Tesla Stock Is Downgraded Twice. Buy GM Because of the 'Rule of 3.'

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Retirement savers in 401(k) plans could soon gain exposure to private-equity strategies, a move that pits proponents of the investment option against critics who say it would introduce unsuitable risks for many investors.

The Labor Department earlier this month issued an information letter that opens the door for average retirement savers to invest in strategies that are typically the domain of high-net-worth investors. The letter doesn't authorize making private-equity investments available for direct investment in defined-contribution plans, such as 401(k)s. But it does appear to sanction their use as an option in a professionally managed multi-asset-class investment vehicle, such as a target-date, target-risk, or balanced fund.

The decision is the culmination of a yearslong battle by the private-equity industry to tap into the estimated $8.9 trillion defined-contribution marketplace. Proponents say private equity's inclusion will help retirement savers diversify and generate stronger performance.

Consumer advocates and some experts, meanwhile, are critical of the move, saying that the unfamiliar private-equity landscape could jeopardize the retirement savings of unsophisticated 401(k) investors by leading them to high-fee investments that are opaque, complex, and risky.

How soon plan sponsors will move to incorporate private equity into workplace plans isn't yet clear. In the meantime, here are some things to be aware of:

Hidden in Plain Sight

The greatest risk with incorporating private equity into 401(k) plans is that savers will be exposed to risks they don't recognize, understand, or anticipate in funds that they expect to be conservative and stable, says Barbara Roper, director of investor protection for the Consumer Federation of America.

If the investments are incorporated as planned into target-date and target-risk funds—the default investment option for many 401(k) participants—they'll land in the portfolios of the least engaged investors.

"You're talking about the investments most likely to be used by the least sophisticated, least wealthy of investors," Roper says. She advises employers to keep it "plain vanilla" when modeling their plans' investments, particularly default options.

If the investments do end up in target-date funds, however, older investors might not be as exposed as younger investors because the funds reduce risk the closer to retirement one is, says Anthony Tutrone, managing director of Neuberger Berman and global head of Neuberger Berman Alternatives. In other words, a target 2025 fund would likely have less exposure to risky private-equity investments than a target 2050 fund.

Do They Truly Diversify?

Some experts warn that private-equity investments may fail to offer a cushion during downturns. While such investments are often touted as uncorrelated because they're not priced in the public market, they're still equity, says John Rekenthaler, vice president for research for Morningstar. "When the stock market goes down, it goes down," he says.

Still, research conducted by Georgetown University's McCourt School of Public Policy's Center for Retirement Initiatives in conjunction with Willis Towers Watson in 2018 found that a diversified target-date fund, including private equity, direct real estate, and hedge funds, could increase the annual retirement income stream generated by a participant's balance by 17%. Willis Towers advises defined-contribution and defined-benefit plan sponsors regarding their fiduciary responsibilities.

David O'Meara, a senior defined-contribution strategist at Willis Towers Watson, says that shows how incorporating alternative investments, including private equity, into a diversified portfolio may improve retirement income and reduce short-term downside risks.

While O'Meara supports giving retirement savers access to private-equity investments, however, he says they shouldn't be made available directly. There are complexities in private-market investments--among them, higher costs and obtaining pricing on companies that don't trade daily—and "you need the requisite skill set in order to manage that effectively in order to harness its benefits," says O'Meara.

Perplexing Performance

Private-equity funds often tout their superior performance, but critics say that it's hard to evaluate their true performance because they're not required to disclose such information and the performance that is disclosed appears to vary widely.

"It's not like you open up the Wall Street Journal and see all the private-equity funds and what their various performance is," says Bart Mallon, a partner at Cole-Frieman & Mallon LLP, a boutique investment-management law firm in San Francisco. This makes it difficult to know how strong their performance is relative to their peers, he adds.

Rekenthaler is skeptical that private equity will boost returns and warns that once private-equity investments are incorporated into mutual funds, it will be difficult for the average investor to evaluate the performance of that component of the fund.

But Tutrone says private-equity investments have historically provided diversity and performed well for pension and sovereign-wealth funds.

Depriving 401(k) participants of the asset class just because the execution is going to be complicated and difficult is not wise, he says. The top tier private-equity firms that Neuberger Berman works with around the world are focused on the defined-contribution plans because they make up a large and quickly growing market in the U.S., he says.

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