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Highlights

Highlights of GAO-10-915T, a testimony before the Subcommittee on Health, Employment, Labor and Pensions, Committee on Education and Labor, House of Representatives

DEFINED BENEFIT PENSION PLANS

Plans Face Valuation and Other Challenges When Investing in Hedge Funds and Private Equity

Why GAO Did This Study

Millions of Americans rely on private or public defined benefit pension plans, which promise to pay retirement benefits that are generally based on an employee's salary and years of service. Plan sponsors are increasingly investing in "alternative" assets such as hedge funds and private equity. This has raised concerns, given that these two types of investments have qualified for exemptions from some federal regulations and could present more risk to retirement assets than traditional investments.

This testimony discusses (1) the extent to which defined benefit plans have invested in hedge funds and private equity, (2) challenges that such plans face in investing in hedge funds and private equity, (3) steps that plan sponsors can take to address these challenges, and (4) the implications of these challenges for the federal government.

To prepare this statement, GAO relied primarily on its published reports on hedge funds and private equity (GAO-08-692 and GAO-08-200), and obtained new data on the extent of plan investments in hedge funds and private equity.

GAO has previously recommended that the Secretary of Labor provide guidance designed to help ERISA fiduciaries better assess their ability to invest in hedge funds and private equity. Labor generally agreed with our recommendation, but has yet to take action.

View GAO-10-915T or key components.
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What GAO Found

A growing number of private and public sector plans have invested in hedge funds and private equity, but such investments generally comprise a small share of total plan assets. According to a survey of large plans, the share of plans with investments in hedge funds grew from 11 percent in 2001 to 51 percent in 2009. Over the same time period, investments in private equity were more prevalent but grew more slowly—an increase from 71 percent in 2001 to 90 percent in 2009. Still, the average allocation of plan assets to hedge funds was less than 5 percent, and the average allocation to private equity was less than 8 percent. Available data also show that investments in hedge funds and private equity are more common among large pension plans, measured by assets under management, compared to mid-size plans. Survey information on smaller plans is unavailable, so the extent to which these plans invest in hedge funds or private equity is unknown.

Hedge funds and private equity investments pose a number of risks and challenges beyond those posed by traditional investments. For example, investors in hedge funds and private equity face uncertainty about the precise valuation of their investment. Hedge funds may, for example, own thinly traded assets whose valuation can be complex and subjective, making valuation difficult. Further, hedge funds and private equity funds may use considerable leverage—the use of borrowed money or other techniques—which can magnify profits, but can also magnify losses if the market goes against the fund's expectations. Also, both are illiquid investments—that is they cannot generally be redeemed on demand. Finally, investing in hedge funds can pose operational risk—that is, the risk of investment loss from inadequate or failed internal processes, people, and systems, or problems with external service providers rather than an unsuccessful investment strategy.

Plan sponsors we spoke with address these challenges in a number of ways, such as through careful and deliberate fund selection, and negotiating key contract terms. For example, investors in both hedge funds and private equity funds may be able to negotiate fee structure and valuation procedures, and the degree of leverage employed. Also, plans address various concerns through due diligence and monitoring, such as careful review of investment, valuation, and risk management processes.

The Department of Labor (Labor) has a role in helping to ensure that plans fulfill their Employee Retirement and Income Security Act of 1974 (ERISA) fiduciary duties, which includes educating employers and service providers about their fiduciary responsibilities under ERISA. According to plan officials, state and federal regulators, and others, some pension plans, such as smaller plans, may have particular difficulties in addressing the various demands of hedge fund and private equity investing. In light of this, in 2008, we recommended that Labor provide guidance on the challenges of investing in hedge funds and private equity and the steps plans should take to address these challenges.