



## CRS Report for Congress

# Pension Funds Investing in Hedge Funds

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### Summary

The proportion of U.S. corporate-defined benefit pension funds investing in hedge funds has increased to 24% in 2006, up from 19% in 2004 and 12% in 2000. Although statistics vary, total corporate pension fund assets allocated to hedge funds in 2006 was 2.1%. Because of hedge funds' risky nature, rapid growth, lack of oversight, and recent losses, some wonder if they are appropriate investments for workers' retirement funds. In 2004, the Securities and Exchange Commission (SEC) issued a rule requiring many hedge fund advisers to register as investment advisers under the Investment Advisers Act. The rule took effect in February 2006, but in June 2006 a court challenge was upheld, and the rule was vacated. In early 2007, while the Bush Administration called for increased vigilance rather than new government rules to handle industry risks, Congress has asked the Government Accountability Office to examine the use of hedge funds by public and private sponsors of defined benefit pension plans.

### What is a Hedge Fund?

Although there is no precise accepted or legal definition, the term "hedge fund" generally refers to an entity that holds a pool of securities or other assets, whose interests are not sold in a registered public offering, and that is not registered as an investment company under the Investment Company Act of 1940.<sup>1</sup> Alfred Winslow Jones is credited with establishing one of the early funds in 1949 by investing in equities and using short selling to "hedge" the portfolio's exposure to movements in the equity market.<sup>2</sup> Today, hedge funds trade in a variety of investment vehicles such as equity and fixed income securities, currencies, derivatives, futures contracts and other assets. Hedge funds often

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<sup>1</sup> For more information on regulation of hedge funds, see CRS Report 94-511, *Hedge Funds: Should They Be Regulated?*, by Mark Jickling.

<sup>2</sup> A "long" investment involves buying a stock today in order to sell it in the future; long investors realize a profit if the value of the stock rises. Alternatively, "short" investors sell stocks first and buy them back at a future date; short investors realize a profit if the value of the stock declines. Brokers facilitate these transactions by loaning stocks to short investors who then sell them on the market. When investors subsequently buy the stock back, they then return it to the broker.

seek to profit by using leverage (investing borrowed money, which can increase gains or losses) and other speculative investment practices that may increase the risk of investment loss.<sup>3</sup>

Because hedge funds do not register the offer and sale of their interests under the Securities Act, they may not offer their securities publicly or engage in a public solicitation. Generally, they sell their interests in private offerings. They may sell their interests to “accredited investors,” which includes individuals with a minimum annual income of at least \$200,000 (\$300,000 with spouse) or \$1 million in net worth and most institutions with at least \$5 million in assets. Alternatively, they may sell to “qualified purchasers,” a standard with significantly higher financial requirements than those necessary for accredited investors.<sup>4</sup>

Hedge funds are also characterized by their fee structure. Advisers typically receive 1% to 2% of assets as a management fee and a share of the capital gains and capital appreciation, commonly 20%. Hedge funds often employ a “lock-up period” during which investors may not liquidate their investments.

## Concern About Hedge Funds

Hedge funds are coming under scrutiny due to their rapid growth, lack of oversight, high risk, and recent fund losses and failures. Pension funds have increased their allocation of assets to hedge funds in recent years. Some question the appropriateness of exposing workers’ retirement savings to the potential losses of hedge funds.

**Growth Rate.** The hedge fund industry is experiencing rapid growth in both the number of hedge funds and the amount of assets associated with them. It is estimated that in 2006, there were approximately 8,800 hedge funds managing about \$1.2 trillion in assets, which represents a 3,000% increase in assets over 16 years.<sup>5</sup>

**Hedge Fund Oversight.** Because hedge funds are not required to register with the Securities and Exchange Commission (SEC), they are exempt from standardized reporting requirements and from examination by the SEC. The SEC claims these exemptions deny investors material information from which to make informed decisions and hamper their ability to detect hedge fund fraud.<sup>6</sup>

**Riskiness.** Hedge funds can be characterized as high-risk, high-return operations: they pursue high returns by taking risks. Often they seek what is called *alpha* return, that is, returns uncorrelated to market performance. That means that hedge funds can be profitable when the market in general is not. For that reason, successful hedge funds provide not only high returns to their investors, they contribute to financial markets’

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<sup>3</sup> U.S. Securities and Exchange Commission’s Staff Report, “Implications of the Growth of Hedge Funds,” September 2003.

<sup>4</sup> Qualified purchasers include individuals with more than \$5 million in investments.

<sup>5</sup> *Benefits Law Journal*, “Monitoring Hedge Funds Investments,” Summer 2007, p. 65.

<sup>6</sup> SEC Staff Study, *Implications of the Growth of Hedge Funds*, September 2003, p. 76.

efficiency, liquidity, and stability.<sup>7</sup> However, unsuccessful hedge funds can cost investors everything they have invested.

Hedge funds often use borrowed money to produce high returns, which is commonly called leveraging.<sup>8</sup> Prior to the 1929 stock-market crash, customers could buy stocks with as much as 90% borrowed money, called margin debt. Today, the Federal Reserve limits margin borrowing by most investors to 50% of a stock's purchase price. However, that limit doesn't apply to "leveraging tools such as derivatives," which allow funds to add leverage without borrowing money.<sup>9</sup> Tanya Azarchs, who analyzes banks and brokers at Standard & Poor's Corp., expresses concern about the growth of leverage fueled by hedge funds when she says, "There's leverage everywhere. It sort of feels like something's got to give."<sup>10</sup>

**Recent Fund Losses and Failures.** In 1998, Long-Term Capital Management's (LTCM's) capital shrank from \$4 billion to \$360 million in a matter of weeks, which led to a bailout engineered by the Federal Reserve Bank of New York. The bailout was based on the belief that the fund's failure might have caused widespread disruption in financial markets because of the fund's size (it held \$125 billion in assets, nearly four times the amount of the next largest fund), its highly leveraged position (assets to capital ratio greater than 25-to-1), and the large size of its investments in certain markets (e.g., LTCM's position represented more than 5% of the open interest in a number of futures markets).<sup>11</sup> Regardless, the Fed's intervention was unusual and triggered concerns that funds would take greater risks on the assumption that the Fed was there to bail them out.

In September 2006, Amaranth Advisors fund lost \$6.4 billion from a peak of \$9 billion. Amaranth's losses were attributed to ill-timed speculation in natural gas prices. The losses did not affect the overall market, as was feared with LTCM, and did not trigger action by the Fed.<sup>12</sup> In the period between LTCM and Amaranth, the industry saw several major hedge fund losses and failures due to financial issues and fraud.<sup>13</sup>

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<sup>7</sup> Ibid.

<sup>8</sup> Leveraging refers to investing with borrowed money as a way to amplify potential gains (at the risk of greater losses). However, investors can obtain leverage through various investment vehicles without explicitly borrowing money. These include short selling, derivatives, futures, options, etc.

<sup>9</sup> *Wall Street Journal*, "Outer Limits: As Funds Leverage Up, Fears of Reckoning Rise," April 30, 2007, p. A1.

<sup>10</sup> Ibid.

<sup>11</sup> Report of The President's Working Group on Financial Markets, *Hedge Funds, Leverage, and Lessons Learned from LTCM*, April 1999, p. 12. The difference between an entity's capital and its assets are its liabilities. That is, LTCM's \$125 billion in assets and \$4 billion in capital implies liabilities (e.g., loans and other obligations) of \$121 billion.

<sup>12</sup> *Wall Street Journal*, "Outer Limits: As Funds Leverage Up, Fears of Reckoning Rise," April 30, 2007, p. A1.

<sup>13</sup> For more information, see CRS Report RL33746, *Hedge Fund Failures*, by Mark Jickling and Alison A. Raab.

## Pension Funds and Hedge Funds

The proportion of U.S. corporate pension funds investing in hedge funds has increased from 12% in 2000 to 24% in 2006; these pension funds invest, on average, about 5.4% of their assets in hedge funds.<sup>14</sup> Total pension assets allocated to hedge funds has grown from 1.3% in 2003 to 2.1% in 2006.<sup>15</sup> Boeing, for example, announced that it was increasing its bond allocation from 37% to 45% and cutting equity from 55% to 28%. At the same time, Boeing will increase its investment in alternative investments — including private equity, real estate, and hedge funds — from 2% to 14%.<sup>16</sup>

Pension funds' increased interest in hedge funds, coupled with the concerns listed above, have led some to question the appropriateness of pension funds investing in hedge funds. In addressing this question, however, it is important to distinguish between the riskiness of a single investment and the risk to a portfolio. Individual hedge fund investors seek high returns, but they risk losing their entire investment. And the LTCM and Amaranth collapses show that this can happen in a short period of time.

As part of a portfolio, though, hedge fund investments can mitigate risk. “Due in part to their non-correlation to traditional stock markets, hedge funds are powerful tools for portfolio diversification, and help to enhance returns, reduce volatility and increase risk-adjusted returns, especially during bear markets.”<sup>17</sup> During the first quarter of 2001, when the S&P 500 Index experienced its worst quarter since 1987, pension fund managers saw hedge funds perform well while their stock values suffered.<sup>18</sup>

The San Diego County Employees Retirement Association's (SDCERA's) recent experience illustrates the effects — good and bad — that hedge funds can have on pension funds. In 2005, the SDCERA invested with Amaranth. When the hedge fund failed, SDCERA estimated the losses to its portfolio at \$100 million.<sup>19</sup> Even with this loss, though, SDCERA's fund earned 14.57% last year. And, although SDCERA is suing Amaranth, it continues to invest \$1.2 billion (or 15%) of its \$8 billion portfolio in hedge funds and other alternative investments.<sup>20</sup>

<sup>14</sup> Greenwich Associates, *Investment Management: The Calm Before the Liability Storm*, February 2007, p. 4.

<sup>15</sup> Greenwich Associates, *New Products and Strategies Shake Up “Traditional” Assets Allocations for U.S. Institutions*, February 2007, p. 1.

<sup>16</sup> Fundfire, *Boeing Cuts Equity, Raises Bonds, Alts*, April 2007, at [[http://www.fundfire.com/articles/20070426/boeing\\_cuts\\_equity\\_raises\\_bonds\\_alts](http://www.fundfire.com/articles/20070426/boeing_cuts_equity_raises_bonds_alts)].

<sup>17</sup> *Journal of Pensions*, “The Role of Hedge Funds in Pension Fund Portfolios: Buying Protection in Bear Markets,” April 2002, p. 237.

<sup>18</sup> *Ibid.*

<sup>19</sup> *Chicago Tribune*, “Worries Grow over Pension Investments in Hedge Funds,” May 20, 2007.

<sup>20</sup> *Wall Street Journal*, “Your Money: Rest Later; Check Pension Plan Now; You May Have Money in Hedge Funds or Other Risky Bets. They Can Win Big or Lose Big, as San Diego Learned the Hard Way,” May 13, 2007.

**Existing Forms of Regulation.** Pension funds are not prohibited from investing in hedge funds. The Employee Retirement Income Security Act (ERISA) codifies the legal requirements for defined benefit pension plans. Although it provides few restrictions on the investment of pension funds, it does require that pension funds must be managed in accordance with fiduciary responsibilities, which include acting solely in the interest of plan participants, defraying reasonable expenses of administering the plan, diversifying investments so as to minimize the risk of large losses.<sup>21</sup> Accordingly, the protection of pension plan participants from hedge fund losses falls to pension fund investment fiduciaries.

The Pension Protection Act of 2006 (P.L. 109-280 or PPA) modified the rules under which hedge funds become fiduciaries of pension funds. The PPA provides that investment funds and limited partnerships (including hedge funds) will not be treated as plan fiduciaries under ERISA if investments by ERISA-covered plans account for less than 25% of assets of the investment fund or limited partnership. Investments of governmental and foreign plans, which are not subject to ERISA, will not be taken into account in this calculation, as they were under prior law.

In 2004, the Securities and Exchange Commission issued a rule requiring many hedge fund advisers to register as investment advisers under the Investment Advisers Act. The rule took effect in February 2006, and some basic information on registering hedge funds appeared on the SEC website. In June 2006, however, an appeals court found that the rule was arbitrary and not compatible with the plain language of the Investment Advisers Act, and vacated it.

In December 2006, the SEC proposed a regulation that would raise the accredited investor threshold from \$1 million to \$2.5 million in assets. If adopted, the rule would significantly reduce the pool of potential hedge fund investors but would not be expected to have a strong impact on the largest funds, which rely more on institutional investors and qualified purchasers.<sup>22</sup>

**Policy Considerations.** Corporate pension funds are backed by the Pension Benefit Guaranty Corporation (PBGC), a wholly owned government entity. Although it receives no appropriations, some fear that its failure could require a taxpayer-funded bailout.<sup>23</sup> Although Congress does not regulate public pensions (e.g., the San Diego County Employees Retirement Association), shortfalls in those plans are also borne by taxpayers in those jurisdictions. As pension funds increasingly invest in hedge funds, their influence on pension funds' returns grows.

Opinions differ on whether pension funds are adequately protected from hedge fund losses. Former Treasury Assistant Secretary Emil Henry characterizes corporate pension funds as risk averse investors that diligently investigate investment opportunities before

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<sup>21</sup> ERISA §404, 29 U.S.C. §1104.

<sup>22</sup> For more information, see CRS Report 94-511, *Hedge Funds: Should They Be Regulated?*, by Mark Jickling.

<sup>23</sup> For more information, see CRS Report RL33937, *The Financial Health of the Pension Benefit Guaranty Corporation (PBGC)*, by William Klunk.

committing their funds.<sup>24</sup> He believes that these characteristics will be embraced by hedge funds as they seek to attract pension funds dollars. “I think it is safe to say that as pensions continue to invest in hedge funds, the industry will further adjust and further impose upon itself a ... risk management strategy which should — at some level — mitigate risk.”<sup>25</sup> The President’s Working Group on Financial Markets, which was formed in 1999 in the aftermath of the LTCM failure, recently noted that “[i]n our market-based economy, market discipline of risk-taking is the rule and government regulation is the exception.”<sup>26</sup>

Senators Baucus and Grassley have expressed interest in learning whether hedge funds pose a threat to workers’ retirement security.<sup>27</sup> The Senators have asked the Government Accountability Office (GAO) to investigate the benefits and risks that hedge funds pose to pension funds and their participants.

ERISA does not currently require pension plan sponsors to report the number of hedge funds they use or the amount of money invested in them. Some say this information could enable policymakers to quantify the portion of pension assets that are being invested in hedge funds. It could, they say, also help distinguish pension funds whose hedge fund investments are concentrated in one or two funds versus those more diversified, that is, spread over a larger number of hedge funds.

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<sup>24</sup> *Wall Street Journal*, “Treasury Official Henry Addresses Federal Reserve Bank of Atlanta,” April 16, 2006.

<sup>25</sup> *Benefits Law Journal*, “State Pension Funds Are Hedging Their Bets,” Autumn 2006, p. 70.

<sup>26</sup> PWG Releases Agreement on Private Pools of Capital, at [[http://www.treasury.gov/press/releases/reports/hp272\\_principles.pdf](http://www.treasury.gov/press/releases/reports/hp272_principles.pdf)], February 2, 2007.

<sup>27</sup> U.S. Fed New Service, *Sens. Baucus, Grassley Question Hedge Fund Investments for American Workers’ Pension Plans*, March 1, 2007.