benefits MAGAZINE

What Should My Asset Allocation Be?

Five Key Factors for Employee Benefit Funds

by | **Jennifer Mink**

What is the best asset allocation for an employee benefit fund? The author offers five factors trustees should consider when determining the mix of investments for defined benefit pension funds, trustee-directed defined contribution funds, and health and welfare funds.

Asset allocation is considered the fundamental driver of investment returns, but there is often confusion regarding what the ideal asset allocation is for a benefit fund. Trustees often ask whether there is a model asset allocation design for an investment portfolio . . . there is not. Every benefit fund is unique, so there is no one-size-fits-all asset allocation model; however, when building an investment portfolio, there are five key factors every benefit fund must consider.

Since trustees may serve on more than one type of employee benefit fund, it is important to understand how these five key factors influence and impact the asset allocation of a defined benefit (DB) pension fund, trustee-directed defined contribution (DC) fund, and a health and welfare fund.

Factor 1: Investment Objective

Every investment decision should begin by identifying and defining the investment objective. What is the benefit fund trying to achieve? For many, the objective may be a target rate of investment return over a particular period of time. This return target could be an absolute return, such as 5%; a return tied to a particular benchmark, such as Treasury bills plus 3%; or an assumed rate of return determined by a plan actuary, such as 7.5%. The investment objective also could be to generate a certain level of income or to preserve capital through defensive positioning. Investment objectives often vary significantly among DB, DC, and health and welfare funds.

takeaways

- There is no one-size-fits-all model for asset allocation for employee benefit funds, because every fund is unique.
- Factors to consider when determining asset allocation include the fund's investment objective, cash flow needs, fund size, expected returns and risk tolerance.
- Asset allocation strategies also vary by type of fund. For example, the asset allocation model of a trustee-directed defined contribution fund tends to be more conservative than that of a defined benefit pension fund.
- Asset allocation among health and welfare funds tends to be more varied than among retirement funds.
- It is important to revisit an asset allocation strategy annually or whenever one of the five factors change.

Factor 2: Cash Flows

Cash flows are simply defined as money flowing into and out of an account. For benefit funds, money flows into a fund via contributions and out of the fund to meet benefit obligations and pay expenses. A fund also may experience investment gains and losses, but those fluctuations are not known factors and can vary greatly. For that reason, gains and losses are considered separately from cash flows. Contributions into an employee benefit fund are prenegotiated amounts received on a regular schedule, typically monthly. Every employee benefit fund also has monthly outflows, in the form of benefit payments and *expenses* (costs associated with fund administration, investment management, plan professionals, etc.). It is important to note that both cash flow components can and do change. If workhours decline, contributions into the fund will decrease, and if there is a spike in retirements or medical costs, benefit payments and flows out of the fund will increase.

An employee benefit fund's cash flows can be considered either positive or negative. If a fund has *positive cash flow,* the contributions made into the fund on behalf of the participants are equal to or greater than benefit/expense payments, which means that benefits and expenses can be paid for out of current contributions. A fund with *negative cash flow* has contributions that are less than the benefit/expense payments; therefore, investments must be sold to meet cash needs. Identifying the type of cash flow a fund has is important. Since investments will need to be sold on a regular basis to meet cash needs, a fund with negative cash flow may require limited or no exposure to less liquid asset classes. Also, the cash flows of retirement funds may vary from those of health and welfare funds, especially considering that medical funds could be unexpectedly impacted by catastrophic claims.[1]

Factor 3: Fund Size

Under federal securities law, the Securities and Exchange Commission (SEC) uses three categories to classify investors, all of which are based on fund size. Each category has specific distinctions, and those distinctions ultimately impact the types of investments each investor can and cannot make. Those categories are:

1. **Accredited investor:** Under the Securities Act of 1933 (33 Act), an *accredited investor* is defined as an employee benefit fund with assets in excess of $5 million.[2]

TABLE

Comparing Asset Classes

Asset Class		Advantages	Disadvantages
Stocks	U.S. Large Cap Equity	• High expected returns • Liquid	• Volatile • Chance of large losses
	U.S. Small/Mid Cap Equity		
	International (Developed) Equity		
	Emerging Markets Equity		
Bonds	Core Fixed Income	• Provide income • Relatively liquid	• Low expected returns • Interest rate sensitive
	High-Yield Bonds		
	Non-U.S. (Developed) Fixed Income		
	Non-U.S. Emerging Markets Fixed Income		
Cash	Cash	• Protect principal • Liquid	• Low expected returns
Alternatives	Real Estate	• High expected returns • Provide income • Low correlation*	• Less liquid • Long lock-ups • Higher fees**
	Hedge Funds		
	Infrastructure		
	Private Equity		

**Correlation* is a statistical measure of how two asset classes perform in relation to each other. The correlation between different asset classes is an input used in asset allocation modeling and can reflect the benefits of diversification among asset classes.

***Investment manager fees are an important consideration in portfolio construction. It should be noted that alternative investments typically have higher fees than traditional stock and bond investments and may also include incentive fees or profit sharing.

2. **Qualified purchaser:** The Investment Company Act of 1940 (40 Act) identifies a *qualified purchaser* as an investor that owns and invests on a discretionary basis no less than $25 million in investments.[3]
3. **Qualified institutional buyer:** Rule 144A of the 33 Act categorizes institutions that own and invest on a discretionary basis no less than $100 million as a *qualified institutional buyer (QIB).*[4]

Before a security can be offered to the general public, the 33 Act stipulates that the issuer must register it with SEC and provide extensive documentation through a filing with the agency. Alternative or private fund investments, such as real estate, hedge funds and private equity, whether organized as a limited partnership (LP) or a limited liability company (LLC), often pursue an exemption from SEC registration due to the expense related to registering. Both the 33 Act and the 40 Act provide for an exemption by limiting private investment offerings exclusively to accredited investors, qualified purchasers and QIBs. Therefore, if an employee benefit fund is considering an investment in real estate, hedge funds, private equity or any other type of private investment, the trustees need to ensure their fund is of the required fund size to legally make an investment in that particular vehicle.

Factor 4: Expected Returns

Once a benefit fund has determined the investment objective, understands the cash flow needs and identifies possible limitations of regulatory requirements based on plan size, the fund can then consider the risk-and-return expectations of the asset classes that may be suitable. Although no one can predict what will occur in the financial markets, a wide range of public sources provide guidance on the expected future investment returns of various asset classes.

These return forecasts are typically long-term (ten to 20 years) net of fee "market" or index returns based on a variety of factors that take into account the current market environment, where markets are in the business cycle, global interest rates and other economic considerations. Reviewing return expectations can help

guide the asset allocation decision. For example, if the investment goal is 5% and the expected return of U.S. bonds over the next ten years is 3%, then the fund may need to consider other asset classes that are expected to generate a return higher than bonds.

It is also important that the trustees or the investment consultant review more than one set of assumptions to ensure the projected returns used in the asset allocation modeling are reasonable.[5] If industry consensus assumes a 7% future return for large cap U.S. equities, it may be unrealistic for a fund to assume a 10% return for that asset class. Also, since expectations change over time, it is vital to revisit and update the assumptions used in asset allocation modeling, typically annually.

Factor 5: Risk Tolerance

As important as historical and future investment returns are when constructing an asset allocation model, it is imperative to consider the risk associated with various asset classes. Trustees, in conjunction with the investment consultant, should determine their risk tolerance. It is important to note that there are several types of risk, including market risk, interest rate risk and liquidity risk.

Market risk or the volatility of investment returns is commonly measured by standard deviation.[6] A high standard deviation indicates the range of expected returns of a particular asset class can be wide or more volatile (higher highs and lower lows). Equities tend to have a higher standard deviation than bonds and alternative investments. Bonds, on the other hand, have a low standard deviation but are sensitive to changes in interest rates. In a rising interest rate environment, the expected return of bonds tends to be below the long-term average. Alternative investments, while offering higher expected returns than bonds and less volatility than equities, often have restrictions on withdrawals, which may impact the amount investors should allocate to those strategies. The table on page 19 highlights the advantages and disadvantages of asset classes to consider when constructing the asset allocation of an investment portfolio.

Asset Allocation Strategies for Different Types of Funds

After considering the five factors that affect asset allocation, trustees can then determine what is appropriate for the specific type of fund.

DB Pension Funds

It is easy to understand why one might think there is a model portfolio for retirement funds, since most DB funds have a long-term investment horizon typically spanning 30 years or more. In addition, most pension funds have an actuarial assumption in the range of 6.0% to 8.0%. If two pension funds have the same time horizon and similar actuarial assumptions, it seems reasonable to assume each would have the same asset allocation, right? Not necessarily. As indicated by the five factors, the size, cash flow needs and risk tolerance of the trustees should dictate the types of assets that can and will be used by a fund. Therefore, it is reasonable for two similarly sized pension funds, with the same assumed rate of return, to have completely different asset allocation targets based on cash flows and risk tolerance.

Trustee-Directed DC Funds

Similar to a DB fund, a DC fund is a retirement fund with a long-term investment horizon, so it stands to reason that the asset allocation of each should be similar, but often they are not. A DB pension is a pool of money that is invested on behalf of fund ben-

learn more

Education

Portfolio Concepts and Management
April 20-23, 2020, Philadelphia, Pennsylvania
Visit *www.ifebp.org/wharton* for more information.

Investments Institute
April 27-29, 2020, New Orleans, Louisiana
Visit *www.ifebp.org/investments* for more details.

From the Bookstore

Trustee Handbook: A Guide to Labor-Management Employee Benefit Plans, Eighth Edition
Lawrence R. Beebe. International Foundation. 2017.
Visit *www.ifebp.org/trusteehandbook* for more information.

Tools & Techniques of Investment Planning, Fourth Edition
Stephan R. Leimberg, Thomas R. Robinson and Robert R. Johnson. National Underwriter. 2017.
Visit *www.ifebp.org/books.asp?9099* for more details.

eficiaries. A fund actuary assumes the assets will be invested and grow at a certain rate (an assumed rate of return, such as 7.5%) over time so that when the beneficiary is ready to retire (30+ years later), there is a defined dollar amount (the actuarial equivalent of defined benefit) available to pay to the beneficiary in retirement.

For a DC fund, beneficiaries direct a defined dollar amount to invest (the defined contribution) on their behalf as a form of supplemental retirement savings (supplemental to the DB pension). Under a trustee-directed DC fund, the assets are invested on behalf of all participants, regardless of age or retirement time horizon. Since there is not a defined rate of return for a DC fund and all beneficiaries of the DC fund are treated equally, the asset allocation of a DC fund tends to be more conservative than that of a DB fund, with the objective of generating moderate gains while limiting losses. Also, unlike a DB pension, beneficiaries of a DC fund receive statements regarding the investment returns of their actual ownership of assets. The asset allocation, therefore, typically involves a lower equity target (to reduce market risk) than DB funds. The amount of fixed income and alternatives will be dictated by fund size and the overall investment objective of the trustees.

bio

Jennifer Mink is a senior consultant at Investment Performance Services (IPS), LLC, located in metropolitan Philadelphia, Pennsylvania. She has extensive experience working with defined benefit, defined contribution and welfare plans throughout the United States and assists client funds with investment policy design, asset allocation strategies, performance reporting and compliance monitoring of managers. With more than 20 years of investment experience, Ms. Mink is a member of the IPS Investment Committee and serves as a Board Advisor to the National Conference of Public Employee Retirement Systems. She was a contributing author to the *Investment Policy Guidebook for Trustees* (fifth edition) published by the International Foundation and is a frequent speaker at educational conferences. She earned her B.S. degree from North Carolina State University and an M.B.A. degree from Rider University. She can be reached at jmink@ips-net.com.

Health and Welfare Funds

Asset allocation among health and welfare funds tends to be more varied than among retirement funds. Retirement funds tend to have similar objectives (actuarial assumption of 6% to 8%) and share a long-term time horizon. Health funds, on the other hand, have a shorter time horizon (money is paid by the fund on a monthly basis for medical costs today as opposed to benefit obligations 30 years later) and, rather than a known defined benefit, the actual medical claims are unknown and, in some instances, catastrophic. Furthermore, some health and welfare funds are insured while others are self-funded,[7] which may impact the level of risk a fund can take as well as the degree of liquidity that should be maintained.

Finally, the financial health of a health and welfare fund is often measured in terms of the reserve level. The reserves of a health fund refer to the amount of time the current market value of the fund could pay known medical costs and expenses if contributions into the plan were to stop. For example, if a fund with $5 million in total assets typically has claims that average $250,000 per month, that fund would have 20 months of reserves. Fund size, cash flows, reserve levels, and whether the plan is self-insured or not should dictate the asset classes that can be considered for investment.

Historically, due to the short investment horizon, health and welfare funds were comprised entirely of fixed income and/or cash. Today, asset allocations vary dramatically and can include allocations to equity and, depending on the fund size, alternative investments. Due to the volatile nature of equities, a general rule of thumb might be to consider a health and welfare fund with less than 12 months of reserves to be less likely to tolerate potential losses associated with equities. Typically, the equity allocation for health funds is 25% or less, but it likely depends on the overall risk tolerance of the trustees.

Fixed income investments tend to be the largest allocation for most health funds, but considering the low expected returns for investment grade bonds, given the low level of interest rates, diversification within the fixed income asset class to include high-yield bonds[8] may be a

consideration. Finally, health funds with at least $5 million in total fund assets may consider alternative investments as a means to diversify, increase expected returns or decrease overall fund volatility. It is important that the cash flow needs of the fund are considered before allocating to less liquid alternative investments.

Ongoing Asset Allocation Decisions

Diversification is the process of allocating capital in a way that reduces the exposure to any one particular asset or risk. The rationale behind this technique is that a portfolio constructed of different kinds of assets will, on average, yield higher long-term returns and lower the risk of any individual holding or security.[9] Therefore, a fund should be diversified among various asset classes, but it also should consider diversification within those asset classes. Diversification within asset classes may include consideration of different capitalization ranges (small, mid and large), country of origin (U.S. vs. non-U.S.), growth vs. value styles or active vs. passive investments.

Once the asset allocation of a fund is determined, it should not be considered static. The actual allocation of a fund will change with market fluctuations, and the trustees or investment consultant should have a regular and ongoing rebalancing policy in place to help maintain the asset allocation targets. It is also important to revisit the allocation targets of a fund at least annually because factors such as fund size, cash flows and expected return assumptions change over time. In addition, asset allocation models should be rerun any time there is a change in the fund's assumption rate or investment objective because there may be a better combination of assets to achieve the objectives of a fund.

In conclusion, the asset allocation of a fund will largely determine its investment success, and the basis for a fund's particular asset allocation is unique to that fund. Because the five factors that influence asset allocation can, and do, change over time, trustees should maintain a record of and document their asset allocation decisions. In addition, the fund's investment policy statement should be updated accordingly to reflect the current asset allocation targets as well as clearly define the asset classes permitted and prohibited by the fund.

Endnotes

1. A *catastrophic medical claim* usually involves high costs for hospitals, doctors and medicines and is usually associated with severe illness requiring prolonged hospitalization or recovery. Examples would include cancer, leukemia, heart attack or stroke. High claim costs can also be associated with out-of-network emergencies, treatments or hospitals.
2. "Accredited Investors," www.sec.gov.
3. "Qualified Purchasers under the Investment Company Act," www.compliancebuilding.com/2010/04/21/qualified-purchasers-under-the-investment-company-act.
4. "Qualified Institutional Buyer," www.investopedia.com/terms/q/qib.asp.
5. Horizon Actuarial Services, LLC, publishes an annual capital markets assumptions survey. This survey asks investment advisors/consultants to provide their expectations for future risk and returns for different asset classes in which pension funds commonly invest. The survey, which includes more than 30 different firms, can be reviewed at www.horizonactuarial.com.
6. *Standard deviation* is a mathematical concept that measures volatility, or the average amount by which individual data points differ from the mean. Simply put, standard deviation helps determine the spread or range of returns from the average. For example, if an asset class has an expected return of 7.0% with a standard deviation of 16%, the range of returns for that asset class could conceivably be as high as 33% or as low as -9.0%. Conversely, if an asset class has an expected return of 5.0% with a standard deviation of 6.5%, the range of returns could be as high as 11.5% or as low as -1.5%.
7. A self-funded or self-insured benefit plan bears the financial risk for providing health care benefits. Self-funded plans pay claims out of pocket because they are submitted instead of paying a predetermined premium to an insurance carrier.
8. Bonds rated by a major ratings agency below BBB (Standard & Poor's) or Baa (Moody's) are referred to as *high-yield bonds*. The ratings are based on the credit worthiness of the issuing company, and because these offerings are rated below investment grade (BBB/Baa and above are considered investment grade), the issuing companies must offer a higher coupon or yield on the bond to attract investors.
9. "Diversification," www.investopedia.com.

pdf/1019