Retirement Issues, Plans and Lifestyles

Pensions

Backgrounds, Trends and Issues

Henry J. Mullen
Editor

RETIREMENT ISSUES, PLANS AND LIFESTYLES

PENSIONS: BACKGROUNDS, TRENDS AND ISSUES

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Nova Science Publishers, Inc.

New York

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Pensions : backgrounds, trends, and issues / editor, Henry J. Mullen.
p. cm.
Includes index.
ISBN 978-1-60876-840-0 (hardcover)
1. Pensions. 2. Pension trusts. I. Mullen, Henry J.
HD7105.4.P47 2009
331.25'2--dc22

2009046488

Published by Nova Science Publishers, Inc. ✢ New York

PREFACE

Millions of retired Americans rely on defined benefit pension plans for their financial well-being. Recent reports have noted that some plans are investing in 'alternative' investments such as hedge funds and private equity funds. To better understand this trend and its implications, this book examines the extent to which plans invest in hedge funds and private equity, the potential benefits and challenges of hedge fund investments, the potential benefits and challenges of private equity investments and what mechanisms regulate and monitor pension plan investments in hedge funds and private equity. Moreover, this book examines common 401(k) plan features and challenges sponsors face in fulfilling their fiduciary obligations when overseeing plan operations. In addition, the aging of the American population has made retirement income an issue of increasing concern to the Congress and the public. This book summarizes recent trends in pension sponsorship, labor force participation and social security issues. This book consists of public documents which have been located, gathered, combined, reformatted, and enhanced with a subject index, selectively edited and bound to provide easy access.

Chapter 1 - Millions of retired Americans rely on defined benefit pension plans for their financial well-being. Recent reports have noted that some plans are investing in 'alternative' investments such as hedge funds and private equity funds. This has raised concerns, given that these two types of investments have qualified for exemptions from federal regulations, and could present more risk to retirement assets than traditional investments.

To better understand this trend and its implications, GAO was asked to examine (1) the extent to which plans invest in hedge funds and private equity; (2) the potential benefits and challenges of hedge fund investments; (3) the potential benefits and challenges of private equity investments; and (4) what mechanisms regulate and monitor pension plan investments in hedge funds and private equity.

To answer these questions GAO interviewed relevant federal agencies, public and private pension plans, industry groups and investment professionals, and analyzed available survey data.

Chapter 2 - Private defined benefit (DB) pension plans are an important source of retirement income for millions of Americans. However, from 1990 to 2006, plan sponsors have voluntarily terminated over 61,000 sufficiently funded single-employer DB plans. An event preceding at least some of these terminations was a so-called plan "freeze"—an amendment to the plan to limit some or all future pension accruals for some or all plan participants. Available information that the government collects about frozen plans is limited in scope and may not be recent. GAO conducted a stratified probability sample survey of 471 single-employer DB plan sponsors out of a population of 7,804 (with 100 or more total plan participants) to gather more timely and detailed information about frozen plans. This report has been prepared under the Comptroller General's authority as part of our ongoing reassessment of risks associated with the Pension Benefit Guaranty Corporation's (PBGC) single-employer pension insurance program, which, in 2003, we placed on our high-risk list of programs that need broad-based transformations and warrant the attention of Congress and the executive branch. Frozen DB plans have possible implications for PBGC's long-term financial position. This report examines (1) the extent to which DB pension plans are frozen and the characteristics of frozen plans; and (2) the implications of these freezes for plan participants, plan sponsors, and the PBGC.

To view the full product, including the scope and methodology, click on GAO-08-817. To view the survey results click on GAO 08-818SP. For more information, contact Barbara Bovbjerg, at (202) 512-7215 or bovbjergb@gao.gov.

Chapter 3 - According to the Census Bureau's *Current Population Survey (CPS)*, the number of private-sector workers between the ages of 25 and 64 whose employer sponsored a retirement plan rose from 51.2 million in 2006 to 53.5 million in 2007. The number of private-sector workers who participated in employer-sponsored retirement plans rose from 42.0 million in 2006 to 44.1 million in 2007. The proportion of 25 to 64 year-old workers in the private sector who participated in employer-sponsored retirement plans increased from 43.2% in 2006 to 45.1% in 2007. Between 2000 and 2007, the number of private-sector workers between the ages of 25 and 64 who participated in employer-sponsored retirement plans fell from 46 million to 44 million. The percentage of workers who participated in an employer- sponsored plan fell from 50.3% in 2000 to 45.1% in 2007.

A CRS analysis of the *Current Population Survey* indicates that, among private-sector workers aged 25 to 64 who were employed *year-round, full-time*:

The percentage of workers whose employer sponsored a retirement plan rose from 57.2% in 2006 to 59.9% in 2007.

The percentage of workers who participated in employer-sponsored retirement plans rose from 49.2% in 2006 to 52.0% in 2007.

Only 25.5% of workers at firms with fewer than 25 employees participated in an employer-sponsored retirement plan in 2007, compared to 45.5% of workers at firms with 25 to 99 employees and 65.4% of workers at firms with 100 or more employees.

Among men and women who were employed year-round, full-time, 51.6% of men and 52.6% of women participated in an employer-sponsored retirement plan in 2007.

Only 43.0% of private-sector workers aged 25 to 34 and employed year- round, full-time participated in an employer-sponsored retirement plan in 2007, compared to 5 1.8% of workers aged 35 to 44, 57.4% of those aged 45 to 54, and 57.6% of those aged 55 to 64.

Black, Hispanic, and other non-white workers were less likely to have participated in an employer-sponsored retirement plan. Fifty-eight percent of white workers participated in a company-sponsored retirement plan in 2007, compared to 47.1% of black non-Hispanic workers, 30.6% of Hispanic workers, and 48.5% of other non-white workers (mainly Asian- American and Native American workers).

Only 27.7% of workers whose earnings were in the lowest quartile in 2007 (under $27,000) participated in a retirement plan at work, compared to 69.2% of workers whose earnings were in the top quartile (above $63,000).

The percentage of part-time workers in the private sector whose employer sponsored a retirement plan rose from 37.8% in 2006 to 38.3% in 2007. Twenty-three percent of part-year or part-time workers in the private sector participated in an employer sponsored retirement plan in 2007, essentially unchanged from 2006.

Chapter 4 - Conflicts of interest typically exist when someone in a position of trust, such as a pension consultant, has competing professional or personal issues. Such competing interests can make it difficult for pension plan fiduciaries and others, in general, to fulfill their duties impartially and could cause them to breach their duty to act solely in the interest of plan participants and beneficiaries. The proliferation of consulting work and the complexity of business arrangements among investment advisors, plan consultants, and others have increased the likelihood of conflicts of interests for both defined benefit (DB) plans, where investment risk is largely borne by the plan sponsor and defined contribution (DC) plans, where such risk is largely borne by the participant. Given the potential financial harm conflicts of interest may pose to DB and DC plans, GAO was asked to report on (1) the effects undisclosed conflicts of interest may have on the financial performance of DB plans, and (2) the vulnerabilities that conflicts of interest may pose for DC plan participants. GAO interviewed a variety of experts, reviewed the Department of Labor's (Labor) legal and regulatory authority and analyzed government and industry data associated with terminated plans.

Chapter 5 - American workers increasingly rely on 401(k) plans for their retirement security, and sponsors of 401(k) plans—typically employers—have critical obligations under the Employee Retirement Income Security Act of 1974 (ERISA). When acting as fiduciaries, they must act prudently and solely in the interest of plan participants and beneficiaries. The Department of Labor (Labor) is responsible for protecting private pension plan participants and beneficiaries by enforcing ERISA. GAO examined: (1) common 401(k) plan features, which typically have important fiduciary implications, and factors affecting these decisions; (2) challenges sponsors face in fulfilling their fiduciary obligations when overseeing plan operations; and (3) actions Labor takes to ensure that sponsors fulfill their fiduciary obligations, and the progress Labor has made on its regulatory initiatives. To address these objectives, GAO administered a survey asking sponsors how they select plan features and oversee operations, reviewed industry research, conducted interviews, and reviewed related documents.

CONTENTS

In: Pensions: Backgrounds, Trends and Issues
Editor: Henry J. Mullen

ISBN: 978-1-60876-840-0

Chapter 1

GUIDANCE NEEDED TO BETTER INFORM PLANS OF THE CHALLENGES AND RISKS OF INVESTING IN HEDGE FUNDS AND PRIVATE EQUITY

United States Government Accountability Office

WHY GAO DID THIS STUDY

Millions of retired Americans rely on defined benefit pension plans for their financial well-being. Recent reports have noted that some plans are investing in 'alternative' investments such as hedge funds and private equity funds. This has raised concerns, given that these two types of investments have qualified for exemptions from federal regulations, and could present more risk to retirement assets than traditional investments.

To better understand this trend and its implications, GAO was asked to examine (1) the extent to which plans invest in hedge funds and private equity; (2) the potential benefits and challenges of hedge fund investments; (3) the potential benefits and challenges of private equity investments; and (4) what mechanisms regulate and monitor pension plan investments in hedge funds and private equity.

To answer these questions GAO interviewed relevant federal agencies, public and private pension plans, industry groups and investment professionals, and analyzed available survey data.

WHAT GAO RECOMMENDS

GAO recommends that the Secretary of Labor provide guidance on investing in hedge funds and private equity that describes steps plans should take to address the challenges and risks of these investments. Labor generally agreed with our findings and recommendation.

What GAO Found

According to several recent surveys of private and public sector plans, investments in hedge funds and private equity generally comprise a small share of total plan assets, but a considerable and growing number of plans have such investments. Available survey data of mid to large-size plans indicate that between 21 and 27 percent invest in hedge funds while over 40 percent invest in private equity; such investments are more prevalent among larger plans, as shown below. The extent of investment in hedge funds and private equity by plans with less than $200 million in total assets is unknown.

Pension plans invest in hedge funds to obtain a number of potential benefits, such as returns greater than the stock market and stable returns on investment. However, hedge funds also pose challenges and risks beyond those posed by traditional investments. For example, some investors may have little information on funds' underlying assets and their values, which limits the opportunity for oversight. Plan representatives they take steps to mitigate these and other challenges, but doing so requires resources beyond the means of some plans.

Pension plans primarily invest in private equity funds to attain returns superior to the stock market. Pension plan officials GAO spoke with generally had a long history of investing in private equity and said such investments have met expectations for returns. However, these investments present several challenges, such as wide variation in performance among funds, and the resources required to mitigate these challenges may be too substantial for some plans.

The federal government does not specifically limit or monitor private sector plan investment in hedge funds or private equity, and state approaches to public plans vary. Under federal law, fiduciaries must comply with a standard of prudence, but no explicit restrictions on hedge funds or private equity exist. Although a federal advisory council recommended that the Department of Labor (Labor) develop guidance for plans to use in investing in hedge funds, Labor has not yet done so. While most states also rely on a standard of investor prudence, some also have legislation that restricts or prohibits plan investment in hedge funds or private equity. For example, one state prohibits plans below a certain size from investing directly in hedge funds.

Abbreviations

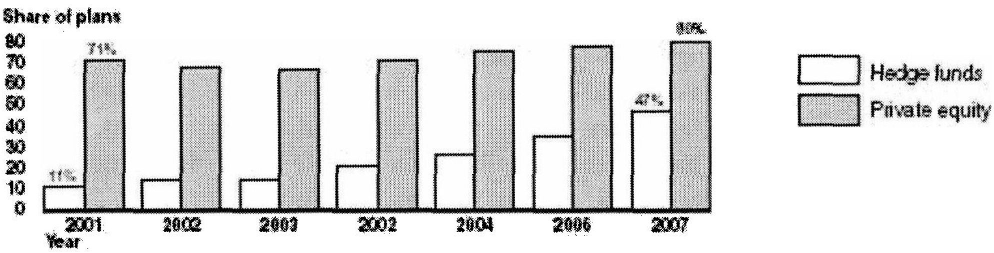
DB	defined benefit
DC	defined contribution
EBSA	Employee Benefits Security Administration
ERISA	Employee Retirement Income Security Act of 1974
NASRA	National Association of State Retirement Administrators
PBGC	Pension Benefit Guaranty Corporation
PERAC	Public Employee Retirement Administration Commission
SEC	U.S. Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
S&P	Standard and Poor's
TRS	Teacher Retirement System of Texas

August 14, 2008

Congressional Requesters

Millions of Americans rely on defined benefit pension plans for their financial well-being after their working years.[1] In order to pay promised retirement benefits when due at an acceptable cost, employers must make adequate contributions to these funds and plan fiduciaries must invest the fund balance in assets that yield an adequate rate of return over time. Historically, public and private sector pension plans have primarily invested in traditional investments such as stocks and bonds; however, recent press reports indicate that plans are increasingly investing in "alternative" investments such as hedge funds and private equity funds.

While there is no statutory definition of hedge funds, the phrase "hedge fund" is commonly used to refer to a pooled investment vehicle that is privately organized and administered by professional managers, and that often engages in active trading of various types of securities and commodity futures and options contracts.[2] Similarly, private equity funds are not statutorily defined, but are generally considered privately managed investment pools administered by professional managers, who typically make long-term investments in private companies, taking a controlling interest with the aim of increasing the value of these companies through such strategies as improved operations or developing new products. Both hedge funds and private equity funds may be managed so as to be exempt from certain aspects of federal securities law and regulation that apply to other investment pools such as mutual funds.



Source: *Pensions & Investments*' 2007 annual survey.

Share of Large Plans Investing in Hedge Funds and Private Equity

Pension plan investments in hedge funds and private equity have been controversial for a number of reasons. While hedge funds investments are made mainly by relatively wealthy individuals and institutional investors, the recent increase in pension plan investments in hedge funds indirectly exposes people of modest incomes to the risks of hedge fund investing. This has been cited as a concern because a pension plan that experiences substantial losses as a result of a hedge fund investment may be unable to meet its obligations to pensioners. The perceived riskiness of hedge funds and the collapse of some of these funds in recent years have led some industry experts and union officials to express concern about plan investments in such vehicles, including the appropriate steps plan officials should take in conducting proper due diligence. A further cause for their concern is the ability of hedge funds and private equity funds to qualify for exemptions from certain aspects of federal securities law and regulations that apply to other investment pools.

In order to better understand the extent to which defined benefit pension plans invest in hedge funds and private equity and the implications of such investments for the security of pension plan assets, you asked us to examine the extent and nature of defined benefit pension plans' investments in these alternative investments. Specifically, you asked us to address the following questions:

1. To what extent do public and private sector pension plans invest in hedge funds and private equity funds?
2. What are the potential benefits, risks, and challenges pension plans face in making hedge fund investments, and how do plans address the risks and challenges?
3. What are the potential benefits, risks, and challenges pension plans face in making private equity fund investments, and how do plans address the risks and challenges?
4. What mechanisms regulate and monitor pension plan investments in hedge funds and private equity funds?

To answer these questions, this report was reviewed with relevant literature and survey data and conducted in-depth interviews with pension plan representatives and industry experts. We obtained and analyzed data on the extent of pension plan investments in hedge funds and private equity from private organizations such as Greenwich Associates, *Pensions & Investments*, and Pyramis Global Advisors. Although these surveys had several limitations— for example, the survey data generally represent the holdings of larger pension plans—we determined they were sufficiently reliable for purposes of our study. To answer the second and third questions, we conducted in-depth interviews with representatives of 26 public and private sector DB pension plans and, where possible, obtained and reviewed supporting documentation. These plans were selected based on several criteria, including the range of investment in hedge funds and private equity and the amount of total plan assets. We also interviewed officials of regulatory agencies, relevant industry organizations, investment consulting firms, and other national experts. To identify state and federal regulatory and monitoring policies, we interviewed officials at the Department of Labor (Labor) and representatives of relevant agencies in selected states, and reviewed relevant policy documents. We contacted regulators in 11 states, including the 10 states with the largest amount of public pension assets according to the National Association of State Retirement Administrators (NASRA) Public Funds Survey data.[3]

We conducted this performance audit from June 2007 to July 2008, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

RESULTS IN BRIEF

While hedge fund and private equity fund investments generally comprise a limited share of total plan assets, a considerable and growing number of private and public DB plans make such investments. According to available survey data, which generally reflect the holdings of larger DB plans, average allocations to hedge funds and private equity in 2007 were around 4 percent and 5 percent of total plan assets, respectively. However, according to one survey, a few pension plans had relatively large allocations of about 30 percent to hedge funds, while one public plan had an allocation of about 20 percent to private equity. Available survey data indicate that from about 21 to 27 percent of mid- to large-size pension plans invested in hedge funds in 2006, while just over 40 percent invested in private equity. Although investments in private equity remain more prevalent than hedge fund investments among both private and public pension plans surveyed, the number of plans investing in hedge funds has increased in recent years more than for private equity funds. Investments in hedge funds and private equity are more common among large pension plans, measured by assets under management, compared to mid-size plans. For example, about 16 percent of plans with $250 to $500 million were invested in hedge funds, while 29 percent of plans with $1 billion or more had such investments, according to a 2006 survey. Similarly, for private equity, 16 percent of plans with $250 - $500 million had such investments compared to 77 percent of plans with $1 billion or more in 2006. Survey data on plans with less than $200 million in assets are unavailable and, in their absence, the extent to which these plans invest in hedge funds or private equity is unknown.

Pension plans invest in hedge funds to obtain various benefits, but some characteristics of hedge funds also pose challenges that demand greater expertise and effort than more traditional investments, which some plans may not be able to fully address. Pension plans told us that they invest in hedge funds in order to achieve one or more of several goals, including steadier, less volatile returns, obtaining returns greater than those expected in the stock market, or diversification of portfolio investments. Pension plan officials we spoke with about hedge fund investments all said these investments had generally met or exceeded expectations. However, at the time of our contact in 2007, several plan officials noted that their hedge fund investments had not yet been tested under stressful economic conditions, such as a significant stock market decline. Further, some indicated mixed experiences with hedge fund investments. At the time of our discussions, however, officials of each plan interviewed indicated that they expected to maintain or increase the share of assets invested in hedge funds. Nonetheless, hedge fund investments pose investment challenges beyond those posed by traditional investments in stocks and bonds. These additional challenges include: (1) the inherent risks of relying on the skill and techniques of the hedge fund manager; (2) limited information on a hedge fund's underlying assets and valuation (limited transparency); (3) contract provisions which limit an investor's ability to redeem an investment in a hedge fund for a defined period of time (limited liquidity); and 4) the possibility that a hedge fund's active or risky trading activity will result in losses due to operational failure such as trading errors or outright fraud (operational risk). Although there are challenges of hedge fund investing, plan officials and others described steps to address these and other challenges. For example, plan officials and others told us that it is important to negotiate key investment terms and conduct a thorough "due diligence" review of prospective hedge funds, including review of a hedge fund's operational structure. Further, pension plans can invest in funds of hedge funds, which charge additional fees but provide diversification and the additional skill of the fund of funds manager. According to plan officials and others, some of these steps require considerably greater effort and expertise from fiduciaries than is required for more traditional investments, and such steps may be beyond the capabilities of some pension plans, particularly smaller ones.

Pension plans invest in private equity primarily in expectation of higher rates of return than traditional investments, but these investments too pose challenges that require substantial effort and expertise to address. The major benefits pension plans seek from private equity investments are long-term returns in excess of stocks and, to a lesser degree, to further diversify the plan's portfolio. Pension plan officials we spoke with generally had longer experience investing in private equity than in hedge funds—in some cases over 20 years—and each plan's representatives indicated these investments have met expectations and most expressed plans to maintain or increase their allocations. Nevertheless, investments in private equity present distinct challenges and risks beyond those faced with traditional investments. These include: (1) the variation of performance among private equity funds, which is greater than for other asset classes, and the difficulty of gaining access to recognized top-performing funds; (2) longer-term commitments of 10 years or more, during which the pension plan may not be able to redeem its investment; and (3) valuation of the investment, which is difficult to assess prior to the sale of underlying holdings. As with hedge funds, taking steps to mitigate the challenges of investing in private equity funds requires greater expertise and effort than making traditional investments. Plans told us that, as a part of their due diligence and ongoing monitoring efforts, they regularly reviewed reports on the performance of the underlying investments of the private equity fund and held periodic meetings with fund managers. As with hedge funds, the extensive amount of monitoring required for private equity investments may be impractical for pension plans that have more limited resources, such as smaller plans.

The federal government does not specifically limit or monitor private sector pension investment in hedge funds or private equity and, while some states do so for public plans, their approaches vary. Under the Employee Retirement and Income Security Act (ERISA), plan fiduciaries are expected to meet general standards of prudent investing and no specific restrictions on investments in hedge funds or private equity have been established. Labor is tasked with helping to ensure plan sponsors meet their fiduciary duties; however, it does not currently provide any guidance specific to pension plan investments in hedge funds or private equity. Conversely, some states do specifically regulate and monitor public sector pension investment in hedge funds and private equity, but these approaches vary from state to state. While states generally have adopted a "prudent man" standard similar to that in ERISA, some states also explicitly restrict or prohibit pension plan investment in hedge funds or private equity. For instance, in Massachusetts, the agency overseeing public plans will not permit plans with less than $250 million in total assets to invest directly in hedge funds. Some states have detailed lists of authorized investments that exclude hedge funds and/or private equity. Other states may limit investment in certain investment vehicles or trading strategies employed by hedge fund or private equity fund managers. While some guidance exists for hedge fund investors, specific guidance aimed at pension plans could serve as an additional tool for plan fiduciaries when assessing whether and to what degree hedge funds would be a prudent investment.

To ensure that all plan fiduciaries can better assess their ability to invest in hedge funds and private equity, and to ensure that those that choose to make such investments are better prepared to meet these challenges, we recommend that the Secretary of Labor provide guidance on investing in hedge funds and private equity specifically designed for qualified plans under ERISA. In responding to a draft of this report, Labor generally agreed with our findings and recommendation.

Labor and other federal agencies also provided technical comments on the draft report, which we have incorporated where appropriate.

BACKGROUND

Millions of current and future retirees rely on private or public DB pension plans, which promise to pay retirement benefits that are generally based on an employee's salary and years of service. The financial condition of these plans—and hence their ability to pay promised retirement benefits when such benefits are due—depends on adequate contributions from employers and, in some cases, employees, as well as prudent investments that preserve principal and yield an adequate rate of return over time. The plan sponsor must make required contributions to the plan that are intended to ensure it is adequately funded to pay promised benefits. To maintain and increase plan assets, fiduciaries of public and private sector pension plans invest in assets that are expected to grow in value or yield income. In making investments, DB plan managers consider a plan's benefit payment requirements and balance the desire to maximize return on investment and the desire to limit the overall risk to the investment portfolio to an acceptable level. In doing so, plan fiduciaries invest in various categories of assets classes, which traditionally have consisted mainly of stocks and bonds. Stocks offer relatively high expected longterm returns at the risk of considerable volatility, that is, the likelihood of significant short-term losses or gains. On the other hand, bonds and other fixed income investments offer a steady income stream and relatively low volatility, but lower expected long-term returns. Different proportions of these two asset classes will, therefore, provide different degrees of risk and expected return on investment. Pension fiduciaries may also invest in other asset classes or trading strategies, such as hedge funds and private equity, which are generally considered to be riskier investments, so long as such investments are prudent.

Private sector pension plan investment decisions must comply with the provisions of ERISA, which stipulates fiduciary standards based on the principle of a prudent man standard. Under ERISA, plan sponsors and other fiduciaries must (1) act solely in the interest of the plan participants and beneficiaries and in accordance with plan documents; (2) invest with the care, skill, and diligence of a prudent person with knowledge of such matters; and (3) diversify plan investments to minimize the risk of large losses. Under ERISA, the prudence of any individual investment is considered in the context of the total plan portfolio, rather than in isolation.[4] Hence, a relatively risky investment may be considered prudent, if it is part of a broader strategy to balance the risk and expected return to the portfolio. In addition to plan sponsors, under the ERISA definition of a fiduciary, any other person that has discretionary authority or control over a plan asset is subject to ERISA's fiduciary standards.[5] The Employee Benefit Security Administration (EBSA) at Labor is responsible for enforcing these provisions of ERISA, as well as educating and assisting retired workers and plan sponsors. Another federal agency, the Pension Benefit Guaranty Corporation (PBGC), collects premiums from federally insured plans in order to insure the benefits of retirees if a plan terminates without sufficient assets to pay promised benefits.

In the public sector, governments have established pension plans at state, county, and municipal levels, as well as for particular categories of employees, such as police officers, fire fighters, and teachers. The structure of public pension plan systems can differ considerably from state to state. In some states, most or all public employees are covered by a single consolidated DB retirement plan, while in other states many retirement plans exist for various units of government and employee groups. Public sector DB plans are not subject to funding, vesting and most other requirements applicable to private sector DB plans under ERISA, but must follow requirements established for them under applicable state law. While states generally have adopted standards essentially identical to the ERISA prudent man standard, specific provisions of law and regulation vary from state to state. Public plans are also not insured by the PBGC, but could call upon state or local taxpayers in the event of a funding shortfall.

Hedge Funds Use Broad Range of Investment Strategies to Achieve Desired Return

Although there is no statutory or universally accepted definition of hedge funds, the term is commonly used to describe pooled investment vehicles that are privately organized and administered by professional managers and that often engage in active trading of various types of securities, commodity futures, options contracts, and other investment vehicles. In recent years, hedge funds have grown rapidly. As we reported in January 2008, according to industry estimates, from 1998 to early 2007, the number of funds grew from more than 3,000 to more than 9,000 and assets under management from more than $200 billion to more than $2 trillion globally.[6]

Hedge funds also have received considerable media attention as a result of the high-profile collapse of several hedge funds, and consequent losses suffered by investors in these funds. Although hedge funds have the reputation of being risky investment vehicles that seek exceptional returns on investment, this was not their original purpose, and is not true of all hedge funds today. Founded in the 1940s, one of the first hedge funds invested in equities and used leverage and short selling to protect or "hedge" the portfolio from its exposure to movements in the stock market.[7] Over time, hedge funds diversified their investment portfolios and engaged in a wider variety of investment strategies. Because hedge funds are typically exempt from registration under the Investment Company Act of 1940, they are generally not subject to the same federal securities regulations as mutual funds. They may invest in a wide variety of financial instruments, including stocks and bonds, currencies, futures contracts, and other assets. Hedge funds tend to be opportunistic in seeking positive returns while avoiding loss of principal, and retaining considerable strategic flexibility. Unlike a mutual fund, which must strictly abide by the detailed investment policy and other limitations specified in its prospectus, most hedge funds specify broad objectives and authorize multiple strategies. As a result, most hedge fund trading strategies are dynamic, often changing rapidly to adjust to market conditions.

Hedge funds are typically structured and operated as limited partnerships or limited liability companies exempt from certain registration, disclosure and other requirements under the Securities Act of 1933,[8] Securities Exchange Act of 1934,[9] Investment Company Act of

1940,[10] and Investment Advisers Act of 1940[11] that apply in connection to other investment pools, such as mutual funds. For example, to allow them to qualify for various exemptions under such laws, hedge funds usually limit the number of investors, refrain from advertising to the general public, and solicit fund participation only from large institutions and wealthy individuals. The presumption is that investors in hedge funds have the sophistication to understand the risks involved in investing in them and the resources to absorb any losses they may suffer. Although many workers may be impacted by any losses resulting from pension fund investment in hedge funds, a pension plan counts as a single investor that does not prevent a hedge fund from qualifying for the various statutory exemptions.

Individuals and institutions may also invest in hedge funds through funds of hedge funds, which are investment funds that buy shares of multiple underlying hedge funds. Fund of funds managers invest in other hedge funds rather than trade directly in the financial markets, and thus offer investors broader exposure to different hedge fund managers and strategies. Like hedge funds, funds of funds may be exempt from various aspects of federal securities and investment law and regulation.

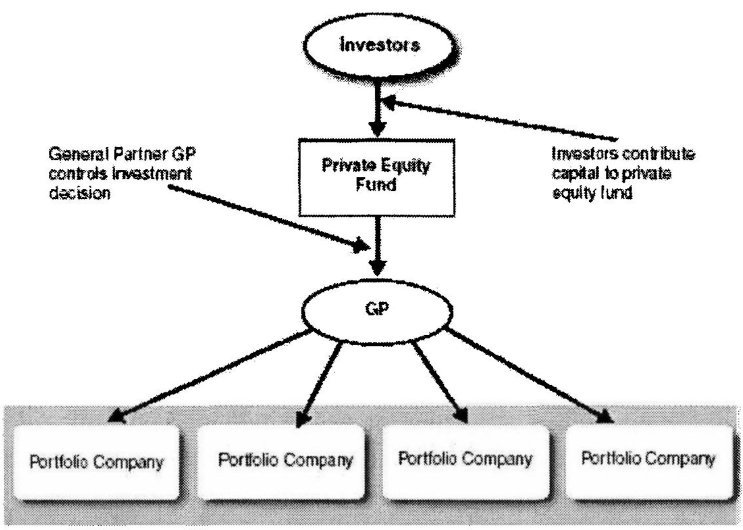
Private Equity Funds Obtain Returns from Manager Skill and Investing Capital in a Limited Number of Private Firms

Like hedge funds, there is no legal or commonly accepted definition of private equity funds, but the term generally includes privately managed pools of capital that invest in companies, many of which are not listed on a stock exchange. Although there are some similarities in the structure of hedge funds and private equity funds, the investment strategies employed are different. Unlike many hedge funds, private equity funds typically make longer-term investments in private companies and seek to obtain financial returns not through particular trading strategies and techniques, but through long-term appreciation based on corporate stewardship, improved operating processes and financial restructuring of those companies, which may involve a merger or acquisition of companies. Private equity is generally considered to involve a substantially higher degree of risk than traditional investments, such as stocks and bonds, for a higher return.[12]

While strategies of private equity funds vary, most funds target either venture capital or buy-out opportunities. Venture capital funds invest in young companies often developing a new product or technology. Private equity fund managers may provide expertise to a fledgling company to help it advance toward a position suitable for an initial public offering. Buyout funds generally invest in larger established companies in order to add value, in part, by increasing efficiencies and, in some cases, consolidating resources by merging complementary businesses or technologies. For both venture capital and buy-out strategies, investors hope to profit when the company is eventually sold, either when offered to the public or when sold to another investor or company. Each private equity fund generally focuses on only one type of investment opportunity, usually specializing in either venture capital or buyout and often specializing further in terms of industry or geographical area.[13] Investment in private equity has grown considerably over recent decades. According to a venture capital industry organization, the amount of capital raised by private equity funds grew from just over $2 billion in 1980 to about $207 billion in 2007; while the number of private equity funds grew from 56 to 432 funds over the same time period.

As with hedge funds, private equity funds operate as privately managed investment pools and have generally not been subject to Securities and Exchange Commission (SEC) examinations. Pension plans typically invest in private equity through limited partnerships in which the general partner develops an investment strategy and limited partners provide the large majority of the capital. After creating a new fund and raising capital from the limited partners, the general partner begins to invest in companies that will make up the fund portfolio (see figure 1). Limited partners have both limited control over the underlying investments and also limited liability for potential debts incurred by the general partners through the fund.

Similar to hedge funds, private equity funds may be structured to qualify for exemptions from certain registration and disclosure requirements of federal securities laws; for example, by refraining from advertising to the general public. The majority of investments in private equity funds come from wealthy individuals and institutional investors, such as endowments, banks, corporations, and pension plans.



Source: New York State Common Retirement Fund Division of Pension Investment and Case Management.

Figure 1. Structure of Private Equity Investing

A Growing Number of Pension Plans Are Investing in Hedge Funds or Private Equity, but Such Investments Are Generally a Small Portion of Plan Assets

According to several recent surveys, investments in hedge funds and private equity are typically a small portion of total plan assets—about 4 to 5 percent on average—but a considerable and growing number of plans invest in them. While investment in hedge funds is