Fiduciary Hot Topics

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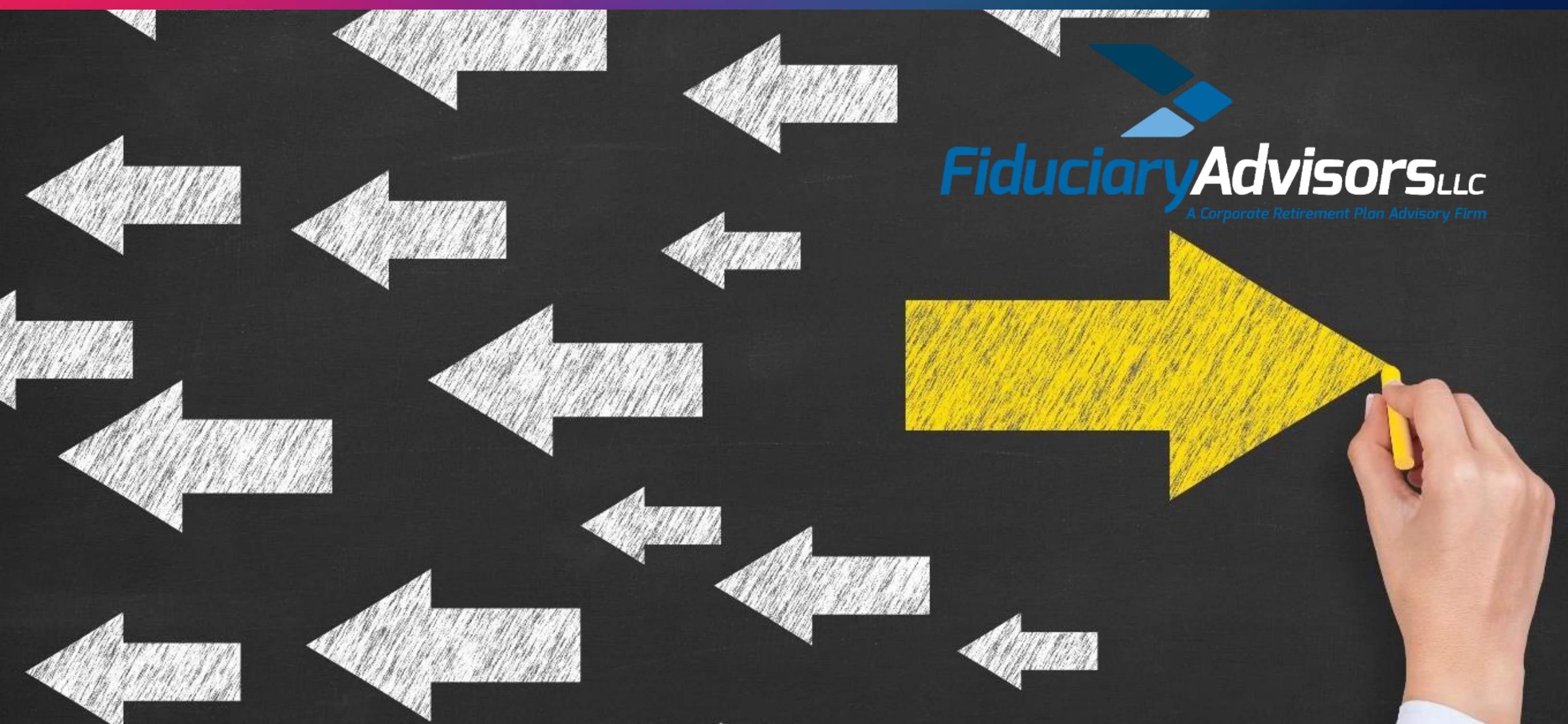

"ALTERNATIVE INVESTMENTS" IN RETIREMENT PLANS

Recently, investors are showing an increasing appetite for risk. To this end, more investors are now moving away from the public markets into alternative investments such as private equity, corporate loans and real estate. This includes retirement plans where there is growing interest in "alternative investments."

Public Pension Plans Hope to Increase Returns by Taking on More Investment Risk through "Alternative Investments"

- Public pension plans today face a significant funding gap. It is estimated that unfunded liabilities in these plans total almost one trillion dollars. This predicament is due to years of underfunding; overpromising; unrealistic demands from public employee unions; and rich early retirement benefits.

- Demographics are now exacerbating this dilemma. The graying of America is resulting in a cash flow shortfall as the number of retirees is increasing relative to the number of active workers. Benefits paid out by the majority of public pension systems now exceed contributions coming in. Two obvious ways to close the funding gap are reduce benefits and/or raise taxes. These alternatives present obvious political challenges so many plans have chosen instead to try and increase investment returns by taking on more risk.

- Historically, pension plans have been conservative investors allocating their portfolios primarily to publicly traded stocks and investment grade bonds.

- However, in recent years, many public pension plans have allocated a portion of their portfolios to alternative investments such as private equity, corporate loans, and real estate. Alternative investments are relatively

expensive, lack liquidity, and can be difficult to evaluate. There are very high minimums and funds are locked up, sometimes for many years. There is concern that because alternative investments tend to be opaque, the risks may not be well understood by many plan fiduciaries.

- To date, these investments appear to be paying off. Alternative investments were a big driver of the returns during 2021 in many public pension plans. The average median return for public pension plans in the 12 months period ending June 30, 2021, was 27 percent. As a result, the funding status of these plans has improved - the ratio of assets to liabilities on average is now about 85 percent. While these returns are impressive, some public pension plans achieved comparable or better returns while maintaining a more traditional portfolio invested in publicly traded stocks and bonds.
- However, the outsized returns that many investors achieved in 2021 are not expected to continue indefinitely. While alternative investments offer the potential of higher returns, this obviously comes with increased risk. This can be especially true in down markets because of the lack of liquidity. A possible omen of things to come may be the Orange County 1994 debacle when significant bets on risky derivatives forced the County into bankruptcy.

Department of Labor Issues Cautionary Letter Clarifying It Does Not View Private Equity as Appropriate for Most Defined Contribution Plans

- During the Trump administration in 2020, the Department of Labor issued an information letter stating that alternative investments can be added to defined contribution plans without violating ERISA's fiduciary standards.
- This letter did not endorse adding private equity directly to an investment lineup. Rather, the letter stated it may be appropriate for defined contribution plans to include private equity indirectly through a target date, target risk or a balanced fund.
- In December, the Department issued a follow up letter clarifying the 2020 letter. This letter was issued because the Department is concerned that the original letter has been used as a marketing tool and has been interpreted as a broad endorsement of alternative investments in defined contribution plans.
- In this letter, the Department states that the original 2020 letter was directed only to large plan sponsors that have both a defined benefit and a defined contribution plan where the plan fiduciaries have experience evaluating private equity. The letter further states that the Department does not believe alternative investments are appropriate for the majority of defined contribution plans.

The Department of Labor takes a 180 Degree Turn on ESG Investing

- Proposed regulations published in December allow plan fiduciaries, when evaluating investments, to consider climate change and other environmental, social and governance (ESG) issues as risk factors affecting workers' financial security.

- At the very end of the Trump administration, the Department issued final regulations on ESG investing. Practically speaking, these regulations made it difficult for plan fiduciaries to add ESG options. Nonfinancial factors such as climate change and racial diversity could only be considered as a tie breaker. In March of last year, the Biden ministration announced that it would walk back these rules.

- The Department has gone back and forth for many years on its position regarding ESG investing. Democrats indorse the concept while Republicans are more skeptical. The fact that the latest proposed regulations are such a radical departure from the Trump rules suggests that this back and forth will only continue.

- These proposed regulations seem go beyond just permitting consideration of ESG factors. Comments from administrative officials accompanying the publication of these regulations indicate that the current thinking of the Department is that ESG factors, and climate change issues in particular, pose financial risks that plan sponsors should consider as prudent fiduciaries in evaluating investments.

- Significantly, the proposed regulations would permit the use of ESG investments as the qualified default investment alternative ("QDIA").

- Over 200 comments have been submitted regarding these proposed regulations. The majority are favorable. However, some comments express concern that these proposed regulations may be interpreted as not only permitting but requiring plan fiduciaries to consider ESG factors in making prudent investment decisions.

- The Securities and Exchange Commission has not issued any rules regarding ESG investments and comments from the Commissioner indicate there are no plans to do so.

- When voting proxies, the proposed regulations also make it clear that, in contrast to the trump rules, plan fiduciaries may take into consideration climate change, environmental and social concerns.

- Two things to ponder. Promulgating a regulation that contains specific criteria for evaluating investments is unprecedented. While the Securities & Exchange Commission and other financial regulators have promulgated many rules over the years, there are none that establish specific criteria that must be applied to evaluate a particular investment. Also, one has to wonder how Department officials think they are helping plan fiduciaries with the never-ending back and forth on ESG investing.

The Schlichter Firm Gets its Hand Slapped

- Most class action lawsuits filed against plan sponsors have been initiated by the St. Louis firm Schlichter, Bogard & Denton. In a suit filed by the Schlichter firm against Great-West, the district court judge held for the defendant and granted its motion for sanctions. The Schlichter firm was ordered to pay $1.5 million of Great-West's legal fees. It is rare for judges to order a party to pay legal fees and do so only in the most egregious situations.

- The case combined three separate class actions against Great-West and culminated in an 11-day bench trial this past August. The plaintiffs alleged Great-West was charging excessive fees in violation of section 36(b) of the Investment Company Act. The standard is a high one. Fees are considered excessive only if "*so*

disproportionately large they bear no reasonable relationship to the services rendered and could not have been the product of arms-length negotiating." No plaintiff has ever prevailed in a lawsuit brought under section 36(b).

- The judge ruled that it was "imprudent" for the plaintiffs to pursue their claims because the evidence was overwhelming that Great-West's fees were reasonable under the circumstances.
- This lawsuit reveals that the Schlichter firm will pursue a cause of action even where the evidence clearly does not support its allegations. This is in hopes of a settlement granting the firm significant fees. The many cases this firm has initiated consume the money and resources of plan sponsors and are of little benefit to participants as the amount of the recoveries Schlichter has obtained historically have represented very small amounts on a per participant basis.

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