DEFINED CONTRIBUTION IN REAL ESTATE

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An interview with:

Karyn Lujan
Public Employees Retirement Association of New Mexico (PERA)

Paul Cowie
Meketa Investment Group

A series of interviews on defined contribution in real estate investment management

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DCREC DEFINED CONTRIBUTION REAL ESTATE COUNCIL

NAREIM The business of real estate investment management

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Taking the reins

The introduction of core real estate into a defined contribution plan offers the benefits of diversification, stable income returns, stronger risk-adjusted returns, and the potential for inflation protection with the benefits of reducing volatility in the portfolio. But what happens in an extreme market? How do illiquid assets work in reality?

Karyn Lujan of Public Employees Retirement Association of New Mexico and consultant Paul Cowie of Meketa Investment Group speak with DCREC and NAREIM about how the public pension's voluntary deferred compensation plan introduced core private real estate into their target date funds and the lessons learned during the Covid-19 pandemic when rebalancing was top of mind.

Their key lessons learned: Understand the legal reviews required, be proactive in rebalancing and embrace the fiduciary oversight you provide participants.

Participants

Karyn Lujan, PERA SmartSave Deferred Compensation Plan Manager, Public Employees Retirement Association of New Mexico (PERA)

Karyn oversees the $727 million supplemental plan with over 23,000 participants, and growing. Karyn joined NM PERA in 2015 and her first order of business was the initiation of a complete rebrand of the plan. This included the adoption of a new plan name: The PERA SmartSave Deferred Compensation Plan. Within 12 months of the rebrand, participation increased by more than 13% as well as the AUM by 9%. Another early accomplishment was an in-depth administrative fee analysis which resulted in the PERA Board adopting a new hybrid fee structure that lowered the annual administrative fee for two-thirds of plan participants. In 2017, Karyn actively participated in the annual New Mexico Legislative Session to update the plan's 36-year-old governing statutes to allow for online transactions — a feat that had never been pursued.

Since the success of the newly adopted legislation to allow for online transactions, Karyn is currently working towards plan evolution; this includes an endeavor to implement education and tools on simple financial wellness.

Paul Cowie, Managing Principal/Consultant, Meketa Investment Group and lead consultant, State of New Mexico 457(b) Plan, PERA SmartSave

Paul joined Meketa Investment Group in 2005 and has been in the industry for 19 years. A Managing Principal of the firm, Paul is based out of the San Diego office and works directly with several of their West Coast clients. He serves as a consultant on various defined benefit, defined contribution, annuity and health & welfare funds with public, Taft-Hartley and corporate plan sponsors. His consulting work includes investment policy design, asset allocation modeling, public manager due diligence, and fund performance analysis. Paul is also the Chair of the firm's Profit Sharing Plan Committee and a member of the Defined Contribution Committee. He graduated from Bucknell University with a Bachelor's degree in Economics and a minor in Political Science.

Prior to joining the firm, Paul was employed by Standish Mellon Asset Management and State Street Corporation as a portfolio accountant. Paul has completed Levels I and II of the CFA Program and is a member of the CFA Society of San Diego.

KEY HIGHLIGHTS

- Introducing core private real estate can improve a portfolio's risk-return profile, provide downside protection and improve participant outcomes.
- Illiquid strategies involve contracts and agreements, which need to be reviewed by legal resources.
- Be thoughtful about rebalancing amidst market volatility.
- Bringing a DC plan in-house, rather than letting a recordkeeper run it, reinforces the plan sponsor's role of fiduciary oversight and improves participants' trust in the plan.
- Participation is the main goal. Change the participants' mindset by educating them to start investing now.

Public Employees Retirement Association of New Mexico

Size of DC plan: $727 million (as of December 2022)

Number of balances: 23,000

Type of plan: 457(b)

Number of eligible employees: 64,000

Percentage participating: 35%

The State of New Mexico government employees are mandated to the defined benefit pension system and can voluntarily participate in the supplemental 457(b) plan called PERA SmartSave.

Tell us about the evolution of PERA's DC allocation and how real estate fits in.

Karyn Lujan: When I joined New Mexico PERA in 2015, the only real estate investment option in our fund lineup was a global REIT. Our recordkeeper at the time was inadvertently running the defined contribution (DC) plan, and my first job duty was to take back control of our plan.

One of the first steps we took was to rebrand, which is how PERA SmartSave was born. We worked with our consultant Meketa to review our fund lineup. In reviewing the plan's real estate exposure, they found that all of the plan's real estate exposure was to REITs through both target date fund lifecycle portfolios and as a standalone option.

Recognizing the benefits of blended exposure to both private and public real estate, Meketa explored the possibility of adding core private real estate to the target date funds.

Historically, the DC plan didn't get a lot of undivided attention. When our investment consultant proposed more innovative solutions within our fund lineup, it piqued the PERA Board's interest.

Our target date funds are custom built from the majority of offerings in our existing core fund lineup. Our current core fund lineup consists of about 17 individual funds and one stable value fund.

Paul Cowie: When we started the conversation with PERA seven years ago, our initial review was to do a deep dive into the allocation of their custom target date funds. And as we were going through our assessment, we realized we could improve some of the underlying asset class exposures and not just make tweaks [at the edges]. It was a case of recommending keeping REITs in the target date funds but, as a future project for PERA, investigating core private real estate as a potential asset class for investment.

I do think core private real estate has more favorable attributes within a diversified portfolio and with signifi-

> “Core private real estate has more favorable attributes within a diversified portfolio and with significantly less volatility than REITs.”
> **Paul Cowie**

cantly less volatility than REITs. At Meketa, we had been meeting with managers and knew there were existing DC-oriented products.

It was therefore about planting a seed with PERA, which is what the initial asset allocation review did. It wasn't until a year later, in early 2017, that we launched the formal search for a core private real estate manager with Karyn and her team. It took us until the end of 2017 to bring it to the New Mexico PERA Board.

When you were doing the portfolio review, did you recommend broad-based changes, or was it focused on bringing in real estate because you thought the markets had evolved enough and it made sense from a return perspective?

Paul Cowie: I would say it was a more broad-based review recommending broad-based changes. When we first looked at the target date portfolios, we recommended increasing PERA's passive exposure in some of the more efficient areas.

Within a portfolio, real estate offers distinct private market benefits such as diversification, downside protection and stronger risk-adjusted returns. What were some of those drivers as you looked at the asset and portfolio allocation? What did PERA want to achieve?

Paul Cowie: We wanted to primarily strengthen the plan outcome for participants and control costs. That was one of the main drivers of bringing in more index funds and having some exposure to asset classes that we didn't already have, such as high-yield bonds and real estate.

At the time, real estate lived within the real asset bucket, which was a REIT fund and then a diversified inflation-hedging option. The real asset bucket had about five or six different underlying asset classes in it.

With respect to core private real estate, it was based on Meketa's view that if we could swap the majority of the real estate exposure with core private, we would really improve the risk-return profile of that portion of the portfolio and provide downside protection for PERA and the beneficiaries.

OPERATING A DC PLAN

What did you find to be the main difference between your past investing strategy and having an illiquid fund in the DC plan?

Karyn Lujan: The main difference between our past investments in mutual funds and the illiquid strategy is that the mutual fund investments were fairly straightforward from the recordkeeping standpoint, while the illiquid strategy involves contracts and various agreements. Because we have to sign contracts, our legal team has to get involved, which brings with it associated attorney fees, something the plan wasn't used to.

Our attorneys and our internal legal resources from the pension side had to review DC contracts and issues. It meant they had to go back to the beginning of the DC plan to understand the plan's objectives and governing documents. In the case of PERA, our DC Plan Document referred to a Trust Agreement, so we had to go back through the archives to figure out if we even had a Trust Agreement. It's those unexpected things. But this process did help us review and improve our governing documents.

Paul Cowie: I would add another part of the process which was quite different to the past way of working —

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> **Karyn Lujan**

we needed to set up servicing agreements with the recordkeeper and the real estate manager. It’s another agreement to add to the mix, so you have not only the agreement with the DC plan, but also an agreement with the recordkeeper for them to have the fund on their platform and to manage the cash flows on a daily basis.

Karyn Lujan: That was an interesting thing to see change within New Mexico — to move from a culture where the DC plan was seen as the recordkeeper’s plan, quite separate and not owned by PERA, to a culture where New Mexico’s participants understand this plan belongs to PERA. The reason why that’s so important is because of the fiduciary oversight.

As we went through this review of our underlying funds and asset classes, we also eventually changed our recordkeeper. But that also enabled us to get our rebranding message across. More people now know that New Mexico’s DC plan is overseen by PERA and managed by PERA.

How much of an impact do you think it had to have the ability to say, “This is PERA, this is ours. We have a fiduciary duty to you, our participants and employees?”

Karyn Lujan: It has been huge to be able to say that we’re PERA SmartSave and we’re letting our plan participants know that they are making a smart decision to save. We have external outreach reps who work for the recordkeeper, live in New Mexico and are connected to PERA. This has helped get their team involved with our employees quicker; they don’t look like an outsourced vendor trying to sell them something.

New Mexico’s employees now know that getting contacted means it has something to do with their pension and their pension is real and legitimate.

As for the fiduciary oversight, while most plan participants don’t understand the details, it is appreciated. I’m constantly drilling into that fiduciary oversight and getting the message out to our participants in our marketing pieces or meetings with the Board.

Education is critical. How did you educate your stakeholders?

Karyn Lujan: From the plan sponsor perspective, first and foremost, Paul and his team provided informational sessions to the Board on the benefits of replacing the REIT from our target date fund allocation with core private real estate strategy. We had to reiterate that this would only be offered in the target date funds and not on the core menu. And then we explained why and how that is allowed.

From a participant perspective, there wasn’t much intended education because PERA has control over how the target date funds are built; however, we updated fund fact sheets and that allowed for participant education for those who actually take the time to pay attention to their asset allocations.

Again, this is why fiduciary oversight is such an important message, because it allows participants to understand that the target date funds are pre-designed, which can alleviate the stress of needing investment knowledge to participate in the plan.

Was there also internal education on DC because this was the first time that the attorneys were dealing on the DC side?

Karyn Lujan: My position is housed in the Investments Division and I report directly to the Chief Investment Officer. When we are making any changes to the fund lineup, we go through the same due diligence process

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as the defined benefit pension funds. I'm surrounded by investment professionals, and we have a real estate portfolio professional on our team. That's a plus because the benefits of the strategy didn't need to be sold, only the manager selection did.

For us the challenge of explaining was more about, how was this allowed to be in the DC plan, considering the illiquid aspect of it? As soon as that was explained, the internal staff and the Board were in full agreement.

That's a really unique position to have your DB team and your real estate portfolio manager so close to help explain and educate how investing in real estate can actually work on the DC side. What do your target date funds look like today?

Paul Cowie: One of the unique funds that New Mexico has within its fixed income portfolio is stable value funds, especially within the shorter date funds. It's a good time for those now in a rising interest rate environment. Other than that, the portfolio is pretty standard: investment grade, emerging markets, high yield.

Within equity, there is a lot of passive US exposure, a couple of active mid cap and small cap funds. There is some international exposure within index funds in developed large cap, and one active manager with a dedicated, emerging market strategy.

In the real assets bucket, we have the core real estate fund and diversified real asset fund, which is a combination of commodities, master limited partnerships, bank loans and Treasury inflation-protected securities (TIPS).

Karyn Lujan: When we are looking at making changes to the fund lineup, we have to consider how they affect the target dates because we're using our individual core menu funds to build our target date funds. For example, if we have to change out a small cap fund, we have to see where that is in the target date funds. We have to make sure we're choosing the fund that's going to fit the needs of both standalone funds and target date funds. This doesn't affect private real estate, which is not offered in a standalone fund, but it is something we keep in mind when considering other investments.

Paul Cowie: For the most part, all the options within the target date funds are available on the core lineup, with the exception of high-yield bonds and real estate.

REAL ESTATE IN THE DC PLAN

How does your allocation to real estate look across the glide path? There are static allocations, and there are shifts depending on whether it's earlier or closer to retirement. What did you decide to implement?

Paul Cowie: We decided to overweight for the longer-dated funds. For example, our 2060 fund has 12% and then it gradually works its way down to 8% towards retirement.

How do you fund that? You mentioned you had the REIT, but did you take it from anywhere else when you were considering allocating to this asset class?

Paul Cowie: When we took on the target date portfolios, they already had a pretty sizable allocation to the REIT and we may have increased it slightly for the longer-dated funds. Other than that, there wasn't a drastic change in the quoted real assets bucket for the target date portfolios.

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> **Karyn Lujan**

When you thought about investing in private real estate, were there characteristics or structures you were specifically looking for? What were your considerations when you were vetting that out?

Paul Cowie: When we first started looking at the space and then conducting the search, we found there were only seven established products and a couple of managers in the marketplace that had a reasonable track record. That narrowed things down for us. The key things we were looking for were a long performance history of at least 10 years, a daily pricing function and a well-built-out process of having that daily pricing independently verified. We also wanted the ability to have redemptions on a daily basis.

In an ideal world, we would want those structures to have as much exposure to the core real estate as possible that could meet our liquidity requirement. We recognized the ideal real estate solution would have a liquidity sleeve with REIT exposure and hold exposure to core private real estate.

The market is broadly recognizing that there is value to having a blended exposure because it forms the buffer in liquidity as it is a less liquid asset class on the private side.

Paul Cowie: Yes. The first quarter of 2020 was a good test of that. It was an interesting time for the plan; it wasn't necessarily that we wanted to get out because it was a poorly performing asset class, or we necessarily needed the liquidity; actually the [real estate DC] fund performed so much better than the majority of the other investments in the plan that it became meaningfully overweight its target. At the end of each quarter, the plan's recordkeeper automatically rebalances each underlying fund in the portfolios back to target. Because of this positive performance disparity, it resulted in a rebalancing redemption that was up against the real estate fund's 10% quarterly limit.

However, the issue quickly resolved itself as the market rebounded so fast and the real estate fund saw inflows due to rebalancing in subsequent quarters.

Karyn Lujan: One of our board members asked, "What would have to happen in order for an illiquid fund to not work in this sort of plan?" And we said, "It would be akin to a mass exodus of participants cashing out." Although that's likely not to happen, market volatility during the pandemic did have an effect on cash outflows from the plan. This is now something we are aware of and have a backup plan for unexpected events.

Paul Cowie: This goes for our side and the recordkeeper's side too. We need to be aware of those types of situations. In hindsight, we realized we need a little more discretion around rebalancing amidst market volatility.

What would you do differently the next time there is an unexpected event?

Paul Cowie: Karyn mentioned that breaching a liquidity limit might be an issue if we have a mass exodus from the target date funds. But PERA's experience during the pandemic was prompted by good performance and different returns between asset classes. It wasn't something we were really thinking about.

So for me, I would take a more active approach to rebalancing rather than to rely solely on a rules-based process. It's similar to how most of our pension funds work. They have target ranges and there's

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some discretion around when to rebalance. It's not all done automatically.

Karyn Lujan: An administrative benefit of target date funds is we aren't required to notify participants when we are making these changes like we do for the standalone options. We have the flexibility to go behind the scenes and make adjustments as needed for the benefit of the portfolio.

LOOKING AHEAD

As you think 10 to 20 years into the future, do you see more of the plan asset allocation changing or would you see your real estate mix changing?

Paul Cowie: One of the things Meketa would really like to do with New Mexico is to continue to streamline the core lineup and to do more white label funds – obviously target date funds within equity, fixed income and maybe real assets. We hope to simplify choices for our participants because there's still education to be done. We don't have a large number of funds, but there are some funds that may be a little complex for folks. Anything we can do to make decisions easier and improve outcomes would be helpful.

How do you increase participation among plan participants?

Paul Cowie: We encourage people to start with the target date fund.

Karyn Lujan: Participation is the main goal. The plan is voluntary and supplemental; everybody has their guaranteed PERA pension but we find that people don't save enough for retirement. It's human behavior to think that we need our entire paycheck and not to start saving now for an event like a retirement taking place 30 years in the future.

The main thing is changing the culture. It's getting people to see the benefits of paying yourself first and then paying, for example, streaming subscriptions. Our education plan consists of two simple steps: one, start your participation, and two, keep increasing your contributions over time.

As for the fund lineup, our participants, generally speaking, are not investors. We offer target date funds as our default option to make it easy for non-investors to feel comfortable enrolling. We have licensed outreach reps who are able to educate. We take our responsibility very seriously.

What are the key lessons learned?

Karyn Lujan: From a plan sponsor point of view, be prepared for the legal aspects of setting up and monitoring an illiquid strategy, and have a budget for legal fees. Paul mentioned that when the fund changed from a separate account to a limited partnership structure, that required another legal review.

Regarding illiquidity, what we feared could be a mass exodus did not occur. However, it was something we learned as the pandemic affected the stock market. Being proactive in rebalancing can help manage that aspect.

Paul Cowie: We already experienced rebalancing and liquidity challenges in stressful periods. The reduction of REIT exposure has helped reduce volatility and improve risk-adjusted returns of the target date portfolios when other investments weren't doing as well.

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