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Advisory Council on Employee Welfare
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DEFINED BENEFIT
PENSION PLANS

Plans Face Challenges
When Investing in Hedge
Funds and Private Equity

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Education, Workforce, and Income Security

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ACCOUNTABILITY ★ INTEGRITY ★ RELIABILITY

Highlights of [GAO-11-901SP](#), statement before the U.S. Department of Labor's Advisory Council on Employment Welfare and Pension Benefit Plans

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.

View [GAO-11-901SP](#). For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjerg@gao.gov.

August 31, 2011

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.

Mr. Chairman and Members of the Council,

I am pleased to be here today to discuss plan fiduciaries' investments in hedge funds and private equity.¹ As you know, millions of Americans rely on retirement savings plans for their financial well-being in retirement. Much has happened in the financial markets since we issued three reports in 2008—one that addressed defined benefit (DB) pension plan investments in hedge funds and private equity, another that addressed federal oversight and other issues regarding hedge funds exclusively, and a third that addressed private equity funds.² Hedge funds were deeply affected by the financial market events of 2008. According to a 2009 industry survey, most hedge fund strategies produced double-digit losses in 2008, and hedge funds saw approximately \$70 billion in redemptions between June and November 2008.³ Nevertheless, many of these investments have rebounded, and a 2010 industry survey of institutional investors suggests that these investors continue to be committed to investing in hedge funds, but with a shifting set of objectives and criteria.⁴

My statement today is based primarily on findings from our 2008 report on private and public sector DB pension plan investments in hedge funds

¹ 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.

²GAO, *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).

³Greenwich Associates and SEI Knowledge Partnership, *Hedge Funds under the Microscope: Examining Institutional Commitment in Challenging Times* (January 2009).

⁴Greenwich Associates and SEI Knowledge Partnership, *Institutional Hedge Fund Investing Comes of Age: A New Perspective on the Road Ahead* (June 2011).

and private equity, and a subsequent 2010 testimony that we have updated to reflect more recent data.⁵ Specifically, 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 of these challenges for plan sponsors and the federal government. In addition, we currently have work under way examining DB plans' recent experiences investing in these vehicles. Specifically, this project—being conducted for the ranking member of the Subcommittee on Health, Employment, Labor and Pensions of the House Committee on Education and the Workforce—seeks to assess the extent to which DB plans have realized desired benefits from investing in hedge funds and private equity, and what actions they may have taken in response to lessons learned over the last 5 years. We expect to issue a report on this work early next year.

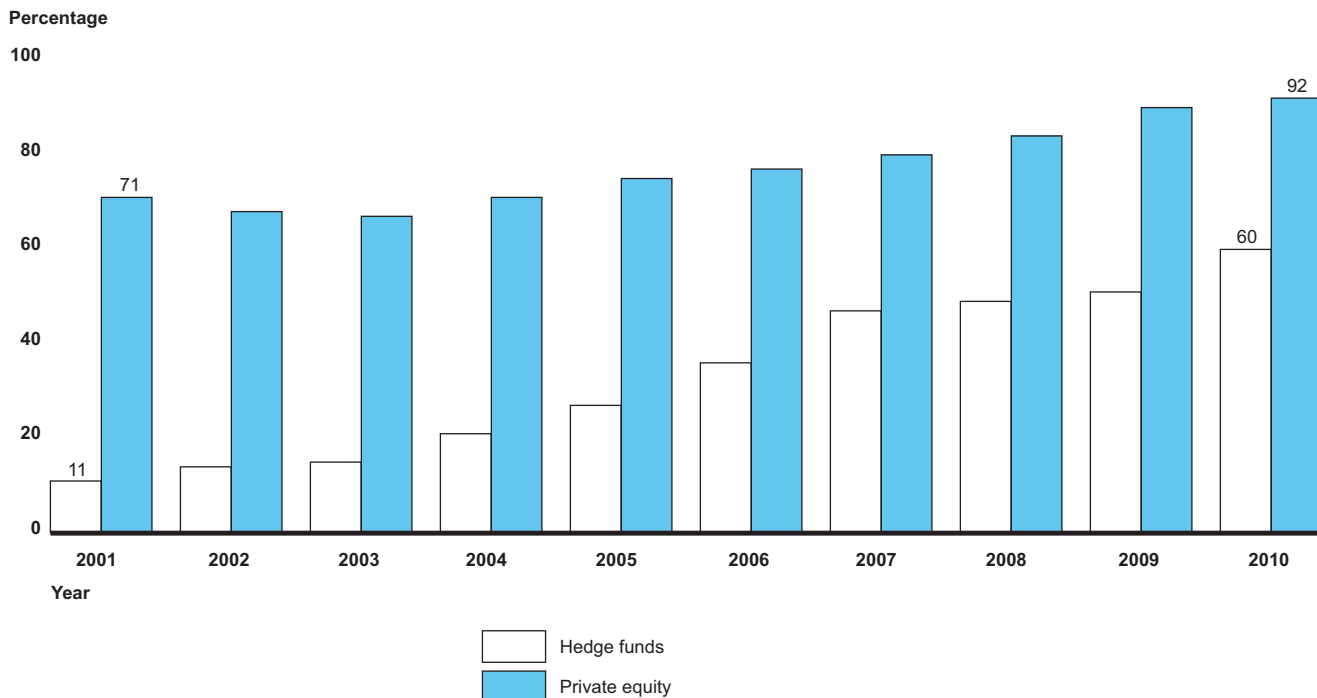
In conducting our prior work, we reviewed relevant literature and survey data and conducted in-depth interviews with pension plan representatives and industry experts. We obtained and analyzed data on the extent of pension plan investments in hedge funds and private equity from private organizations such as Greenwich Associates and Pensions & Investments. We updated these data for purposes of my statement today. We also conducted in-depth interviews with representatives of 26 public and private sector DB pension plans and obtained and reviewed available 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 work in accordance with generally accepted government auditing standards. Additional information on our scope and methodology is available in the published reports.

⁵GAO, *Defined Benefit Pension Plans: Plans Face Valuation and Other Challenges When Investing in Hedge Funds and Private Equity*, [GAO-10-915T](#) (Washington D.C.: July 20, 2010).

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. This remains the case today. 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 60 percent in 2010 (see fig. 1). Over the same time period, the percentage of large plans that invest in private equity grew at a much slower rate—71 percent to 92 percent—likely because of the fact that 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 from 2001 to 2010

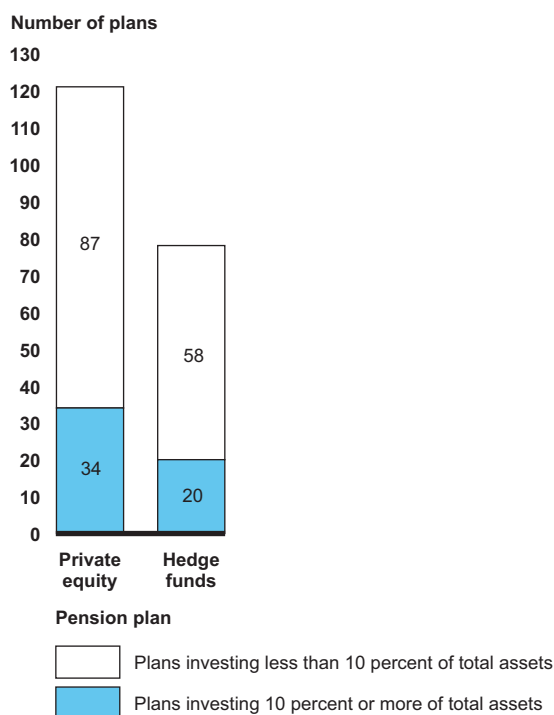


Source: GAO analysis of *Pensions & Investment* 2001-2010 annual survey data.

Data from the same survey reveal that investments in hedge funds and private equity typically constitute a small share of plan assets. The average allocation to hedge funds among plans with such investments was a little over 5 percent in 2010. Similarly, among plans with investments in private equity, the average allocation was a little over 9

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 78 large plans that reported hedge fund investments in 2010, 20 had allocations of 10 percent or more (see fig. 2). The highest reported hedge fund allocation was 33 percent of total assets. Similarly, of the 121 plans that reported private equity investments in 2010, 34 had allocations of 10 percent or more, and the highest reported private equity allocation was 30 percent.

Figure 2: The Number of Large DB Plans with Investments in Hedge Funds or Private Equity by Size of Allocation, 2010



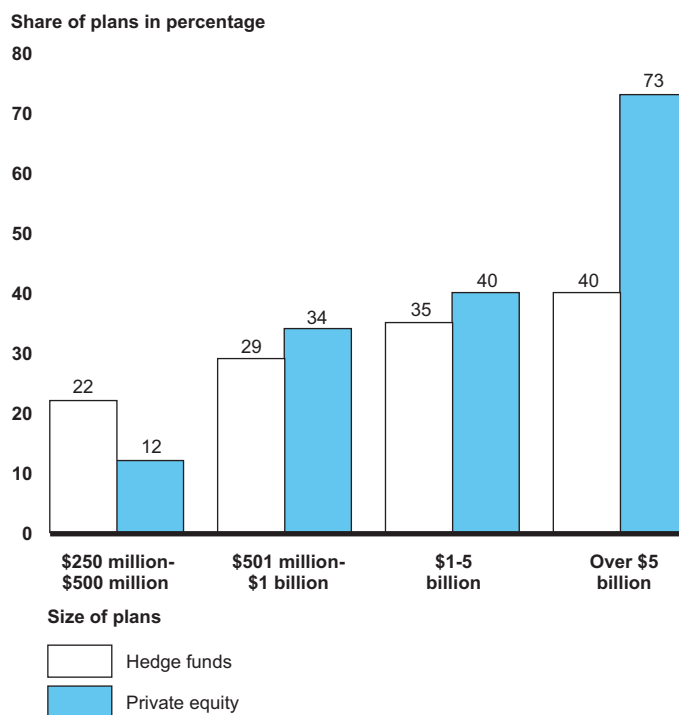
Source: GAO analysis of *Pensions & Investment* 2010 annual survey data.

Note: A total of 121 large DB plans reported investing in private equity, and a total of 78 large plans reported investing in hedge funds.

Available survey data show that larger plans, measured by total plan assets, are more likely to invest in hedge funds and private equity compared with midsize plans. As shown below, a 2010 survey by Greenwich Associates found that 22 percent of midsize plans—those with \$250 million to \$500 million in total assets—were invested in hedge funds

compared with 40 percent of the largest plans—those with over \$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, the extent to which these smaller plans invest in hedge funds and private equity is unclear.⁶

Figure 3: Pension Plans with Investments in Hedge Funds and Private Equity by Size of Total Plan Assets, 2010



Source: Greenwich Associates, 2010.

Note: The figure above includes public and corporate plans and does not include investments of collectively bargained plans.

⁶According to the Pension Benefit Guaranty Corporation (PBGC), individual DB plans with less than \$200 million in total assets composed about 15 percent of the total assets of all DB plans in 2005.

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

Valuation Risk

One of the major challenges that both hedge fund and private equity investments pose to plan sponsors is uncertainty over the current value of the sponsors' investment. With regard to hedge funds, we noted that plan officials 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 subjective, a plan official may not be able to obtain timely information on the value of assets owned by a hedge fund.⁷ Further, hedge fund managers may decline to disclose information on asset holdings and the net value of individual assets largely because the release of such information could compromise their trading strategy.⁸ In addition, even if hedge fund managers were to provide detailed positions, these managers may seek to profit through complex and simultaneous positions and can abruptly change their positions and trading tactics in order to achieve a desired return as changing market conditions warrant, making it difficult for plans to independently ascertain the value or fully assess the degree of investment risk. Although we noted in January 2008 that some hedge funds have improved disclosure and transparency about their operations because of the demands of institutional investors, several pension plans cited limited transparency as a prime reason they had chosen not to invest in hedge funds.⁹

⁷A security is described as thinly traded when trading infrequently or in low volume.

⁸For example, disclosure of asset holdings could enable a competitor to either duplicate or sabotage a manager's ability to profit from the opportunity he has identified.

⁹See [GAO-08-200](#).

As with hedge funds, valuations of private equity investments are uncertain during the investment's long duration, which often lasts 10 years or more. Unlike investments that are traded and priced in public markets, plan officials have limited information on the value of private equity investments until the underlying holdings are sold.¹⁰ In some cases, private equity funds estimate the value of the fund by comparing the value of companies in their portfolio with the value of comparable publicly traded assets. However, prior to the sale of underlying investments, assessing the value of a private equity fund is difficult.

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 of capital invested. Although registered investment companies are subject to strict leverage limits, a hedge fund or private equity fund can make relatively unrestricted use of leverage. Leverage can magnify profits, but 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 typically involves concentrating its holdings in a limited number of underlying companies—generally about 10 to 15 companies, often in the same sector. The returns for such concentrated, undiversified funds are highly susceptible to the success or failure of each underlying company and related market sector conditions. Further, hedge funds and private equity funds can also feature relatively costly fee structures compared with those of mutual funds. These fee

¹⁰The 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.

structures can have a significant impact on net investment returns.¹¹ Despite these fee structures, pension plan officials we contacted cited attaining returns superior to those attained in the stock market as a reason for investing in hedge funds and private equity. One plan official noted that as long as hedge funds add value net of fees, they found the higher fees acceptable.

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 a plan’s investment for a year or more, during which an investor cannot cash out of the hedge fund. After the initial lockup period, hedge funds offer only periodic liquidity, such as quarterly. Hedge funds impose such liquidity limits because sudden liquidations could disrupt a carefully calibrated investment strategy. Nonetheless, these constraints 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, and during that period, a plan may have no ability to redeem its investments—and can often require additional capital over the life of the investment. A private equity fund cycle typically follows a pattern known as the J-curve, which reflects an initial period of negative returns during which investors provide the fund with capital to invest in underlying companies and then obtain returns over time as investments mature.

Operational Risk

We reported that pension plans investing in hedge funds are also exposed to operational risk—that is, the risk of investment loss because of 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. While most investments can pose some type of operational risk, according to a report by an investment consulting firm, many hedge

¹¹For 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.

funds engage in active, complex, and sometimes heavily leveraged trading, and a failure of operational functions, such as processing or clearing one or more trades, and may have particularly grave consequences for the overall position of the hedge fund.

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

Pension plan officials 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, plan sponsors noted 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. Most of the plans we contacted described one or more specific strategies for their hedge fund investments. Several sources stated that private equity investments have greater variation in performance among funds, particularly among venture capital investments compared with 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 those 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 fee¹² 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.

Due diligence and ongoing monitoring, beyond those required for traditional investments, are also important. For hedge funds, due

¹²Hedge fund and private equity managers typically charge a performance fee, in addition to a fee based on the amount of assets under management.

diligence can be a wide-ranging process including study of a hedge fund's investment, 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.

Also, several plan sponsors address some of the risks and challenges of investing in hedge funds and private equity by investing via a fund of funds.¹³ 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, a fund 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 through direct investment. 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 5 to 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. However, investing through a fund of funds does not relieve plan sponsors of their fiduciary duties; accordingly, the plan sponsors must act prudently in selecting and monitoring funds of funds.

¹³A fund of funds is an investment fund that buys shares of multiple underlying funds. For example, by investing in multiple hedge funds, fund of funds managers offer investors broad exposure to different hedge fund managers and strategies.

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

According to plan officials, 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, medium-size and small 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. Smaller plans may have only one-or two-person staffs, or may lack the resources to hire outside consulting expertise and may be locked out of top-performing funds. To a lesser extent, some 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, and as predecessors to this 2011 ERISA Advisory Council have concluded, the Department of Labor (Labor) can play a role in helping to ensure that plans fulfill their Employee Retirement Income Security Act of 1974 (ERISA) fiduciary duties when investing in hedge funds and private equity.¹⁴ 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.¹⁵ 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 composed.¹⁶ 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.¹⁷ The report acknowledged that hedge

¹⁴The Advisory Council on Employee Welfare and Pension Benefit Plans was created under ERISA to provide advice to the Secretary of Labor.

¹⁵Advisory Council on Employee Welfare and Pension Benefit Plans, *Report of the Working Group on Prudent Investment Process*, 2006.

¹⁶Advisory Council on Employee Welfare and Pension Benefit Plans, *Report on Hard to Value Assets and Target Date Funds*, 2008.

¹⁷Investor's Committee, *Principles and Best Practices for Hedge Fund Investors: Report to the President's Working Group on Financial Markets*, January 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, and the Commodity Futures Trading Commission, and the Investors' Committee consists of a broad array of investors and investor advocates.

fund investments are not necessarily suitable for some investors and provided 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 ensuring 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.¹⁸ For example, we stated that Labor’s Employee Benefits Security Administration (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. Although Labor generally agreed with our recommendation, the agency explained that the lack of uniformity among these investments could complicate the development of comprehensive guidance for plan fiduciaries. To date, Labor has not acted on this recommendation.

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. In light of these trends and ongoing public equity market volatility, 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 investment options. 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.

¹⁸[GAO-08-692](#).

These challenges can be daunting even for large plan sponsors. Accordingly, 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 beneficial.

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

**GAO Contacts and
Staff
Acknowledgments**

For further questions on this statement, please contact me at (202) 512-7215. Individuals making key contributions to this statement include Michael Hartnett, Sharon Hermes, David Lehrer, and Amber Yancey Carroll.

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