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# DEFINED BENEFIT PENSION PLANS

## Recent Developments Highlight Challenges of Hedge Fund and Private Equity Investing

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Highlights

Highlights of GAO-12-324, a report to the Ranking Member, Subcommittee on Health, Employment, Labor, and Pensions, Committee on Education and the Workforce, House of Representatives

### Why GAO Did This Study

Millions of Americans rely on defined benefit pension plans for their financial well-being in retirement. Plan representatives are increasingly investing in a wide range of assets, including hedge funds and private equity funds. In recent years, GAO has noted that plans may face significant challenges and risks when investing in these alternative assets. These challenges and ongoing market volatility have raised concerns about how these investments have performed since 2008.

As requested, to better understand plan sponsors' experiences with these investments, GAO examined (1) the recent experiences of pension plans with investments in hedge funds and private equity, including lessons learned; (2) how plans have responded to these lessons; and (3) steps federal agencies and other entities have taken to help plan sponsors make and manage these alternative investments.

To answer these questions, GAO analyzed available data; interviewed relevant federal agencies and industry experts; conducted follow-up interviews with 22 public and private pension plan sponsors selected among the top 200 plans and contacted in the course of GAO's prior related work; and surveyed 20 plan consultants, academic experts and other industry experts.

This report reemphasizes a 2008 recommendation that the Secretary of Labor provide guidance to help plans investing in hedge funds and private equity.

View GAO-12-324. For more information, contact Charles Jeszeck at (202) 512-7215 or jeszeckc@gao.gov.

### What GAO Found

While plan representatives GAO contacted generally stated that their hedge fund and private equity investments met expectations in recent years, a number of plans experienced losses and other challenges, such as limited liquidity and transparency. National data indicated that hedge fund and private equity investments were significantly affected by the 2008-2009 financial crisis, and plans and experts GAO contacted indicated that pension plan investments were not insulated from losses. Most of the 22 plan representatives GAO interviewed said that their hedge fund investments met expectations overall, despite, in some cases, significant losses during the financial crisis. A few plan representatives, however, expected hedge fund investments to be much more resilient in turbulent markets, and found the losses disappointing. Given the long-term nature of private equity investments, almost all of the representatives were generally satisfied with these investments over the last 5 years. Some plan representatives described significant difficulties in hedge fund and private equity investing related to limited liquidity and transparency, and the negative impact of the actions of other investors in the fund—sometimes referred to as co-investors. For example, representatives from one plan reported they were unable to cash out of their hedge fund investments due to discretionary withdrawal restrictions imposed by the fund manager, requiring them to sell some of their stock holdings at a severe loss in order to pay plan benefits.

Most plans included in our review have taken actions to address challenges related to their hedge fund and private equity investments, including allocation reductions, modifications of investment terms, and improvements to the fund selection and monitoring process. National data reveal that plans have continued to invest in hedge funds and private equity—for example, one survey revealed that the percentage of large plans investing in hedge funds grew from 47 percent in 2007 to 60 percent in 2010—and most plans GAO contacted have also maintained or increased their allocations to these investments. However, most plans have adjusted investment strategies as a result of recent years' experiences. For example, three plans have reduced their allocations to hedge funds or private equity. Other plan representatives also took steps to improve investment terms, including more favorable fee structures and enhanced liquidity. However, some plan representatives and experts indicated that smaller plans would likely not be able to take some of these steps.

The Department of Labor has provided some guidance to plans regarding investing in derivatives, but has not taken any steps specifically related to hedge fund and private equity investments. In recent years, however, other entities have addressed this issue. For example, in 2009, the President's Working Group on Financial Markets issued best practices for hedge fund investors. Further, both GAO and a Department of Labor advisory body have recommended that the department publish guidance for plans that invest in such alternative assets. To date, it has not done so, in part because of a concern that the lack of uniformity among such investments could make development of useful guidance difficult. In 2011, the Department of Labor advisory body specifically revisited the issue of pension plans' investments in hedge funds and private equity, and a report is expected in early 2012.