PENSION PLAN INVESTMENT INTO HEDGE FUNDS
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Background

- Hedge funds are actively managed investment funds geared to institutional and high net-worth investors. They are typically subject to fewer regulatory requirements than other managed funds such as mutual funds. Hedge funds usually charge a one to two percent management fee and a 20 percent performance fee.

- Institutional investment into hedge funds comes from pension funds, endowments, charitable foundations, and governmental authorities.
  - In addition to directly investing in hedge funds, institutions invest indirectly through funds of hedge funds (FOHF). FOHF are investment funds that manage a portfolio of hedge fund investments. They charge a second layer of management and performance fees to investors. FOHF are also considered a type of institutional investor.

Current State of Institutional Investment in Hedge Funds

- As of 2006, 15 percent of institutional investors worldwide invested in hedge funds; each institution invested about 2 percent of its assets in hedge funds; and about 30 percent of hedge fund assets came from institutions.
  - U.S. institutional investors invest about $148 billion in hedge funds. U.S. corporate and public pensions invest 0.9 percent and 0.7 percent of their assets in hedge funds, respectively. In 2006, a majority of institutional inflows to hedge funds were through FOHF.

- Why 85 percent of institutional investors worldwide are still reluctant to invest in hedge funds:
  - Headline Risk. Negative publicity associated with hedge fund failures can have undesirable implications for institutional investors (and their trustees) whose public posture often brings high media scrutiny.
  - Lack of Transparency. Institutional investors are accustomed to complete transparency, and some U.S. public pension plans are even required to track every trade their managers perform. However, because hedge funds are not generally subject to federal reporting and registration requirements, they are less likely to disclose their investment strategies.
  - Fees. Hedge fund fees are substantially higher than those charged by other managed funds. Some institutional investors find the fees charged by hedge funds to be unreasonable.
Pension Plan Investment into Hedge Funds Continues to Grow

- Over the last decade, investment by individuals into hedge funds has constituted a decreasing percentage of total investment inflows.

- Since 2004, U.S. institutional investment in hedge funds (excluding banks) more than doubled, from $66 billion to $136 billion. Much of this growth is from investment in hedge funds by pension plans (Exhibit 1).

- Increasing institutional demand for hedge funds is primarily driven by:
  
  o *Diversification*. Institutions seek more balance in their portfolios with hedge funds, which have relatively low or negative correlation with typical market benchmarks, in part due to their short-selling practices designed to profit from securities price decreases.

  o *Higher returns*. Low returns from traditional investments such as bonds are driving institutional investors to seek better returns from alternatives such as hedge funds.

  o *Increased comfort*. Increasingly sophisticated institutional investors now better understand and accept the potential benefits from hedge fund investing techniques, such as the use of short-selling, derivatives, and leverage.

- By 2010, it is estimated that:
  
  o Global institutional investment in hedge funds will triple to nearly $1 trillion (Exhibit 2).

  o More than 40 percent of hedge fund assets will come from institutions.

  o Institutions will allocate 3.5 percent of their total assets to hedge funds.

- Most of the new institutional investment into hedge funds will come from retirement plans, which will account for 65 percent of institutional inflows through 2010 (Exhibit 3).
• Many public pensions ultimately seek a 10-20 percent allocation to hedge funds.

• Legal changes have made pension funds more attractive to hedge funds.
  
  o Hedge funds with 25 percent or more of their equity assets owned by pension plans may be subject to the Employee Retirement Income Security Act (ERISA), which regulates employee benefits for most U.S. employees. ERISA imposes additional fiduciary and disclosure obligations on investment funds and their managers.
  
  o The Pension Protection Act of 2006 made it easier for hedge funds to accept retirement assets without triggering ERISA. For example, hedge funds may now accept unlimited funds from government pensions without being subject to ERISA.
  
  o Nonetheless, some hedge funds are willing to abide by the additional obligations of ERISA in order to attract more pension fund capital.

How Institutional Investors Evaluate Hedge Funds

• When exercising due diligence in connection with selecting hedge fund managers, institutional investors take into account several factors such as:
  
  o Source and Consistency of Returns. Understanding and validating the sources and sustainability of an investment manager’s returns are two of institutional investors’ most important selection criteria in deciding where to invest.
  
  o Risk-management and client service. Institutions demand the highest levels of risk management, operational quality and client service, particularly because most significant hedge fund losses stem from risk management and operational failures. To meet such demands, hedge funds have significantly improved their risk management practices.
  
  o Management experience, firm reputation, and transparency.

Experiences of Pension Plans Investing in Hedge Funds

• Institutional investors are overwhelmingly satisfied with their investment experience with hedge funds.
  
  o However, many funds of hedge funds have failed to satisfy. A 2006 Mercer Investment Consulting survey of pension funds worldwide found that only 23 percent of pension plans were satisfied with their investments in funds of hedge funds, but a majority nonetheless plan to increase their allocations.

• The City of New Orleans used hedge fund investments to help its pension fund absorb the costs of Hurricane Katrina in 2005. In 2006, hedge funds gained 28 percent for the New Orleans pension fund, helping it to achieve a seven-year high return of 5.7 percent.
San Diego County Pension Fund and Amaranth. In September 2006, Amaranth Advisors LLC suffered the largest collapse in hedge fund history, losing $6.5 billion in a few weeks from investments in natural gas futures. Investors lost about two-thirds of their investments.

- The San Diego County pension fund, serving approximately 34,000 beneficiaries, had invested approximately $175 million in Amaranth at the time of its collapse. The San Diego fund lost an estimated $105 million, accounting for less than 2 percent of the fund’s $7.3 billion in assets, 20 percent of which were allocated to hedge funds.

- However, the collapse of Amaranth did not disturb distributions to beneficiaries of the San Diego County pension fund. Even after its loss from Amaranth, the San Diego pension fund was up $320 million for the year.

References


- Institutional Investors’ Perspective on Hedge Funds, by Randy Warsager and Ryan Duncan. MFA Reporter (August/September 2006).


- Pension Protection Act of 2006; Public Law 109-280.
