

## 2011 ERISA Advisory Council

### Hedge Funds and Private Equity Investments

**Issue Chair:** Michael Tomasek  
**Issue Vice Chair:** Michael Sasso  
**Drafting Team:** Theresa Atanasio, Sewin Chan, Gary Thayer

#### Description

The recent extreme volatility in the markets has led many plan sponsors to seek ways to further diversify, improve the downside protection of their plans and reduce the amount of correlation between market performance and plan returns, by looking beyond traditional long-only stocks and bonds. Industry research and survey data has shown that on average, plan fiduciaries have been increasing their allocations to hedge funds and private equity funds as they seek to achieve these goals. However, the risks associated with some strategies tend to be more complex relative to traditional equity and fixed income investments, thus requiring a greater level of investment sophistication and due diligence both at the initial stage and on an ongoing basis. The Council will study these potential investments for retirement plans with the goal of providing the Department of Labor (DOL) recommendations for guidance to provide plan sponsors, such as suggested best practices for purposes of evaluating investment strategies and monitoring these investments in retirement plans.

#### Project Objective and Scope

The objective of the study is to develop recommendations for plan fiduciaries when investing retirement plan assets in hedge funds and/or private equity funds and in monitoring such plan investments. In developing best practices guidance, the study will address the following topics:

- Nature of and Differences Among Strategies
- Performance Objectives and Actual Performance Among Strategies
- Risks associated with:
  - Leverage
  - Liquidity
  - Transparency
  - Fees—knowing the fee structure
  - Valuation
  - Operational Due Diligence
  - Organizational Structure and Control
  - Contractual Privity (or lack thereof)
  - International Investments
  - Fund Terms and Offering Documents
  - Client and Asset Concentration
  - Regulation
- Role of Manager Due Diligence
  - Role of Trustee/Sponsor Due Diligence
- Role of Investment Databases in Manager Sourcing
  - Quality of Information

- Survivorship Bias
- Assessing and Benchmarking Performance
- Role of Direct Investments vs. Fund of Funds
- Viability of Hedge Funds and Private Equity Investments in Defined Contribution Plans
- Viability of Hedge Funds and Private Equity Investments in Defined Benefit Plans including Impact on Annual Actuarial Certification
- Role of Hedge Fund and Private Equity Investments in the Broader Economy

### **Questions for the Witnesses**

1. What are the essential characteristics of a hedge fund?
2. What are the essential characteristics of a private equity fund?
3. To what degree do hedge funds and private equity funds outperform (or under perform) traditional plan investments?
4. To what degree are the returns of hedge funds and private equity funds correlated with the performance of the markets and traditional plan investments?
5. What role do hedge funds and private equity funds play in the investment strategy of defined benefit plan sponsors and/or defined contribution plan sponsors and participants?
6. What unique benefits and risks do hedge funds and private equity funds present over traditional plan investments?
7. What steps can defined benefit and defined contribution sponsors take to mitigate the lack of liquidity that is characteristic of these investments?
8. What role could plan sponsors expect for investment managers, advisors, consultants and other service providers with regard to due diligence and ongoing monitoring?
9. Are hedge fund and private equity fund investments viable with regard to both defined benefit and defined contribution plans?
10. Given the often illiquid nature of both hedge funds and private equity, what other options are available to plan sponsors and participants that would provide exposure to the unique investment opportunities offered by hedge fund and private equity investments, but that provide for greater (and possibly daily) liquidity and pricing?
11. What steps can plan sponsors take to ensure fee transparency?
12. How do private equity and hedge fund investments affect the broader financial economy?
13. To what degree are hedge fund and private equity fund managers and the funds themselves currently subject to regulation?
14. Discuss key recommendations for plan sponsors that are best practices when analyzing and assessing these unique risk factors.
15. Overall, what unique steps should plan sponsors take when considering and monitoring hedge fund and private equity investments relative to traditional investment vehicles?
16. Are there any unique diversification benefits offered by hedge funds and private equity investments?
17. What are the benefits and drawbacks of investing in direct hedge funds and private equity investments as opposed to a fund of funds?
18. What are the benefits and drawbacks of investing in actual hedge funds and private equity investments to gain access to these strategies as opposed to investing in more traditional investment options that may utilize similar strategies (such as long/short equity or merger arbitrage mutual funds or long/short separate accounts)?

19. To what extent have defined contribution plans been offering these types of strategies to their participants? Has it been through actual hedge fund or private equity investments or through traditional investment options? Also, has it been as a stand alone option within a plan lineup or through the use of a target date fund or managed account type product?
20. How do target date fund managers view the viability of including these strategies within their funds? In what capacity have they begun to offer this type of exposure or see themselves including it in the future?
21. What are some of the differences in management, fee structure and investment strategy between a hedge fund or private equity fund which is a plan asset vehicle (i.e., 25% or more benefit plan investors) and a non-plan asset vehicle?