United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Health, Employment, Labor, and Pensions, Committee on Education and Labor, House of Representatives

For Release on Delivery
Expected at 10:00 a.m. EDT
Tuesday, July 20, 2010

DEFINED BENEFIT PENSION PLANS

Plans Face Valuation and Other Challenges When Investing in Hedge Funds and Private Equity

Statement of Barbara Bovbjerg, Managing Director,
Education, Workforce, and Income Security

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Highlights

Highlights of GAO-10-915T, a testimony before the Subcommittee on Health, Employment, Labor and Pensions, Committee on Education and Labor, House of Representatives

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Why GAO Did This Study

Millions of Americans rely on private or public defined benefit pension plans, which promise to pay retirement benefits that are generally based on an employee's salary and years of service. Plan sponsors are increasingly investing in "alternative" assets such as hedge funds and private equity. This has raised concerns, given that these two types of investments have qualified for exemptions from some federal regulations and could present more risk to retirement assets than traditional investments.

This testimony discusses (1) the extent to which defined benefit plans have invested in hedge funds and private equity, (2) challenges that such plans face in investing in hedge funds and private equity, (3) steps that plan sponsors can take to address these challenges, and (4) the implications of these challenges for the federal government.

To prepare this statement, GAO relied primarily on its published reports on hedge funds and private equity (GAO-08-692 and GAO-08-200), and obtained new data on the extent of plan investments in hedge funds and private equity.

GAO has previously recommended that the Secretary of Labor provide guidance designed to help ERISA fiduciaries better assess their ability to invest in hedge funds and private equity. Labor generally agreed with our recommendation, but has yet to take action.

View GAO-10-915T or key components.
For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

What GAO Found

A growing number of private and public sector plans have invested in hedge funds and private equity, but such investments generally comprise a small share of total plan assets. According to a survey of large plans, the share of plans with investments in hedge funds grew from 11 percent in 2001 to 51 percent in 2009. Over the same time period, investments in private equity were more prevalent but grew more slowly—an increase from 71 percent in 2001 to 90 percent in 2009. Still, the average allocation of plan assets to hedge funds was less than 5 percent, and the average allocation to private equity was less than 8 percent. Available data also show that investments in hedge funds and private equity are more common among large pension plans, measured by assets under management, compared to mid-size plans. Survey information on smaller plans is unavailable, so the extent to which these plans invest in hedge funds or private equity is unknown.

Hedge funds and private equity investments pose a number of risks and challenges beyond those posed by traditional investments. For example, investors in hedge funds and private equity face uncertainty about the precise valuation of their investment. Hedge funds may, for example, own thinly traded assets whose valuation can be complex and subjective, making valuation difficult. Further, hedge funds and private equity funds may use considerable leverage—the use of borrowed money or other techniques—which can magnify profits, but can also magnify losses if the market goes against the fund's expectations. Also, both are illiquid investments—that is they cannot generally be redeemed on demand. Finally, investing in hedge funds can pose operational risk—that is, the risk of investment loss from inadequate or failed internal processes, people, and systems, or problems with external service providers rather than an unsuccessful investment strategy.

Plan sponsors we spoke with address these challenges in a number of ways, such as through careful and deliberate fund selection, and negotiating key contract terms. For example, investors in both hedge funds and private equity funds may be able to negotiate fee structure and valuation procedures, and the degree of leverage employed. Also, plans address various concerns through due diligence and monitoring, such as careful review of investment, valuation, and risk management processes.

The Department of Labor (Labor) has a role in helping to ensure that plans fulfill their Employee Retirement and Income Security Act of 1974 (ERISA) fiduciary duties, which includes educating employers and service providers about their fiduciary responsibilities under ERISA. According to plan officials, state and federal regulators, and others, some pension plans, such as smaller plans, may have particular difficulties in addressing the various demands of hedge fund and private equity investing. In light of this, in 2008, we recommended that Labor provide guidance on the challenges of investing in hedge funds and private equity and the steps plans should take to address these challenges.

Mr. Chairman and Members of the Subcommittee,

I am pleased to be here to participate in today's hearing on creating greater accounting transparency for pensioners. As you know, millions of Americans rely on defined benefit (DB) plans for their financial well-being after their working years. Historically, public and private sector pension plans have primarily invested in traditional investments such as stocks and bonds; but more recently, plans are increasingly investing in "alternative" investments such as hedge funds and private equity.

While there is no statutory definition of hedge funds, the phrase "hedge fund" is commonly used to refer to a pooled investment vehicle that is privately organized and administered by professional managers, and that often engages in active trading of various types of securities, as well as futures and options contracts. Similarly, private equity is not statutorily defined, but is generally considered to be privately managed investment pools administered by professional managers who typically make long-term investments in private companies, taking a controlling interest with the aim of increasing the value of these companies through such strategies as improving operations or developing new products. Both hedge funds and private equity may be managed so as to be exempt from certain aspects of federal securities law and regulation that apply to other investment pools such as mutual funds. There are a number of investments that are considered to be alternative investments, but my statement today will focus on our prior work on pension plan investment in hedge funds and private equity.

Much has happened in the financial markets since we issued three reports—one which addressed pension plan investments in hedge funds and private equity, another which addressed federal oversight and other issues regarding hedge funds exclusively, and a final report addressed private equity funds—in 2008.[1] Hedge funds have been deeply affected in the financial turmoil. According to an industry survey, most hedge fund strategies produced double-digit losses in 2008, and hedge funds saw

[1]GAO, *Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention Is Needed*, GAO-08-200 (Washington D.C.: Jan. 24, 2008); *Defined Benefit Pension Plans: Guidance Needed to Better Inform Plans of the Challenges and Risks of Investing in Hedge Funds and Private Equity*, GAO-08-692 (Washington D.C.: Aug. 14, 2008); and *Private Equity: Recent Growth in Leveraged Buyouts Exposed Risks That Warrant Continued Attention*, GAO-08-885 (Washington D.C.: Sept. 9, 2008).

approximately $70 billion in redemptions between June and November 2008.[2] Some observers blamed hedge funds for dramatic volatility in the stock and commodity markets in 2008 and some funds of hedge funds[3] were heavily invested in the Madoff fraud. Nevertheless, an industry survey of institutional investors suggests that these investors are still committed to investing in hedge funds in the long term.

My statement today is based primarily on our 2008 report on pension plan investments in hedge funds and private equity. My comments will focus on 1) the extent to which DB plans have invested in hedge funds and private equity, 2) challenges that such plans face in investing in hedge funds and private equity, 3) steps that plan sponsors can take to address these challenges, and 4) the implications these challenges for plan sponsors and the federal government.

In conducting our prior work, we reviewed relevant literature and survey data and conducted in-depth interviews with pension plan representatives and industry experts. We obtained and analyzed data on the extent of pension plan investments in hedge funds and private equity from private organizations such as Greenwich Associates, Pensions & Investments, and Pyramis Global Advisors. We updated these data for purposes of my testimony today. We also conducted in-depth interviews with representatives of 26 public and private sector DB pension plans and, where possible, obtained and reviewed supporting documentation. These plans were selected based on several criteria, including the range of investment in hedge funds and private equity and the amount of total plan assets. We also interviewed officials of regulatory agencies, relevant industry organizations, investment consulting firms, and other national experts. We conducted our prior work from June 2007 to July 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

[2]Greenwich Associates and SEI Knowledge Partnership, *Hedge Funds under the Microscope: Examining Institutional Commitment in Challenging Times* (January 2009).

[3]Funds of funds are investment funds that buy stakes in multiple underlying hedge funds. Fund of funds managers invest in other hedge funds rather than trade directly in the financial markets, and thus offer investors broader exposure to different hedge fund managers and strategies.

Background

Millions of current and future retirees rely on private or public DB plans, which promise to pay retirement benefits that are generally based on an employee's salary and years of service. The financial condition of these plans—and hence their ability to pay promised retirement benefits when such benefits are due—depends on adequate contributions from employers and, in some cases, employees, as well as prudent investments that preserve principal and yield an adequate rate of return over time. The plan sponsor must make contributions to the plan that are intended to ensure it is adequately funded to pay promised benefits. To maintain and increase plan assets, fiduciaries of public and private sector pension plans choose investments that are expected to grow in value or yield income. Plan fiduciaries invest in various categories of asset classes, which traditionally have consisted mainly of stocks and bonds. Pension fiduciaries may also invest in other asset classes or trading strategies, such as hedge funds and private equity, which can generally be riskier investments, so long as such investments are prudent.

To obtain favorable tax treatment private sector pension plan investment decisions must comply with the provisions of the Employee Retirement and Income Security Act of 1974 (ERISA), under which plan sponsors and other fiduciaries must act solely in the interest of the plan participants and beneficiaries, (1) for the exclusive purpose of providing benefits to participants and their beneficiaries, as well as defraying reasonable expenses of administering the plan; (2) with the care, skill, prudence, and diligence then prevailing that a prudent man acting in a similar situation would use; (3) by diversifying plan investments so as to minimize the risk of large losses; and (4) in accordance with plan documents consistent with ERISA.[4] Under ERISA, the prudence of any individual investment is considered in the context of the total plan portfolio, rather than in isolation. Hence, a relatively risky investment may be considered prudent if it is part of a broader strategy to balance the risk and expected return to the portfolio. The Employee Benefit Security Administration (EBSA) at the Department of Labor (Labor) is responsible for enforcing these standards, as well as educating and assisting plan participants and plan sponsors.

In the public sector, governments have established pension plans at state, county, and municipal levels, as well as for particular categories of employees, such as police officers, fire fighters, and teachers. The structure of public pension plan systems can differ considerably from state

[4]29 U.S.C. § 1104(a).

to state. Public sector DB plans are not subject to funding, vesting, and most other requirements applicable to private sector DB plans under ERISA,[5] but must follow requirements established for them under applicable state law and have generally adopted fiduciary standards similar to those of ERISA.

Generally privately managed and engaged in active trading of various types of securities, hedge funds are typically structured and operated as limited partnerships or limited liability companies exempt from certain registration, disclosure, and other requirements under the Securities Act of 1933,[6] Securities Exchange Act of 1934,[7] Investment Company Act of 1940,[8] and Investment Advisers Act of 1940[9] that apply to other investment pools, such as mutual funds.[10] Unlike a mutual fund, which must strictly abide by the detailed investment policy and other limitations specified in its prospectus, most hedge funds specify broad objectives and authorize multiple strategies. They may invest in a wide variety of financial instruments, including stocks and bonds, currencies, futures contracts, and other assets.

Like hedge funds, there is no legal or commonly accepted definition of private equity funds, but the term generally includes privately managed pools of capital that invest in companies, many of which are not listed on a stock exchange. Although there are some similarities in the structure of hedge funds and private equity funds, the investment strategies employed are different. Unlike many hedge funds, private equity funds typically make long-term investments in private companies and seek to obtain financial returns not through particular trading strategies and techniques,

[5]29 U.S.C. § 1003(b)(1).

[6]Ch. 38, tit. I, 48 Stat. 74 (codified at 15 U.S.C. § 77a et seq.).

[7]Ch. 404, 48 Stat. 881 (codified at 15 U.S.C. § 78a et seq.).

[8]Ch. 686, tit. I, 54 Stat. 797 (codified as amended at 15 U.S.C. § 80a-1 et seq.).

[9]Ch. 686, tit. II, 54 Stat. 847 (codified as amended at 15 U.S.C. § 80b-1 et seq.).

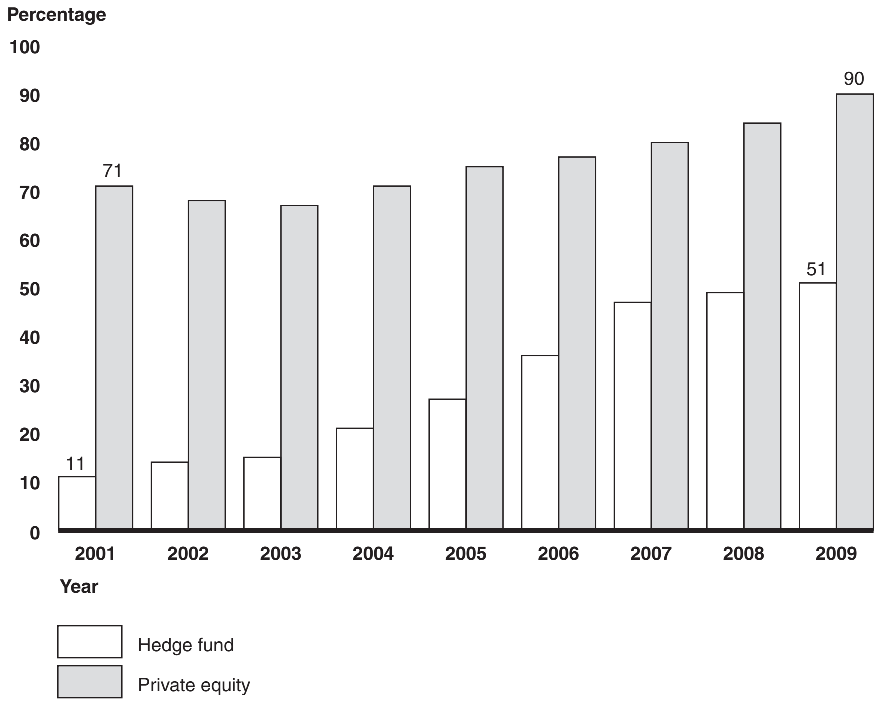
[10]Although certain advisers may be exempt from registration requirements, they remain subject to anti-fraud, anti-manipulation, and large trading position reporting rules. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act advisers of all private funds, including hedge funds and private equity funds with $150 million or more in assets under management in the U.S. may be required to register with the Securities and Exchange Commission (SEC), obligated to comply with new recordkeeping and reporting requirements, and subject to enhanced SEC scrutiny and audit. H.R. 4173, 111th Cong. tit. IV (as reported out of conference on June 29, 2010).

but through long-term appreciation based on corporate stewardship, improved operating processes, and financial restructuring of those companies, which may involve a merger or acquisition. Private equity is generally considered to involve a substantially higher degree of risk than traditional investments, such as stocks and bonds, in exchange for a higher return.

A Growing Number of Pension Plans Are Investing in Hedge Funds or Private Equity, but Such Investments Are Generally a Small Portion of Plan Assets

We reported in 2008 that DB plan investments in hedge funds and private equity have grown, but such investments are generally a small portion of plan assets, and this trend has continued. According to a Pensions & Investments survey, the percentage of large plans (as measured by total plan assets) investing in hedge funds grew from 11 percent in 2001 to 51 percent in 2009 (see fig. 1). Over the same time period, the percentage of large plans that invest in private equity grew at a much lesser rate—71 percent to 90 percent—because a much larger percentage of plans were already invested in private equity in 2001.

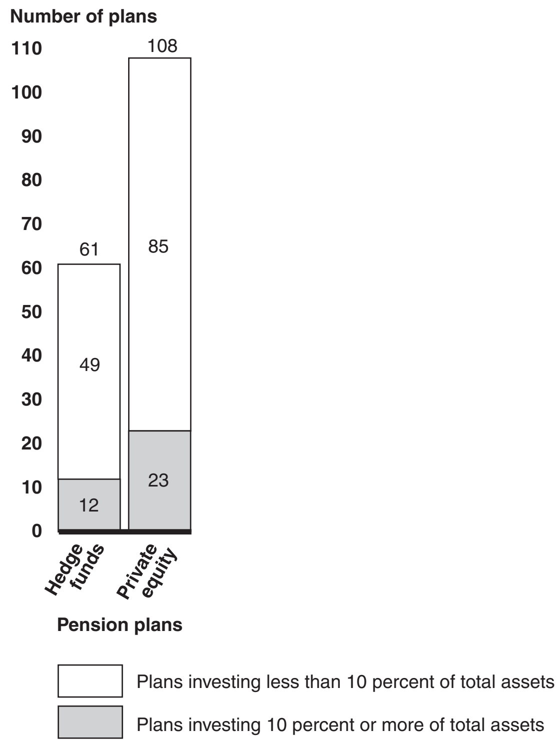
Figure 1: Share of Large DB Plans Investing in Hedge Funds and Private Equity



Source: *Pensions & Investments'* 2009 annual survey.

Data from the same survey reveal that investments in hedge funds and private equity typically comprise a small share of plan assets. The average allocation to hedge funds among plans with such investments was not quite 5 percent in 2009. Similarly, among plans with investments in private equity, the average allocation was less than 8 percent. Although the majority of plans with investments in hedge funds or private equity have small allocations to these assets, a few plans have relatively large allocations, according to the Pensions & Investments survey. Of the 61 plans that reported hedge fund investments in 2009, 12 had allocations of 10 percent or more (see fig. 2). The highest reported hedge fund allocation was 29 percent of total assets. Similarly, of the 108 plans that reported private equity investments in 2009, 23 had allocations of 10 percent or more and the highest reported private equity allocation was 26 percent.

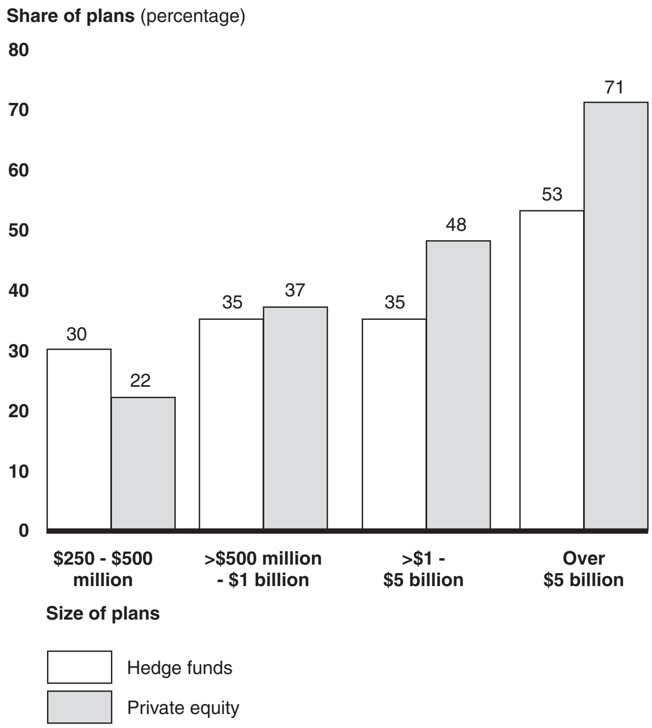
Figure 2: The Number of Plans with Investments in Hedge Funds or Private Equity by Size of Allocation



Source: GAO analysis of *Pensions & Investments* 2009 annual survey data.

Available survey data show that larger plans, measured by total plan assets, are more likely to invest in hedge funds and private equity compared to mid-size plans. As shown below, a survey by Greenwich Associates found that 30 percent of mid-size plans—those with $250 to $500 million in total assets—were invested in hedge funds, compared to 53 percent of the largest plans—those with more than $5 billion in total assets (see fig. 3). Survey data on plans with less than $200 million in assets are unavailable and, in the absence of this information, it is unclear to what extent these plans invest in hedge funds and private equity.

Figure 3: Pension Plans with Investments in Hedge Funds and Private Equity by Size of Total Plan Assets



Source: Greenwich Associates, 2009.

Note: The figures above include public and corporate plans. Information on the investments of collectively bargained plans by size of total assets was not available.

Hedge Fund and Private Equity Investments Pose Various Risks and Challenges for Plan Sponsors

Valuation

One of the major challenges that both hedge fund and private equity investments pose to plan sponsors investing is uncertainty over the current value of their investment. With regard to hedge funds, we noted that plans may lack information on both the nature of the specific underlying holdings of the hedge fund, as well as the aggregate value on a day to day basis. Because many hedge funds may own thinly traded securities and derivatives whose valuation can be complex, and in some cases subjective, a plan may not be able to obtain timely information on the value of assets owned by a hedge fund.[11] Further, hedge fund managers may decline to disclose information on asset holdings and the net value of individual assets largely because release of such information could compromise their trading strategy. In addition, even if hedge fund managers were to provide detailed positions, plan sponsors might be unable to fully analyze and assess the prospective return and risk of a hedge fund. As we noted in our August 2008 report, hedge fund managers may seek to profit through complex and simultaneous positions and can abruptly change their positions and trading tactics in order to achieve desired return as changing market conditions warrant. Consequently, a plan may not be able to independently ascertain the value or fully assess the degree of investment risk posed by its hedge fund investment. Although we noted in January 2008 that some hedge funds have improved disclosure and transparency about their operations due to the demands of institutional investors, several pension plans cited limited transparency as a prime reason they had chosen not to invest in hedge funds.[12] During our research for that report, representatives of one plan told us that they had considered investing in hedge funds several years before, but that most of the hedge funds it contacted would not provide position-level information,

[11] A security is described as thinly traded when trading infrequently and/or in low volume.

[12] See GAO-08-200.

and they were reluctant to make such an investment without this information.

Similar to hedge funds, valuations of private equity investments are uncertain during the fund's cycle, which often lasts 10 years or more. Unlike investments which are traded and priced in public markets, plans have limited information on the value of private equity investments until the underlying holdings are sold. Some plan representatives we interviewed explained that fund managers often value underlying holdings at their initial cost until they are sold through an initial public offering or other type of sale.[13] In some cases private equity funds estimate the value of the fund by comparing companies in their portfolio to the value of comparable publicly-traded assets. However, an investment consultant explained that such periodic valuations have limited utility. Prior to the sale of underlying investments, assessing the value of a private equity fund is difficult. In 2008, plan officials we interviewed acknowledged the difficulty of valuing private equity investments and generally accepted it as a trade-off for the potential benefits of the investment.

Investment risk

While any plan investment may fail to deliver expected returns over time, hedge fund and private equity investments pose investment challenges beyond those posed by traditional investments. For example, both hedge fund and private equity managers may use leverage—that is, borrowed money or other techniques—to potentially increase an investment's return without increasing the amount invested. While registered investment companies are subject to strict leverage limits, a hedge fund or private equity fund can make relatively unrestricted use of leverage. This is noteworthy because while leverage can magnify profits, it can also magnify losses to the fund if the market goes against the fund's expectations. In addition, a private equity fund manager's strategy

[13]The definition of fair value has been codified by the Financial Accounting Standards Board (FASB) at Accounting Standards Codification (ASC) 320-10-20 Investments—Debt and Equity Securities, Overall, Glossary. ASC 320-10-20 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As discussed in SFAS No. 157, Fair Value Measurements, which is codified at FASB ASC 820, Fair Value Measurements and Disclosures, the changes to current practice resulting from the application of ASC 820 relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. The definition of fair value may change the manner in which some entities, such as private equity funds, determine fair value.

typically involves concentrating its holdings in a limited number of underlying companies—generally about 10 to 15 companies, often in the same sector. Further, hedge funds and private equity funds also feature relatively costly fee structures, which have significant impact on net investment returns.[14] In 2008, we reported that hedge funds and private equity funds often charge an annual fee of 2 percent of invested capital and 20 percent of returns, whereas mutual fund managers reportedly charge a fee of about 1 percent or less of assets under management.[15] For private equity, if the gross returns are not sufficiently high, net returns to investors will not meet the commonly cited goal of exceeding the return of the stock market and, thus, plans will not have earned a premium for assuming the risks inherent in private equity investments.

Lack of liquidity

Hedge funds and private equity are also relatively illiquid investments—that is, investors generally cannot easily redeem their investments on demand. Hedge funds often require an initial lockup of 1 year or more, during which an investor cannot cash out of the hedge fund. After the initial lockup period, hedge funds offer only occasional liquidity, sometimes with a prenotification requirement. Hedge funds impose such liquidity limits because sudden liquidations could, for example, disrupt a carefully calibrated investment strategy. Nonetheless, they also pose certain disadvantages to plan sponsors, such as inhibiting a plan's ability to limit a hedge fund's investment loss. Private equity funds require an even longer-term commitment than hedge fund investments. Private equity funds can require commitments of 10 years or more, and during that time, a plan may have no ability to redeem its investments. A private equity fund cycle typically includes an initial period in which investors must provide the fund with capital when called upon, which may not be redeemed for several years, to invest in underlying companies and then obtain returns over time as investments mature. Several plan representatives and other experts we interviewed stated that the nature of private equity necessitates long commitments as returns are generated through long-term growth strategies, rather than short-term gains. Representatives of several

[14]For example, we reported that the typical hedge fund fee structure consists of 2 percent of total assets under management and a performance fee of about 20 percent of the funds annual profits. This fee structure would reduce a 12 percent return to only 7.6 percent, after fees are deducted.

[15]Some plans may ensure they will not pay a performance fee unless the value of the investment passes a previous peak value of the fund shares. This provision is known as a high water mark.

plans noted that they expect higher returns from private equity investments in exchange for the long-term commitment.

Operational risk

Finally, we reported that pension plans investing in hedge funds are also exposed to operational risk—that is, the risk of investment loss due not to a faulty investment strategy, but from inadequate or failed internal processes, people, and systems, or problems with external service providers. Operational problems can arise from a number of sources, including inexperienced operations personnel; inadequate internal controls; lack of compliance standards and enforcement; errors in analyzing, trading, or recording positions; or outright fraud. According to a report by an investment consulting firm, because many hedge funds engage in active, complex, and sometimes heavily leveraged trading, a failure of operational functions, such as processing or clearing one or more trades, may have grave consequences for the overall position of the hedge fund. Several pension plans we contacted expressed concerns about operational risk; one noted back office and operational issues become deal breakers in some cases.

Plan Sponsors Take a Number of Steps to Address the Risks of Hedge Fund and Private Equity Investing

Pension plans we spoke with take a number of steps in an attempt to mitigate the risks and challenges of investing in hedge funds and private equity.

First, discussions with plan sponsors revealed the importance of making careful and deliberate fund selection when investing in hedge funds and private equity. In the case of hedge funds, plan sponsors emphasized defining a clear purpose and strategy for their hedge fund investments. One plan fiduciary noted that plan sponsors should decide exactly why they want to invest in hedge funds. The official noted that there are many different possible hedge fund strategies, and a simple desire for the reportedly large returns of hedge funds is not sufficient. Most of the plans we contacted described one or more specific strategies for their hedge fund investments, such as a pure long-short strategy.[16] Several sources stated that private equity investments have greater variation in performance among funds, particularly among venture capital

[16]A long-short strategy exploits perceived anomalies in the price of securities. For example, a hedge fund may buy bonds that it believes are under-priced and sell short bonds that it believes to be over-priced.

investments, compared to other asset classes, such as domestic stocks, and, therefore, they must invest with top performing funds in order to achieve long-term returns in excess of the stock market.

Plan sponsors and others also cited the importance of negotiating key terms of investments in hedge funds and private equity. They said in the case of hedge funds, such terms can include fee structure and conditions, degree of transparency, valuation procedures, redemption provisions, and degree of leverage employed. For example, pension plans may want to ensure that they will not pay a performance fee unless the value of the hedge fund investment passes a previous peak value of the fund shares—known as a high water mark. Key contract terms for private equity may also include fee structure and valuation procedures, though one plan sponsor noted the ability to negotiate favorable contract terms is limited when investing in top performing funds, because investing in such funds is highly competitive. In addition, any “side letters” or contracts that may grant special rights or terms to other investors are also thought to be critical. Side letters document specific arrangements regarding, for example, prohibited transactions, redemption rights, reporting, and disclosure under which investors that are party to them receive advantages that may come at the detriment of other investors.

Due diligence and ongoing monitoring, beyond those required for traditional investments, are also important. For hedge funds, due diligence can be a wide ranging process including study of a hedge fund’s investment process, valuation, risk management processes, and compliance procedures, as well as a review of back office operations. As with hedge fund investments, plans take additional steps to mitigate the challenges of investing in private equity through extensive and ongoing monitoring, beyond that required for traditional investments. Plan representatives we interviewed said these steps include regularly reviewing reports on the performance of the underlying investments of the private equity fund and having periodic meetings with fund managers. In some cases, plans participate on the advisory board of a private equity fund, which provides a greater opportunity for oversight of the fund’s operations and new investments; however this involves a significant time commitment and may not be feasible for every private equity investment.

Finally, several plan sponsors address some of the risks and challenges of investing in hedge funds and private equity by investing via funds of funds. Investing in a fund of funds provides investors with diversification across multiple funds, which can mitigate the effect of one manager’s poor performance. In particular, funds of private equity funds can allow plans to invest in a variety of managers, industries, geographies, and year of initial capital investment. In addition, a plan sponsor may be able to rely on a fund of funds manager to conduct negotiations, due diligence, and monitoring of the underlying hedge funds. As we reported, funds of funds can be appropriate if plan sponsors do not have the skills necessary to manage a portfolio of hedge funds. In addition, investing through a fund of funds may provide a plan better access to hedge funds or private equity funds than a plan would be able to obtain directly. Nonetheless, investing in a fund of funds has some drawbacks and limitations, including an additional layer of fees—such as a 1 percent flat fee and a performance fee of between 5 and 10 percent of returns—on top of the substantial fees that a fund of funds manager pays to the underlying hedge funds. Furthermore, funds of funds also pose the same challenges as hedge funds, such as limited transparency and liquidity, and the need for the plan to conduct a due diligence review of the fund of funds firm. Investing through a fund of funds does not relieve plan sponsors of their own fiduciary duties; accordingly, the plan sponsors must act prudently in selecting and monitoring fund of funds.

The Federal Government Can Help Educate Plans on the Challenges of Investing in Hedge Funds

According to plan officials, state and federal regulators, and others, some pension plans, especially smaller plans, may find it particularly difficult to address the various demands of hedge fund investing. For example, an official of a national organization representing state securities regulators told us that medium- and small-size plans may not have the expertise to oversee the trading and investment practices of hedge funds. Some plans may also lack the ability to conduct the necessary due diligence and monitoring of hedge fund investments. This official said that smaller plans may have only one or two person staffs, or may lack the resources to hire outside consulting expertise. A labor union official made similar comments, noting that smaller pension plans lack the internal capacity to assess hedge fund investments, and that such plans may be locked out of top performing hedge funds. While such plans might often be smaller plans, larger plans may also lack sufficient expertise. A representative of one pension plan with more than $32 billion in total assets noted that before investing in hedge funds, the plan would have to build up its staff in order to conduct the due diligence necessary during the fund selection process.

In light of these challenges, Labor can play a role in helping to ensure that plans fulfill their ERISA fiduciary duties when investing in hedge funds and private equity. For example, in 2006, the ERISA Advisory Council recommended that Labor publish guidance about the unique features of hedge funds and matters for consideration in their use by qualified plans.[17] In 2008, the ERISA Advisory Council recommended that Labor publish guidance to clarify the role of ERISA fiduciaries in selecting, valuing, and accounting for hard to value assets, of which many hedge funds and private equity funds are comprised.[18] In addition, the Investor's Committee formed by the President's Working Group on Financial Markets published a report in January 2009 on the best practices for hedge fund investors.[19] The report acknowledges that hedge fund investments are not necessarily suitable for some investors and provides many recommendations for investors selecting and monitoring their hedge fund investments—including best practices for valuation—such as obtaining a written statement of the fund's valuation policies and procedures and assuring the fund's portfolio is being valued in accordance with Generally Accepted Accounting Principles (GAAP).

In 2008, we recommended that Labor provide guidance for qualified plans under ERISA on the unique challenges of investing in hedge funds and private equity and the steps plans should take to address these challenges. For example, we stated that EBSA could outline the implications of a hedge fund's or fund of funds' limited transparency on the fiduciary duty of prudent oversight. EBSA can also reflect on the implications of these best practices for some plans—especially smaller plans—that might not have the resources to take actions consistent with the best practices, and thus would be at risk of making imprudent investments in hedge funds. Finally, we noted that while EBSA is not tasked with offering guidance to public sector plans, such plans may nonetheless benefit from such guidance. To date, Labor has not acted on this recommendation.

[17]The Advisory Council on Employee Welfare and Pension Benefit Plan, which was created under ERISA to provide advice to the Secretary of Labor, published the report on Prudent Investment Process in 2006.

[18]The Advisory Council on Employee Welfare and Pension Benefit Plan, which was created by ERISA to provide advice to the Secretary of Labor, published the report on Hard to Value Assets and Target Date Funds in 2008.

[19]*Principles and Best Practices for Hedge Fund Investors: Report of the Investors' Committee to the President's Working Group on Financial Markets* (Jan. 15, 2009). The President's Working Group on Financial Markets includes the heads of the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Investors' Committee consists of a broad array of investor and investor advocates.

Concluding Observations

As plan sponsors seek to better ensure adequate return on assets under management, recent trends suggest that investments in alternative assets such as hedge funds and private equity are becoming more commonplace. It is reasonable to expect that the number of plan sponsors making such investments will increase in the future. Our past work indicates that such assets may serve useful purposes in a well thought out investment program, offering plan sponsors advantages that may not be as readily available from more traditional assets. Nonetheless, it is equally clear that investments in such assets place demands on plan sponsors that are significantly beyond the demands of more traditional asset classes.

In light of these challenges, which can be daunting even for large plan sponsors, we believe that, as we recommended in 2008, the Secretary of Labor should provide guidance regarding investing in hedge funds and private equity specifically designed for qualified plans under ERISA. In particular, we believe that a discussion of the challenges that such investments pose to small plan sponsors would be particularly beneficial.

This concludes my prepared statement. I would be happy to answer any questions that the subcommittee may have.

GAO Contact and Staff Acknowledgments

For further questions on this testimony, please contact me at (202) 512-7215. Individuals making key contributions to this testimony include Joseph Applebaum, Michael Hartnett, Sharon Hermes, Angela Jacobs, David Lehrer, Ryan Siegel, and Craig Winslow.

GAO's Mission

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