

Why GAO Did This Study

Millions of Americans rely on retirement savings plans for their financial well-being in retirement. Plan sponsors are increasingly investing in assets such as hedge funds (privately administered pooled investment vehicles that typically engage in active trading strategies) and private equity funds (privately managed investment pools that typically make long-term investments in private companies). Given ongoing market challenges, it is important that plan fiduciaries apply best practices, and choose wisely when investing plans assets to ensure that plans are adequately funded to meet future promised benefits.

This statement addresses (1) what is known about 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 plan sponsors and the federal government.

To prepare this statement, GAO relied primarily on its prior products on hedge funds and private equity ([GAO-08-692](#) and [GAO-10-915T](#)), and obtained new data on the extent of plan investments in hedge funds and private equity.

DEFINED BENEFIT PENSION PLANS

Plans Face Challenges When Investing in Hedge Funds and Private Equity

What GAO Found

A growing number of private and public sector pension plans have invested in hedge funds and private equity, but such investments generally constitute 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 60 percent in 2010. Over the same time period, investments in private equity were more prevalent but grew more slowly—an increase from 71 percent of large plans in 2001 to 92 percent in 2010. Still, the average allocation of plan assets to hedge funds was a little over 5 percent, and the average allocation to private equity was a little over 9 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 with midsize 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 risks—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 GAO 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 private plans fulfill their fiduciary duties, which includes educating employers and service providers about their fiduciary responsibilities under Employee Retirement Income Security Act of 1974 (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, GAO 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. Labor generally agreed with our recommendation, but has yet to take action. The agency explained that the lack of uniformity among these investments could complicate the development of comprehensive guidance for plan fiduciaries.