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Defined-Contribution Plans Diversify With Real Estate Funds

By **Kaitlin Ugolik**

Law360, New York (June 20, 2014, 2:38 PM ET) -- A recent shift in the structure of employer-sponsored investment plans has helped inspire a flood of new funds aimed at diversifying investors' portfolios with real estate and other illiquid assets, though experts say a steep learning curve still exists for both plans and fund sponsors.

The use of traditional defined benefit plans, which set a specific benefit that will be available to investors when they retire, has fallen out of favor in recent years and largely been replaced with defined contribution plans, which specify how much goes into the plan and give investors more flexibility.

This increase in flexibility, coupled with a desire for more yield and diversity, has led an increasing number of defined contribution plans to seek out direct investments in real estate. This creates new opportunities for investors as well as sponsors of real estate funds, but it also requires a level of adaptation that parties on both sides are still working out, experts say.

"Defined contribution plans are increasingly the primary, if not the sole, employer-sponsored retirement vehicle, which raises the stakes on how those plans are invested," said Drew Carrington, head of institutional defined contributions at Franklin Templeton Investments.

With the stakes higher, diversification is increasingly important. While the perception tends to be that investing solely in mutual funds and other liquid assets is a safer bet than putting money in something less liquid such as real estate, experts say that strategy actually may be less safe because it puts the investor at the mercy of the equity market.

Open-ended real estate funds — particularly those that focus on a specific segment of the real estate market — have emerged as a popular diversification opportunity for some investment plans as they experience an growing need for cash flow.

"The way pensions have been evolving, with traditional defined benefit plans really on the decline significantly in the U.S., [they're] less and less able to invest in closed-end funds ... as their retirees are starting to cash out," said Lennine Occhino, a partner with Mayer Brown LLP.

Immediately following the downturn, a lot of investors wanted to get away from open-ended real estate funds, but experts say that trend reversed itself quickly as core real estate once again became a favored area for pension funds and other institutional investors.

This reversal came around the same time that new automations in retirement savings plans made it easier for individual investors to take part in more lucrative investments without needing the expertise to do so themselves, as well as on the heels of the shift from defined-benefit to defined-contribution plans.

The result, experts say, has been the advent of a new family of funds created by sponsors to specifically address the needs of defined-contribution plan participants. These funds are typically focused on what some experts call the "Big 3": real estate, private equity and hedge fund investment.

"What these assets do — real estate in particular — is provide uncorrelated returns with U.S. large cap equity," Carrington said.

Defined contribution plans are only putting a small amount of their eggs in the real estate basket, but experts say even a small piece of a defined contribution pie that includes $5 billion to $6 billion is a significant investment, and the returns can be worth the potential cash flow and valuation issues, especially since the rest of the pie is typically invested in more liquid assets.

Some plans are taking a different route, focusing on creating custom target date funds, on the heels of a 2013 note from the U.S. Department of Labor that encouraged customizing these investments.

There's a lot of money pouring into these custom funds each month, and real estate is an attractive way to customize because it can be more lucrative than some more liquid types of assets, said Joseph Adams, a partner with McDermott Will & Emery LLP.

"The increasing prevalence of custom target date funds is one thing that could lead to more real estate investments being added to defined contribution plans," Adams said.

As the appetite for open-ended real estate funds increases, however, so do the challenges faced by fund sponsors hoping to attract this specific subset of investors.

In order to meet the needs of a defined contribution plan, a fund will not only have to have access to good income-producing core real estate assets, but it will also need to be able to value the assets as accurately as possible on a daily basis.

It's hard to get an accurate reading on what a piece of property is worth day by day, but experts say sponsors are working with consultants and coming up with ways to provide estimates based on quarterly appraisals.

There are still a lot of kinks to be worked out, but experts say it's clear that employers see a value in adding real estate to their defined-contribution portfolios.

"You have the direct institutional real estate market, which is very unfamiliar with defined contribution plans because they just haven't been investors in real estate ... and then on the other end you have the defined-contribution market [which has] never really included illiquid assets. Both sides see that it is really inevitable and essential to try to work out the hurdles so [they] are trying to get an education on it," Occhino said.

--Editing by Elizabeth Bowen and Katherine Rautenberg.

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