Protecting Pension Plans'

Could Hedge Funds Play a Role?

by | **Joe Marenda**

Hedge funds may help pension plans protect their funded status in the event of a recession or stock market correction, but trustees should proceed with forethought when considering these differentiated but complex investments.

Hard-Won Gains:

Since the financial crisis, pension plans across the country have fought a long battle to improve their funded status. Many have. Some are well on their way to a derisking path. Regardless of funded status, however, with U.S. equity markets at all-time highs due to the longest bull market in U.S. history, plans should be seeking ways to protect their funded status from an inevitable recession or market correction. The difficulty facing trustees is how to do so while still benefiting from today's favorable economy—and without increasing their plan's risk profile.

If implemented effectively, a hedge fund allocation can play a valuable, additive role in addressing this challenge. Hedge funds have provided attractive long-term returns that have lower volatility than, and lower correlation to, equities. These attributes have made hedge funds useful regardless of plan type or status, provided that (1) the hedge fund allocation was sized appropriately and (2) the strategies and specific hedge funds were selected carefully to achieve the desired benefit. The hedge fund allocation should complement, and must be considered in the context of, the total portfolio and its objectives.

Understanding hedge funds and their role in a plan's investment strategy is critical before implementing an allocation. Trustees should consider issues such as high fees, transparency, illiquidity and sources of return that accompany many hedge funds.

Hedge Funds: An Overview

The term *hedge fund* describes a legal structure and little else today. Indeed, the hedge fund universe includes a huge number of strategies, the widest of any traditionally defined asset class. For example, purely equity-focused strategies, whether investing in the United States or any geographic area, are called *long/short funds. Event-driven funds* invest only in companies that are going through some sort of corporate "event" such as a merger transaction or asset sales. Some funds, including *global macro* or *systematic trend,* pursue strategies that invest in the foreign exchange markets, commodities, sovereign bonds, equity indexes, or derivatives and futures in countries around the world. *Distressed funds* invest primarily in the bonds or equities of companies in financial distress or that have filed for bankruptcy. Other funds combine several or even all of these strategies into a single entity. These examples are just a few of the myriad investment strategies commonly labeled as a hedge fund.

Combining funds that pursue different strategies into a well-planned hedge fund allocation should reduce total portfolio volatility because hedge funds typically have lower volatility than equities. The plan also should gain exposure to investments and strategies that its other investments miss, thus gaining greater investment diversification for the total portfolio. As a result of the lower volatility, broader investment strategy and increased diversification, the plan should experience smoother total portfolio returns over time.

The fluid nature of some hedge fund strategies and their ability to actively manage exposures and to opportunistically shift positioning toward less exploited areas also can help protect portfolios and, potentially, achieve returns unavailable through other investment strategies.

The Pension Plan Dilemma—A Role for Hedge Funds?

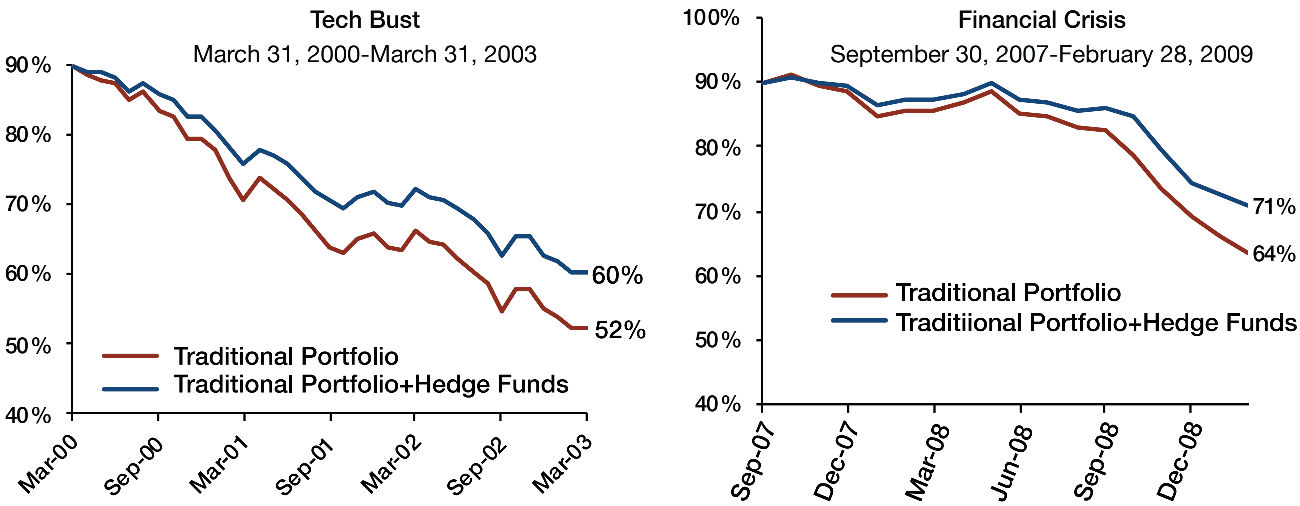
Over the last decade, the global financial crisis, market volatility, changes in the discount rate and mortality assumptions have played havoc with funded status for many defined benefit plans, including multiemployer, single employer and public employer plans. This funded status volatility has placed an added strain on corporate financial statements and on municipalities and states, making the jobs of plan trustees much more difficult.

Regardless of funded status, plans with high equity allocations are particularly sensitive to any decline (also called a *drawdown*) in the equity markets. While the definition of an equity market correction is a decline of 20% or more from the market's peak, a decline of even 10% can be very damaging to a plan and erase years of hard work. Since 2001, there have

FIGURE 1

Adding Hedge Funds Has Helped Preserve Funded Status in Stock Market Crises

Assumed Initial Funded Status of 90%



Sources: Bloomberg L.P., Barclays, Cambridge Associates LLC, MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties. Please see figure notes and the performance disclosure at the end of the publication for information about the composite.

been 12 market drawdowns where the MSCI All Country World Index lost at least 8% in a single month, although it has been an astonishing six years since the last drawdown of this magnitude.

The dilemma for most plans is how to achieve their funded status goals in a way that marries their need for excess return with their limited risk tolerance.

A carefully selected group of hedge funds could help plans generate excess returns while significantly reducing volatility relative to traditional growth assets such as long-only equities, which often dominate pension plan growth portfolios.

Controlling equity market exposure is especially important for pension plans because stock market declines often coincide with periods of decreased economic activity and financial stress, making it difficult for plan trustees to make contributions in these conditions. For corporate plans, this pain is further compounded in tough economic times because interest rates typically fall, which causes plan liabilities to rise, creating "perfect storms." Today, U.S. equity indexes are at all-time highs, and the Federal Reserve has raised interest rates and intends to continue doing so. Protecting against another perfect storm is critical for plan fiduciaries.

Increasing bond exposure at the expense of equities is one way to reduce total portfolio drawdown risk, but bonds are richly valued today and are unlikely to deliver significant value (or may even decrease in value) with rising interest rates. On the other hand, a carefully selected group of hedge funds could reduce downside risk and have an opportunity to deliver excess returns, even while interest rates and equity markets continue to rise.

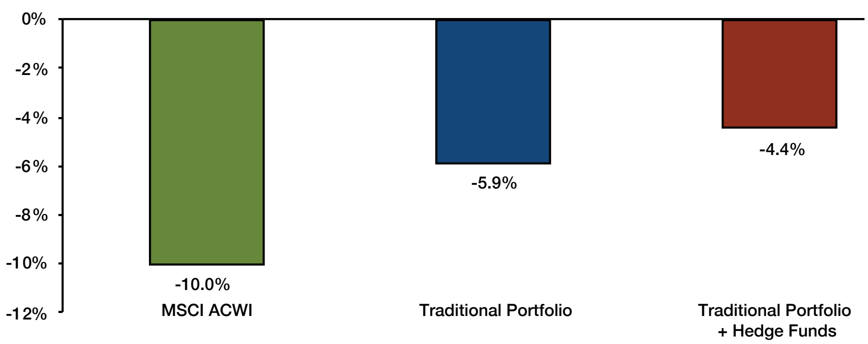
Figure 1 shows how adding hedge funds to a traditional *60/40 portfolio* (60% global equities and 40% long-duration bonds) would have reduced a plan's funded status drawdown during the 2000-03 tech bust and the 2007-09 global financial crisis. A plan with $1 billion in assets and $1.11 billion in liabilities (90% funded) would have lost $124 million less in assets during the tech bust and $75 million less during the global financial crisis, which significantly decreases the size of required shortfall contributions from the trustees. While these particular illustrations are for a corporate plan, the lessons could apply to other plan types as well.

Taking another perspective, Figure 2 shows a hypothetical 10% equity market correction based on August 31, 2018 market values. Under this scenario, the traditional portfolio falls by 5.9%, while the portfolio with a 20% hedge fund allocation falls by 4.4%. The smaller loss in the portfolio incorporating hedge funds improves the plan's funded status relative to the traditional 60/40 portfo-

FIGURE 2

Hedge Funds Could Help Preserve a Plan's Assets in a 10% Market Decline

Based on Market Values as of August 31, 2018



Sources: Bloomberg L.P., Barclays, Cambridge Associates LLC, MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties. Please see figure notes and the performance disclosure at the end of the publication for information about the composite.

lio at a time when the trustee is unlikely to want to contribute additional funds.

The ability of hedge funds to reduce a portfolio's downside in market corrections is attractive based on the experience of investors during the early 2000s tech correction and the global financial crisis. In the five-year period following each crisis, a traditional 60/40 portfolio still would have generated less cumulative wealth five years after the crisis than would a portfolio with hedge funds. Assuming a $100 million portfolio, in the case of the early 2000s tech bust, the difference in value would have been $11 million, and in the case of the global financial crisis, the difference in value would have been $4 million, even five years after the event, as detailed in the table on page 35.

By losing less during bear markets such as the global financial crisis, hedge funds can help a plan preserve capital, and long-term returns subsequently benefit from a higher base upon which to grow. Historically, some hedge funds have produced much smaller declines than long-only equities and recovered to prior peak value more rapidly after any losses. This can be seen from the reduction in losses suffered by portfolios using hedge funds, compared with a simple 60/40 portfolio in Figure 1, Figure 2 and the table. This desirable outcome is primarily due to two reasons. First, because they lost less, they needed to recover less. Second, they have greater flexibility to increase their investment level when valuations are cheaper because they can invest more than 100% of their total assets if the market opportunity is attractive enough, which is something that a traditional long-only equity or bond fund cannot do.

Hedge Fund Challenges

Manager and Strategy Selection

We believe that only about 5% of the approximately 8,000 hedge funds available worldwide merit a plan's consideration. As a result of our views, the "average" hedge fund is unattractive. If plans are going to receive only the returns of the average hedge fund, they should not make the investment in the first place. The key is to identify and invest in a select group of managers that generates significant net-of-fee returns in excess of relevant benchmarks, in which case, paying the higher fees may be merited.

The difference between the best performing managers and the average fund is significant. Based on our research, the universe of hedge funds has the greatest dispersion of returns as compared with core bonds, U.S. large cap equity, U.S. small cap equity, global ex-U.S. equity and emerging markets equity managers. The difference between the best hedge funds and worst hedge funds over a 15-year period ending March 31, 2018 is at least twice as wide as any of these other investment strategies. The return differential is more than 10% for hedge funds, while emerging markets and U.S. large cap tie for only 4.6%. Such wide dispersion means investors are well-rewarded for investing with the better hedge funds.

Choosing which strategies to include in a portfolio at any point in time is just as important as choosing the right individual funds. Hedge fund allocations, and the managers and strategies within them, are never static and should reflect where the best opportunities lie in the economic and stock market cycles.

Fees

Investors are right to be concerned about fees since hedge funds in aggregate charge high fees and generate very little additional value. Since the global financial crisis, hedge fund fees have been under the microscope, and many funds have reduced their management fee, incentive fee or both. Some funds have added a hurdle, which they must beat to take any incentive fee. Others have proposed fee structures that allow investors to choose a flat management fee or a high incentive fee.

Many hedge funds offer "high watermarks," which generally require the fund to return to an investor's previous peak value before it can begin charging incentive fees. Thus, the recovery period from a fund's low to the prior peak value has no incentive fees. But the investor must remain invested in the fund to achieve the benefit. Giving up a high watermark in an existing fund to invest in a new fund without a high watermark can be expensive if the original fund subsequently turns its performance around. *Churning* a hedge fund portfolio by trustees chasing returns can destroy long-term value.

TABLE

Comparing the Impact of Hedge Funds on Portfolio Performance Following Two Crises

Tech Bust

	Traditional Portfolio	Traditional Portfolio + Hedge Funds	Difference
Starting Value 3/31/2000	$100	$100	—
Market Bottom 9/30/2002	$78	$90	+$12
Year 1 9/30/2003	$93	$105	+$12
Year 2 9/30/2004	$105	$116	+$11
Year 3 9/30/2005	$121	$132	+$11
Year 4 9/30/2006	$133	$144	+$11
Year 5 9/30/2007	$153	$164	+$11

Global Financial Crisis

	Traditional Portfolio	Traditional Portfolio + Hedge Funds	Difference
Starting Value 9/30/2007	$100	$100	—
Market Bottom 2/28/2009	$65	$73	+$8
Year 1 2/28/2010	$90	$96	+$6
Year 2 2/28/2011	$106	$110	+$4
Year 3 2/29/2012	$115	$120	+$5
Year 4 2/28/2013	$124	$129	+$5
Year 5 2/28/2014	$137	$141	+$4

Sources: Barclays, Cambridge Associates LLC, MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties. Please see figure notes and the performance disclosure at the end of the publication for information about the composite.

Liquidity: Many Aspects to Consider

Hedge funds generally provide fewer opportunities to redeem than a long-only equity fund but are typically more liquid than a traditional private equity fund. A well-constructed hedge fund portfolio should have staggered opportunities to exit or redeem investments to allow portfolio rebalancing without compromising total portfolio liquidity.

Some strategies require longer *lockups* (periods during which the investment cannot be exited or redeemed) to be successful. These strategies can be undermined if capital is redeemed at the wrong time. Trustees should make sure that they are comfortable with a fund's lockup periods before investing.

Trustees also should question funds that offer limited liquidity when the underlying assets are liquid. The opposite is especially true; if a fund invests in securities that trade infrequently, offering investors quarterly liquidity can be disastrous if too many investors redeem at the same time. Avoiding mismatches between a fund's liquidity terms and the liquidity of the fund's investments is paramount.

Similar to fees, hedge fund liquidity terms have come under scrutiny and evolved over time. After the 2008 global financial crisis, many hedge funds stopped investing in private companies entirely, if they ever did. Of those funds investing in illiquid securities, many allow investors to "opt out" of *illiquid side pockets* and avoid these investments altogether.

Transparency

The less transparent approach adopted by some hedge funds can be a source of frustration. Adequate disclosure is necessary to evaluate whether a manager is truly skilled and what risks the fund is taking. Fortunately for investors, transparency has improved over the past decade as a result of regulation and increasing investor demands. Developing strong long-term manager relationships, particularly

takeaways

- Hedge funds may provide attractive long-term returns that have lower volatility than, and lower correlation to, equities. They may be attractive to plans looking for a strategy to protect their funded status in the event of a recession or stock market correction.
- Sizing of the hedge fund allocation, strategy selection and manager selection are critical to long-term success.
- Effective manager selection is crucial to a successful hedge fund allocation because the difference between the best performing managers and the average fund is significant.
- Challenges include high fees, lack of transparency, illiquidity, use of leverage, market beta and alpha source.
- To implement a hedge fund strategy, pension funds may choose to hire skilled staff, partner with an experienced hedge fund advisor or hire a fund-of-funds manager.

through face-to-face meetings, also can help experienced investors and advisors fill any information gaps.

Sources of Return: Leverage, Beta and Alpha

Trustees should not miss the opportunity to understand how a fund makes money for its investors. Is it alpha, leverage or beta? *Alpha* (the excess return of an investment relative to the return of a benchmark index) is rare and has high fees associated with it due to its scarcity. Many hedge fund strategies use *leverage* (borrowed capital), which influences returns. Another source of returns is *market beta,* which indicates the degree to which the manager's returns are very similar to the broader market's returns (hedge funds exhibit a wide range of market beta from low beta to high beta). High leverage or high beta should not warrant the same fees and illiquidity as returns sourced from *alpha*.

Conclusion

For trustees exploring the use of hedge funds, the ability to extract maximum value from hedge funds depends on taking one of three paths. Trustees can (1) hire experienced and skilled staff; (2) partner with an experienced, well-resourced hedge fund advisor with a history of identifying and accessing best-in-class managers and of building portfolios that complement the rest of the client's portfolio; or (3) hire a fund-of-funds (FOF) manager, which packages a portfolio of hedge funds into an investment product. A FOF simplifies administration since it is only one line item and one decision for the trustees. But the portfolio chosen by the FOF to have broad appeal to many different investors may not suit the unique needs of the plan and carries with it an added layer of fees and limited liquidity. When embarking on a hedge fund program, choosing which path to take may be the most critical decision.

In today's markets, where many traditional assets are overvalued and U.S. equities are at all-time highs, hedge funds' usefulness in achieving a plan's long-term risk-and-return goals can be substantial. However, successfully implementing a hedge fund allocation is challenging. Significant variations in performance among managers in the same strategies and differences across strategies make manager selection, and customized portfolio construction, essential.

Before investing, trustees must consider important issues such as fees, liquidity, transparency, leverage and beta when selecting individual managers. Building a diversified and differentiated portfolio of strategies and managers that complement the rest of a plan's portfolio also can be challenging. These hurdles notwithstanding, an allocation to the right hedge fund managers can play a powerful role in enhancing a plan's risk-adjusted returns.

Figure Notes

The Traditional Portfolio is made up of 60% MSCI All Country World Index (Net) and 40% Bloomberg Barclays Long-Term Government/Credit Index. The Traditional + HF Portfolio is made up of 40% MSCI All Country World Index (Net), 20% CA Nondiscretionary Portfolio Management Hedge Fund Composite, and 40% Bloomberg Barclays Long-Term Government/Credit Index. All portfolios are rebalanced monthly and do not include any contributions or benefit payments. The Bloomberg Barclays US Long Credit return is used as a proxy for the change in liability. MSCI ACWI returns use returns gross of dividend taxes prior to February 28, 2001 and returns net of dividend taxes thereafter. Returns are in US$ terms.

Performance Disclosure

The CA Nondiscretionary Portfolio Management Hedge Fund Composite includes 396 hedge fund program returns for the Cambridge Associate Group's hedge fund clients who receive(d) hedge fund performance reports as of March 31, 2018. Returns shown are net of manager fees but gross of CA fees. At the inception of the composite, CA had two hedge fund clients in the sample. Clients are added to the sample over time based on their nondiscretionary investment management contract start date and are included for those periods during which they are nondiscretionary portfolio management clients. Annualized mean returns are calculated based on a monthly asset-weighted client composite return. This research note contains hypothetical performance. Hypothetical performance results have many inherent limitations and are used for illustrative purposes only.

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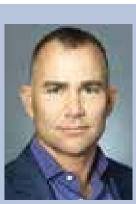

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