

## Are hedge funds right for you?

Pension fund sponsors do themselves a disservice by making uninformed decisions about the suitability—or lack thereof—of hedge funds.

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Are hedge funds an appropriate investment for pension funds? If more pension funds had allocations to hedge funds, would this make them more appropriate? David Swenson, chief investment officer at Yale University's endowment fund, has said "fund fiduciaries hope to retain power by avoiding controversy, pursuing only conventional investment ideas. By operating in the institutional mainstream of short horizon, uncontroversial opportunities, committee members and staff ensure unspectacular results, while missing potentially rewarding longer-term contrarian plays." Only in the last few years have more Canadian pension funds begun to consider the appropriateness of hedge funds. However, wealthy individuals and endowments/foundations have been utilizing hedge funds for quite some time.

Are hedge funds too risky for pension funds? Some may think so. Are hedge funds ticking time bombs, waiting for the next negative headline blow up? The many myths floating around about hedge funds are generally due to lack of knowledge. What we do know, however, is anyone considering a hedge fund allocation should follow a detailed, clearly documented process to assess their suitability.

Pension fund fiduciaries are increasingly required to be more knowledgeable of a wider array of investment strategies; neglecting or disregarding any potentially viable strategy for ambiguous reasons may be an imprudent move. Good governance requires fiduciaries to explore the possible use of all viable investment strategies to ensure the pension promise.

An examination of legislation, professional standards, and guidelines<sup>1</sup> shows that investing in hedge funds is not inherently imprudent. The prudent expert rule requires fiduciaries to diversify holdings and reduce the risk of large losses. Hedge funds in a portfolio context can reduce the risk of the total portfolio due to their low or negative correlation to traditional asset classes. And, potentially large losses can be reduced with hedge funds by diversification among hedge fund managers and strategies. The result is that fiduciaries should consider hedge funds within their portfolio's risk management and diversification framework to ultimately determine their appropriateness.

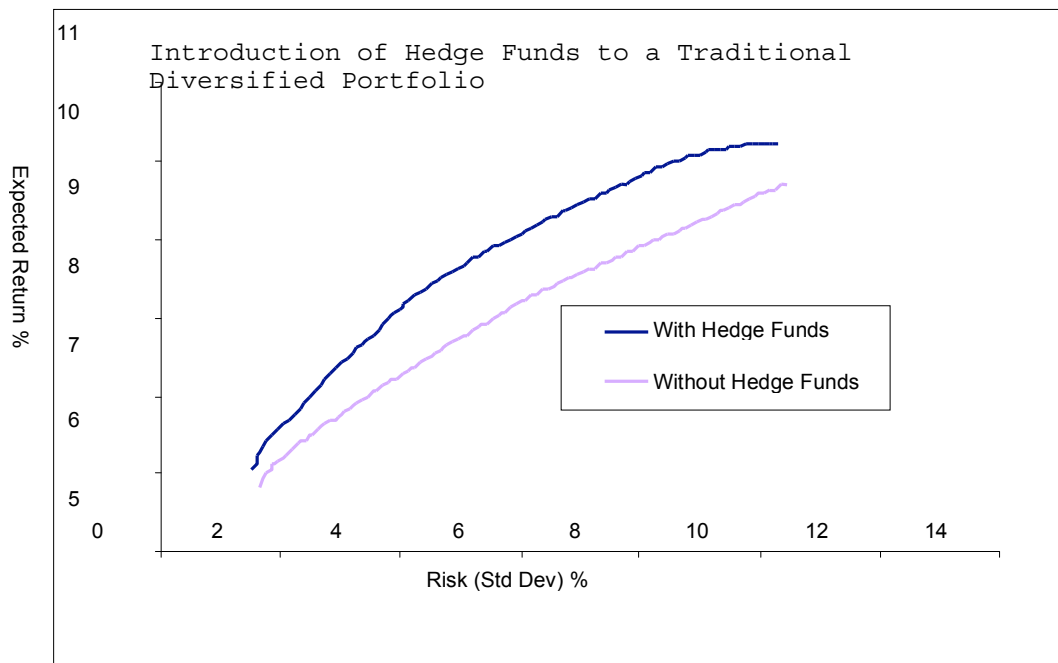
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<sup>1</sup> such as ERISA (the Employee Retirement Income Security Act in the U.S.) and the prudent expert rule it requires of its fiduciaries, the CFA Institute and its code of ethics, the Myners Report (a review of and recommendation for best practices for institutional investments in the UK), and the Pension Benefits Standards Act in Canada

## Why hedge funds?

In a quantitative sense, modern portfolio theory dictates that combining low or uncorrelated assets may result in better risk-adjusted returns. Hedge funds' historical attributes would shift the efficient frontier curve up and to the left (see Figure 1), suggesting that any addition of hedge funds to a traditional portfolio will improve its risk-return characteristics. While this makes intuitive sense, and many may even make an allocation to hedge funds based on these findings, others may conclude they are too risky due to other factors such as potential leverage exposure. What we will learn, however, is that there is much more to be considered.

Figure 1



Below we have listed specific reasons provided by pension funds explaining why they have made allocations to hedge funds, or are considering an allocation to hedge funds. Note that this list is not exhaustive:

- Historically, hedge funds have been used to protect against bear markets and reduce risk of the total portfolio due to significant market volatility, for instance in the equity market during the 2000-2002 period.
- Capital markets have become more correlated as globalization progresses, and investors are seeking better ways of diversifying their portfolios other than by geography.
- Investors are looking for ways to increase returns in a low-interest rate environment.
- Many pension funds are questioning whether a traditional investment in equities and/or fixed income can provide necessary returns for funding the pension fund over the long run.

- Hedge funds can be considered leading edge strategies, providing access to highly specialized and motivated talent.

### **Why *not* hedge funds?**

*“No, we don’t (currently invest in hedge funds)—it is completely obvious that hedge funds don’t work. We are not a casino.”*

- CIO, anonymous

Are casinos really risky? Probably less so if you’re the owner. Similarly, are hedge funds risky? We can safely say that hedge funds are heterogeneous, or different in many ways, making them difficult to understand. Their associated terminology can be frightening: default swaps, convertible arbitrage, distressed securities, and the list goes on.

The following is a list of some specific reasons why pension funds have dismissed hedge funds due diligence; again, this is not an exhaustive list:

- The process is time-consuming, however it must be done in order to do it right.
- A small “trial” allocation demands a disproportionate amount of time and costs for selecting and monitoring, and will only have a minimal impact on risks and returns even if returns are positive as expected.
- If the results are not good, you have headline risk.
- The results are widely dispersed, making the manager selection process paramount.
- Fees are high on an absolute basis when compared to traditional asset classes.
- Mismatch risk versus liabilities.
- Lack of liquidity.
- Use of leverage.
- Limited transparency by managers.

### **A three-step determination process**

Although doing nothing in the current low return environment is not an option, neither is making matters worse by rushing into a hedge fund allocation. The following is a sample three-step process that will help ensure good governance practices are followed during the decision process:

#### ***Step 1 – Determination as it relates to your objectives and constraints***

This forces you to understand the pension fund as it relates to hedge funds. Does your atypical pension fund have a typical asset allocation? Can your mismatch between assets and liabilities be improved? Your asset allocation strategy will dictate whether or not hedge funds are ultimately useful. At the heart of it is the question, ‘What is the desired role of hedge funds – to provide diversification, to better match the pension fund’s liabilities, or increase returns?’

Before you can answer the question, however, you must understand your pension fund’s objectives. Most pension funds would probably start with the financial objectives and constraints. In considering the pension fund’s financial objectives, one should also look at the impact an underfunded position can have on the corporate balance sheet or

beneficiaries' benefit payment. A small underfunded position in a large pension fund can have a major impact on the financial position of a company that is in a low-margin business. Indeed, a poor result can bankrupt the company. Similarly, an underfunded position in a multi-employer pension fund could force Trustees to reduce pension benefits.

Historically, we have seen pension accounting investment return assumptions in the range of 8% to 10%; today, we are probably closer to 6% (due to the high allocation to fixed income securities with a current yield of 5%). Is it wise to continue to assume an accounting return assumption of 8% with only traditional investments? Figure 2 offers an example of a simple asset mix comparison using expected returns for each asset class drawn from Aon's survey of investment manager forecasts and volatility and correlation characteristics based on history.

*Figure 2*

<b>10 Year Horizon Analysis</b>	<b>Current Portfolio</b>	<b>Sample Portfolio</b>
<i>Asset Classes</i>		
Money Market	4%	2.0%
Universe Bonds (Mid-Term)	36%	36.0%
Canadian Equities	34%	32.0%
Global Equities	26%	18.0%
Hedge Fund	0%	10.0%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>

<b>Portfolio Statistics</b>	<b>Current Portfolio</b>	<b>Sample Portfolio</b>
<i>(10 year time horizon)</i>		
Expected Nominal Return (%)	7.0%	7.5%
Std Deviation of Nominal Return (%)	9.5%	8.5%
Probability (Return < 0.00%)	1.0%	0.5%
Probability (Return < 7.50%)	38.0%	45.0%
Probability (Return < 8.00%)	32.0%	35.0%
Probability (Return < 8.50%)	26.0%	30.0%
Probability (Return < 9.00%)	20.0%	25.0%
Probability (Return < 9.50%)	16.0%	20.0%
Probability (Return < 10.00%)	12.0%	18.0%

In this particular case we ask just one of potentially many important financial questions: can you continue to justify an 8% expected return assumption? The current portfolio has an allocation to traditional asset classes only, while the sample portfolio has a 10% allocation to hedge funds, taken mostly from the equity allocation. (If the allocation came

completely from bonds, the results of adding hedge funds would probably be more compelling.). If we look at the bottom chart, the current portfolio would provide you with a 32% probability of meeting the 8% objective; the sample portfolio probability is slightly higher at 35%. This chart illustrates that, for many pension fund sponsors with traditional asset mixes, a return expectation of 8% may be too high. However, an allocation to hedge funds is expected to get the pension fund closer to the 8% level, with less volatility.

The expected return assumption is just one of many tests that can help determine hedge fund suitability; another may be to minimize the expected present value of required pension fund contributions. This would require a more detailed asset-liability study. What are the risks? Refer again to the current portfolio versus the sample portfolio with an allocation to hedge funds as outlined above: what happens to contributions in the worst 20% of scenarios? You might find that your current portfolio is too risky right now, an unfortunate fact that many may already know given the poor equity market results in 2000-2002. Can your pension fund really make do with its current asset mix under similar equity market conditions?

Only after considering the financial probabilities and understanding the pension fund's objectives and risk constraints can any allocation to hedge funds be considered.

### ***Step 2 – Education***

Education requires a commitment by all decision makers in order to make an appropriate decision. Decision makers don't need to know the ins and outs, however: they need to know enough to make an informed decision regarding an allocation to hedge funds. Education is a long process, and should be done in stages. Remember to keep the terminology simple and consider finding a knowledgeable resource early in the process.

So what does the board need to know? For starters, they need to know what hedge funds are. Remember to keep it simple: a lack of understanding due to highly technical terminology will more often than not result in a poor decision. If, in Step 1, you determine that hedge funds might be appropriate, then be sure to provide a compelling reason why—the same goes for making a determination that they're not appropriate. Remember to clearly articulate the objective of a hedge fund allocation as it relates to the pension fund; for instance, they should provide for higher risk-adjusted returns. Ensure that the key decision makers buy into it. And finally, ask the question: what can go wrong?

### ***Step 3 – Document***

This step is very important, whether or not you make an allocation to hedge funds. If hedge funds are not appropriate, the pension fund sponsor should document and minute the decision, and provide reasons. If hedge funds are deemed appropriate, implementation is the next phase, and the next article.

What are other pension funds doing? An Aon Consulting survey of the 50 largest pension funds in Canada (smaller pension funds have limited access to hedge funds), shows that

approximately 20% of these pension funds are invested in hedge funds. Further, of the pension funds that have allocations to hedge funds, the medium allocation is approximately 8%, with a high of 12% and a low of 2%.

### **Final thoughts**

It's easy to be discouraged by weighing all the factors in determining hedge fund suitability, but remember: sticking with the status quo is a decision in and of itself. What's worse, in most cases it's a decision made without any due process whatsoever. At the very minimum, pension funds should examine the potential contribution—and pitfalls—of hedge funds relative to their situation, thoroughly documenting the whys and why nots along the way.

The thorough three-step process to determine the appropriateness of hedge funds outlined above will go a long way toward ensuring that pension fund fiduciaries are practicing good pension fund governance, and leaving no stone unturned in the quest for a more efficient and higher-returning pension portfolio.