From "Permitted" to "Prudent"

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How Private Investments are Entering the 401(k) Maintstream and what it means for Investment Fiduciaries

Executive Summary

Key takeaways (3(38) fiduciary lens):

- Private investments are moving from theoretical to implementable in DC primarily through professionally managed, multi-asset structures (e.g., TDFs and balanced funds)—not standalone participant-directed options.
- Regulatory posture is best understood as permissive-but-principles-based: the burden remains on fiduciary process, documentation, and monitoring discipline.
- For 3(38) fiduciaries, diligence must expand beyond manager selection to include liquidity engineering, valuation governance, recordkeeping operations, participant suitability, and fit-for-purpose oversight.

Introduction: Why this moment is different

For more than a decade, the defined contribution (DC) industry has debated whether private investments should be allowed in 401(k) plans. The question is no longer theoretical. Regulatory signals, product design, and plan sponsor interest are converging, pushing the conversation from "can we?" to "how do we do this prudently?"

From a 3(38)-investment fiduciary perspective, this shift is significant. The investment fiduciary role is not to champion asset classes or follow trends. The responsibility is to determine whether, how, and under what conditions a particular investment approach can be implemented in a manner consistent with ERISA's duties of prudence and loyalty and aligned with the realities of participant behavior, plan operations, and governance capacity.

Private investments are not becoming "mainstream" in DC because they are new or fashionable. They are becoming relevant because they are increasingly engineered into structures that address long-standing DC constraints and because policymakers have sent clearer signals that access, by itself, is not incompatible with fiduciary responsibility. What follows is a fiduciary-first assessment of how we arrived here, what has changed, and how the rise of private investments within multi-asset DC options is reshaping the 3(38) evaluation and selection process.

The Regulatory Arc: What changed—and what did not

It is critical to begin with a reminder: ERISA's fiduciary standards have not changed. Prudence, loyalty, diversification, and the reasonableness of fees remain the governing principles. What has evolved is the regulatory posture on how those standards can be satisfied when non-traditional asset classes are involved.

For many years, private investments were treated as de facto incompatible with DC plans, not by statute, but by assumption. Daily valuation expectations, participant-directed trading, and liquidity needs were seen as insurmountable obstacles.

That posture shifted meaningfully when the Department of Labor clarified that private equity could be used as a component of a professionally managed, diversified investment option, such as a target-date fund, Managed Account, or asset allocation fund, provided fiduciaries engaged in a prudent selection and monitoring process. Importantly, this was not an endorsement of private investments as standalone, participant-directed options. It was a recognition that structure matters.

Subsequent regulatory commentary introduced cautionary language, which many interpreted as a renewed headwind. More recent actions have reset the tone toward a more neutral, principles-based framework and, at the policy level, expressed a stated interest in expanding access so long as fiduciary in expanding access so long as fiduciary safeguards are observed.

The fiduciary takeaway is straightforward: the environment today is permissive but not promotional. Regulators are not instructing plan fiduciaries to include private investments, but the burden, as always, remains on prudent process.

The Implementation Evolution: Why structure is the story

Private investments did not suddenly become suitable for DC plans. What changed is how they are implemented.

From a fiduciary standpoint, private investments begin to make sense in DC plans only when embedded in professionally managed, multi-asset solutions. These structures can address several historical friction points:

- Liquidity management: Public market sleeves can be used to absorb daily participant transactions, shielding private sleeves from forced selling.
- Valuation alignment: Periodic private valuations can be integrated into unitized funds without disrupting participant-level accounting.
- Governance control: Asset allocation decisions, rebalancing, and sizing of private exposure remain under professional oversight rather than participant discretion.

This is why early and current implementations are concentrated in target-date funds, balanced or outcome-oriented funds, and managed account solutions (where operationally feasible). In each case, the private investment is not the focus; it is a component.

The industry is moving from pilots toward more standardized design frameworks. That shift matters for fiduciaries: repeatability improves benchmarking, strengthens monitoring discipline, and reduces operational risk. It also signals that private investments are increasingly engineered for the DC environment rather than merely adapted to it as an afterthought.

What this means for the 3(38) fiduciary role

As private investments enter DC plans through multi-asset structures, the 3(38) fiduciary role expands not in liability but in the scope of analysis. Traditional due diligence lenses remain necessary but need to be expanded.

Evaluating a DC investment option that includes private investments requires fiduciaries to look beyond historical performance and manager pedigree. At a minimum, a prudent review should include the mechanics that determine whether participant outcomes can be delivered fairly and consistently.

A 3(38)-diligence framework typically comprises the following pillars:

Liquidity and cash-flow design: How is participant liquidity met under normal and stressed conditions? What mechanisms exist to prevent dilution, forced selling, or inequitable treatment across participant cohorts?

Valuation governance: How are assets valued, how often, and by whom? What controls are in place to mitigate stale pricing, conflicts of interest, or valuation bias?

Fee transparency and reasonableness: Can all layers of fees be identified and evaluated? Is the fee structure reasonable relative to expected benefits and realistic return assumptions?

Operational readiness with the recordkeeper and investment manager: Can the recordkeeper and investment manager support the structure (unitization, trading restrictions, data feeds, participant statements)? Are error-handling and reconciliation processes fully tested?

Participant-centric suitability: Which participants are expected to benefit, and why? Is the option defensible as a default option (QDIA), or is it better positioned as an opt-in, professionally managed solution?

Ongoing monitoring: Does the monitoring cadence align with the valuation cadence and liquidity terms? Are escalation triggers defined (team changes, strategy drift, liquidity deterioration, fee changes)?

Enhanced Investment Due Diligence: Measuring What Matters

As private market exposures are incorporated into DC investment structures, investment managers and 3(38) fiduciaries must confront analytical challenges that differ significantly from those in traditional evaluations of public market managers. These challenges are not academic; they go directly to whether private investments can be justified as prudent complements rather than costly substitutes for public market exposures.

Measuring Return Premiums Relative to Public Market Peers

A central due diligence question is how to define and measure the return premium required to justify private market allocations within DC plans.

Private investments typically involve:

- Higher and multi-layered fee structures
- Reduced transparency
- Liquidity constraints
- Greater operational and governance complexity

Against this backdrop, fiduciaries must establish what level of net-of-fee excess return is reasonably required relative to comparable public-market exposures. This requires more than referencing long-term private market averages. A prudent framework should include:

- Identification of appropriate public-market proxies or synthetic replicating portfolios
- Adjustments for leverage, sector tilts, vintage-year effects, and smoothing
- A clear focus on net participant outcomes, not gross performance narratives

Correlation Benefits and the Reality of DC Liquidity Engineering

Private investments are frequently cited for their diversification and low correlation with public markets.

To support daily participant liquidity, most DC implementations rely on public-market sleeves to absorb cash flows. Fiduciaries must therefore assess:

- Whether the intended diversification benefits persist once liquidity sleeves are introduced
- How allocation ratios between public and private sleeves are governed and rebalanced
- Whether correlation benefits are meaningfully realized at the total-portfolio level

The key fiduciary question is not whether private markets theoretically diversify public markets, but whether the implemented structure efficiently captures those benefits relative to the return premium required

Performance Reporting, Valuation Lag, and Risk Transparency

Another critical area of scrutiny is whether private market investments are truly less exposed to adverse market environments or whether the impact is merely delayed or obscured by valuation practices.

Fiduciaries should evaluate:

- The degree to which valuation lag and appraisal smoothing affect reported volatility
- Whether performance reporting masks drawdowns that would be visible in public markets
- How risk metrics are constructed and interpreted in participant-facing vehicles

Prudence requires acknowledging that lower observed volatility does not necessarily equate to lower economic risk. Robust documentation should reflect how valuation timing and reporting conventions influence perceived outcomes.

Lessons from the Defined Benefit Experience

The growth of private markets in defined benefit plans offers useful lessons for DC fiduciaries, though not directly transferable.

Key corollaries include:

- The importance of scale, governance capacity, and long-term capital
- The role of disciplined sizing and pacing rather than opportunistic allocation

- The value of integrating private investments as portfolio complements rather than return panaceas

DC plans can benefit from these lessons only when adapted to participant-level liquidity, fairness, and disclosure requirements. The DB experience informs the "how," but does not eliminate the need for DC-specific prudence.

Clarifying accountability: 3(38) versus plan sponsor

Clear delineation of roles is essential. A 3(38) fiduciary may exercise discretion to select and monitor investment options, but plan sponsors retain authority over plan design decisions, including whether an option is designated as a QDIA, how participant communications are delivered, and which service providers are retained under the plan's contracting framework.

A well-constructed fiduciary file should reflect this division of responsibilities and document how the investment decision aligns with the plan's objectives, demographics, and operational realities.

A practical roadmap for plan sponsors

From a fiduciary standpoint, successful implementation begins with disciplined sequencing. The most common failures in complex DC implementations are rarely investment-related; they stem from feasibility gaps, unclear objectives, and under-resourced governance.

A practical roadmap looks like this:

1. Define the goal: Is the objective diversification, return enhancement, volatility management, inflation sensitivity, or retirement income support? The goal should be explicit enough to guide sizing, structure, and evaluation criteria.

2. Choose the implementation rung: Balanced fund → Target-date/QDIA → Managed accounts. Each rung has distinct operational and governance demands. Starting with the simplest viable rung often produces the strongest fiduciary outcomes.

3. Run a feasibility screen: Confirm the recordkeeper and investment manager's capability, data feeds, unitization approach, trading policies, and participant transaction assumptions. Assess plan demographics and liquidity profile before selecting a solution.

4. Conduct enhanced due diligence and document it: Apply the expanded framework, including liquidity design, valuation governance, fee transparency, operational readiness, suitability, and a monitoring plan.

5. Build a communication strategy: Participants should understand, in plain language, the long-term nature of the exposure, how valuation timing works, and whether any liquidity constraints exist at the fund level.

6. Establish a monitoring and escalation playbook: Define what is reviewed quarterly versus annually, what data is required, and what triggers actions such as watch status, re-approval, or replacement

Addressing skepticism directly

Concerns about private investments in DC plans are legitimate. High fees, valuation opacity, liquidity constraints, and litigation risk are understandable concerns. They must be explicitly addressed.

From a 3(38) perspective, these concerns do not automatically disqualify the asset class. However, they do raise the bar for structural, sizing, discipline, operational engineering, and documentation.

- "High fees will eat the alpha." A prudent review requires layered fee transparency, realistic return assumptions, and a reasonableness determination grounded in expected participant outcomes rather than marketing narratives.
- "Opaque valuations create inequity." Valuation policies, third-party oversight, and controls for stale pricing are fiduciary necessities; monitoring cadence must align with valuation cadence.
- "Participant liquidity conflicts with illiquidity." Liquidity sleeves, trading policies, and stress testing (e.g., elevated withdrawals during market drawdowns)

should be part of the core design review.

- “Fiduciary liability will increase.” Liability is most often driven by weak processes: insufficient documentation, poor fee transparency, and inadequate monitoring. Strong governance reduces risk across all asset classes.

Conclusion: From novelty to fiduciary discipline

Private investments are not entering defined contribution plans because they are exciting. They are entering because the industry is increasingly able to reconcile institutional investment concepts with participant-centric realities—primarily through professionally managed, multi-asset structures.

For 3(38) fiduciaries, this evolution presents both an opportunity and a responsibility. The opportunity is to help plan sponsors thoughtfully expand the toolkit available to participants. The responsibility is to ensure that enthusiasm never outruns prudence.

In the end, private investments in DC plans will succeed based on fiduciary discipline. That discipline begins and ends with a defensible process.

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