



## ADVISORY

A GFOA *advisory* identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

### **The Use of Alternative Investments for Public Employee Retirement Systems and Other Post Employment Benefit (OPEB) Established Trusts (2000 and 2008) (CORBA)**

**Background.** Alternative investments are assets or investment strategies that are not included or practiced in the traditional investment classes of equities, fixed income and cash. They typically include hedge funds, private equity, venture capital, real estate, and real assets, although this investment category is fluid, and new products are constantly being developed. Alternative investments use techniques and instruments that are unavailable in traditional investment approaches. Investments may be made in either listed or unlisted companies, securities, or assets. These alternative investments generally have a low correlation with traditional asset classes, and may provide improved diversification and return enhancement. Alternative investments seek to capitalize on market inefficiencies and/or provide a hedge for other investments or interest rate positions. During volatile markets, some alternatives may provide additional diversification. Notwithstanding these potential benefits, public pension and other post employment benefits (OPEB) portfolios that use alternative investments should also consider the inherent risks associated with these types of investments. Further, systems should confirm whether alternative investments are permissible under applicable state law.

#### **Objectives**

Investors may utilize this asset class for several reasons:

- To diversify a portfolio using innovative strategies;
- To produce higher returns than may be available from other investments;
- To reduce portfolio volatility and risk through low or negative correlation of returns with traditional asset classes or by correlating returns with inflation.

#### **Types**

Although the investments discussed below are all classified as alternative investments, the characteristics of each are unique.

##### *Hedge Funds*

Less stringently regulated, privately managed pools of capital that typically employ sophisticated investment strategies, including the use of short-selling, long-short strategies (e.g., 130/30, 120/20)<sup>1</sup>, leverage, derivatives, and other means of seeking alpha<sup>2</sup> and hedging risk.

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<sup>1</sup> While some consider these long-short strategies equity investments, others consider them alternatives.

<sup>2</sup> The term alpha may be defined as earnings above market returns.

### *Private Equity*

Funds that take an equity stake in a private company to push management to develop new products and technologies, expand working capital, make acquisitions or strengthen a company's balance sheet. Generally, these funds then sell their stake sometime in the future after investment goals have been achieved.

### *Venture Capital*

Provides financing for new businesses with perceived long-term growth potential. This form of capital raising is popular among new companies, or ventures, with limited operating history, which cannot raise funds through a debt issue.

### *Real Estate*

Investments directly in real estate properties.<sup>3</sup>

### *Real Assets*

Investments in real assets, such as commodities, timber, oil, gas, infrastructure, art, metal and energy.

### **Risks**

While alternative investments may serve many beneficial purposes, they also carry several inherent risks. As some alternatives are relatively new, historical return data may be limited. In addition, valid benchmarks for comparison of performance may be scarce. Illiquidity, the lack of ready trading markets, is considered to be the most common risk, and may eliminate the ability of investors to end an investment early regardless of its success, as well as determine a marketable value. Lock-up periods, required by many venture capital firms and hedge fund managers, obligate clients to commit their capital investment for a minimum period of time, typically no less than one or two years. Lack of transparency and regulation, combined with the use of leverage and other speculative techniques, provide an additional layer of risk to most alternative investments. Some alternative investments may carry substantial, additional risk, which may result in the loss of some or all of the investment.

The market compensates investors for these risks with a higher expected return. PERS and governments using alternative investments should carefully evaluate the associated risks in achieving the desired returns. Analysis of *net* return is critical as manager fees are typically much higher (1-2% of assets) plus a share of profits (typically 20%); and if investing in "fund of funds,"<sup>4</sup> there are typically additional, multiple layers of fees. It merits noting that fee structures continue to change with new investment products and changing market conditions.

### **Alternative Investing Due Diligence**

The complexity or uniqueness of these investments makes them more difficult to understand and be accepted by trustees, staff, plan sponsors and the general public. Alternative investments may require additional staff expertise, increased due diligence<sup>5</sup> and careful attention to controls. Manager selection is arguably the most critical factor in successful alternative investing. Key factors to consider include the manager's experience, risk controls, track record and strategies.

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<sup>3</sup> Real estate investment trusts (REITs), which invest in real estate directly either through properties or mortgages, are securities that are traded like stocks on the major exchanges and therefore are not considered alternatives.

<sup>4</sup> A fund of funds allows an investor to invest in a series of hedge funds and thus diversify by investing in multiple managers. A fund of funds also permits an investor to rely on the expertise of the fund of funds manager for additional due diligence and hedge fund selection.

<sup>5</sup> Due to the increased risk of misstatement inherent with these investments resulting from incorrect valuation, part of the increased due diligence could be to obtain a reasonable understanding of the procedures that may be applied to them during the independent audit of the financial statements. Accordingly, those considering obtaining positions in such investments should review *Alternative Investments – Audit Considerations, A Practice Aid for Auditors* issued by the Alternative Investments Task Force of the American Institute of Certified Public Accountants.

In selecting alternative investments, a number of judgments must be made, including:

- Whether available alternative investments are consistent with the return objectives, risk tolerance, time horizon and liquidity needs, and will enhance the current portfolio in achieving these policies and objectives;
- Whether investment managers can be identified who have the capacity to find and make desirable investments;
- Whether acceptable terms can be agreed on that align the interests of the system and investment managers to ensure a high probability that good investment decisions will be consistently made.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that state and local governments exercise extreme prudence and appropriate due diligence be exercised in the use of alternative investments in public pension and OPEB portfolios. Alternative investments should be limited to achieving a measurable objective such as increasing risk-adjusted net return or reducing portfolio volatility and, if included in the portfolio, should be included as part of an overall investment strategy based on all of the following considerations:

- The existence of sound investment policies and objectives that address the unique return and risk characteristics of alternatives, and prudent limits on these investments.
- Clear articulation of the economic rationale and overall importance of the specific investment in the marketplace as well as in the portfolio.
- Identification of appropriate benchmarks for comparison of investment performance in terms of returns and risk, and through industry cyclical downturns or bear markets.
- Consideration of resources in terms of staffing, culture and managerial discipline, and the ability to measure and monitor performance, risks and costs.
- A commitment to expanded due diligence by trustees, fiduciaries and staff.
- Careful due diligence in the selection of a firm or manager whose experience and ability enables them to provide the desired risk-adjusted net returns while reducing overall portfolio volatility. This investment fiduciary should be committed to a high level of transparency, which allows for the evaluation of the investment, manager or fund.
- A clear understanding of the legal terms of the investment and the recourse, rights and obligations of the investors.
- An analysis of liquidity needs to determine whether an investment's cash flows are adequate.
- The ability to evaluate the effect of such investments on the overall portfolio, particularly with regard to liquidity and volatility

## **References**

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