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INSIGHTS

# Diversified Multi-Asset Strategies in a Defined Contribution Plan

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## EXECUTIVE SUMMARY

* Traditional public equity and fixed income asset classes typically dominate a defined contribution plan lineup.
* A diversified multi-asset option can provide participants with a diversifying strategy that tactically allocates across markets.
* Although many plan sponsors have either considered or added a real asset strategy to their lineup, we believe a diversified multi-asset option should be considered as a long-term inflation hedge.
* Traditional real asset options can still play a valuable role in a DC plan. It may also be appropriate to offer both a traditional real asset strategy and a multi-asset strategy depending on the overall plan design and the specific managers selected for each strategy.
* There are a number of considerations that plan sponsors should address before investing in a diversified multi-asset strategy, including higher fees and difficulty in benchmarking and communicating the strategies.


### Introduction

Investors of all types are currently faced with an environment that is marked by relatively expensive assets and low return expectations. This is particularly true for defined contribution participants where plan lineups are often dominated by traditional fixed income and equity exposures. One potential solution to this problem is to consider adding a diversified multi-asset strategy to a plan's lineup. In short, these strategies target positive real returns (typically, 3-5% over inflation) with modest levels of expected risk (typically, less than half that of public equities). For reasons we will explain in this paper, these strategies may also be an effective hedge against inflation. There are, of course, considerations which plan sponsors must explore before offering one of these strategies to participants. However, on balance, Rocaton believes a diversified multi-asset strategy generally would be a robust addition to a defined contribution lineup. The balance of this paper will review the characteristics of these strategies, provide a comparison to more traditional real asset strategies and outline some of the considerations plan sponsors should understand.

### Defining the Opportunity Set

While it can be difficult to paint the multi-asset space with a broad brush, the strategies that we believe are most appropriate are those that dynamically allocate across markets and have the ability to respond to market conditions in a timely manner in an attempt to meet the return and risk objectives we outlined above. Importantly, these strategies should offer daily liquidity and provide access to the liquid global market opportunity set including asset classes such as public equities, corporate, securitized, inflation-linked and sovereign debt, commodities, and currencies. Exposures in the portfolio will likely be located in both developed and emerging markets. While some strategies may not make use of every asset class, a flexible and wide opportunity set is critical. Although some derivative usage is typical, strategies that make use of leverage generally should be avoided, given the incremental risks associated with leverage[1]. A key benefit to participants is that a diversified multi-asset strategy provides exposure to asset classes typically not found elsewhere in the lineup. Further, asset classes that may not be appropriate as a stand-alone option in a DC plan (e.g. commodities, currency) can be incorporated in a diversified multi-asset strategy. It is worth restating that we would expect the strategy's investment manager to tactically allocate among these markets. The time horizon for these tactical shifts to work will vary by strategy and can range from several months to upwards of five years. Many strategies will also make use of relative value trades and, in some cases, will have outright short positions.

As we previously stated, the volatility target for our preferred strategies is less than half that of public equities. Many strategies will state absolute risk levels between 5-10%[2], although extreme market volatility can cause realized volatility to fall outside these ranges. Perhaps more important is the drawdown profile exhibited by a strategy. In 2008, with global equity markets down nearly 50%, some of the best multi-asset class strategies were down high single-digits or low double-digits. It is worth noting, however, that the worst performers experienced drawdowns similar to public equity markets (see Figure 3). When evaluating appropriate strategies for this space, we would seek to choose an investment manager who has a successful track record navigating through market drawdowns. The use of cash or similarly conservative assets in a market correction is fairly common and something investors should expect.

### Using a Multi-Asset Strategy as an Inflation Hedge

Despite the recent lack of global economic growth and low inflation for many years, the potential for higher inflation still exists, particularly as central banks have maintained easy monetary policy. One of the key features of a diversified multi-asset strategy is its real return target. Many plan sponsors have either considered or already added a "traditional real asset" strategy to their plan lineup. We would define a traditional real asset strategy as one that includes some combination of inflation-linked bonds, commodities, REITs, natural resource equities and bank loans. These strategies generally make limited or no use of tactical asset allocation and often maintain strategic targets to each of the previously mentioned asset classes. Admittedly, a traditional real asset strategy has an intuitive appeal as an inflation protection option as each of the aforementioned asset classes have either an implicit or explicit link to inflation. However, there is significant uncertainty about what type of inflation the U.S. may experience and how that inflation may impact economic growth and relative asset price changes. Additionally, some inflation protection asset classes (including U.S. TIPS) have yet to be "put to the test"

1 It should be noted that because many strategies make use of long and short positions, gross exposures will likely exceed 100%. However, net exposure is typically kept at or below 100% for strategies which Rocaton views as being appropriate for consideration.

2 Expressed as annualized standard deviation.

in an actual inflationary environment. The asset classes typically found in a traditional real asset strategy can also exhibit periods of high volatility and large drawdowns, as was the experience during the 2008/2009 global financial crisis and more recently when oil prices fell by more than half. Figure 1 below provides a more detailed comparison of defined contribution investment options.

Figure 1:
Comparison of Defined Contribution Plan Options

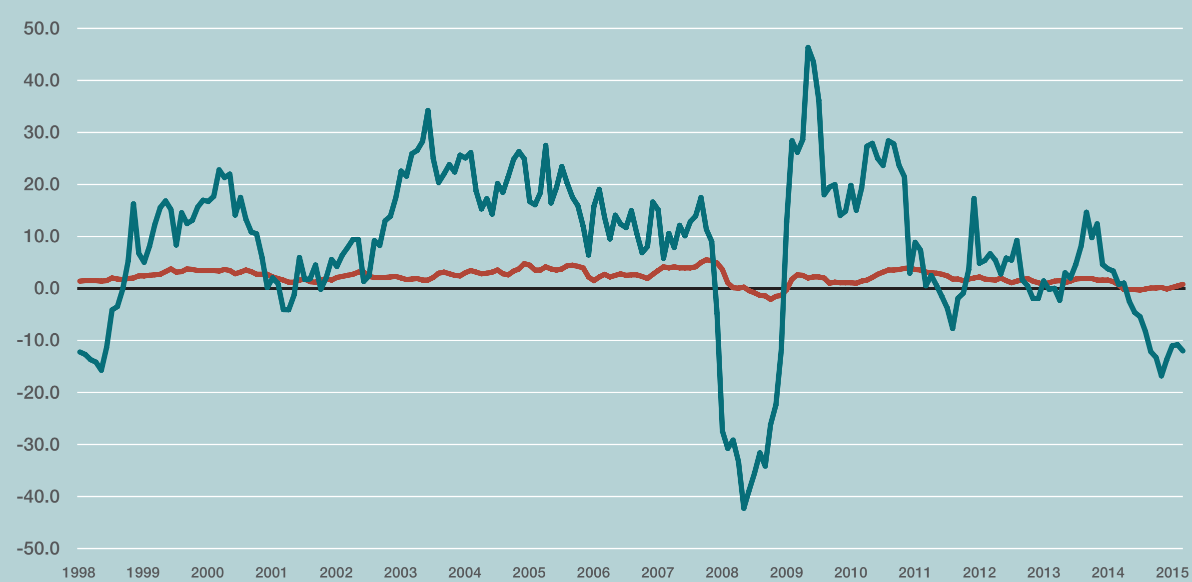
Return and volatility expectations based on Rocaton's Capital Market outlooks.

The risk/return expectations and inflation protection characteristics for diversified multi-asset strategies rely heavily on the use of active management and may not be achieved in all scenarios.

| DC Investment Option | Investment Grade Fixed Income | Diversified Multi-Asset Strategy | Traditional Real Asset Strategy | Public Equity |
|---|---|---|---|---|
| Exposures | U.S. Treasuries, corporate bonds, securitized products | All liquid capital markets | Inflation Linked Bonds, Commodities, REITs, Natural Resource Equities, Bank Loans | Developed and Emerging Equities |
| Current Return Expectation | Low | Moderate | Low | Moderate |
| Inflation Protection | Low | Moderate to High | Varies | Varies |
| Volatility Expectation | Low | Low to Moderate | High | High |
| Drawdown Potential | Low to Moderate | Low to Moderate | Moderate to High | High |

While we still believe that traditional real asset strategies can be effective in inflationary environments, we would also point out that there are aspects of diversified multi-asset strategies which may be appealing. Although CPI may not be the best gauge of inflation, it is certainly the most widely accepted measure. Historically, CPI has exhibited low levels of volatility and the measure typically records a small, positive increase each month with few negative observations over a 12-month timeframe (see Figure 2 below). We believe the characteristics of CPI may be more closely aligned with those of a diversified multi-asset strategy than with more traditional inflation hedging strategies. As we have already mentioned, many diversified multi-asset strategies target an excess return over inflation and attempt to limit drawdowns.

Figure 2:
Rolling 12 Month Performance–Traditional Real Asset Portfolio and Inflation




Legend:

Inflation (CPI)

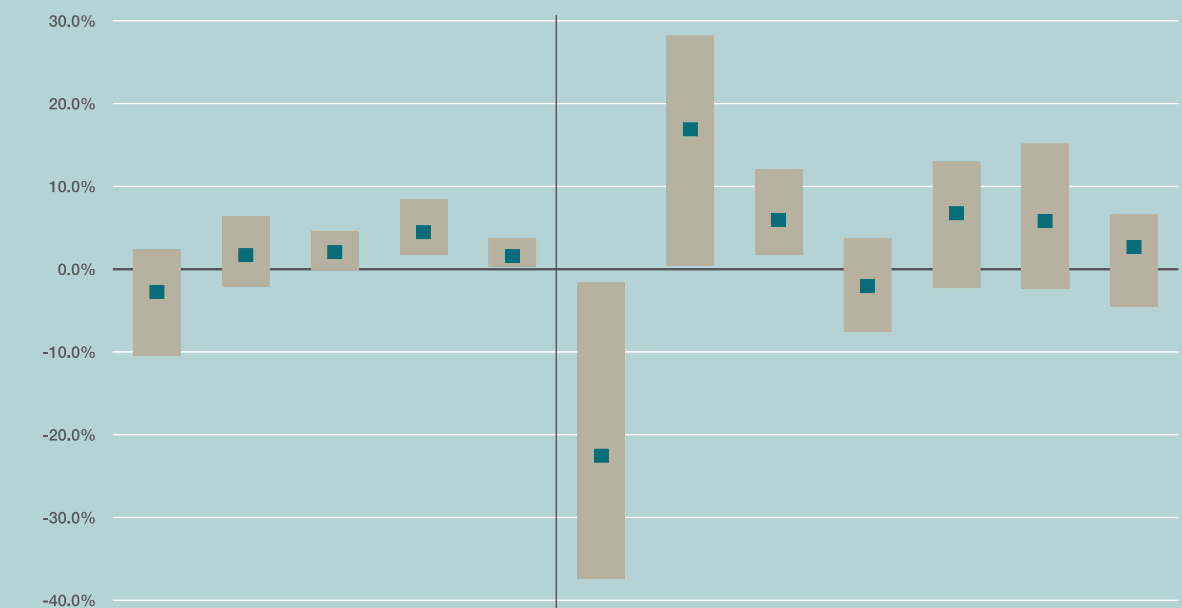
Traditional Real Asset Portfolio

Traditional Real Asset portfolio includes equal weight exposure to U.S. TIPS, REITs, Commodities and Natural Resource Equities.

### Considerations

Diversified multi-asset strategies are not without their drawbacks. To start, there is a wide array of products available to investors and not all strategies will be appropriate for a defined contribution plan. Figure 3 below shows the dispersion of returns across multi-asset products. There are also no passive alternatives available as the use of tactical asset allocation and security selection are key elements to these strategies. This makes manager selection and monitoring a critical element. The required due diligence and thorough examination of strategy objectives ultimately leads to a much smaller list of choices for plan sponsors. In the public equity and fixed income arenas, there are likely to be dozens of viable candidates from which plan sponsors can choose. At present, there are only a handful of high quality strategies that Rocaton would recommend should a plan sponsor wish to include a diversified multi-asset strategy in their lineup. Naturally, the fees for these strategies are also higher than their public market counterparts[3]. In our view, the fees may be justified if the value provided to the plan (which can be defined in many ways) is meaningful.

Figure 3:
Dispersion of Returns for Diversified Multi-Asset Strategies




| | 1 Year | 3 Year | 5 Year | 7 Year | 10 Year | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 5th Percentile | 2.4% | 6.4% | 4.6% | 8.4% | 3.7% | -1.6% | 28.2% | 12.1% | 3.7% | 13.0% | 15.2% | 6.6% |
| **Median** | **-2.6%** | **1.8%** | **2.2%** | **4.6%** | **1.7%** | **-22.4%** | **17.0%** | **6.1%** | **-1.9%** | **6.9%** | **6.0%** | **2.8%** |
| 95th Percentile | -10.5% | -2.1% | -0.2% | 1.7% | 0.3% | -37.4% | 0.4% | 1.7% | -7.6% | -2.3% | -2.4% | -4.6% |

Based on the Morningstar Multi-alternative peer group. Trailing returns are through December 31, 2015.

Returns are shown net of fees. Performance for periods greater than 1-year is annualized.

Performance measurement and evaluation for a diversified multi-asset strategy is also difficult as there is no universally accepted asset mix to benchmark against and the construction of products varies meaningfully. The inflation hedging objective is also difficult to assess as inflation has been tame for much of the last 20 years. Over a full market cycle, we believe

3 Diversified multi-asset strategies typically charge flat management fees ranging from 0.75% to 1.50% annually.

a reasonable benchmark would be CPI plus a premium of 3-5%. Plan sponsors should expect a modest degree of tracking to this benchmark over the short-term.

### Why should Plan Sponsors consider a diversified multi-asset strategy?

In many cases, a diversified multi-asset strategy will be added as a new option with no mapped assets. As with most new options, in the absence of any mapped assets, the option is unlikely to garner significant assets. As a result, many plan sponsors may be questioning the need to include a diversified multi-asset option in the plan's lineup. However, we believe there are many benefits to offering this type of strategy to participants. More sophisticated participants who favor a "build it yourself" approach may find these strategies particularly appealing.
As we have already outlined, we believe a diversified multi-asset option provides participants with an effective inflation hedge. It may also provide participants with exposure to new asset classes not found elsewhere in the lineup and offer them a solution that can more quickly allocate across markets. Should a plan sponsor decide to move forward with the addition of this option, communicating the strategy to participants is critical. Rocaton would suggest rolling the option out as part of a broader communication effort and not posing it as just another new option. Educational materials surrounding the benefits of this type of option are also important as many participants may not fully understand the strategy based on a simple strategy description.

### Conclusion

At best, we believe traditional asset classes are poised to deliver modest returns over the next several years and, at worst, these assets may experience a sharp correction. Although not an issue today, inflation is also a real risk that plan sponsors and individual investors face in building retirement assets for plan participants. Adding a diversified multi-asset strategy to a defined contribution plan may help address both of these challenges. While there is no "silver bullet" in investing, we believe these types of strategies can provide modest levels of return with risk and drawdown potential that is far less than that of public equities. Plan sponsors must complete due diligence on these strategies and be prepared for higher fee products when considering a diversified multi-asset strategy. We believe that plan sponsors should continuously seek to provide participants with the best tools to become "retirement ready" and the addition of a diversified multi-asset strategy should help meet that objective.

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