Attracting pension plan assets
What alternative investment managers need to know

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At a glance

Retirement plan sponsors are continuing to give alternative investments, including hedge funds and private equity funds, a closer look.

They continue to be attracted by the lower historical volatility, higher absolute and risk-adjusted returns and varied correlations these funds can offer relative to traditional investment advisor portfolios.

While plan sponsors continue to be attracted to the performance characteristics of alternative investments, they also are seeking increased levels of information on their operational complexities in order to address the total risk (investment and operational) funds pose to pension assets.

Alternative investments must recognize the holistic nature of additional information data requests. This allows managers flexibility in promptly and effectively satisfying increased transparency requirements of institutional investors.

Here is a look towards ways to increase institutional investor trust and ultimately satisfy as well as attract plan sponsors.
Retirement plan sponsors are taking a closer look at hedge fund and private equity fund investing.

Retirement plan sponsors searching for higher potential performance without comparably higher potential risk are looking more closely at alternative investments, including hedge funds and private equity funds as another investment option. These investments have historically displayed lower levels of volatility higher absolute and risk-adjusted returns and varied correlations compared to traditional markets as seen in the table below. While other investment and operational factors may increase the risks these vehicles pose to an institutional portfolio, based solely upon the statistics listed below, hedge and private equity funds may be a valuable addition to traditional institutional investment portfolios.

<table>
<thead>
<tr>
<th>Performance Statistics</th>
<th>S&amp;P 500 Total Return Index</th>
<th>Barclays Aggregate Bond Index</th>
<th>Cambridge Associates LLC US Private Equity Index</th>
<th>HFRI Fund Weighted Composite Index</th>
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</thead>
<tbody>
<tr>
<td>Annualized Return</td>
<td>9.6%</td>
<td>6.6%</td>
<td>14.3%</td>
<td>11.9%</td>
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<tr>
<td>Standard Deviation</td>
<td>16.5%</td>
<td>4.1%</td>
<td>10.4%</td>
<td>8.7%</td>
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<tr>
<td>Downside Deviation</td>
<td>11.8%</td>
<td>1.5%</td>
<td>8.3%</td>
<td>6.0%</td>
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<tr>
<td>Maximum Drawdown</td>
<td>-45.8%</td>
<td>-3.9%</td>
<td>26.2%</td>
<td>-19.0%</td>
</tr>
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Source: Pertrac. Quarterly data, Q1 1990 through Q4 2010

Alternative investments already are becoming a larger part of the portfolios of many plan sponsors. According to a March 2011 Preqin survey, pension fund investment in hedge funds has been increasing in recent years.1 By the beginning of 2011, public pension plans that invest in hedge funds had grown this allocation to 6.6 percent of assets, up from 3.6 percent at the end of 2007.

A survey by Russell Investments found that institutional investors are likely to increase their allocation to alternative investments from 14 percent of assets in 2010 to 19 percent by 2013. The 14 percent allocation in 2010 included a 4.3 percent allocation to private equity, 4.2 percent to hedge funds, and 4 percent to real estate, in addition to growing investments in areas such as infrastructure and commodities.2

Although plan sponsors increasingly recognize the potential benefits of increasing their allocation to hedge funds, private equity funds and similar investments, they also have concerns about these products. If alternative investment products are going to be able to attract and retain pension assets in even greater numbers, the managers of these funds must address investor concerns. One way managers can do so is by reviewing their own operational readiness for greater regulator and investor scrutiny.

2 http://www.russell.com/Institutional/research_commentary/alternative_investments_survey.asp
How to address due diligence concerns

Despite the many benefits of alternative products, there are a number of risks unique to investing in them that raise concerns among pension plan sponsors. Here are some common concerns, and ways in which alternative investment managers can seek to address each one.

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<th>Concern and what plan sponsors are thinking</th>
<th>What investment managers can do</th>
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<tr>
<td><strong>Market risks</strong></td>
<td>• Determine if the fund’s portfolio risk management systems and hedging techniques can detect and mitigate portfolio risks. Additionally, assess whether investor due diligence efforts can verify that such controls are in place.</td>
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<tr>
<td>Alternative investments involve varying degrees of market risk including equity, interest rate, foreign exchange and commodity risks. These risks can be exacerbated by the use of leverage.</td>
<td>• Highlight how a fund can provide desirable portfolio diversification in order to help mitigate the market risks of alternative fund investing.</td>
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<tr>
<td><strong>Illiquidity</strong></td>
<td>• After an initial lock-up period, offer investors monthly or quarterly redemption rights.</td>
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<tr>
<td>Fund managers sometimes invest in exotic instruments or other less-liquid investments, reducing the possibility of a quick exit for investors. This illiquidity can be especially troublesome if multiple investors try to exit a hedge fund simultaneously, forcing the fund manager to unwind multiple positions to meet requests. In private equity funds, the lock-up period may be far longer, possibly between five and ten years.</td>
<td>• Consider offering investors a managed account or a fund-of-one structure that provides improved liquidity and/or direct control of the underlying portfolio investments.</td>
</tr>
<tr>
<td></td>
<td>• Suggest to prospective private equity investors that a diversification of funds or a stacking strategy can help mitigate the liquidity risk associated with extended lock-up periods.</td>
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## Valuation

Certain hedge fund strategies involve investments in less-liquid hard to value instruments such as distressed debt, direct loans, private equity or complex financial derivatives.

- Determine if the fund has rigorous valuation practices and methodologies in place, including ASC 820 and back testing for level 3 securities, and explain them to plan sponsors. If possible, these policies should be adopted and regularly reviewed by an independent oversight governance board.

- Provide documented valuation procedures, signed approvals and, if possible, independent, third-party verification of investment values.

  This verification may be provided via auditing reports such as an AT201 report (or more commonly known as an Agreed Upon Procedures report). Additionally, an AT 101 report may also be pursued. This report provides asset managers and independent auditors with greater flexibility with respect to the scope of work, as the report targets specific areas for independent verification, providing comfort on areas of investor interest, such as internal controls related to valuation and pricing, risk management, etc.

- Explain to investors how hedge funds assist in price discovery for securities, particularly in newly developing financial markets or complex investment instruments where price transparency can be challenging. Highlight and demonstrate consistent application of approved policy.
### Operational Complexities

The operational complexities associated with executing many hedge fund strategies often times include risks related to back-office systems and controls, appropriate segregation of duties amongst personnel, execution accountability, legal review, regulatory readiness, as well as a number of other factors.

In particular, operational risks are at their greatest when inadequate internal control environments exist. One such example is when the day-to-day operations are overseen by the same personnel who manage the portfolio, indicating a lack of effective segregation of duties between front- and back-office personnel. Additionally, these risks are exacerbated when the internal control environment is inadequate to mitigate the inherent risks in portfolio pricing and securities valuation.

- Explain any operational complexities associated with the fund and detail the best practices followed in managing them.
- Determine if the key controls to identify and resolve any operating issues are in place, are operating effectively and are transparent to existing and prospective investors.
- To understand the effectiveness of existing internal controls, consider having an independent third party provider perform an operational readiness assessment, identifying weakness in the internal control environment prior to an investor operational due diligence review. This allows for a timely and disciplined approach to fix any deficiencies; particularly, before investors develop any negative perceptions over the operational infrastructure and risks posed by the fund to investor capital.

Subsequently, provide evidence that internal controls have been reviewed for design and operating effectiveness at least annually, communicating such evidence through an independent auditor’s report on internal controls, such as an AT 101 report.

As mentioned in the Valuation section above, an AT 101 report is similar in construct to a SSAE 16 (formerly SAS 70) report. Consider an independent report validating certain key sections of the due diligence questionnaire (DDQ) provided to investors.

- Consider the use of third party administrators and other service providers to provide middle and back office functions and eliminate any potential/perceived conflicts of interest.
- Evaluate and leverage the use of technology across the organization to help understand and monitor financial and operation risk across the business value chain.
- As managers prepare for regulatory reviews, they should assess the consistency and standardization of communication provided to investors.

As such, consider having an independent review of documentation and presentations provided to investors, focusing on consistency of themes and identification of control issues with recommendations for process improvements where applicable.
Concern and what plan sponsors are thinking

What investment managers can do

**Regulatory Obligations**

Many hedge and private equity funds are not registered under the Investment Company Act of 1940 and lack the protections associated with mutual funds.

- Communicate with plan sponsors the oversight and controls to which the fund is subject, such as ERISA and DOL regulations, including the ERISA fiduciary provisions and prohibited transaction restrictions.
- If required, comply fully with Dodd-Frank’s requirement to register with the SEC and file required documents in a timely manner. Be fully transparent on Form ADV which provides detailed information about the adviser’s operations and investment activities.
- Establish a plan for compliance with FATCA and Form PF, and test firm capabilities to adhere to the new standards prior to their implementation.
- Establish a compliance program with written policies and procedures, develop an effective surveillance and testing program and appoint a Chief Compliance Officer (CCO).
- Even if exempt from SEC registration, uphold any record-keeping and reporting obligations which are still subject to SEC review.

**Strategy risk**

Active portfolio management can lead to deviations from the stated strategy. This style drift creates investment planning and risk control issues for investors, such as using a mismatched benchmark and higher tracking error.

Other concerns include the manager straying from his area of expertise and lower diversification of a pension plan’s overall portfolio if the implemented strategy is more closely correlated than expected with other assets in the portfolio.

- Increase use of technology to focus on the monitoring of transactions to proactively identify instances where style drift may occur and provide fund management greater transparency into investment decision making practices.
- Show plan sponsors that they can identify possible style drift by performing a benchmarking analysis of a fund’s returns. The fund should have more positive and less negative returns than its benchmark, and the tracking error of the fund’s returns compared to the benchmark’s returns should be low. Exceptions can indicate possible style drift so be prepared to provide adequate explanation of anomalies.

**Counterparty risk**

Although hedging strategies seek to reduce the risk of losses associated with downward price movements, there still are residual inherent risks present in a portfolio such as counterparty risk.

For instance, in any transaction in which one party is reliant on another to complete the transaction, the investor is exposed to counterparty risk. This is an issue for hedge funds and private equity funds due to, in part, their use of leverage and/or over-the-counter (OTC) trading transactions.

- Implement effective risk controls, including position limits or counterparty credit limits along with reporting mechanisms to track these risks.
- Explain the review and oversight of existing Prime Brokerage relationships and the demand and reasons for a multi-prime environment.
- Show plan sponsors how they can assess a fund’s use of leverage historically, currently and on a going-forward basis. Obtaining this information allows a plan sponsor to get a better idea of the fund’s efforts in controlling counterparty risk as well as the impact the risk could have if not properly managed/mitigated.
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**Sub-advisor risk**

Investors have experienced tremendous market volatility, fraudulent investment schemes and increased regulatory scrutiny. As a result, they seek more transparency from their investment managers.

- Adopt a due diligence program with well-documented oversight, coupled with a periodic risk assessment that identifies and prioritizes emerging trends and risks in sub-advisory relationships. The program should allow for modifications to the identified risk areas.

**Vendor selection**

The stability of third-party vendors in providing middle- and back-office services is increasingly critical, since these vendors frequently are instrumental to a manager’s operations.

- Develop documented and transparent processes and procedures that establish mechanisms to evaluate service providers, given a manager’s specific needs.
- Review and determine the existence of operational risk assessments conducted by third-party service providers upon their own control environments.
- Validate sub-vendor relationships, including those in overseas markets, to determine the risk of fiduciary infractions.
- Ongoing monitoring of establish Service Level Agreements (SLA’s) with service providers to ensure that they are performing at the agreed upon and intended levels.
What this means for asset managers

The growing popularity of hedge funds, private equity funds and other alternative investments among pension plan sponsors makes this an opportune time for the managers of these funds to ramp up their marketing efforts to this key investor base.

Addressing the key issues identified in this white paper, providing relevance on the mitigation of investment as well as operational risk factors can help investment managers make the most of this opportunity. Managers of alternative asset funds should ask themselves:

- Has my firm documented its critical business processes in one place and clearly identified the risks inherent in its business?
- Does my firm have an enterprise governance, risk and control framework that can be leveraged in helping to manage critical business risks?
- Has my firm evaluated and tested the design and operating effectiveness of its controls?
- Has my firm considered independent operational risk assessments or mock operational due diligence services to best identify and assess control weaknesses prior to engaging in an investor’s operational due diligence review?
- Has my firm considered the use of an independent third party AT 101 report in targeting areas of investor interest and the effectiveness of internal controls within those areas?
- Does my firm continually monitor the effectiveness of its operating environment?
- Does my firm effectively document the result of its control activities to enable review and/or audit?
- Has my firm completed a risk assessment of its key business processes and supporting technology?
- Is my firm as ready for scrutiny by institutionally-oriented investor reviews as it for regulatory reviews?

If investment managers have the proper capabilities in place and can help plan sponsors resolve the concerns they may have about investing in alternative funds, then the funds will be well positioned to benefit from enhanced asset flows and new mandates.

PwC, which provides services to many of the world’s leading hedge funds and private equity firms, is well-positioned to help alternative asset managers in these efforts. PwC can provide clients with insights and perspectives on industry issues and leading practices, evaluate their current practices and operations and enable them to successfully undergo due diligence efforts in ways that may better position themselves competitively via our independent perspectives and broad expertise in process improvement.