TD Global Investment Solutions

Investor Knowledge 10 Minutes

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Unlocking the Value of Alternatives:

A Framework for Defined Benefit Plans

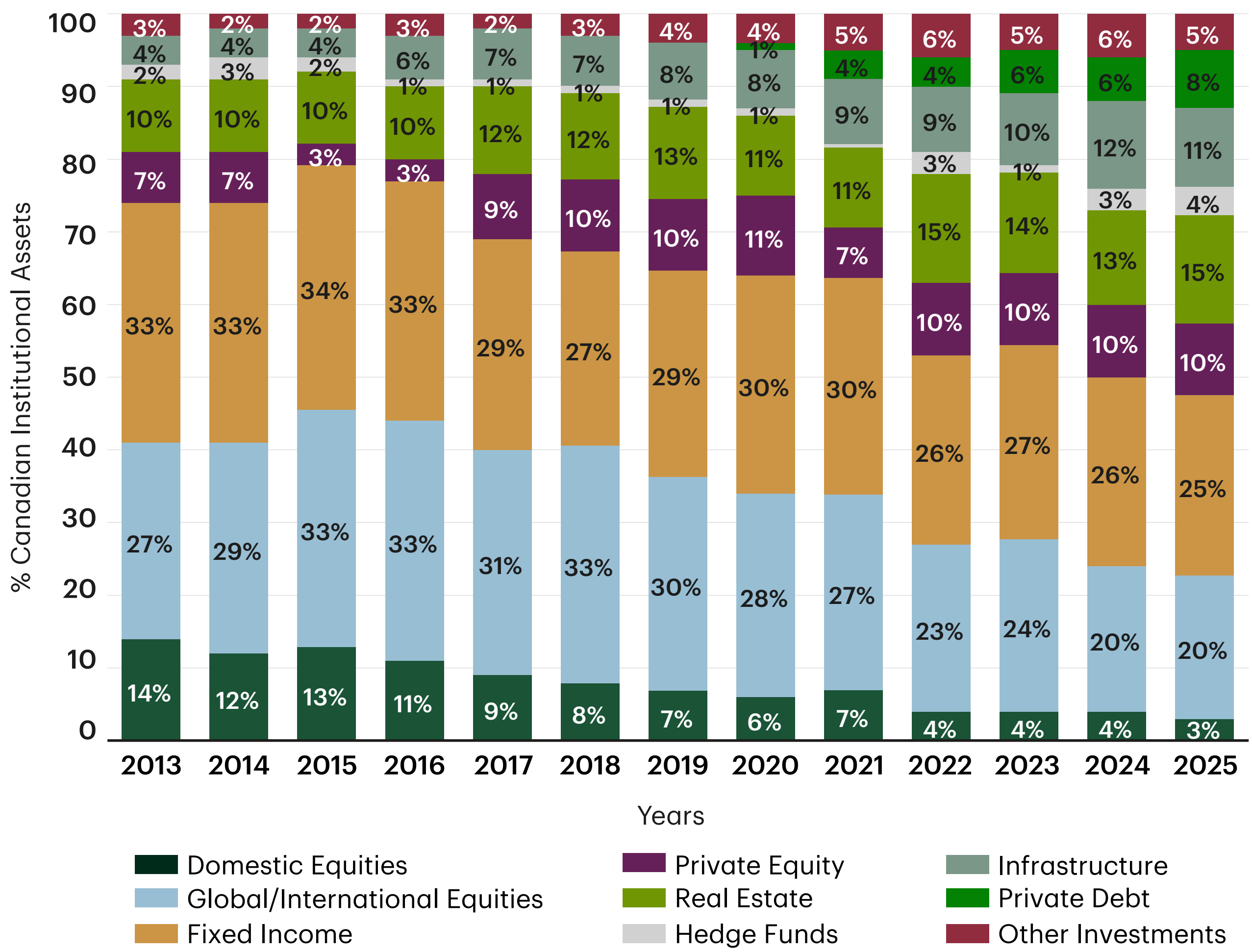
Defined Benefit (DB) pension plans are increasingly incorporating alternative investments into their portfolios because of these assets' potential to offer higher returns and better diversification, among other things. However, plan sponsors may question the right amounts or the types of alternatives they need to use. This is why a framework to guide their strategic asset allocation decisions is crucial. TD Asset Management Inc. (TDAM) has recently developed this type of framework - the Total Portfolio Compass. It outlines how all assets function within a portfolio, considering shifting DB demographics and risk budgeting. This paper examines the main benefits of alternatives and addresses the challenges associated with their implementation.

Adapting to Market Realities: Rethinking Investment Strategies

The landscape for Canadian DB plans is at an inflection point. After years of hard work, many sponsors find their plans in a healthy funded position. This creates a unique opportunity to reassess investment strategies. However, today's market realities - inflationary pressures, interest rate uncertainty and concentrated equity markets - demand a more sophisticated approach than the traditional playbook of simply shifting assets between equities and bonds.

With the rising adoption of alternatives as illustrated in **Figure 1**, we outline a new Total Portfolio Compass built on the frameworks established in our previous papers: **Right-Risking – Helping Pension Plans Set Their Hedging Objectives, Demographic Focused Investing (DFI) – If Your Plan's Demographics Are Changing, So Should Your Investment Approach**, and Navigating Funding Surplus in Defined Benefit Pension Plans >. This roadmap allows us to explore the benefits of alternatives and how to approach their main implementation challenges.

Figure 1: DB plans and investment pools asset mix



Note: "Other Investments" includes commodities, money market, cash and short-term investments, and other.
Source: Coalition Greenwhich Voice of Client – 2025 Canadian Institutional Investors Study.

Canadian institutions shifted asset allocations further towards alternatives, including increases in Private Debt and Real Estate

Total Portfolio Compass

Most DB plan investors are familiar with the classic approach to classifying assets within a liability-driven framework: liability-hedging assets (LHA) such as fixed income are used to match the liability cash flows, whereas return-seeking assets (RSA) such as equities are used to generate a return above and beyond the liabilities.

While these categories provide a useful starting point, in practice most investors operate along a continuum rather than within fixed definitions. Differences in funding status, governance and investment beliefs often lead to variations in how liability-hedging and return-seeking assets are combined. As a result, allocations are not always clear-cut. Instead, they reflect each plan's specific objectives and constraints.

Rather than viewing each investment in isolation, we classify sub asset-classes within a functional framework as interdependent components of a total portfolio. The Total Portfolio Compass (**Figure 2**) provides a simple yet powerful lens for visualizing all asset classes across four dimensions:

1 **Investor demographic focus:** retirees, actives or surplus.

2 **Asset type:** traditional versus alternative.

3 **Role within the portfolio:** liability-hedging vs. return-seeking.

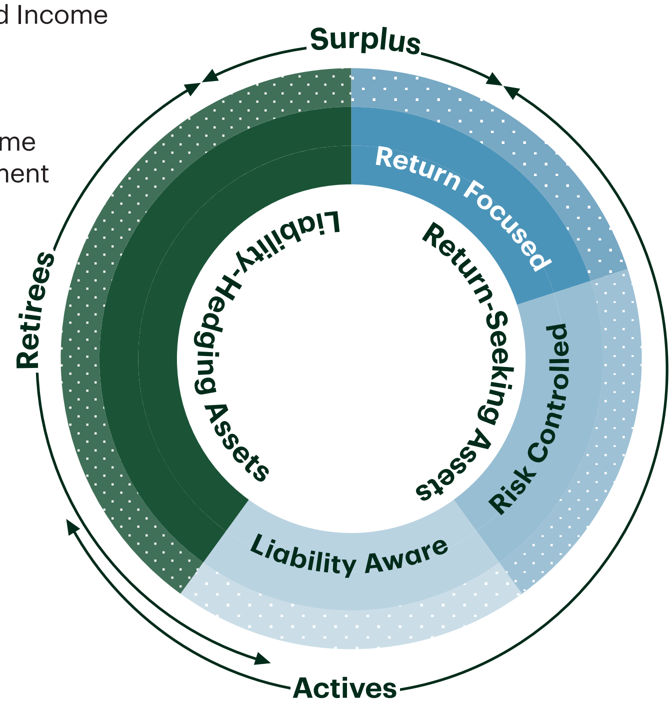
4 **Investment style within the RSA, for both traditional and alternative assets:** liability-aware, risk-controlled, return-focused.

Figure 2: Total Portfolio Compass

Liability-Hedging Assets

Buy-and-Maintain Credit
Fundamental Fixed Income
Core Plus[1]
High Yield[2]
Global Bonds
Passive Fixed Income
Liquidity Management
Bond Overlay[3]

IG Private Credit
Mortgages
Portable Alpha



Legend:

Solid fill = Traditional

Pattern fill = Alternatives

Return-Seeking Assets

Return Focused

Equity Active Fundamental Core Growth
Equity Active Quantitative Alpha
Equity Passive

Global Private Credit
Extension strategies (130/30)
Private Equity

Risk Controlled

Equity Active Free Cash Flow
Equity Active Quantitative Risk Focused (Low Volatility)

Hedge Fund Long Short Equity

Liability Aware

Global Unconstrained Fixed Income
High Yield[2]

Commodities
Infrastructure
Real Estate

The inclusion of alternatives in institutional portfolios, as a multifaceted asset class, prompts important considerations regarding their role in portfolio construction, the proportion of risk budget allocated to them, and their potential liability-hedging characteristics. Additional implementation aspects include evaluating their diversification benefits, managing liquidity requirements, and assessing their contributions to sustainable investment objectives.

1 Investor Demographic Focus

By reframing the asset allocation process through the lens of plan demographics, alternative assets can effectively support the distinct objectives of retirees, active plan members and surplus investors.

Retirees:

In this pool, assets are mapped to current retirees with the objective of custom horizon matching, using LHA to secure near-term payments. The risk budget is generally lower. Private credit instruments, such as mortgages and investment-grade private debt, provide incremental return potential over public fixed income while maintaining strong alignment with interest rate and credit-hedging needs.

Actives:

This asset pool is managed for liability-aware growth. It requires a blend of LHA and RSA, commanding a higher risk budget. Global private credit and private equity offer additional return potential through access to illiquidity and complexity premium.

Surplus:

An asset-focused approach which is managed according to target spend objectives can lead to a higher risk budget, drawing specific ingredients from LHA and RSA to drive higher returns without impacting the security of accrued benefits. A wide range of alternative strategies can be employed, tailored to balance return generation, liquidity and long-term sustainability.

2 Asset Type

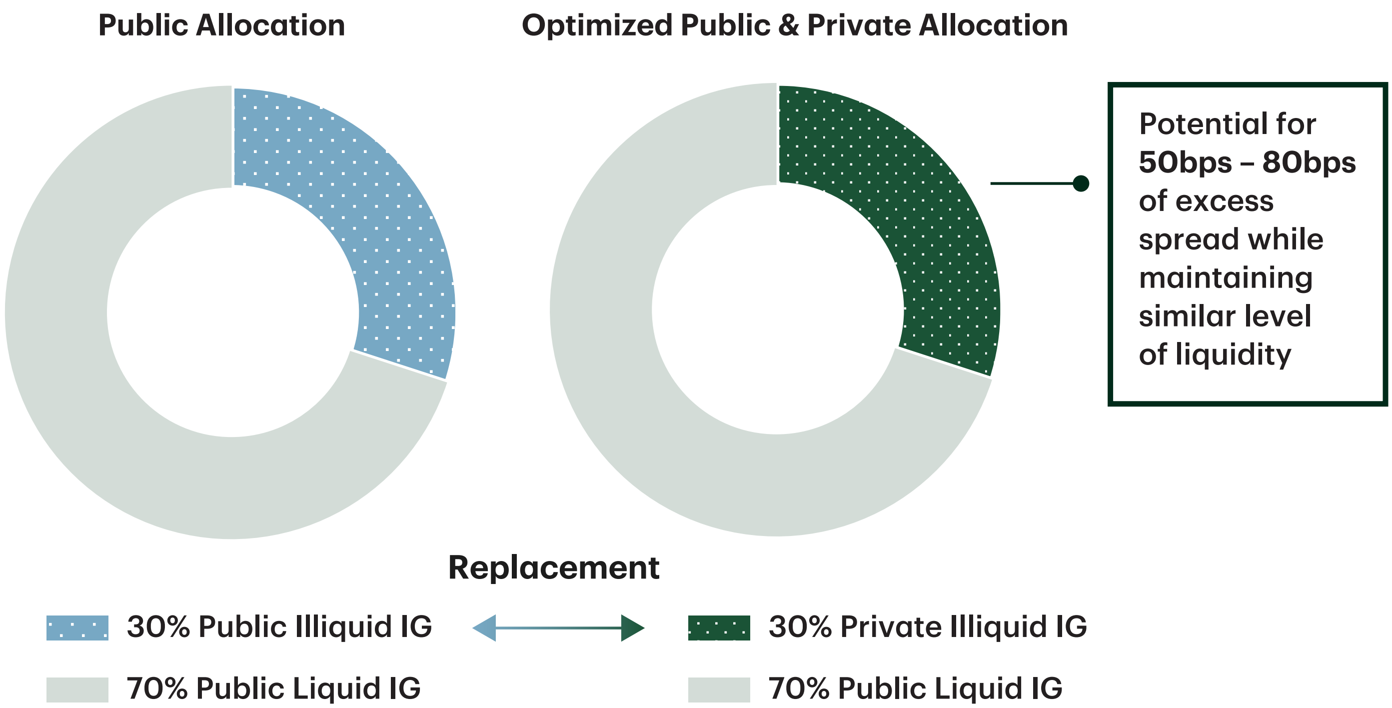
Traditional assets are typically publicly traded, liquid and easily benchmarked, offering transparency and daily pricing, but they provide limited access to illiquidity premiums or complexity premiums.

Alternative assets, on the other hand, are usually privately negotiated and less liquid. However, they can offer higher return potential, better diversification and characteristics that align closely with long-term pension objectives.

Investment-grade private debt is a prime example. It is a natural extension of the fixed income universe, which means that when implemented correctly, it has the potential to enhance yield and to provide diversification and alignment with long-term liability objectives without materially altering the portfolio's liquidity profile.

To blend traditional investment-grade public bonds with private debt, we look under the hood at the individual securities. Our research has shown that a notable portion of public investment-grade bond holdings is effectively illiquid, particularly in Canadian markets, where 20% to 30% of the public investment-grade universe trades infrequently or in limited size. As illustrated in **Figure 3**, replacing this inherently illiquid segment with well-structured private credit exposures can increase portfolio yield while maintaining comparable levels of liquidity, duration and credit quality.

Figure 3: Replacing public bonds with private investment-grade debt



Source: TDAM. As of September 30, 2025.

For most plans, determining the optimal allocation depends on liquidity requirements, risk tolerance and governance readiness. In practice, many sponsors view private credit as a complementary building block within the liability-hedging allocation, gradually scaling exposure as the plan matures. Allocations in the range of 5% to 10% of total plan assets, or approximately 20% to 30% of the credit portfolio, can meaningfully enhance income and diversification without compromising liquidity management.

3 Role in the Portfolio

By using a holistic and functional LHA/RSA portfolio design, plans can align their investments with specific objectives. Even plans focused on going concern valuations can assess the sensitivity of their assets to underlying changes in yield assumptions built into the going concern discount rate. The separation between LHA and RSA for traditional assets is usually straightforward, with buy-and-maintain credit strategies > and active fixed income strategies > belonging to the LHA, and equities to the RSA.

However, the complexity of alternatives makes it difficult to determine a clear split. For private credit, the delineation can be made from the term, rate and credit rating of the securities held. Private credit assets with investment-grade quality, fixed terms and fixed rates, such as mortgages and Universe and Long investment-grade private debt make them a natural fit in the LHA bucket. Global private credit with below-investment-grade floating rate instruments and a shorter term to maturity reside on the RSA side.

The way certain provincial regulators treat some alternatives for funding valuation purposes highlights these assets' dual nature of offering sensitivity to interest rates and potentially higher returns than investment-grade fixed income. For example, the interest-hedging properties of infrastructure and real estate are explicitly capped. Because these two types of assets have the potential to generate long-term cash flows, provide inflation protection and deliver equity-like returns, we believe they are better suited to RSA, while having distinct liability-aware characteristics.

4 Investment Style in the RSA for Both Traditional and Alternative Assets

The RSA domain is vast and diverse. Over time, the market has grown increasingly more complex. DB plan sponsors, through governance, third-party providers and tools, have gained access to this broad opportunity set. Sponsors naturally diversify their RSA allocations by drawing from different asset classes. This is often done without formal classification through the Statement of Investment Policies and Procedures on how each individual piece fits.

Our Total Portfolio Compass categorizes investments into three styles based on their portfolio function, formalizing an approach to support allocation and risk budgeting decisions as well as identifying gaps across traditional and alternative assets.

How traditional assets fit into investment styles:

- **Liability-aware:** Global unconstrained fixed income strategies and high-yield bonds, while geared to produce higher returns than traditional bonds, do have a liability-hedging base inherent in their exposures along the short end of the curve.
- **Risk-controlled:** Low volatility equity strategies, with an explicit goal of providing a more stable return experience and reducing market concentration.
- **Return-focused:** Since the natural objective of RSA is to provide a risk premium higher than the one for instruments classified under LHA, more aggressive equity strategies focused on growth are needed to achieve higher return expectations.

How alternative assets fit into investment styles:

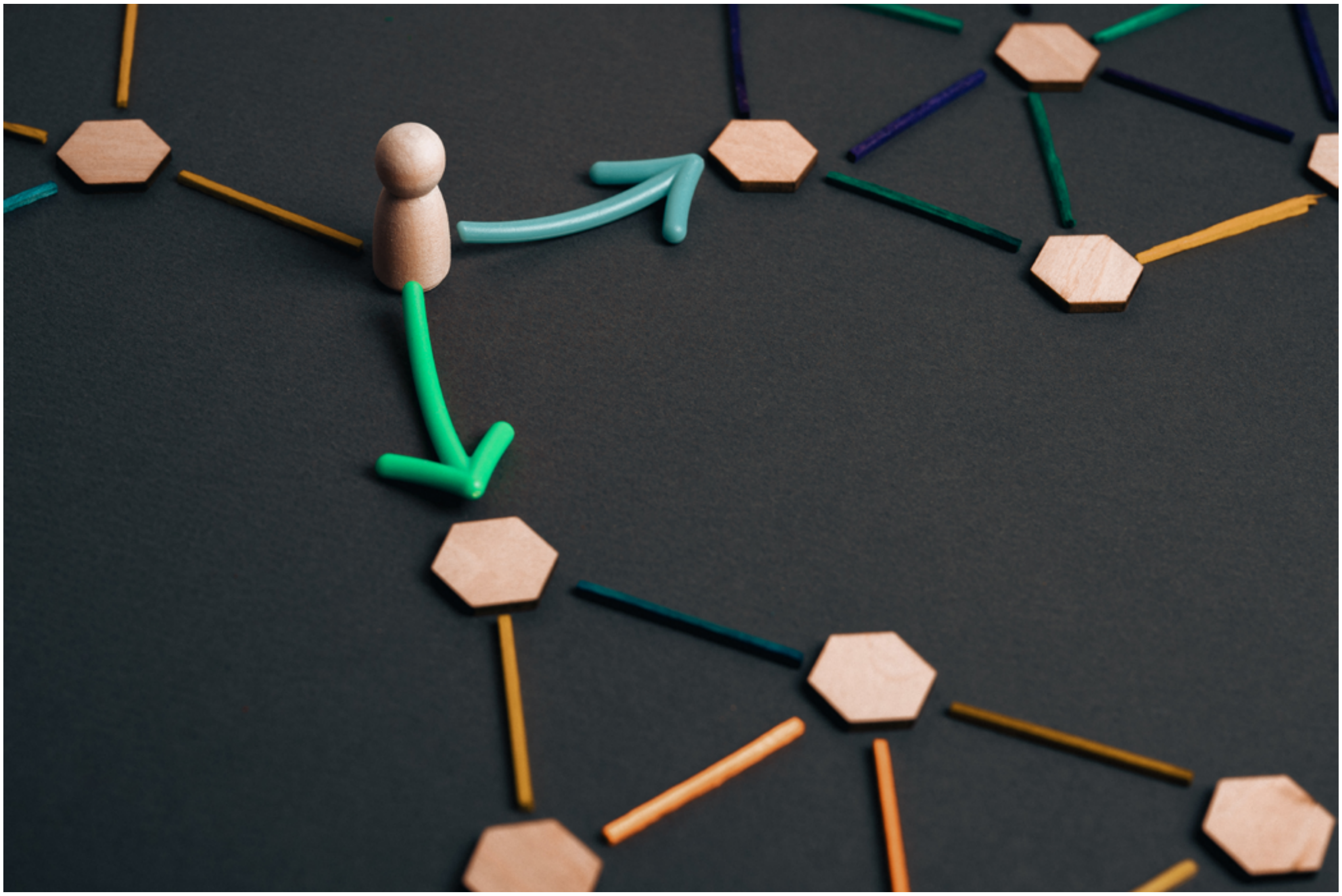
- **Liability-aware:** Commodities, infrastructure and real estate can offer accretive return potential while exhibiting liability characteristics such as inflation protection > and future long-term income-generating cash flows >.

- **Risk-controlled:** The long-short hedge fund equity strategy - where equity positions aim to take advantage of market opportunities by holding long positions in stocks anticipated to rise and shorting those expected to fall - can maintain liquidity, enhance returns and manage market volatility.

- **Return-focused:** Private equity and extension strategies[4] drive higher return expectations. The latter allow the portfolio manager to express views on stocks through both long and short positions, which means they can benefit when stock prices move up and down.

The Total Portfolio Compass illustrates how asset classes, both traditional and alternative, can be combined to meet the different needs of retirees, actives and surplus assets. By defining each asset's role within the liability-hedging and return-seeking spectrum, sponsors can construct portfolios that are more intentional, resilient and aligned with long-term objectives.

As plan sponsors look ahead, the focus shifts from classifying assets to deploying them effectively in an evolving market landscape. This requires viewing diversification as a dynamic exercise grounded in funded status risk management and navigating the hurdles that can trip up successful implementation.



Incorporating Alternatives: The Power of Diversification and Funded Status Risk Management

In the current environment of record high equity markets, alternative investments can bring powerful diversification benefits to DB pension plans seeking to generate equity-like returns while reducing overall correlation to the market. With global equities expected to return a compound annual growth over the next 10 years similar to alternative asset classes like mortgages, private credit, and direct real estate and infrastructure (see **Figure 4**), the near-zero correlation of these asset classes to public equities also means that they are not tied to volatile stock market ups and downs.

Figure 4: Alternatives' return and correlation profile vs public equities

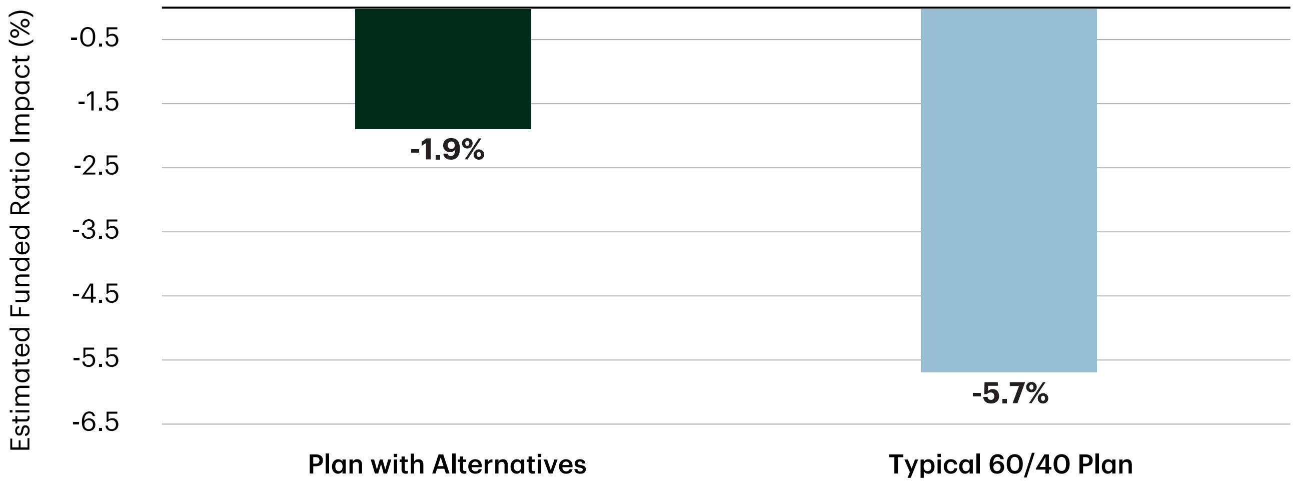
		Correlation Matrix						
10-yr Geometric Return	Asset classes	Canadian Real Estate	Global Infrastructure	Global Real Estate	IG Private Debt	HY Private Debt	Commercial Mortgages	Global Equities (All World)
6.6%	Canadian Real Estate	1.0						
7.2%	Global Infrastructure	0.0	1.0					
6.9%	Global Real Estate	0.0	0.0	1.0				
5.8%	IG Private Debt	0.0	0.0	-0.2	1.0			
7.0%	HY Private Debt	0.0	0.0	0.7	0.0	1.0		
6.0%	Commercial Mortgages	0.0	0.0	-0.1	0.9	0.0	1.0	
6.6%	Global Equities (All World)	0.0	0.0	0.2	0.3	0.0	0.2	1.0

High correlation; Low correlation; Negative or no correlation

Source: TDAM. Data as of December 31, 2025.

The lower correlation of alternatives to public equities can allow pension plans to stabilize their funded ratio even during periods of extreme stress. During the COVID-19 crisis in the first quarter of 2020, equities and credit markets experienced a steep sell-off. **Figure 5** illustrates how during that period, a pension plan invested in a mix of 40% fixed income, 30% equities and 30% alternatives vastly outperformed a typical Canadian pension asset mix invested in 60% equities and 40% fixed income.

Figure 5: A comparison of pension plan performance during the COVID-19 crisis, Q1 2020



Source: TDAM. Data as of March 31, 2020.

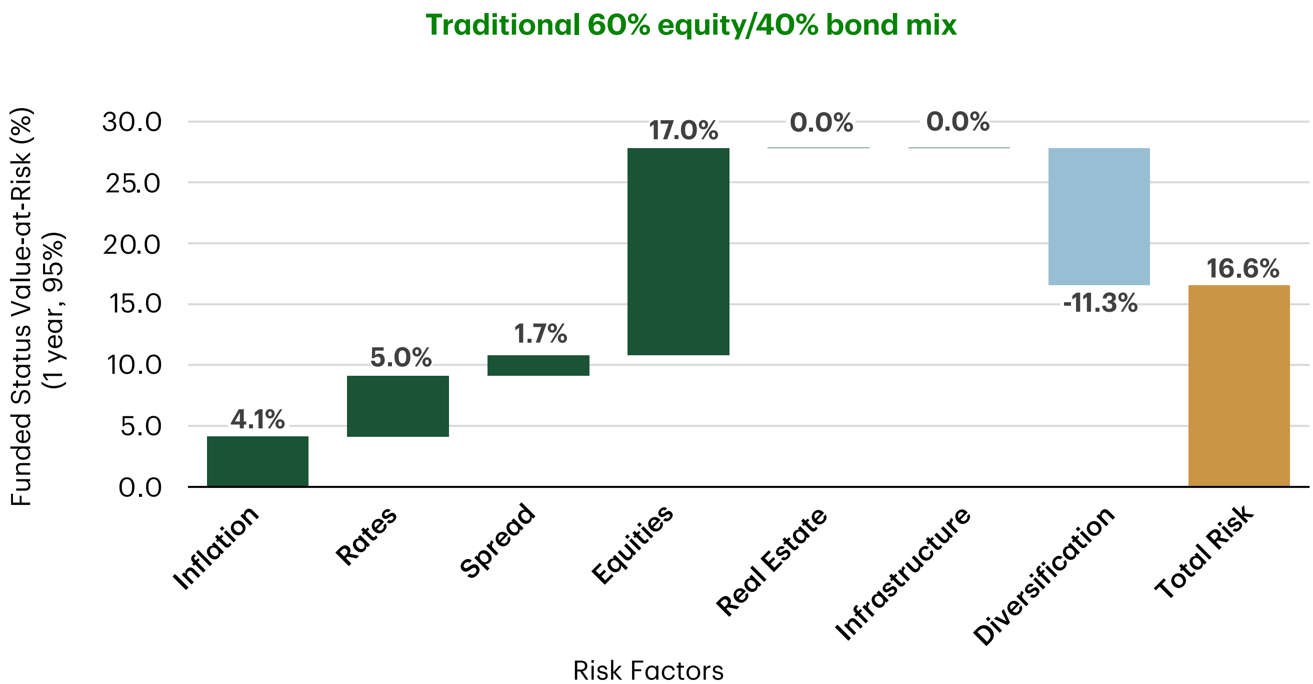
The typical 60/40 plan was invested in 60% global equities and 40% universe bonds.

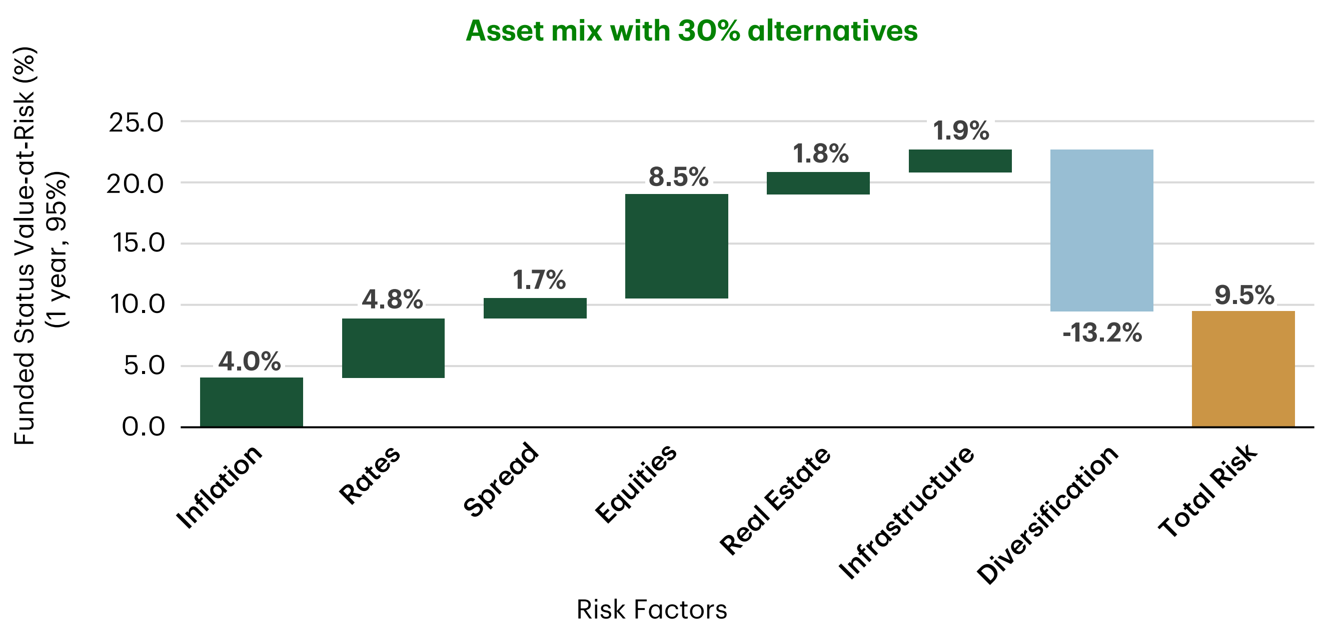
While actual historical events are useful testing grounds, DB pension plans require a larger sample size and a more thoughtful approach to how they manage downside risk versus their liabilities. A 95% funded status value-at-risk is a useful forward-looking measure of risk that shows how much a plan's funded ratio could decline in a 1-in-20-years type of event.

From **Figure 6**, we can see that equity risk dominates the funded status risk profile of a typical inflation-linked plan. Equities can be substituted for alternatives in the form of direct real estate and infrastructure to diversify the plan's return-seeking exposure and reduce total risk. The low correlation of alternatives to public assets combined with their inflation-hedging properties leads to a larger overall diversification effect, which could further reduce the overall risk of the plan.

Diversify

Figure 6: Using alternatives to manage funded ratio downside risk





Source: TDAM. As of December 31, 2025.

Alternative assets form a crucial part of the risk management framework. Particularly for DB plan sponsors, they can materially reduce funded status risk during periods of higher market stress.

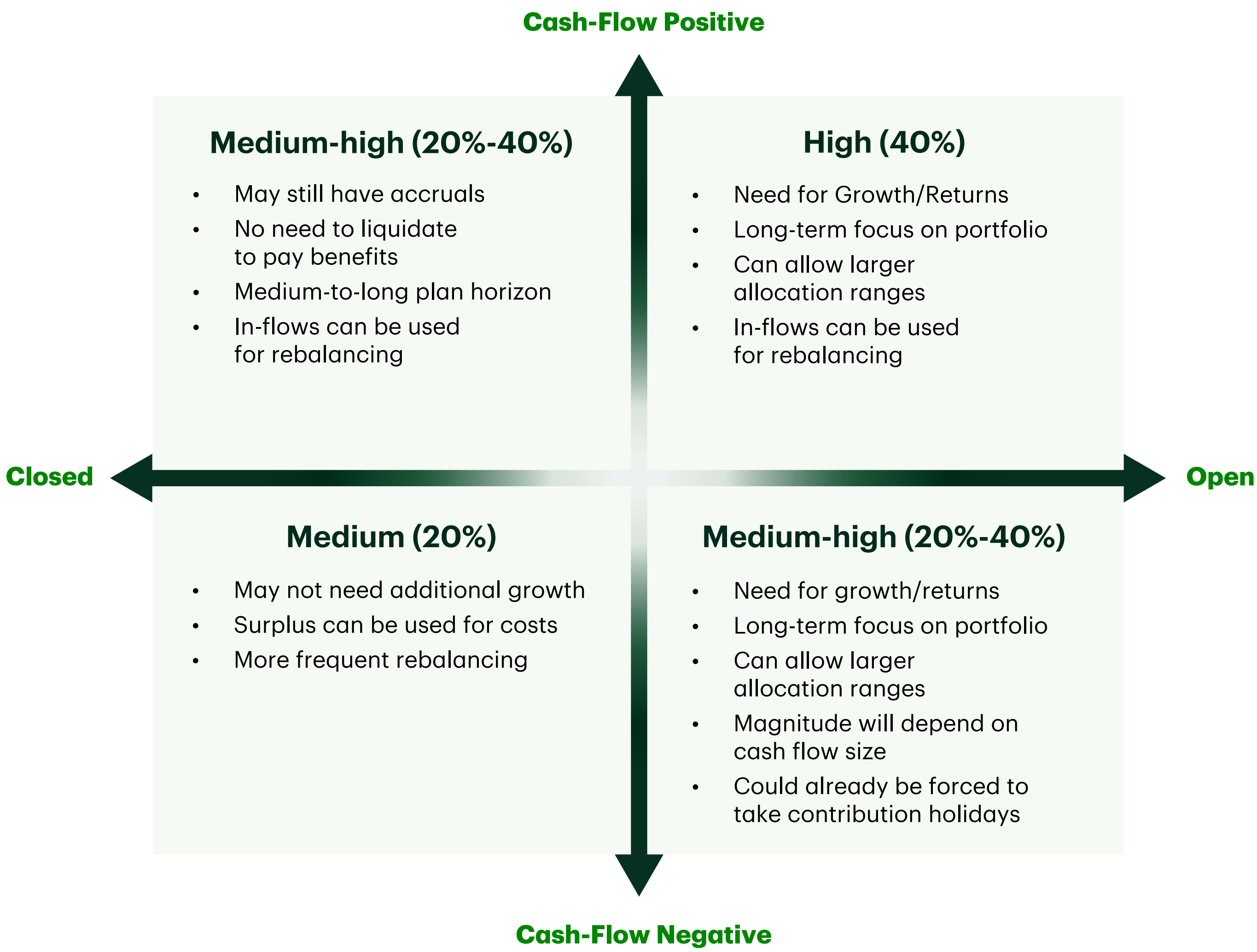
Incorporating Alternatives: Putting Strategy to Action

Private market alternatives can account for a disproportionate amount of implementation considerations, even if they make up a smaller allocation within the portfolio. This is due to their liquidity constraints, capital structures, irregular pattern of invested and returned capital, and lack of familiarity for decision makers. This doesn't mean they shouldn't be included in investment strategies; rather, there needs to be careful planning throughout the investment lifetime, starting with how much to allocate.

The exact amount to allocate to alternatives can vary significantly depending on a DB plan sponsor's specific goals and the role alternatives play in achieving those goals. Decisions can be supported through education, market research and quantitative modeling, as a few examples. But these decisions may ultimately come down to two key plan-specific characteristics: whether the plan is open or closed and whether the fund is cash-flow positive or negative.

Figure 7 shows where an alternatives allocation may land under various iterations of answers to these two characteristics as well as some of the justifications often cited.

Figure 7: Alternatives' allocation and key plan characteristics



In **Figure 7**, we have assumed that the plan in question is not considering an imminent wind-up or termination. However, from a diversification perspective, even a plan in hibernation may benefit from using alternatives as a portion of the return-seeking bucket, especially with plans at record surplus levels >.

Capital Structures and Liquidity

Many private market alternative funds are closed-ended, meaning that investor capital is locked for an extended period of time and returned only when the investments have matured and sold. This can be a significant source of returns over the long term; however, it may prove problematic for DB plan sponsors that need to exit investments due to strict rebalance requirements and/or large unexpected cash flows.

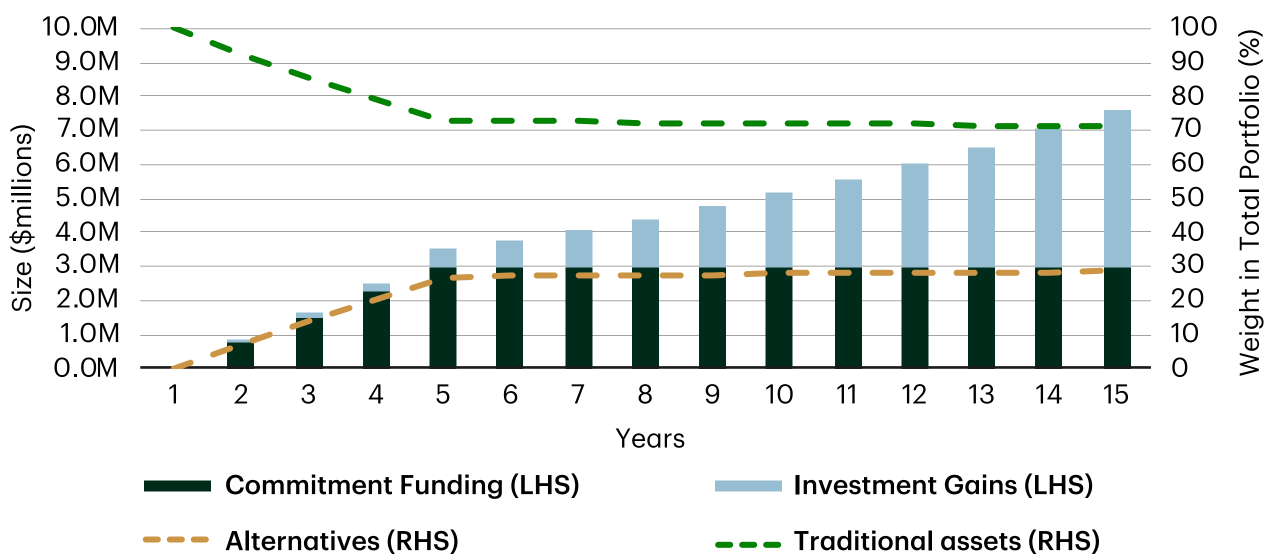
To combat this, there has been a rise in open-ended or evergreen funds which have no fixed lock-up period and can be exited with more ease. These fund structures can also allow for more regular cash flow generation to help support pension payments without having to sell assets to raise cash. In essence, they resemble bonds in terms of liquidity management while maintaining return potential.

Managing and Monitoring Alternatives Allocations in a Pension Context

Managing alternative asset allocations in a pension context is different than managing traditional assets only because the maturity of the pension plan will have a significant impact on how allocations evolve over time. Younger plans with a higher proportion of active members may not have the large net cash outflows that exist for mature plans with more retirees. How allocations are built up and maintained depends on the make-up of the underlying demographics of the pension plan. The allocations should be able to evolve throughout a plan's life cycle.

To illustrate this difference, we've prepared the following two projection scenarios (**Figures 8 and 9**). The first represents how an alternative allocation will evolve over time for a younger plan with neutral net cash flows. The second represents a mature plan, where there are regular and material net cash outflows paid from the non-alternative (or liquid) portion of the portfolio.

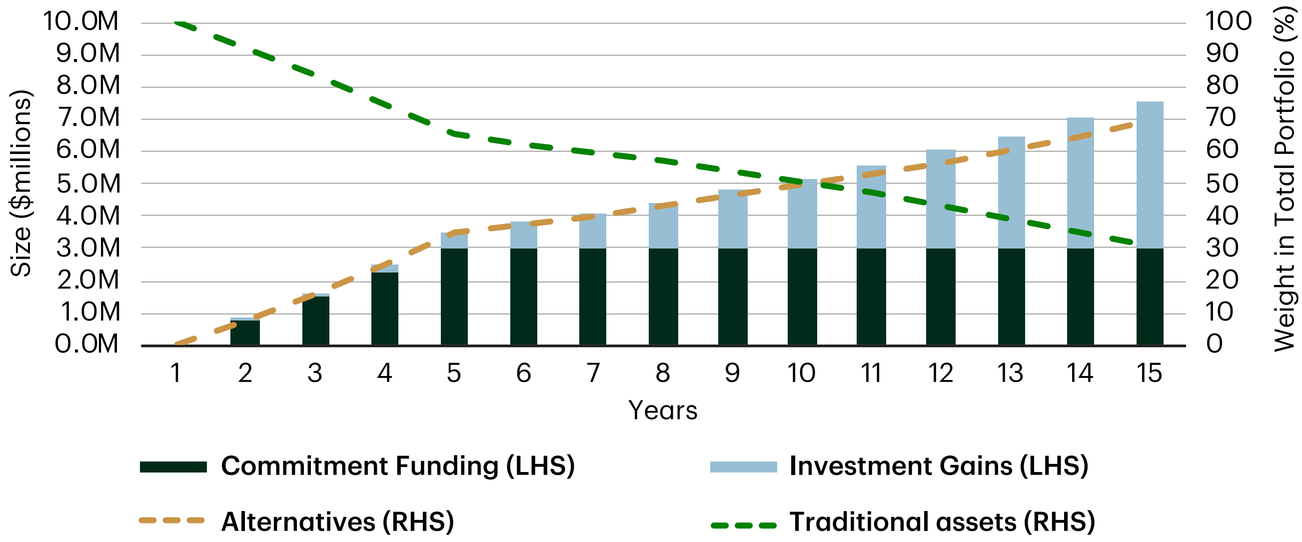
Figure 8: Asset allocation for younger pension plans (more actives)



Source: TDAM. For illustrative purposes only.

The alternatives allocation is expected to grow into the target over the commitment period. Beyond the commitment funding period, the relative returns of the alternatives to the rest of the portfolio will determine if the allocation trends higher or lower than the target. Barring any significant overperformance or underperformance of any of the asset classes, the allocations are not expected move significantly.

Figure 9: Asset allocation for mature pension plans (more retirees)



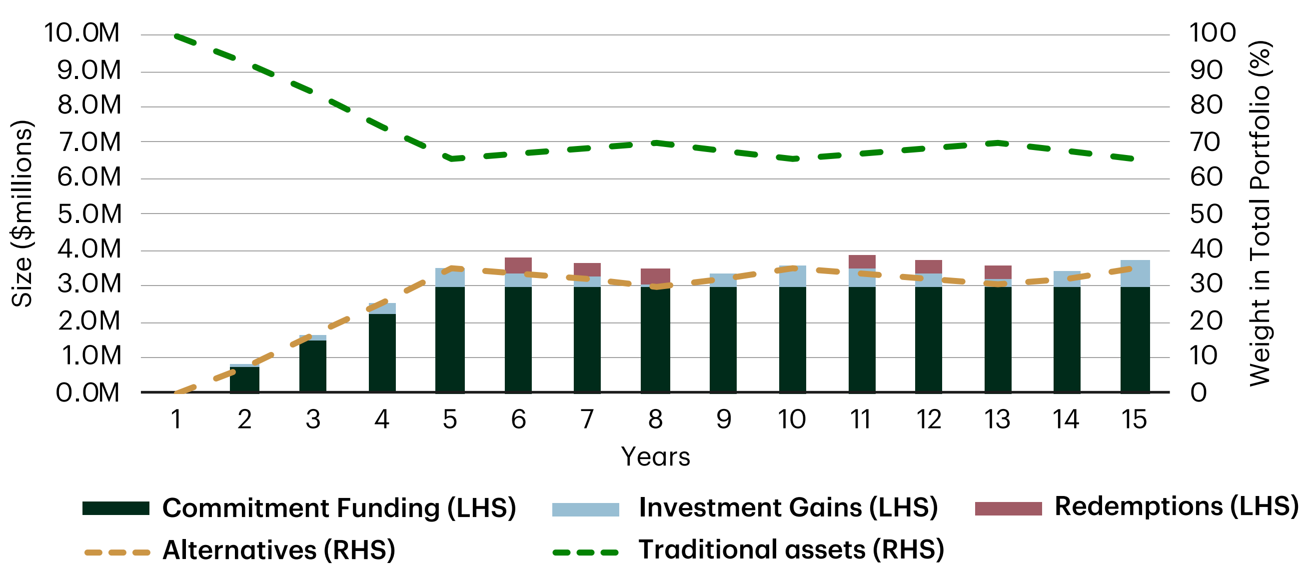
Source: TDAM. For illustrative purposes only.

For the mature pension plan, the size of the alternative allocation can grow out of control over time as monthly pension payments are funded through the liquid portion of the portfolio. The illiquidity of alternatives forces a new approach to managing allocations more dynamically over time, while considering several factors:

- Where to park dollars in the call-down period and the risk exposure to the plan
- How to stagger commitments to avoid over-committing
- Fund structures that would allow for moving in and out of investments smoothly
- Hard and soft thresholds when managing to target

An illustration of how these factors can be employed to manage allocations and liquidity needs is shown in **Figure 10**. In this scenario, we have assumed a three-year redemption payment period. In practice, the period may be much longer for closed-ended funds or much shorter for open-ended funds. The structure and market conditions will govern the timeframe, but if appropriately planned for, the illiquidity risk can be mitigated.

Figure 10: Asset allocation with a management strategy



Source: TDAM. For illustrative purposes only.

This liquidity-allocation management strategy can be supplemented by consistent cash flows or yield generated by the alternative assets themselves, depending on the structure chosen. Commitments can also be staggered to avoid over-allocating as a result of strong investment performance in the asset class. In general, DB plan sponsors who need more regular cash flow generation should consider open-ended over closed-ended funds.

Harmonizing the execution, monitoring and reporting of these strategies is imperative to their success. Having a partner who can bring together the complexity of the assets with the nuances of liabilities opens up a world of possibilities.

Direct Integration of Sustainability Goals

The alternative asset space provides a stronger avenue for sustainability and Environmental, Social and Governance (ESG) directives due to direct control and/or influence, sustainability-linked covenants, operational decision rights and longer-term investment horizons. Sponsors can invest directly in projects or through funds that support their objectives while leading to better investment outcomes. For example, TDAM's experience in the commercial mortgage space suggests that tenants value highly sustainability/ESG factors within the physical asset, which can lead to higher quality counterparties and lower vacancy/default risks. The TD Greystone Mortgage Fund is ranked #1 in North America for ESG Performance[5].

A process for evaluating, monitoring and reporting on ESG factors is crucial to oversight and accountability. TDAM has received accreditation across several funds from globally recognized independent ESG evaluators, including GRESB, an organization which provides a rigorous methodology and consistent framework to evaluate and benchmark the performance of real assets, guided by the material issues identified by investors and industry leaders.

Beyond industry benchmarking, the ability of alternative or private asset funds to back additionality projects can potentially lead to stronger sustainability characteristics. Additionality in this context refers to financing avenues available beyond the core mortgage financing to provide an attractive cost of capital that encourages borrowers to enhance the sustainable performance of the underlying asset.

For example, TDAM adopted a Green Plus Financing Program[6] designed to support sustainability-related improvements in mortgage investments in the TD Greystone Mortgage Fund.

If you would like to learn more about TDAM's approach to sustainability you can access more information on our website >.

Strategies

ALM Total Portfolio Management Dashboard: TDAM Portfolio Navigator

Successfully investing in alternative assets is not a one-off decision but a continuous, long-term commitment. To address the associated challenges, implementing a Total Portfolio Compass can clearly outline the role of these assets alongside traditional investments. With emphasis on governance, repeatability and adaptability, each incremental investment builds upon a clear, long-term strategy rather than opportunistic or episodic decisions.

At TDAM, this is exemplified by the **TD Portfolio Navigator >**, a proprietary suite of Asset Liability Management (ALM) tools developed to help institutional investors solve their most important challenges. The TD Portfolio Navigator brings the concepts of this paper to life, taking a holistic view of the portfolio and serving as the bridge from strategy to execution by breaking down silos, focusing on risk factors and aligning with plan objectives:

- **Breaking down silos:** The TD Portfolio Navigator's ALM capabilities allow sponsors to model and evaluate the entire integrated portfolio, across public and private markets, rather than analyzing each asset classes in isolation. This helps visualize how adding a new private credit allocation, for example, will affect the risk, return and liquidity profile of the total plan.
- **Focusing on risk factors:** Through advanced scenario analysis and stress testing, the TD Portfolio Navigator allows fiduciaries to assess how the total portfolio responds to changes in economic drivers such as inflation, interest rates and credit spreads.
- **Aligning with plan objectives:** The platform facilitates the design of a customized investment program that explicitly links the opportunity set - across all asset types and instruments - to the plan's liability profile and long-term funding objectives.

TD Portfolio Navigator Dashboard

Through its dashboard, the TD Portfolio Navigator enables investors to manage portfolios holistically using the Total Portfolio Compass, to make faster and better-informed decisions, and to ultimately enhance the likelihood of meeting long-term pension objectives.

Set up your Plan Dashboard on TD Portfolio Navigator today.

Reach out to your Relationship Manager. ■

Note: For illustrative purposes only.

Alternatives

[1] Core Plus strategies mainly allocate to traditional fixed income instruments while investing in alternative private credit instruments.

[2] High Yield securities being non-investment grade, they have both liability hedging characteristics while providing enhanced return expectations and therefore belong to both Liability Hedging and Return Seeking allocations.

[3] Bond Overlays are classified as Traditional although they require the use of derivatives-based strategies.

[4] Extension strategies are equity strategies designed to outperform a benchmark through both long and short positions. In portfolio construction, this provides additional flexibility to express a portfolio manager's best ideas through overweights and underweights versus that benchmark with a total net exposure typically at 100%.

[5] As of November 1, 2025.

[6] https://www.td.com/content/dam/tdgis/document/ca/en/pdf/resource-pdf/policies-and-frameworks/tdam-green-plus-financing-framework-en.pdf

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