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Hedge Funds and Pensions - Cutting Back the Confusion

What do pension schemes need before they invest?

There has been a lot of talk recently about the possible attractions of hedge fund investment for pension schemes. However, relatively few schemes have taken the plunge. In this article, I will aim to analyse, from the lawyer's perspective, why this is the case. I will also look at some key issues for schemes which are considering investing in hedge funds.

Why are hedge funds becoming more attractive to pension schemes?

There are two main drivers behind the interest in hedge funds. First, equity markets have been through a difficult time, so trustees are looking for new ways to diversify their investment risk and to add value. Second, Myners encourages trustees to look at a wider range of potential asset classes.

Key questions for trustees thinking about investing in hedge funds

Taking a step back, trustees have to satisfy themselves, when considering a new investment, that it is suitable for their scheme. They must also consider the need to diversify their assets, in so far as that is right for the scheme. They will therefore want to be convinced, having taken advice, that investment in a hedge fund fits into a well-considered strategy for meeting their scheme's liabilities.

Trustees should make sure they understand the risks, both investment and legal, before deciding whether to invest in a particular fund. They also need to be able to monitor any investment they make.

Understanding hedge funds

The term "hedge fund" covers a very wide variety of different types of investment strategy and structure. Trustees are often unfamiliar with these strategies. They therefore need help from their advisers to understand the potential risks and rewards and how they might fit in with their investment strategy. Hedge fund providers could help trustees by providing "Plain English" explanations of their strategies.

Liquidity

Pension schemes tend to be wary about investing in a product if it is not easy to disinvest relatively quickly. Hedge funds investors often only have the right to disinvest on quarterly or six-monthly dealing days. There may also be provisions which allow withdrawals to be phased or held back if lots of investors try to withdraw at the same time. A lot of hedge fund providers are seeking to improve liquidity, but very frequent dealing could detract from the effectiveness of some hedge fund strategies. Trustees will want to consider whether any lock up periods are acceptable.

Reporting and valuations

Trustees must monitor their investments. With hedge funds they will also want to monitor the level of risk – e.g. how much gearing is used. It is often not as easy with hedge funds as with more "traditional" investments to see how things are going. Hedge funds generally are seeking to improve the information they give to investors, but pension scheme trustees will want to know, before they invest, what sort of reports they can expect.

When trustees invest in a hedge fund, they are usually investing in shares in an investment company or in a similar unitised structure. The value put on the underlying assets is very important. The underlying assets of hedge funds are often not so easy to value as those of more "traditional" funds.

If there is a performance fee, trustees may be concerned that hedge fund managers will have an interest in putting a high value on underlying investments. If the fund is valued too highly, this could favour investors who are withdrawing over those who stay. Investors will therefore be interested in understanding whether there is a suitable infrastructure to support valuations and whether there are checks and balances in the system to help manage conflicts of interest.

Legal structure

Trustees should understand the legal structure of any hedge fund they are considering. As mentioned earlier, the legal structure is likely to be an investment company. This is likely to mean that the trustees will not have any direct interest in the underlying assets and that it would be more difficult to sue the hedge fund manager if it is negligent. It may however be attractive to know that if you are buying shares in a company, the most you can normally lose is the amount you invest.

It is important to do appropriate investment and legal due diligence before deciding whether to invest. They need to form confidence in the key players in the hedge fund and its infrastructure.

Fees

Fees tend to be much higher than in "traditional" investment structures. Trustees need to understand how the fee structure in the hedge fund works, and how it could impact on overall performance.

Factors which may help trustees to invest in hedge funds

A number of developments may help trustees who wish to invest in hedge funds. The first is improved transparency and liquidity. Hedge fund managers are now targeting institutional investors like pension schemes who require regular reporting and better, more frequent, "exit" opportunities.

Secondly, there is the development of "fund of funds" hedge funds, which give relatively easy access to a diversified portfolio of hedge funds. This can be attractive, as it can be expensive to put together your own portfolio and monitor it. Trustees still need, though, to understand the fund of funds manager's overall strategy. They will also want to be satisfied that the fund of fund manager's has suitable robust due diligence procedures.

The development of products with a capital guarantee may also be interesting to schemes who are concerned by the potential for big losses in some hedge fund strategies.

The development of hedge fund indices to help measure performance may help to measure performance. Trustees may however be more interested in "absolute" performance of a hedge fund than its performance relative to other funds.

To sum up: There are quite a few issues for trustees to think about before investing in a hedge fund. They should some due diligence and understand the investment and legal risks. Having understood the risks, however, a hedge fund may be a valuable way to help diversify risk.

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