Alternative Investments: A Discussion of Their Central Characteristics and a Due Dilgence Checklist

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So called "Alternative Investments" have moved from being merely fashionable to a staple of many public retirement systems. Plans which have not yet adopted these strategies will likely confront repeated opportunities to do so in the near future.

The unique complexity and risk of Alternative Investments often causes one of the following opposite knee jerk reactions: (1) rejection of the strategy altogether; or (2) adoption of the strategy without full knowledge of its nature or consequences. Fiduciary obligations are left unfulfilled in either case.

Either result can be avoided by observing the basic tenets of due diligence, with an emphasis on obtaining clear, complete, and understandable information regarding the proposed Alternative Investment. This article will assist trustees in meeting their fiduciary obligations by explaining the legal authority permitting investment in these vehicles, providing an overview of the structure and asset base of such investments, and setting forth a trustee due diligence checklist to help assess whether any given Alternative Investment is both prudent and appropriate for a particular retirement system.

I. Alternative Investments: Definition and Permissibility

The term "Alternative Investments" is used to describe asset classes other than traditionally managed stock and bond portfolios[1]. These classes normally refer to private equity, hedge funds (including fund of funds), and managed futures or commodities.

The Public Employee Retirement System Investment Act, Act 314 of 1965 (the "Act"), governs investments by retirement systems in the public sector. Generally, the Act delineates specific investments permitted by public retirement systems such as stocks, bonds, derivatives, and securities. Specifically, section 20(d) of the Act permits retirement systems to invest their assets in vehicles that are not otherwise specifically allowed by the Act. § 38.1140d.[2] This provision has become known as the "basket clause

The amount of a retirement system's assets that may be invested under the basket clause is restricted under the Act based upon the size of the system, as follows:

Assets of Retirement System	Investment Permitted Under Basket Clause
Less than $250 million	Not more than 5% of system's assets
$250 million or more	Not more than 10% of system's assets
$1 billion or more	Not more than 15% of system's assets

II. Distinct Legal and Practical Characteristics of Alternative Investments

The primary legal and practical differences between traditional and alternative investments can be generally summarized as follows:

- **Lack of regulation.** Alternatives often involve investment in entities or securities that are not publicly traded, not subject to direct Securities and Exchange Commission ("SEC") regulation, and thus operate with minimal or no federal regulatory oversight.

- **No delegation to registered investment manager.** Alternatives often do not involve retention of a registered investment manager who assumes fiduciary responsibility for the investment activity. Thus, the trustees are not only responsible for the prudence of initial investment decisions, but for ongoing investment performance.

- **Structure of investment.** Many alternatives are structured as private limited partnerships. The general partner is the sponsoring entity and the investors are limited partners. The "limited" partner means just that: limited rights to withdraw from the investment let alone direct the conduct of the general partner.

- **Liquidity**. Often, the ability to withdraw funds is limited. For example, in a limited partnership the ability of the limited partner to withdraw is set forth in the

1 One might question whether real estate could be considered an Alternative Investment. Several years ago, that was probably the case. However, over time, the real estate asset class has become "institutionalized" and professional investment management firms have developed strategies and products to facilitate investments by retirement plans. Most investors now consider real estate a "traditional" asset class.

2 This section of the Act is aptly entitled "Investments Not Qualified Under the Act."

partnership documents and is often subject to strict timetables which can often be deferred at the election of the general partner, or an investor who is a "participant" in a commingled fund is similarly restricted in its rights to withdraw, among other things.

• **Transparency.** The actual securities, holdings, or detailed strategies within the portfolio are often not fully available to investors.

• **Investment agreement.** Investors are required to execute a complicated set of documents which the sponsoring entity seeks to impose uniformly on all investors. Thus, flexibility in negotiating these agreements is far more limited than in the traditional setting. As a result, trustees must confront extensive indemnity, limitation of liability, statute of limitations, and unfavorable governing law and jurisdictional provisions.

• **Fees.** The fees associated with alternatives are often significantly higher than traditional investments.

• **Time horizon**. The investment horizon may be quite long compared to traditional investing. The partnership term may last 10 or more years. During this period, the general partner is paid its annual management fee even though the vehicle may post negative returns to limited partners.

• **Unspecified Costs and Expenses.** Capital costs and other expenses associated with the operation of the partnership or commingled fund are paid by the investor on a pro rata basis as deemed "reasonable and necessary" by the controlling entity.

• **Skill and expertise of manager.** These investments are not publicly traded and thus not within the common knowledge of traditional money managers, let alone traditional investors. The underlying entities are often startup industries or those in their infant, and thus untested, stages. Additionally, the governing documents provide the manager with broad discretion, including the use of leverage to enhance returns. Thus, the particular expertise and qualifications of the mangers are critical to the success of alternatives.

III. Specifics of Private Equity, Hedge Funds, and Managed Futures/ Commodities

A. Private Equity

Private equity describes various strategies for investing in non-public securities. The major categories are venture capital and buyouts.

Venture capital involves financing to start a new business or grow an existing one. Many funds specialize in a single industry (such as biotechnology, computer hardware, networking). Investments may be made in various stages of the business, generally referred to as the seed, early, and late stages. Additionally, a final round of financing is available which moves the company toward a public offering of stock, a pre-initial public offering (IPO). The earlier stages are considered more risky based on the lack of track record or business model.

"Buyouts" refer to the financing used to acquire a majority or controlling interest in an existing business. These are usually divisions or subsidiaries being sold by larger companies seeking to refocus on their principal business. "Leveraged buyouts" involve buyers making a small equity investment in a company and paying the rest of the purchase price with borrowed funds.

Whether venture capital or buyout, the earnings, if any, on these investments may not materialize for a significant period. Investments are generally made by the general partner during the first 5 to 7 years, during which time capital is called from the limited partners as needed. These funds usually post negative returns during this time. Nevertheless, the general partner earns a fee during this period, usually 1.5% to 2% on committed capital. The total partnership term typically lasts 10 to 12 years. As the fund becomes fully invested, positive returns may be realized by the limited partners.

B. Hedge Fund

The term "hedge fund" derives from a style of investment which "hedges" against overall stock market movement: a combined portfolio of undervalued stocks expected to increase in price along with overvalued stocks expected to decline. It is anticipated that in rising markets, the undervalued stocks will outperform the overvalued stocks and, in a falling market, the reverse would hold true. While many funds engage in this type of long-short investing, hedge funds have come to mean any investment fund that is not managed using traditional stock and bond strategies. Hedge funds often have the following characteristics:

• They are normally established as limited partnerships.

• The managers possess broad investment discretion and may use leverage to enhance returns.

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- The managers are concerned with earning absolute, positive returns as opposed to results relative to a given market benchmark. Further, while the market return is the principal factor driving investment performance for the traditional investment manager, the skill of the hedge fund manager largely dictates the return.

- Hedge fund managers charge fees higher than traditionally managed portfolios (e.g. 1% to 2% percent of the fund's market value). The manager also shares in a percentage of the hedge fund's returns while collecting this fee.

- Compared to private equity, hedge funds provide the limited partnership investor with greater liquidity. Nevertheless, limited partners usually must commit an initial "lock up" for their investment (often one year). Thereafter, withdrawals may occur periodically subject to advance notice set forth in the governing documents.

Also available are "fund of funds" which include a variety of individual hedge funds. They limit the risk normally associated with investing in a single hedge fund by spreading the investments over several different managers and type of strategies. Further, the fund of funds investment manager may be a registered investment manager who will accept the delegation of fiduciary responsibility as in the traditional setting.

C. <u>Managed Futures/Commodities</u>

This strategy remains fairly new to many institutional funds and thus merits the briefest comment. Commodities are raw materials: assets that are tangible such as energy, grains, industrial metals, and livestock. As their prices tend to have a high correlation to changes in expected inflation and a low correlation to stocks and bonds, they may be attractive from a diversification standpoint.

IV. Trustee Due Diligence Checklist

No Alternative Investment should be adopted until the retirement system trustees have satisfied themselves that they fully understand the structure, risks, and benefits of such an investment. The following checklist is designed to assist trustees in assessing whether they have gathered the pertinent information:

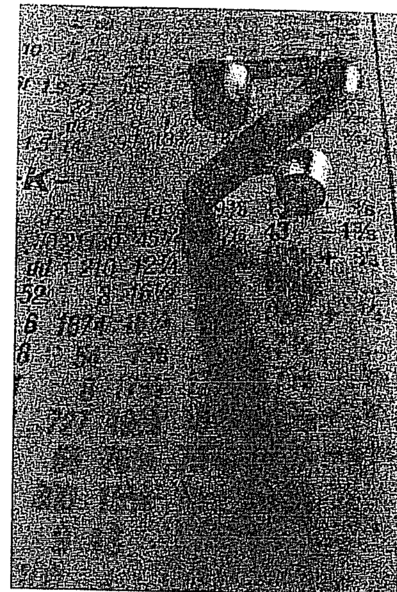
1. Does the investment policy and overall strategy of the retirement system provide for investment in alternative strategies and, if so, in what specific types and amounts?

2. Has the investment consultant provided a clear opinion regarding the suitability of these investments for your specific retirement system? This includes the ability to withstand the lack of liquidity and associated risks.

3. In addition to the obligation to prudently investigate such investments at their inception, who bears the fiduciary liability for performance of the assets? Has delegation of fiduciary responsibility for investment decisions been made to an advisor under the Act? If not, are the trustees willing to accept the potential liability triggered by performance of the manager?

4. What are the specified rights of the limited partner/participant as contained in the governing documents?

5. What do the governing documents provide regarding



the ability to withdraw and the general partner's ability to defer such requests?

6. Has the investment consultant provided a supported opinion regarding the anticipated ability of the fund to timely honor requests for withdrawal?

7. What do the governing documents state regarding the nature and frequency of client reports?

8. Aside from the normal reporting, do investors have access, upon request, to other information regarding the underlying securities and/or overall fund operation?

9. Are the higher fees justified by the greater diversification and expected higher returns? Has the investment consultant provided a supported opinion to that effect?

10. If investment performance suffers as a result of negligence or other malfeasance of the manager, have the trustees preserved their legal rights and remedies, or have they been waived, in whole or part, by the governing documents? Has legal counsel provided a supported opinion

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in this regard which addresses, among other things, the presence and extent of the following "killer clauses:"

- Limitation on legal duties of manager
- Limitation of liability for acts/omissions of manager
- Limitation on damages which may be sought against manager/entity
- Indemnification for claims brought against manager by third parties
- Arbitration clauses which deny access to the judicial system for wrongs committed
- Statute of limitation clauses which provide greater restrictions on the time within which an action can be brought than provided by law

11. In the event the "killer clauses" remain, in whole or in part, are there competing vehicles which offer the same opportunity with more favorable provisions?

12. Finally, has the fiduciary liability insurance carrier provided written confirmation that the investment is covered by the plan's insurance policy?

Conclusion

The same skills which trustees apply to traditional investing can be - with heightened vigilance – successfully adapted to evaluating Alternative Investments. Persistent focus on the central characteristics of such investments and insistence on clear answers to the above inquiries are essential. Regardless of the final decision, the trustees will have demonstrated their prudency, a necessary component of any investment decision, particularly when neither long term results nor incidence of liability are fully known.