a higher risk of default. Losses could exceed the amount invested in the fund's currency instruments. Foreign investing, especially in emerging markets, has additional risks, such as currency and market volatility and political and social instability. The stock prices of midsize and small companies can change more frequently and dramatically than those of large companies. Please see the fund's prospectus for additional risks.

A fund's investment objectives, risks, charges, and expenses should be considered carefully before investing. The prospectus contains this and other important information about the fund. To obtain a prospectus, contact your financial professional, call John Hancock Investments at 800-225-5291, or visit our website at jhinvestments.com. Please read the prospectus carefully before investing or sending money.

John Hancock Funds, LLC ▪ Member FINRA, SIPC
601 Congress Street ▪ Boston, MA 02210-2805 ▪ 800-225-5291 ▪ jhinvestments.com

NOT FDIC INSURED. MAY LOSE VALUE. NO BANK GUARANTEE. NOT INSURED BY ANY GOVERNMENT AGENCY.

MF203466

ALTSDCWP 11/14