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ANOTHER PLAN SPONSOR PERSPECTIVE

Analyzing barriers to adopting alternatives for pension plan sponsors.

In my mind, as the administrator of a pension portfolio worth approximately $800 million, there are several issues with respect to alternative investments. The first issue, liquidity, I approach as a constraint; the other three—transparency, fee structure and sustainability of performance—could be concerns for plan sponsors considering adding alternative investments to their portfolio.

Liquidity—or lack thereof—in alternative investments is something that can be either good or bad, depending on your situation. Usually, illiquid assets are expected to generate higher returns as compensation for tying up capital for an extended period of time. The concern for some pension plans may be that pension plan objectives or strategies can change over time, to the point where illiquid assets may become a burden.

For smaller pension plans, an investment is usually structured as part of a fund where investors initially agree on an investment strategy (the investors should have similar objectives when capital is committed to the fund). However, as time passes and pension plan objectives diverge, it becomes difficult to keep each investor in the fund happy.

To summarize, pension plans must make sure that they consider the issue of liquidity before they commit capital to long-term and illiquid investment strategies. This liquidity issue may be more important for smaller corporate pension funds versus larger public pension funds.

A second issue with respect to alternative investments concerns transparency, which became more important due to the scandals that took place a few years ago in both the corporate world and in the hedge fund industry. Investors are reluctant to commit capital to a fund when the fund's strategy isn't clearly explained.

Also, as a plan sponsor, there is a need to understand and manage risk at the total plan level; however, it becomes difficult to do so if a pension plan can't understand the investment strategies of all their managers. Therefore, the plan sponsor must become comfortable with the activities of their alternative managers in order to adequately measure and analyze the performance and risk. This way, the plan sponsor will have the information to be able to evaluate the marginal contribution to risk—which could potentially be a reduction—of alternative managers to the total plan risk.

A third issue which comes up regularly is fees. As everyone knows, fees are indeed much higher for alternative investments than for traditional investment products, but the real question is: do you get your money's worth? If the answer is yes, then my guess is that pension plan sponsors can live with these higher fees. One additional question regarding the fee structure relates to the high-water mark concept. The alternative investment manager has an implicit series of calls on the net asset value of the fund. If public companies are required to account for options given to management as an expense, shouldn't pension plans take a similar provision for the value of the option given to their manager of alternative investments?

Finally, a quick comment on performance sustainability: history seems to show that performance over time tends to flatten for hedge funds. As the industry is growing rapidly, one can only wonder about the opportunities left in the markets and the expected returns for alternative investments in the future. This makes manager selection even more critical. ■

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