Alternative Investments

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The investments commonly offered in most retirement plans are mutual funds, stocks, bonds, and cash investments that are publicly traded. But we get calls frequently from people who are looking to add alternative investments to their retirement plans. They ask about investing in real estate, cryptocurrency, hedge funds, private equity or gold. Some want to use their retirement plan for business startup cash. Even though ERISA seems to be flexible with respect to what a retirement plan can invest in, as a Plan Sponsor or a plan participant, you need to make sure the additional work and risk is worth including an alternative investment in your plan.

The Department of Labor (DOL) has taken a conservative view of alternative investments as indicated in the Compliance Assistance Release No 2022-01 on March 10, 2022. It specifically supplied some guidance on cryptocurrency but can be inferred for most alternative investments. The DOL has cautioned "plan fiduciaries to exercise extreme care" prior to adding any cryptocurrency to their portfolios and such caution should apply to any other alternative investment as well. This stems from the fact that participants may not have the experience with these types of investments to make prudent decisions. Educating participants and making sure they understand the complex nature of these investments can be daunting.

As a plan fiduciary you must repeatedly perform due diligence on investments that are allowed within your plan. As you add alternative investments to a portfolio or platform, the amount of due diligence increases exponentially. As a Plan Sponsor you must thoroughly check the asset manager's background, operations, valuation and reporting policy, and compliance policy. Review for the different types of alternative assets is unique and more involved than traditional or passive investments, bringing with it more risk, more documents and more agreements to monitor.

Other issues that need to be addressed when you have alternative investments in your plan are:

1. Alternative investments can also linger in the trust for a long time as many investments are illiquid making distributions to participants difficult.
2. Expenses and annual administration can also increase significantly as accountant's opinions for Form 5500 filing will have a broader scope. If the assets are not valued on a stock exchange, valuation and information reporting for these investments cannot be accessed and produced timely.
3. Possible litigation is a risk that must be considered as well. Alternative investments often have higher fees which an attorney or DOL could argue makes it not a "prudent" investment.
4. The IRS also requires 401k plans that purchase equity in an LLC, Limited Partnership or rental property to pay UBIT (Unrelated Business Income Tax) on net income generated from the investment if the business is deemed an active business versus a passive investment business. Additional work necessary to determine UBIT increases the amount of administration and cost to the plan.

Alternative investments bring challenges and risk to portfolio management. As always sound analysis and oversite should serve as the foundation for all investment decisions. But this Author recommends keeping alternative investments outside of your retirement plan. It is not worth the risk and additional work.