



Understanding Alternative Investments

By Elizabeth Fu

GFOA's Committee
on Retirement and
Benefits Administration
sheds light on alternative
investments in public
pension plan portfolios.

Public and private pension funds are increasing their use of private market investments, otherwise known as alternative investments,¹ and for public pensions, in particular, the practice has resulted in heated debate. On one side, advocates argue that pension plans can reap great rewards from investing in alternatives, so long as appropriate considerations are made. On the other side, opponents see great risks that might not result in enhanced performance. Because of this debate and the growing number of alternative investments in public pension plan portfolios,² GFOA's Committee on Retirement and Benefits Administration sought to shed light on the topic. This article summarizes the committee's alternative investments checklist, which is available on GFOA's website (gfoa.org).

DEFINING ALTERNATIVE INVESTMENTS

"Alternative investment" is a broad term that encompasses a wide array of assets and investment strategies that are not considered "traditional." Traditional investment strategies involve taking long-only positions (assets that are purchased with the expectation that they will increase in value) like stocks, bonds, and cash. Alternative investment strategies can involve use of short positions (assets that are purchased with the expectation that the value of a stock will decrease in the short term), leverage

(making an investment using borrowed capital), and/or derivatives (financial securities that are valued based on underlying assets), and they generally include all other non-traditional assets that offer less liquidity. Common alternative investments include private equity, hedge funds, real estate, and real assets/commodities. (See Exhibit 1 for the common types of alternative investments and their characteristics). These strategies can result in performance returns that outperform traditional investments.

DEFINING AN INVESTMENT STRATEGY

Before making investment decisions, public pension plans should evaluate factors such as need for income, need for liquidity (the ability to convert an asset to cash quickly), tolerance for risk, tolerance for volatility (the amount of uncertainty or risk about changes in the value of a security), and investment time horizon (the length of time over which an investment is held before it is sold). After evaluation and consulting with investment professionals, actuaries, and other advisors, the plan should develop a long-term asset allocation policy, which defines the assets necessary to achieve the plan's investment return and risk objectives.³ The asset allocation policy guides a public pension plan's investment decisions, including whether to invest in alternative assets.

Exhibit I: Common Alternative Investments

Investment type	Characteristics
Venture Capital	Funds formed to provide equity financing for early-stage businesses with limited or no operating history. Venture capital is viewed as a high risk / high return endeavor; many or most individual investments made by the fund will fail, but successful investments will provide outsized returns.
Private Equity	Funds formed to take equity stakes in more mature private (unlisted) companies. Funds typically take majority (control) positions and implement strategies to increase company values. Strategies typically involve cost control, product development, investments in technologies, and expansion via acquisitions. Private equity funds generally exit their investments once their investment goals have been achieved.
Private Credit	Funds formed to lend money to private companies. In many cases, the loans are used to fund the purchase of a company by a private equity investor. These debt investments in private companies are viewed as safer, and lower returning, than private equity investments.
Distressed Credit	Funds formed to purchase existing loans owed by companies that are currently, or expected to become, financially distressed. The funds expect either a recovery or to take control of the company via the bankruptcy process.
Real Estate	Funds that make investments directly in real estate properties and real estate debt. These may be “core” investments in fully stabilized properties, or they may involve development or repositioning of existing properties. ⁴
Real Assets ⁵	Investments in real assets other than real estate, such as commodities, farmland, timber, oil and gas reserves, infrastructure, energy, and mining. This category may also include investments in intellectual properties such as patents, copyrights, and music and film royalties.
Hedge Funds	Hedge funds are lightly regulated, privately managed pools of capital that typically employ sophisticated strategies to invest in publicly traded securities. Strategies commonly include the use of short-selling, leverage, derivatives, and other means of seeking alpha (earnings that are greater than risk-adjusted market returns) and hedging risk.

UNDERSTANDING THE RISKS AND BENEFITS

If a public pension plan determines that alternatives align with its asset allocation strategy, the plan should also consider the inherent risks of alternative investments. First, some alternatives are relatively new, so investors are not entirely familiar with the nature of the product. Some argue that the ability to operate in an environment with fewer regulations, compared to traditional investment markets, has benefits; however, one drawback of less regulation is a lack of transparency. Even when information is available, historical return data may be limited. For example, a report on the use of alter-

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native investments in public pensions between 2005 and 2015 concluded that the time period analyzed is “too short to draw any definitive conclusions [and] the relationship between alternatives and public plan performance merits further analysis.”⁶

Second, valid performance benchmarks for some alternative investments are scarce. For example, private equity and hedge funds returns are provided on a voluntary basis, which may bias peer fund comparisons. It can also be challenging to construct performance benchmarks because the way performance is calculated varies. For example, information might be provided before fees or after fees.

Third, illiquidity is a common feature of alternative investments. For example, private equity funds have approximate lifespans of ten years, with the first four to six years typically deemed as the investment period, when capital

is deployed. The remaining years are typically the harvest period in which distributions are received through the liquidation of the fund's underlying assets. Hedge funds also commonly feature lock-ups and limited periodic redemption opportunities.

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To compensate investors for illiquidity and increased investment risk, alternative investments typically result in higher expected returns than traditional investments. They might also have certain features that affect net returns, including higher management fees than traditional investments, performance fees, and other manager compensation such as carried interest.⁷ Public pension plans therefore need to conduct an analysis of net return. In addition, as new alternative investment products are introduced and market conditions change, the fee structures will continue to evolve, making net return analyses more complex.⁸

Given their risks, alternative investments do provide a range of benefits. Generally speaking, alternatives have a low correlation with traditional asset classes, so they can improve diversification, reducing risk and/or enhancing the overall performance return of the

pension plan. Some alternative investments also seek to capitalize on market inefficiencies and/or provide a hedge against other investments or interest rate positions, so a public pension plan might include alternative investments in its portfolio to obtain exposures to assets and strategies with superior risk-return tradeoffs. In times of volatile markets, some alternatives may also provide additional diversification. For example, investors generally look to real estate for protection against inflation as it tends to capture those price adjustments.

DETERMINING THE USE OF ALTERNATIVES

Before entering into any alternative investment, a public pension plan needs to conduct an internal review. It should address:

- 1. Investor Information.** A plan should be able to identify investor information, including the personnel responsible for procuring and monitoring the investment and any known independent advisors. Having such information is essential to any investment, not just alternatives.
- 2. Authority.** A plan should seek an opinion from its general counsel on whether the plan has authority to enter into the investment. For example, certain investment classes, industries, and/or companies may not be permissible under internal policies.
- 3. Asset Allocation.** A plan should review its investment policy to ensure that it is current and permits the use of the alternative investment in question. In addition, an appropriate benchmark must be selected.

After a plan has reviewed the information and confirmed that the use of

alternative investments enhances its investment strategy, the plan should obtain and review specific investment details. The main points of investigation for a plan include:⁹

- **Investment Description.** Includes strategy of the manager or fund, geographic target of the manager or fund, and types of assets targeted.
- **Manager.** Includes operating information, history, key personnel, and references.
- **Due Diligence.** Includes appropriate investment and disclosure documents, and information on prior manager or fund reviews.
- **Fund Details.** The most encompassing area of the four, this includes information on fees, cash allocations, catch-up and clawback provisions, commitments, termination, etc.

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A plan should be able to review and address this information (specifically questions identified in GFOA's alternative investment checklist, available at gfoa.org) before committing to an alternative investment. Plans that cannot answer the questions in the checklist are advised to seek expert guidance before using alternative investments,

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as they are complex and sophisticated investment vehicles.

CONCLUSIONS

Conducting an appropriate review is necessary before committing to alternative investments. A public pension plan should determine whether:

- The available alternative investments are consistent with the plan's return objectives, risk tolerance, time horizon, and liquidity needs.
- The alternative investments will enhance the current portfolio in adhering to the plan's policies and achieving its objectives.
- Investment managers can be identified who have the capacity to find and make desirable investments.
- The plan and the investment managers can agree on acceptable terms that align their interests and ensure a high probability that good investment decisions will be consistently made.
- The investment structure ensures limited liability for the public pension plan.

Alternative investments can be an effective component of a plan's asset allocation, but must be carefully considered, selected, and monitored. ■

Notes

1. Researchers at Harvard University and the National Bureau of Economic Research found that between 2008 and 2017, most pension funds worldwide, including public and private funds, more than doubled their allocations to alternative investments. See: Victoria Ivashina and Josh Lerner, "Looking for Alternatives: Pension Investments around the World, 2008 to 2017," paper presented at 62nd Economic Conference, Boston, Massachusetts, September 7-8, 2018.
2. Jean-Pierre Aubry, Anqi Chen, and Alicia H. Munnell, "A First Look at Alternative Investments and Public Pensions," Center for Retirement Research at Boston College, 2017.
3. Real estate investment trusts (REITs) are a tax-advantaged structure commonly used to invest in real estate properties and mortgages. Listed REITs are securities that are traded like stocks on the major exchanges and are not considered alternatives.
4. Commodities are a subset of broad categories rather than a standalone asset type. They are typically part of a trading strategy and could be in one or more of the broader investment types. For example, a hedge fund manager might trade in commodities, or commodities could be part of a real asset allocation. This is why they are included under real assets.
5. See GFOA's Best Practice, "Asset Allocation for Defined Benefit Plans."
6. Aubry, Chen, and Munnell.
7. Carried interest is a share of future profits. Investors typically provide managers with carried interest as an incentive.
8. See the GFOA Best Practice, "Investment Fee Guidelines for External Management of Defined Benefit Plans."
9. GFOA's alternative investment checklist provides a comprehensive list of questions for plans to answer regarding the alternative investment.

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