

# Does Diversification Require Sophisticated Assets?

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## A. Introduction

1. Trustees have a duty to invest the funds of a trust as a prudent investor would, and, in making and implementing investment decisions, they generally have a duty to diversify the investments of the trust. A principal objective of diversification is to reduce risk. As the realm of investment opportunities for trustees has expanded from traditional investments such as stocks and bonds to non-traditional investments such as hedge funds, private equity, commodities, and real estate, the question arises whether a trustee has a duty to consider and, when appropriate, utilize non-traditional investments for purposes of diversification, associated risk management, and enhanced returns.
2. Pensions funds have invested in private equity for decades and have more recently expanded investments to include hedge funds. It is reported that over 40 percent of large pension funds invest in private equity and between 21 and 27 percent invest in hedge funds. GAO Report to Congressional Requesters, De-

financed Benefit Pension Plans, Guidance Needed to Better Inform Plans of the Challenges and Risks of Investing in Hedge Funds and Private Equity, GAO-08-692, p. 3 (Washington D.C., August 2008) (“GAO Report”). Although the percentage of fund assets allocated to private equity and hedge funds is typically modest, the number of funds investing in such non-traditional assets has increased in recent years. Data regarding the investment of private trusts in non-traditional assets is not readily available. However, many corporate fiduciaries include non-traditional assets in the investment portfolios of their trusts. The following discussion addresses the prudent investor rule as it pertains to non-traditional assets, the potential benefits and challenges associated with investment in non-traditional assets, and practices to consider in the implementation of a non-traditional asset allocation program.

## **B. Background**

1. Investments other than traditional investments in fixed income and publicly traded equity securities are commonly referred to as “alternative investments.” Alternative investments and alternative investment strategies include hedge funds, funds of funds, private equity, commodities, and real estate. This paper discusses alternative investments in trust accounts generally, focusing on hedge funds and private equity in particular.

- a. *Hedge Fund*

- i. There is no standard definition of a hedge fund. A hedge fund itself is not an asset class, but rather a fund that employs a particular investment strategy. A hedge fund commonly refers to a pooled investment vehicle that generally meets most, if not all, of the following criteria: (i) it is not marketed to the general public (that is, it is privately offered); (ii) its investors are limited to high net worth individuals and institutions; (iii) it is not registered as an investment company under relevant laws (for example, U.S. Investment Company Act of 1940); (iv) its assets are managed by a professional investment firm that is compensated in part based on investment performance of the vehicle; and (v) it has periodic but restricted or limited investor redemption rights. Report of the Investor’s Committee to the President’s Working Group on Financial Markets, “Principles and Best Practices for Hedge Fund Investors,” p. 10 (January 15, 2009), available at [www.amaicmte.org](http://www.amaicmte.org).

- ii. Investments in hedge funds grew exponentially from 1998 to 2007. It is estimated that the number of funds grew from 3,000 in 1998 to 9,000 in 2007 and that the value of the assets managed in hedge funds increased from \$200 billion to \$2 trillion during that period. GAO Report, p. 8, citing GAO, Hedge Funds: Regulators and Market Participants Are Taking Steps to Strengthen Market Discipline, but Continued Attention is Needed, GAO-08-200 (Washington, D.C., Jan. 24, 2008). However, in the wake of the market turmoil of 2008, it is estimated that hedge fund assets under management had decreased by 25 percent by the end of 2008. Goldman Sachs, Private Wealth Forum, Survival of the Fittest, p. 3 (Winter 2009). A number of high profile funds collapsed, and many investors sought to exit their hedge fund investments.

- iii. Hedge funds derive their name from the original funds founded in the 1940s, which invested in equities and used leverage and short selling to “hedge” their portfolios from volatility in the stock market. Today, hedge funds encompass a broad range of investment strategies. Hedge funds are not yet regulated, although regulation is expected.

- iv. Funds of funds are another hedge fund investment vehicle. A fund of funds is a pooled investment vehicle that assembles a mix of underlying hedge funds, controls asset allocations among strategies, monitors performance, and replaces underlying hedge funds as appropriate.
- b. *Private Equity*
  - i. Private equity refers to 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 the companies through strategies such as improved operations or development of new products. GAO Report, *supra*, at 10. Private equity funds typically make long-term investments in private companies at various stages of their existence with the expectation of appreciation of the investment. The amount of capital raised by private equity funds grew from approximately \$2 billion in 1980 to \$207 billion in 2007, and the number of funds increased from 56 to 432. GAO Report, *supra*, at 11.
- c. *Risk*. Risk in the investment context refers to the volatility of return. There are two types of investment risk: market risk and unsystematic risk.
  - i. *Market Risk*. Market or systematic risk is the risk associated with the tendency of asset prices to fluctuate with the market. Market risk can only be avoided by not participating in the market. Herbert B. Mayo, *Investments: An Introduction*, p. 8 (7th ed. 2003).
  - ii. *Unsystematic Risk*. Unsystematic or diversifiable risk is the risk associated with individual events that affect a particular asset. Unlike market or systematic risk, unsystematic risk can be reduced by diversification. Mayo, *supra*, at 8.
  - iii. *Measures of Risk*. A beta coefficient is a measure of systematic risk. It is an index of the volatility of the individual asset relative to the volatility of the market. Beta depends on the variability of an individual asset's return, the variability of the market return, and the correlation of the return on the asset and the return on the market. Whether an asset has more or less risk depends on the variability of the asset's return to the variability of the market's return. Mayo, *supra*, at 177.
  - iv. *Hedging*. Hedging is taking opposite positions to reduce risk, such as the risk of price fluctuations. By way of example, a portfolio manager that holds a portfolio of investments that it expects to appreciate in value (long) may buy a futures contract (short) that matches the composition of the portfolio to hedge against an adverse price movement.

### C. General Standard Of Prudent Investment

- 1. *General Rule*. A trustee has a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust.
  - a. *Reasonable Care*. The Prudent Investor Rule requires the exercise of reasonable care, skill, and caution and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

- b. *Diversification*. In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so.
- c. *Delegation And Costs*. Under the Prudent Investor Rule, the trustee is required to (i) conform to the duties of loyalty and impartiality, (ii) act with prudence in deciding whether and how to delegate authority and in the selection and supervision of agents, and (iii) incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship. *Restatement (Third) of Trusts* §90 (ALI 2003).

## 2. *Basic Principles Of Prudent Investment*

- a. *Modern Investment*. Arbitrary restrictions on trust investments are unwarranted and often counterproductive. Trust investment law should reflect and accommodate current knowledge and concepts. Accordingly, no investment is per se prohibited. *Restatement (Third) of Trusts* §90, Introductory Note.
- b. *Principles Of Prudence*. The principles of prudence under the Prudent Investor Rule provide that:
  - i. Sound diversification is fundament to risk management and is therefore ordinarily required.
  - ii. Risk and return are so directly related that trustees have a duty to analyze and make conscious decisions regarding the level of risk appropriate to the purposes, distribution requirements, and other circumstances of a trust.
  - iii. Trustees have a duty to avoid fees, transaction costs, and other expenses that are not justified by needs and realistic objectives of the trust's investment program.
  - iv. The duty of impartiality under traditional income-and-principal rules generally requires a balancing of return between production of current income and protection of purchasing power.
  - v. Trustees may have a duty (and the corresponding authority) to delegate as prudent investors would. *Restatement (Third) of Trusts* §90, Introductory Note.
- c. *Duty Of Caution And Risk Management*. The duty of caution requires the management of non-market risk (through diversification) and the undertaking of market risk appropriate to a trust. There is no objective legal standard for a degree of risk that is appropriate under the Prudent Investor Rule. Risk tolerance varies from trust to trust and may vary from time to time for a particular trust. Investments or techniques that may be characterized as "risky" (such as venture capital, borrowing, and options or futures transactions) are not prohibited:

as long as they are employed in a manner that is prudently designed to reduce the overall risk of the trust portfolio or to allow the trust, in appropriate circumstances, to achieve a higher return expectation without a disproportionate increase in the overall level of portfolio risk.

*Restatement (Third) of Trusts* §90, cmt. e(1).

- d. *Diversification*. Asset allocation among asset classes (such as traditional cash and cash equivalents, fixed income, and equity classes; and alternative private equity, commodities, real estate, and hedge funds) is a first step in the diversification of the investments of a trust. Diversification is achieved through the combination of asset classes whose returns are not correlated. There is no defined set

of asset categories to be considered. The duty to diversify does not require that all categories be represented. *Restatement (Third) of Trusts* §90, cmt. f.

- e. *Costs.* Active investment strategies, particularly active investment strategies utilizing alternative investments, may incur substantial costs. Fees may be layered, computed based on performance or on the value of assets that are difficult to value. The costs associated with due diligence and monitoring may be greater than those for traditional assets. A determination of whether increased costs may reasonably be expected to be compensated by increased returns is required. *Restatement (Third) of Trusts* §90, cmt. h(2).
- f. *Delegation.* A trustee is required to personally determine the investment objectives for a trust. However, a trustee is not required to personally perform all investment functions and may, when prudent, delegate investment authority. The Introductory Note to the Prudent Investor Rule provides:

The...principles of prudence recognize[] that, with proper attention to cost concerns, prudent investing may require or at least benefit from expert assistance in investment matters. Thus, the prudent investor rule views delegation from a positive perspective. Nonetheless, the terms and manner of delegation, the competence of agents, and the supervision or monitoring of agents' activities all remain critical aspects of prudence. The need for delegation may be most readily apparent when complicated or challenging investment strategies are pursued by trustees managing large, diverse portfolios. In quite different ways, however, delegation is also likely to be important to non-expert investors who nevertheless may be well situated and qualified to serve as trustees, as will often be the case with family members or friends. Accordingly, the rule stated in §90 [1992 §227] recognizes the broad authority to delegate in the prudently exercised discretion of the trustee.

- i. By way of Illustration from *Restatement (Third) of Trusts* §90, comment j provides:

Illustration:

The trustees of a large trust, after consultations and study, have reasonably concluded that it would be desirable as a part of an overall portfolio strategy to have a portion of the trust estate committed to a venture-capital investment program. They also have reasonable grounds for preferring to do this directly by holding the company shares in the trust estate, rather than by purchasing shares of some suitable stock mutual funds or other venture-capital pools.... The trustees therefore wish to hire agents with specialized skill to manage the program. In this situation, substantial but prudent delegation is justifiable.

*Restatement (Third) of Trusts* §90, cmt. j.

- ii. The use of pooled investment vehicles necessarily involves delegation to managers. However, under section 90, the relevant securities are considered to be the interests in the particular fund (and not the underlying securities). The trustee controls the decision to invest in the fund. *Restatement (Third) of Trusts* §90, cmt. m.

- 3. *Real Estate And Venture Capital.* The comments to the *Restatement (Third)* Prudent Investor Rule address both real estate and venture capital investment specifically.

- a. *Real Estate.* Real estate may enhance diversification due to its limited covariance with publicly traded securities, may provide long-term protection against inflation, may produce long-term returns comparable to a diversified portfolio of marketable securities, and based on selection, may augment either income productivity or capital appreciation of a trust. However, consideration should be given to the complexities and administrative burdens associated with a real estate investment program. *Restatement (Third) of Trusts* §90, cmt. o.

b. *Venture Capital*. Venture capital historically was not considered an appropriate trust investment. Before 1979, investments in venture capital were potentially viewed as a violation of the Employee Retirement Income Security Act (ERISA). However, in 1979 the Department of Labor clarified that plans may make some investment allocation to “riskier” assets such as venture capital. 44 Fed. Reg. 37,221 (June 26, 1979). Presently, venture capital investment may be considered prudent in particular circumstances. The process for such investment requires special due diligence and monitoring. Use of pooled-investment vehicles may be prudent to facilitate the required due diligence. But the use of pooled investments is not a substitute for the informed decision-making of the trustee with respect to investment objectives and allocations and the monitoring of the manager. *Restatement (Third) of Trusts* §90, cmt. p.

4. *Specific Statutory And Judicial Guidance*. There is limited statutory and judicial guidance regarding the specific issue of the prudence of alternative investments. The Washington Probate Code addresses the issue by placing a 10 percent cap on such investments, providing specifically that:

Subject to the standards of RCW 11.100.020 [Management of trust assets by fiduciary], a fiduciary is authorized to invest in new, unproven, untried, or other enterprises with a potential for significant growth whether producing a current return, either by investing directly therein or by investing as a limited partner or otherwise in one or more commingled funds which in turn invest primarily in such enterprises. The aggregate amount of investments held by a fiduciary under the authority of this section valued at cost shall not exceed ten percent of the net fair market value of the trust corpus, including investments made under the authority of this section valued at fair market value, immediately after any such investment is made. Any investment which would have been authorized by this section if in force at the time the investment was made is hereby authorized.

Wash. Rev. Code §11.100.023 Authority of fiduciary to invest in certain enterprises.

a. In *Harley v. Minnesota Mining and Manufacturing Company*, 42 F.Supp.2d 898 (1999), *aff'd*, 284 F.3d 901 (8th Cir. 2002), *cert. denied*, 537 U.S. 1106 (2003), employees brought an ERISA-based class action claim against 3M for allegedly making an improper \$20 million investment in a hedge fund holding collateralized mortgage obligations (“CMOs”), which eventually collapsed, requiring the plan to write off the investment entirely. The marketing materials for the fund stated that the fund’s strategy would produce very high returns while investing in “low risk instruments.” However, the private placement memorandum expressly stated the substantial risks associated with the fund’s investments and investment strategies, including interest rate risk, difficulties in predicting market movements, possible illiquidity, and the risk of proportionately greater losses due to the use of leverage.

i. The “prudent person” standard under ERISA is analogous in many respects to the Uniform Prudent Investor Rule. The standard is an objective standard, focusing on the fiduciary’s conduct. Under this standard a fiduciary is obligated to undertake an independent investigation of the merits of an investment and to use appropriate, prudent methods in conducting the investigation. Once the investment is made, a fiduciary has an ongoing duty to monitor investments with reasonable diligence and remove plan assets from an investment that is improper. *Harley*, 42 F. Supp.2d at 906–907.

b. Issues addressed in the *Harley* case include (i) whether the company conducted a sufficient investigation of the fund before deciding to invest or undertook reasonably prudent efforts to monitor the

investment, (ii) the extent to which the employer, if lacking the education, experience, or skills required to conduct reasonable and independent investigation and evaluation of the risks and other characteristics of a proposed investment, must seek independent advice, and (iii) whether the fact that the portfolio as a whole profited during the period of the allegedly improper investment would immunize the company from liability for its alleged breach of fiduciary duty. Of particular concern to the court was the limited expertise of the company's pension asset committee in evaluating the investment in CMOs and the failure to monitor and evaluate the fund's risk position, the accuracy of valuations, or whether the fund's strategy had changed. One positive fact was that the plan's investment in the fund constituted less than one percent of the plan's assets. The court held, in relevant part, that (i) there were genuine issues of material fact as to whether the company conducted sufficient investigation of the investment or undertook reasonably prudent efforts to monitor the investment, which precluded summary judgment on the issue of breach and (ii) the fact that the plan's portfolio as a whole profited during the period of the allegedly improper investment would not immunize the employer from liability for its alleged breach. *Harley*, 42 F.Supp. at 916.

#### **D. Diversification And Enhanced Returns With Non-Traditional Investments**

1. *The Objectives And The Challenges.* Alternative investments are used in fiduciary accounts to manage risk and enhance returns. They have been used in pension funds and endowments for a number of years, and at least until the market turmoil of 2008, the extent of their use was increasing.
  - a. *Hedge Funds*
    - i. Investment in hedge funds may be made to lessen the volatility of returns, to obtain returns greater than those expected in the stock market, and to diversify a portfolio by investing in a fund the returns of which will not be correlated to those of other investments in the portfolio.
    - ii. However, there are certain challenges associated with investments in hedge funds that are not present with traditional investments. These challenges include reliance on the skill of hedge fund managers; use of leverage, with both the associated "upside" potential and "downside" risk; higher fees; a greater degree of due diligence requiring specific expertise and expanded legal review; lack of transparency; liquidity limitations; and internal operation risks. GAO Report, *supra*, at 22–24.
    - iii. Hedge funds are actively managed, and investors typically consider the qualifications of fund managers in selecting funds. However, managers may change and investors may not be able to readily divest themselves of their investment upon a change in managers. Some investors would question altogether the ability of fund managers to exceed market performance.
    - iv. Hedge funds may use leverage to potentially enhance returns, and the extent to which leverage may be used is not regulated in hedge funds as it is in mutual funds. Unrestricted use of leverage may be of particular concern to fiduciary investors to the extent that the direct use of leverage is restricted under a particular governing instrument.
    - v. Fees are also a material consideration in hedge funds. A trustee has a duty to incur only reasonable costs associated with investments. Hedge fund fees may be as high as 2 percent of assets under management plus 20 percent of a fund's annual profits.

vi. Lack of transparency in general and with respect to valuation of fund assets in particular present additional challenges for the trustee in evaluating and monitoring hedge fund investments. However, pressure from large institutional investors and government advisor groups (see the discussion of the President's Working Group on the Hedge Fund Industry in Section E below) have improved transparency and valuation reporting.

vii. Finally, liquidity poses a challenge with respect to hedge fund investments. Hedge fund operating agreements commonly provide for "lock-up" periods that limit an investor's ability to liquidate its investment for a defined period following its initial investment, and may suspend redemptions if there are internal liquidity constraints within a fund.

viii. Prudent trustee investment in hedge funds requires clear identification of the investment objectives intended to be achieved by the investment and due diligence and monitoring practices and procedures that address the risks noted above. In some circumstances, funds of funds are used to achieve diversification of hedge fund investments, to obtain the expertise of the fund manager's evaluation of funds, and to obtain access to desired funds.

b. *Private Equity*

i. A principal objective of investment in private equity is to attain returns that are superior to those of investments in the stock market. The "price" for such return is greater risk. Due to correlations with performance of the stock market, certain investments in private equity achieve diversification only on a limited basis.

ii. There are a number of challenges associated with investment in private equity. The investments of private equity funds are typically concentrated in a limited number of companies in a single sector, which may result in increased non-market risk. Buyout funds customarily use significant leverage, and venture capital funds, by definition, invest in companies with a limited record, which may contribute to increased exposure to risk of loss. When market conditions are particularly strong, competitive pressures may cause managers to overpay for opportunities, making it more difficult to generate positive returns. There is a significant variation in performance among private equity funds, and access to top performing funds is limited. Returns of the top quarter funds have been reported to exceed those of the bottom quarter funds by more than seven times. GAO Report, *supra*, at 34 (citing Steven Kaplan and Antoinette Schoar, *Private Equity Performance: Returns, Persistence, and Capital Flows*, 60 *J. Fin.* 1791 (August 2005)). The long-term commitment required for private equity presents another challenge, particularly for fiduciary accounts with ongoing distribution requirements or upon termination of the trust. Valuation of private equity investments may be uncertain. Finally, for the fiduciary, the expertise and resources required to adequately evaluate and monitor private equity investments may be a hurdle.

2. *The Experience.* 2008 was a challenging year for trustees responsible for the investment of fiduciary accounts. Hedge fund, private equity, and other non-traditional assets were not immune from the vagaries of the markets. In addition to erosion of returns, some investors in non-traditional assets were faced with liquidity and cash flow issues, as redemptions from certain hedge funds were subject to suspension and investors were faced with capital calls for private equity investments. Some were required to sell equities to meet capital calls in a deep bear market. In the words of Christopher Ailman, chief

investment officer of the California State Teachers' Retirement System, which is the country's second-largest public pension fund, "What we saw as an asset before, we now see as a liability." *Once Burned, Twice Shy: Pension Funds* (Jan. 3, 2009), <http://online.wsj.com/article/SB123094085873450333.html>. This is in stark contrast to the view expressed many years earlier by one author upon the introduction of the Prudent Investor Rule:

[F]iduciaries—hampered by the antiquated Prudent Man Rule—have been the investment community's ultimate laggards. Thankfully, however, their shackles have finally been removed. The new Prudent Investor Rule brings fiduciary investing out of the 19th century and into the modern world, allowing application of the full array of investment theories, practices, and options enjoyed by all investment professionals. Given the specific requirements of the new standard—including diversification, thorough assessment of risk (including inflation risk), the importance of total return, and the ability to delegate management responsibility to investment professionals—the high-return potential of private equity investing now represents a fully appropriate and even compelling investment option for trustees, executors, guardians of minors, conservators of assets, and other fiduciaries.

Frederick B. Taylor, *Private Equity and the New Prudent Investor*, 135 Tr. & Est. 8 (January 1996).

- a. The Office of the Comptroller of the Currency published its Economics and Policy Working Paper 2008-2 on Alternative Assets and Public Pension Plan Performance in August 2008, available at [www.occ.treas.gov/ftp/workpaper/wp2008-2.pdf](http://www.occ.treas.gov/ftp/workpaper/wp2008-2.pdf). The Working Paper examined how alternative investments such as hedge funds, private equity funds, and real estate have affected plan performance. The Working Paper concludes as follows:

Comparing investment returns of 39 public pension plans, we find that pension plans with alternative asset target allocations of at least 10 percent but less than 20 percent had significantly higher returns than other pension plans at most of the investment horizons we examine. These investment horizons are individual years from 2002 through 2006, and average returns for the three-year, five-year, and 10-year periods ending June 30, 2006. Not only were the returns higher but also the return variances were about the same as for the other pension plans. (Most variances did not differ significantly.)

However, when we look to another measure of risk, namely the standard deviations of returns at individual pension plans, we find that the standard deviations of returns were consistently and significantly higher at pensions investing at least 10 percent of their assets in alternative assets. From this perspective, those pension plans were consistently riskier. Combining the two to look at risk-adjusted returns via the Sharpe Ratio, we find no significant difference in risk-adjusted returns regardless of the alternative asset allocation target. Together, these results suggest that investments in alternative assets brought higher returns over the past few years, but at the cost of greater volatility. It is up to pension fund managers and plan fiduciaries to determine whether the lure of attractive returns outweighs the accompanying increase in return variance.

Although our results provide some evidence in favor of including alternative assets in an investment portfolio if one is seeking higher returns, this endorsement comes with several caveats. First, we need to see how our pension plans perform over the next three to five years before being completely persuaded that alternative investments provide significantly higher long-term returns to pension portfolios. In addition to seeing how alternative investments perform through the market turmoil that began around June 2007, the additional data is also important in light of our tests showing that early and late adopters of alternative asset allocations did not show significantly different returns. These results suggest that most of the benefits of alternative investments came from their strong performance over just the past three years. Pension fund fiduciaries might like to see more evidence of a benefit to long-term investing in alternative assets before dedicating a larger percentage of their assets to these investments.

Another caveat is in order because of the additional risks associated with alternative investments. Because of possible liquidity and disclosure problems, it is absolutely crucial for a public pension plan to have a thorough due diligence effort in place to pick the right alternative investment and to consider the potential operational risks and hazards that these investments pose. Hedge funds, in particular, with their self-regulation, lockup periods, a lack of disclosure that

seems to increase the opportunity for fraud, and other perils, provide a good example of why superior due diligence is a critical need for pension funds that elect to target alternative investments.

Another concern that may emerge over time is how to deal with performance-based compensation for public pension fund managers. This issue recently arose in Massachusetts when the director of the state pension fund asked for and received a performance-based bonus plan. Public plans with performance-based compensation features now include California, Maryland, Massachusetts, Texas and South Dakota. See Frank Phillips, “Pension Director Looks for Bonuses,” *The Boston Globe*, August 8, 2007 and Andrea Estes, “Bonus Plan Approved for Pension Fund Employees,” *The Boston Globe*, October 3, 2007.

Our results show that large allocations for alternative assets may provide significantly higher returns in individual years (for instance, over 300 basis points in 2006). However, at investment horizons of five and ten years, the higher returns tend to be much less dramatic—for example, 102 basis points over five years and 76 basis points over 10 years for pension funds with at least a 10 percent target allocation for alternative assets in 2006. What these results suggest is that public pension fund trustees should be aware that performance-based compensation packages may give fund directors an incentive to swing for the fences with larger allocations for alternative investments even though the pension fund’s long-term benefit from such an investment strategy remains in doubt.

With these caveats in mind, our results do suggest that alternative assets are important investments for pension plans. In light of the turmoil in credit markets in 2007 and how often the business news mentions our alternative assets, namely real estate, private equity, and hedge funds, in connection with this market turmoil, it will be interesting to see how alternative investments and our results regarding them withstand the tests of time and market upheaval.

If maintained, our evidence of superior returns because of alternative assets suggests that a rather striking policy reassessment may be in order. If large allocations for alternative assets produce significantly higher returns over a longer time period, as our evidence suggests, then alternative assets may be an important component of any retirement fund portfolio. If this is true, then policy makers may want to consider ways to make alternative assets, including possibly even hedge funds, more easily available to defined contribution retirement plan participants. As defined contribution plans like 401(k) plans continue to replace defined benefit plans, fewer workers are covered by defined benefit plans like those in our study. While defined benefit plans can easily invest in alternative assets, defined contribution plans usually cannot. But if alternative assets are important components of diversified defined benefit portfolios, the same may be true for individual retirement accounts and defined contribution plan portfolios.

## **E. Best Practices—Hedge Funds**

1. *President’s Working Group*. The Asset Managers’ Committee to the President’s Working Group (“PWG”) on Financial Markets issued Best Practices for the Hedge Fund Industry on January 15, 2009 (“Industry Best Practices”), and the Investors’ Committee to the PWG issued Principles and Best Practices for Hedge Fund Investors (“Investor Best Practices”). Report of the Asset Managers’ Committee to the President’s Working Group in Financial Markets, Best Practices for the Hedge Fund Industry (January 15, 2009); Report of the Investors’ Committee to the President’s Working Group on Financial Markets, Principles and Best Practices for Hedge Fund Investors (January 15, 2009). The full reports can be found at [www.amaicmte.org](http://www.amaicmte.org).
2. *Industry Best Practices*

## Defining Features of Hedge Funds

(from PWG Report Industry Best Practices, supra, p. 11, citing Oliver Wyman, Perspectives on Asset Management—Hedge Funds; Growth Sector or Maturing Industry? (New York, June 2005), p. 5.)

Hedge funds typically:	Traditional products typically:
• Invest both long and short	• Invest only long
• Are leveraged	• Are not leveraged
• Have a high, performance-based fee structure	• Have a lower ad valorem fee structure
• Require co-investment by fund manager	• Do not encourage co-investment
• Are able to use futures and other derivatives	• Are restricted in using derivatives
• Have a broad investment universe	• Have a limited investment universe
• Can have large cash allocations	• Are required to stay fully invested
• Have an absolute return objective	• Have a relative return objective
• Regulate investor access, but the product itself is lightly regulated	• Are frequently heavily regulated

- a. *Disclosure, Etc.* The Industry Best Practices address disclosure, valuation of assets, risk management, business operations, compliance, and conflicts of interest for hedge funds. Disclosure plays a central role in the Industry Best Practices. Disclosure of conflicts of interest and fee arrangements is emphasized. The Industry Best Practices do not address private equity and real estate investments.
3. *Investor Best Practices.* The Investor Best Practices include a Fiduciary’s Guide for persons responsible for determining whether hedge funds are an appropriate component of an investment portfolio and an Investor’s Guide for those responsible for executing and implementing a hedge fund program once a fiduciary decides to add hedge funds to its investment portfolio.
- a. *Fiduciary’s Guide.* The Fiduciary’s Guide provides recommendations to persons charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio. The term “fiduciary” refers to those with portfolio oversight responsibilities. The term “investor” refers more narrowly to investment professionals charged with implementing a hedge fund program.
- i. *Assessing The Appropriateness Of A Hedge Fund Program.* The Fiduciary’s Guide identifies a series of questions the fiduciary should address in its assessment of the appropriateness of a hedge fund program, focusing on:
- (1) *Temperament.* Does the fiduciary organization have the temperament and the “institutional fortitude” to stick with its strategic allocation under circumstances with the potential for significant short-term volatility?

(2) *Manager Selection.* Does the fiduciary organization have staff with the necessary expertise to select managers with true investment skill and will it allocate sufficient resources to manage and monitor hedge fund investments appropriately?

(3) *Portfolio Level Dynamics.* Does the fiduciary institution understand how the hedge fund portfolio will generate investment returns and the associated risks? Does the fiduciary organization understand the degrees and types of leverage used?

(4) *Liquidity Match.* Is the liquidity (or the lack thereof) consistent with the requirements of the fiduciary account?

(5) *Conflicts Of Interest.* Have conflicts of interest been identified and have appropriate steps been taken to mitigate or eliminate the adverse consequences arising from conflicts of interest?

(6) *Fees.* Are the fees associated with the hedge fund investment generally reasonable in the context of the market?

(7) *Citizenship.* Is the hedge fund a “good capital markets citizen?”

ii. *Risk And Uncertainty.* Investing in hedge funds involves both risk and uncertainty. Risk is an element of randomness in situations in which the ultimate outcome is undetermined, but the range of potential outcomes is understood and quantifiable—the “Monte Carlo” analytical framework. Uncertainty is the product of incomplete knowledge about the manner in which events occur, a lack of predictability, and the possibility of unprecedented behavior or events; it is not quantifiable. Hedge funds may present greater uncertainty than other types of investments. Fiduciaries must be capable of assessing both the risk and the uncertainty associated with hedge fund investments.

iii. *Considerations Prior To Investing In Hedge Funds.* The Fiduciary’s Guide cautions that fiduciaries should question the commonly presupposed notion that hedge funds are inherently desirable vehicles and warns that a fiduciary should only pursue a hedge fund investment if:

(1) The fiduciary believes that the hedge fund manager is particularly skilled in active investing and that the investment offers investment strategies to which exposure is most effectively gained through a hedge fund;

(2) The benefit of the manager’s skill and the nontraditional exposure remains after fees, expenses, and due diligence costs;

(3) The fiduciary, with the assistance of staff and consultants, can differentiate between skill-based managers and those generating profits from generic market exposure; and

(4) The fiduciary will have the opportunity to invest in hedge funds that they have identified as suitable investments.

iv. *Fees.* What are the fees associated with the investment and how do they affect realized returns? A fiduciary has a duty to incur only those costs that are reasonable. Hedge fund fees are based both on assets under management and performance. The typical management fee is 1–2 percent of the assets managed, and the performance fee is typically in a range of 10–20 percent of the fund’s

total return. In assessing fees, a fiduciary should consider the methods by which and the frequency with which fund assets will be valued. Valuation methodologies are often more complex than with traditional fiduciary investments.

v. *Fund Of Funds*. Fiduciaries may invest in hedge funds through a “fund of funds”; the investment manager of the fund selects the underlying hedge funds in which the fund will invest. However, even with a fund of funds, the fiduciary must continue to make the initial assessment as to whether investment through a hedge fund is appropriate for the fiduciary account.

vi. *Hedge Fund Investment Policy*. Fiduciaries that intend to make hedge fund investments should establish policies and procedures that address the strategic purpose of investing in hedge funds, the role the hedge funds will play in the overall portfolio, the performance and risk objectives of the hedge fund investment program, who will manage the program, and what investment guidelines will apply to the funds.

vii. *Due Diligence Process And Ongoing Monitoring*. Fiduciaries that intend to make hedge fund investments should establish appropriate due diligence processes and ongoing monitoring procedures. If a fund manager is an ERISA fiduciary, it is required to be registered as an investment advisor under the Investment Advisers Act of 1940 or comparable state law, to acknowledge that it is a fiduciary of the plan, and to have policies and procedures in place to comply with restrictions on “soft dollars,” to prevent prohibited transactions, and to mitigate conflicts of interest. Satisfaction of each of the conditions is equally important to non-ERISA fiduciaries and provides at least some measure of the prudence of investing with the fund manager.

b. *Investor’s Guide*

i. The Investor’s Guide describes best practices and guidelines for investment professionals charged with administering hedge fund investment programs. The Investor’s Guide is a tool for the process of selecting and monitoring particular fund investments.

ii. The Investor’s Guide sets forth guidance with respect to the due diligence process, including assessment of the manager’s investment process (an important component of which is style integrity), performance, personnel, risk management (an important component of which is liquidity and leverage risk), use of third-party service providers, legal structure, domicile, fees, and regulatory compliance.

iii. Valuation is an important component of the investment decision-making process. The complexity of hedge fund portfolios makes the valuation of fund investment difficult and subject to uncertainties not present with more traditional investments. The fund should have a valuation policy and a valuation committee or similar governance mechanism to serve as a control of the consistent and appropriate application of valuation methodologies.

iv. The Investor’s Guide advises that investors develop a comprehensive philosophy regarding the payment of fees and expenses for investment management services contracted, taking into consideration fees and expenses relative to returns and risks.

## F. Due Diligence And Legal Review

1. *General.* A fiduciary investing in alternative investments can only do so prudently if it undertakes a comprehensive due diligence process. Process is a core tenet of the prudent investor rule, and there is no substitute for it. It is necessary for the fiduciary to understand the legal structure and, when necessary, engage legal counsel for a legal review of the fund agreement; understand the investment strategy and the risks associated with the strategy; understand the market or systemic risks and, in the case of a fund, understand the market risks of the market in which the fund invests; understand the composition of the investment and the associated unsystematic or unique risks including credit risks and volatility; understand the liquidity (or lack thereof) of the investment; monitor performance; in the case of a fund, monitor the composition of the fund; monitor redemptions; and require transparency. Paul U. Ali, *Hedge Fund Investments and the Prudent Investor Rule*, 17 Tr. L. Int'l 74, 87–88 (2003).
2. *Legal Review.* The legal review required in connection with investment in non-traditional assets is typically greater than that associated with investment in traditional assets, which often will require no legal review at all. For instance, in the case of an alternative investment fund organized as a partnership or limited liability company, there are issues to address with respect to the proper formation of the fund as well as the ongoing operation of the fund. Operational considerations include the economics of the operation of the fund, such as the allocation of income and losses and distributions from the fund, and contractual limitations on the liability of the fund managers. Funds are commonly organized under Delaware law. Although general partners of limited partnerships and managers of limited liability companies may have certain fiduciary duties, including the duty of loyalty and a duty of care, Delaware law permits the elimination of such duties by contract, with the exception of the implied contractual covenant of good faith and fair dealing. Del. Code. Ann. tit. 6, §§17-1101(d) and 18-1101(c). Another issue for consideration is the extent to which the operating agreement provides for—or, alternatively, limits—access to the entities' books and records. For a detailed discussion of issues raised by institutional investors in hedge funds, see Steven G. Frost, *Issues Raised by Institutional Investors in Hedge Funds*, *Journal of Passthrough Entities* (May–June 2005), pp. 17–25.

## G. Valuation

1. *Trustees' Duty To Inform And Account.* A trustee has a duty to furnish information and accounts to beneficiaries. The fundamental objective of an account is to give “essential and useful information in a meaningful form to the parties interested in the accounting process.” American College of Trust and Estate Counsel, *National Fiduciary Account Standards, Study #19*, p. 19-4 (May 1984) (“ACTEC Study #19”). Accordingly, a fiduciary account is to include carrying values—representing the value of assets at acquisition by the fiduciary—and values at the beginning and end of each accounting period. When values are not precisely determinable, the figures reported “should reflect a thoughtful decision by the fiduciary.” ACTEC Study #19 at 19-8. For assets for which there is no readily ascertainable current value, the source of the value stated in the account is to be explained. The fiduciary is required to make a good faith effort to determine realistic values, but is not required to incur expenses for appraisals when there is no reason to expect that the resulting information will be of practical consequence

to the administration of the trust or the protection of the interested parties. ACTEC Study #19 at 19-8.

2. *General Consideration In Valuation Of Alternative Investments.* One of the challenges for fiduciaries administering non-traditional assets such as hedge funds, private equity and private equity funds, real estate funds, commodity funds, and funds of funds is reporting the value of the assets in accountings. FASB Statement No. 157 (Fair Value Measurements) issued in 2006 by the Financial Accounting Standards Board includes guidance with respect to fair value measurements, valuation techniques and disclosures in financial accounting involving assets for which there are not active markets or other “observable” and independent valuation inputs. SFAS 157 is not an established fiduciary accounting standard. However, its considered approach to valuation issues provides a useful framework for consideration of the question of valuation, reporting and disclosure with respect to non-traditional investments in fiduciary accounts.
  - a. The American Institute of Certified Public Accountants (“AICPA”) Accounting Standard Executive Committee and the Alternative Investments Task Force issued a draft issues paper in January 2009, which addresses FASB Statement No. 157 (Fair Value Measurements) valuation considerations for interests in alternative investments. AICPA Accounting Standards Executive Committee and the Alternative Investments Task Force Draft Issues Paper, FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments (January 2009).
3. *Specific Inquiries.* The AICPA draft issues paper poses the following inquiries regarding the valuation of alternative investments:
  - i. FASB Statement No. 157 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction on the measurement date.” *Id.* par. 5.
  - ii. FASB Statement No. 157 states that a fair value measurement assumes that the transaction to sell the asset occurs in the principal market for the asset, or in the absence of a principal market, the most advantageous market. How should an investor entity determine the principal or most advantageous market for alternative investments? Typically there is no actual market in which transactions in alternative investments occur directly between market participants, so a hypothetical market is assumed. When there are limited principal-to-principal or brokered transactions, such transactions generally lack transparency and may occur under distressed circumstances. AICPA Draft Issues Paper at 6.
  - iii. What inputs should be used in estimating fair value for an interest in an alternative investment? Examples of inputs include net asset value of the underlying fund assets, transactions in brokered markets, features of the alternative investment, and discounted expected future cash flow. AICPA Draft Issues Paper at 7.
  - iv. How should transactions between market participants in external markets be considered in estimating the fair value of an interest in an alternative investment? If there are known transactions in interests in the alternative investment or a similar alternative investment, such transactions and the circumstances of such transactions should be considered. AICPA Draft Issues Paper at 8.

- v. Does an investee fund's net asset value ("NAV"), as most recently reported by the manager of an alternative investment (reported NAV), represent fair value in accordance with the provisions of FASB Statement No. 157? The investing entity should not assume without inquiry that the reported net asset value of fund assets is reliable. The investing entity should "undertake a robust review and understand and evaluate the NAV reported by the investee fund manager." AICPA Draft Issues Paper at 9.
- vi. What consideration should be given to the most recently reported NAV before using it as a starting point for estimating fair value in accordance with FASB Statement No. 157? Key factors for an investor entity to consider before relying on reported NAV as a starting point for fair value measurement include the investee fund's fair value estimation process, controls, policies and procedures, use of independent third party valuation experts and professional reputation, qualifications of the auditors, qualifications of the auditor's report of the investee fund's financial statements, and any history of significant adjustments to NAV. AICPA Draft Issues Paper at 11.
- vii. If the investor entity determines that the most recently reported NAV is an appropriate starting point, what modifications should be considered to adjust NAV in the fair value measurement process? Factors that may require modification to NAV as a starting point for valuation of an interest in an alternative investment include the amount of time elapsed since the valuation, significant balance sheet items not carried at fair value, and allocations of unrealized profits. AICPA Draft Issues Paper at 12-13.
- viii. In addition to NAV, what features of alternative investments should be considered for their potential impact on the estimation of fair value? Relevant factors may include recent subscription and redemptions, expected future cash flows, performance measured against benchmarks, lock-up periods, redemption fees, notice periods, holdbacks, suspension of redemptions or gates, lack of redemption options, required approvals for transfers, significant redemptions, closure to new investors, allegations of fraud against the fund manager, and changes in financial strength or key personnel. AICPA Draft Issues Paper at 13-20.

## **H. Principal And Income**

1. In connection with the investment of a trust estate in non-traditional assets, consider the consequence of the investment on the principal and income allocation of distributions from the investment, particularly in the case of a "traditional" or non-total return trust. The allocation of interest and dividends from traditional investments for trust accounting and tax reporting purposes is very straightforward. They are included in trust accounting income and are included in distributable net income for tax reporting purposes. The allocation of distributions from a non-traditional investment entity and the associated treatment as either included or excluded from distributable net income for tax purposes may be more complicated.
2. The Uniform Principal and Income Act (1997) ([www.law.upenn.edu/bll/archives/ulc/upaia/2000final.htm](http://www.law.upenn.edu/bll/archives/ulc/upaia/2000final.htm)) ("UPAIA") includes for the first time provisions with respect to the allocation of net income from partnership and limited liability company interests acquired by the trustee other than from a decedent (the old Acts dealt only with partnership interests acquired from a decedent). Section 401(a) defines an

“entity” to include corporations, common trust funds, regulated investment companies, and real estate investment trusts, as well as partnerships and limited liability companies. The general rule under section 401(b) is that all money received from an entity is to be allocated to income, but money received in total or partial liquidation of an entity is to be allocated to principal. UPAIA §401(b), (c). Money is considered received in partial liquidation to the extent that the entity indicates that it is a distribution in partial liquidation or if the total amount of money and property received in a distribution or a series of related distributions is greater than 20 percent of the entity’s gross assets, as shown by the entity’s year-end financial statements immediately preceding the initial receipt. UPAIA §401(d). Money is not considered as received in partial liquidation to the extent that it does not exceed the amount of tax that a trustee or beneficiary is required to pay on taxable income of the entity that distributes the money. UPAIA §401(e). A trustee may rely on a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the governing board of the entity. *Id.* §401(f). The UPAIA also includes a power to adjust and, in the case of a particular trust, is subject to any applicable provisions of the governing instrument.

3. Under the Illinois Principal and Income Act, 760 Ill. Comp. Stat. 15/1, et seq., which has not been “modernized” so to speak, provision is made for “corporate distributions,” 760 Ill. Comp. Stat. 15/7, but no specific provision is made for distributions from investment entities organized as limited partnerships or limited liability companies. The Illinois Principal and Income Act gives a trustee, subject to the terms of the governing instrument, broad discretion to make allocations in accordance with “what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal.” 706 Ill. Comp. Stat. 15/3.

## **I. Practical Considerations**

1. The unique nature of many non-traditional assets presents a number of practical administration challenges for trustees in the administration of trusts. Many non-traditional assets are structured as limited partnerships or limited liability companies, which generate K-1s for tax reporting purposes rather than 1099s. The delivery of K-1s to investors is typically long after year end and commonly requires the extension of trust tax return filings, which in turn delays the delivery of trust K-1s to beneficiaries, which delays their personal tax return filings. In addition, many non-traditional investments require multiple state income tax filings, which generate state K-1s from the entity and may require state filings by a trust investor and in turn by trust beneficiaries.
2. Another consideration for a trustee is the administration of non-traditional assets in connection with the division or termination of a trust. It is common for a trust to divide into multiple trusts upon a particular event such as the death of a beneficiary. Transfer of non-traditional assets may be limited by the terms of the operating agreement of the entity, and liquidation may not be feasible.
3. With the dilution of assets upon the division of a trust or distribution to the remainder beneficiaries, the subdivided trusts or remainder beneficiaries may not meet the threshold level of net worth required of investors in certain non-traditional assets. Hedge funds and private equity funds are typically exempt from SEC registration requirements by reason of their investors being “accredited investors” or “qualified purchasers,” depending on the specific exemption, and limit their investors to those who

meet these requirements. An accredited investor includes a trust with assets in excess of \$5 million, not formed to acquire the securities offered, with purchases made by a sophisticated investor. 15 U.S.C. §77b(a)(15)(i). A qualified purchaser is a more stringent requirement. A qualified purchaser includes a trust that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee and each person who has contributed to the trust owns at least \$5 million in investments. 15 U.S.C. §80a-2(a)(51).

4. Finally, for a corporate trustee, its investment policies, procedures, and practices with respect to investment in non-traditional assets will be subject to oversight by its regulator. Although examinations of trust departments by regulators have not historically focused on a corporate fiduciary's investment in non-traditional assets, more recent examinations have included such reviews.

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