Statement of
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on behalf of Plan Sponsor Advisors

Appropriateness of Hedge Funds and Private Equity in Retirement Plans

ERISA Advisory Council Working Group
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Introduction

I appreciate this opportunity to provide Plan Sponsor Advisors' comments to the Advisory Council on Employee Welfare and Pension Benefit Plans of the U.S. Department of Labor ("DOL") today. I am Angelo Auriemma, Director of Investment Advisory Services for Plan Sponsor Advisors.

Plan Sponsor Advisors (PSA) is a registered investment advisor and retirement benefits consulting firm headquartered in Chicago. Since its founding in 2002 PSA has consulted with plan sponsors representing more than $65 billion in retirement plan assets. PSA's mission is to help retirement plan fiduciaries fulfill their fiduciary duties, mitigate risks and improve participant outcomes. The firm's staff has a deep background in investments, record keeping, compliance, plan administration and communication totaling more than 150 years of experience.

On behalf of PSA, I thank you for this opportunity to comment today concerning the appropriateness of hedge funds and private equity in retirement plans. Our understanding is the objective of the Council's study is to develop recommendations for plan fiduciaries when investing retirement plan assets in hedge funds and/or private equity funds, monitoring such plan investments and developing best practices guidance for plan sponsors. PSA supports the Advisory Council's efforts in assisting the DOL in better understanding this important issue.

PSA's perspective

In a challenging investment environment, plan sponsors and plan participants continue to seek higher returns. It is natural that they would consider non-traditional investments in an environment where interest rates are repressed and equity returns have been low relative to prior decades. In fact, many plans have been adding a range of non-traditional investments, including commodities, emerging markets and global bonds, to name but a few. The question that the Council is addressing is the appropriateness of taking a further step toward investment vehicles in qualified retirement plans that have historically been available to sophisticated investors. This is made all the more difficult as the managers who operate under the rubric of being a hedge fund or private equity manager are less constrained than traditional asset managers and these terms cover a very broad array of strategies.

From our perspective, there is not one answer that fits all retirement plans.

DB Plans

Hedge funds and private equity have been used by defined benefit plans, particularly in the large corporate and public funds arena for a number of years. PSA believes that the use of these investment vehicles in defined benefit plans can be reasonable and appropriate. In defined benefit plans, participant benefits are not determined by investment returns (or lack thereof). Investment liquidity of all investments is generally not an issue as plan committees plan for liquidity needs through the investment allocation and/or contributions to the plan. Participants cannot transfer monies in a defined benefit plan and statements showing valuation are typically issued annually.

So long as plan committees have the ability to reach an informed decision about these complex investments and monitor them appropriately, we think they can potentially enhance a plan's asset allocation strategy. However, hedge funds and private equity should not be seen as a panacea for the high correlation among asset classes that we have experienced in recent years as many of these strategies have been subject to the same convergent forces. We would also caution that most defined benefit committees may lack the expertise to perform the necessary due diligence on these products or be poorly equipped to evaluate their consultant's recommendations. That said, we would like to focus the bulk of our comments on defined contribution plans which we believe present a number of concerns as it relates to the use of hedge funds and private equity.

DC Plans

Hedge funds and private equity present a number of challenges within the framework of daily valued, participant directed, defined contribution plans. These challenges extend to both plan fiduciaries and plan participants. For the reasons enumerated below, PSA believes that hedge funds and private equity are not appropriate for defined contribution plans at this time. We reserve the right to reconsider this opinion should the concerns below be addressed. The Working Group of the Advisory Council has outlined a number of concerns that it wishes to address as part of this process and we believe the Group has done a good job in capturing the range of issues confronting plan sponsors who would like to use hedge funds or private equity. In our testimony, we would like to focus on six (6) of those issues which we believe are determinative of the appropriateness of hedge funds and private equity within defined contribution plans.

1. Liquidity. Defined contribution plans are purposely designed to provide participants with flexibility not available in defined benefit plans. Participants are able to direct the investment of their balances as they see fit within the investments offered in the plan. With the exception of stable value or GIC accounts, there is generally no restriction on participant asset movements. This has also afforded §404(c) protection to plan fiduciaries. Liquidity is also important for distributions from the plan. A major reason for the growth of defined contribution plans was the recognition that employees were less likely to remain employed at the same company throughout their career and therefore wanted to ability to move their monies when they changed jobs. Hedge funds can

restrict liquidations and private equity is typically designed to lock up investments for many years in order to provide managers the flexibility to execute their strategies.

2. Transparency. A major regulatory theme within defined contribution plans in recent years is transparency. Over the years there have been numerous efforts to enhance the participant's ability to understand investments within the plan. Prospectuses and other legal documents have been simplified to make them more understandable to participants and clear fee disclosure will be required beginning in 2012, to name but a couple. Hedge funds and private equity investments would be contrary to these efforts. Generally the information that is available on these investments is less than what is available for mutual funds, commingled trusts and separate accounts – the primary investment vehicles for defined contribution plans today. In addition, the investment strategies utilized by hedge funds and private equity can be highly complex, utilizing derivatives, leverage and proprietary trading models that make it difficult for plan sponsors and plan participants to understand what they are doing and to effectively evaluate the risks involved.

3. Fees. While there has been some recent pressure on hedge fund fees, fees for hedge funds and private equity are quite expensive relative to institutionally priced mutual funds, commingled trusts and separate accounts. The pricing model is typically based on a 2% of assets and 20% of profits model. And while there are talented managers who have generated returns well in excess of the returns available through mutual funds, etc., it is not clear that most hedge fund and private equity managers are more skilled than their traditional investment counterparts.

4. Valuation. Valuation poses a significant concern in defined contribution plans. As noted earlier, valuation for defined benefit plans is more of a concern for the plan sponsor, as it affects funding levels. But it has no impact on the value of the benefit to a participant. However, in a defined contribution plan the valuation is critical due to the daily valuation of accounts, the ability to change the asset allocation on any trading day, and the portability of the benefit in the event of a distribution. While non-daily valued investments already exist in some plans, their history has been problematic. Examples of this include some stable value products with hard to value assets, such as private mortgage pools and funds that hold real estate where valuations are generally based on appraisals performed on a periodic basis. It is simply unclear in these cases whether participants are receiving the correct valuation of their accounts at any point in time. There are certainly other examples of valuation issues, even in mutual funds, but it is PSA's position that we should not add to valuation concerns by including assets that, by their design, are not well suited to daily valuation.

5. Regulation. Given the experience of recent years, there has been increased concern on the regulation, or lack thereof, of many investments. Many hedge funds and private equity firms are not registered investment advisors, nor are they required to so long as they meet certain guidelines. Information that is required to be provided to investors (ultimately plan participants) is limited. This is contrary to the desire to provide more,

rather than less information to investors. In fact, one of the concerns about commingled trusts, which have been used by defined contribution plans for generations, is the different regulatory scheme build around these products when compared to mutual funds or separate accounts.

Conversely, there is concern within the hedge fund and private equity industries that working more closely with retirement plans could subject them to additional regulatory scrutiny. It is not at all clear that successful hedge fund and private equity managers would be willing to endure additional regulation as a price for access to defined contribution plan assets.

6. <u>Role of the plan sponsor</u>. Over the past decade the sophistication of plan fiduciaries has grown. It is fair to say that defined contribution plans are beginning to behave in a more institutional manner and adopt some of the rigor more typically seen in defined benefit plans. Nevertheless, the composition of most defined contribution committees is materially different than their defined benefit counterparts. Defined contribution plan committees tend to be heavily weighted toward administrative and human resources staff, while defined benefit plans skew the opposite direction with an emphasis on finance staff. This is due to significant differences in the need to communicate with and educate participants in defined contribution plans and the often shorter timeframe for participation in the plan due to job changes and the ability for participants to direct and withdraw their money. Most defined contribution committees have neither the training or resources to adequately evaluate and monitor the value and risks inherent in hedge funds and private equity.

Summary

In summary, as a best practice, Plan Sponsor Advisors believes hedge funds and private equity do not have a place in defined contribution plans. It is our view that there are currently a number of issues that make hedge funds and private equity incompatible with the regulatory, administrative and operational framework of defined contribution plans.

We would like to thank the Working Group of the ERISA Advisory Council for your time today and for inviting Plan Sponsor Advisors to share our perspective on this important topic with you.