

**Testimony Before the
2006 ERISA Advisory Council
Working Group on Select Issues of a Procedurally Prudent
Investment Process**

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Introduction

I would like to thank the Working Group of the Department of Labor Advisory Council on Employee Welfare and Pension Benefit Plans for the opportunity to be here today. My name is Edward Patchett, and I am a Senior Vice President and Managing Director of Independent Fiduciary Services (“IFS”). Our firm and its predecessor have provided hard-dollar investment consulting services to institutional investors for almost 20 years. Today, IFS is organized along three lines of business (1) on-going retainer investment consulting services to institutional investors (primarily ERISA covered single and multi-employer defined benefit and defined contribution plans) with total assets of more than \$15 billion, (2) best practices Operational Review project assignments and (3) serving as a fiduciary advisor or decision-maker under ERISA for plans or plan sponsors facing a conflict of interest situation. As a firm, we deal with various forms of alternative investments across all three lines of our business.

We understand the Working Group is currently studying selected prudent fiduciary procedures in investing, and is interested in exploring (among other things) whether or not “alternative investments” are appropriate for defined benefit plans. It is about this topic that I would like to share IFS’ thoughts. After summarizing our firm’s view on alternative investments, I’ll provide some definitions and an overview of alternative investments and then discuss the factors we believe prudent plan fiduciaries should consider before investing in alternatives.

Summary

The term “alternative investments” means different things to different investors. In a few moments, I will define what our firm considers to be “alternative investments.” One common refrain we often hear and read is that alternative investments are very complicated and involve a great deal of risk. Without a doubt, the broadly defined universe of alternative investments can be complex and often present unique investment and fiduciary risks. Nonetheless, these types of investments have gained in popularity over the past several years. Traditionally, plan fiduciaries responsible for investing

pension assets have focused their attention on publicly-traded stock and bond portfolios. With relatively low fixed income returns and a volatile stock market over the past few years, many plan fiduciaries have increasingly focused their attention on alternative investments. Conventional wisdom suggests that such investments are attractive for two primary reasons. First, many believe the returns for certain types of alternative investments can exceed those of traditionally managed stock and bond portfolios. Thus, investing in alternatives can potentially increase total plan returns. Secondly, many believe alternative investments can generate returns which aren't highly correlated with those of other asset classes. As a result, an allocation to alternative investments may increase total plan diversification and reduce the volatility of total plan investment performance.

As a firm, we have recommended that our on-going retainer clients explore the possible use of alternative investments in their investment program, subject to the unique financial and actuarial condition of their plan and the risk tolerance of the plan fiduciaries. Within our Operational Review Practice, we've analyzed practices and procedures others use when making and managing these investments. In every case, we have sought to provide independent and objective education and guidance to plan fiduciaries as they have weighed the merits and risks of this kind of investing. In doing so, we believe we have structured an appropriate procedural process for plan fiduciaries to follow in their deliberations and ultimate decision-making.

Alternative Investments Defined

As a firm, we consider the term "alternative investments" to mean investments in asset classes other than traditionally managed, "long-only" stock and bond portfolios. With that definition, one might question whether real estate could be considered an alternative investment. Twenty years ago, that was probably the case. However, over time, real estate as a broad asset class has become much more "institutionalized", and professional investment management firms have developed strategies and products to facilitate investments by ERISA plan investors. As a firm, we generally consider real estate to be a "traditional" asset class, but others may reasonably disagree with that characterization. Additionally, there has been an increasing emphasis by some investors and investment management firms to consider investing in or offering "real asset" portfolios like commodities and timber as a means to diversify plan assets and possibly serve as a hedge against unexpected inflation. These kinds of investments certainly are "alternative" in nature, but the number of institutional investment products or vehicles available is still relatively low which, from a practical perspective, can limit implementation.

Setting real estate, commodities and timber aside, we consider "alternative investments" to fall within two broad categories -- private equity and hedge funds. It is important to point out there is no single definition for "alternative investments," nor for the two types I've mentioned. However, this is how our firm has chosen to broadly classify these types of investments.

Private Equity

The term “private equity” generally means investments in companies that are not made via the public market. A company may choose to raise capital in the private market for many reasons, often because its business is in its infancy or because of the time and/or cost of capital being raised. The major forms of institutional private equity investments are venture capital funds and buyout funds. Venture capital investing involves providing financing to start a new business or to grow an existing one. Many investors tend to associate venture capital investing with technology companies. To be sure, many such companies were the recipients of venture funding during the internet boom in the 1990’s. However, the term really applies to all sectors of the economy.

Venture capital investors normally characterize their investment by the stage of a company’s lifecycle and capital formation. These stages are typically called seed capital, early stage, late stage or mezzanine or pre-initial public offering (“IPO”). Buyouts typically involve providing financing to entrepreneurs (often existing company management) seeking to acquire a majority or controlling interest in an established business. Such businesses being acquired are often divisions or subsidiaries being sold by larger companies seeking to refocus on their “core” business. Leveraged buyouts or “LBOs” involve buyers making a small equity investment in a company and paying the rest of the purchase price using borrowed funds (thus the term “leveraged”).

Hedge Funds

The term “hedge fund” is often misused and misunderstood. The term dates back to 1949 when an investor named Alfred Winslow Jones constructed a portfolio of undervalued stocks he expected to increase in price (the “long portfolio”), and at the same time sold “short” overvalued stocks he expected to decline in price (the “short” portfolio). [In a “short sale”, the investor borrows a security from a lender and sells it, with the expectation of buying the security back at a lower price in the future and returning it to the lender.] In a rising market, Jones figured his undervalued stocks would outperform his overvalued stocks (he’d make more money on the long portfolio than he’d lose on the short portfolio). Conversely, in a falling market, he expected the reverse would be true (he’d make more on the short portfolio than he’d lose on the long portfolio). Thus, Jones expected to make money on the overall portfolio over time through good stock selection regardless of whether the stock market rallied or fell. His portfolio was “hedged” against overall stock market movements.

Many hedge funds today engage in “Jones-style” long-short equity investing, but the term “hedge fund” has really come to refer to an investment structure wherein (1) the manager has broad investment discretion and may use leverage to enhance returns, (2) the manager’s fee structure is weighted heavily toward performance incentives and (3) the manager has a considerable portion of his/her own net worth invested along side the firm’s clients. Generally, the objective of most hedge funds is to earn positive “absolute returns”. By contrast, “long-only” managers tend to construct portfolios and view results relative to a given market benchmark (like the S&P 500 Index). In essence, a traditional

investment manager seeks to earn “incremental return” above its performance benchmark (e.g., earn a higher return than the benchmark when returns are positive and lose less when benchmark returns are negative). While a typical “long-only” equity manager tends to view “risk” relative to its benchmark, the hedge fund manager simply views risk as the prospect of losing money.

Although hedge fund strategy definitions can be ambiguous, industry participants often categorize them into three distinct strategies (1) relative value, (2) event driven and (3) hedged directional / opportunistic. Relative value strategies seek to take advantage of relative price discrepancies between related securities using mathematical, fundamental, or technical analysis to determine misvaluations. The hedge fund manager may identify securities that are mispriced relative to another underlying security, related securities, groups of securities, or the overall market. Event driven strategies seek to exploit opportunities created by significant corporate events, such as spin-offs, mergers and acquisitions, bankruptcy reorganizations, recapitalizations and share buybacks. Hedged directional and opportunistic strategies cover a wide range of hedge fund strategies. The two most often associated with this category are equity long/short and global macro. Equity long-short strategies simply refer to the “Jones-style” of investing I described earlier involving equity-oriented investing on both the long and short sides of the market (however, the objective is not equity market-neutral). Global macro managers construct portfolios based on their “top-down” view of global economic trends by analyzing factors such as interest rates, economic policies, inflation, etc. These hedge fund managers tend to focus on broad asset classes (owning or selling short stock or bond indexes, currencies and commodities) rather than individual securities.

Considerations Regarding Prudent Investment Process

Plan fiduciaries need to follow a prudent investment process in making all investment decisions, and this is particularly true with respect to alternative investments because the “cost” of a bad decision can be quite high. We believe the process should begin with the plan level asset allocation decision, which should be based on a thorough asset allocation or asset/liability study. This type of quantitative analysis should help plan fiduciaries examine the possible impact an allocation to alternative investments could have on their plan from a risk and return perspective. Such an analysis will also help guide decisionmaking with respect to the allocation percentage of total plan assets and the source of funding (e.g., from a reduction in stocks, bonds or both).

As plan fiduciaries evaluate possible alternative investments, we believe there are several key areas that should be carefully considered before a decision is made to invest. Some of these areas are structural, dealing with the legal form of the investment vehicle, while others revolve around the unique investment characteristics of private equity and hedge funds.

Structural Factors

Illiquidity

Alternative investments often take the form of private limited partnerships, where the manager is the general partner (“GP”) and the investors are the limited partners (“LPs”). These partnership investment vehicles are offered for investment under various exemptions from registration under the federal securities laws. To qualify for these exemptions, the partnership is usually limited to a certain number of investors and/or LPs must meet certain minimum qualifications in order to invest. In any case, the LP’s investment interest in a partnership is not listed on any exchange and is not freely nor publicly tradable. With respect to private equity, the life of the fund may be up to 10 years, and investors might not receive any distributions on capital called for several years into the investment. In the case of hedge funds, investors may have to commit to an initial lock-up period on their capital investment (perhaps one or two years) and thereafter have only periodic redemption rights (e.g., quarterly with 90 days notice). Thus, plan fiduciaries need to carefully evaluate this illiquidity in light of their plan’s overall asset allocation, investment structure and on-going cash flow needs.

Limited Regulatory Oversight

Secondly, the GPs of many alternative investment vehicles are not Investment Advisors registered with the U.S. Securities and Exchange Commission (“SEC”). As you are probably aware, the SEC required certain hedge fund managers to register earlier this year, but private equity managers were unaffected. In late July of this year, the U.S. Court of Appeals in Washington, D.C. overturned the SEC’s registration requirement for many managers of hedge funds. Many hedge fund managers had registered because of this requirement and because doing so gave them more credibility with potential investors. Going forward, it is unclear whether these managers will maintain their registration without being legally required to do so. This fact, coupled with the lack of registration of the partnership itself, means that many alternative investments are offered and operate largely outside any regulatory oversight. Therefore, initial investment due-diligence and ongoing monitoring by plan fiduciaries is critically important.

Managers Not ERISA Fiduciaries

Thirdly, many alternative investments are structured so as to avoid being deemed “plan assets”, in which case the manager is not a fiduciary under ERISA. In the case of private equity, the limited partnership vehicle is commonly structured as a Venture Capital Operating Company (“VCOC”) to avoid this scenario. With respect to hedge funds, many rely on a so-called “25 percent limit” to avoid being deemed “plan assets” under ERISA. In general, this means the assets of a hedge fund in which a plan has invested will not be considered “plan assets” under ERISA if participation in the hedge fund by “benefit plan investors” is “not significant” (e.g., is below 25 percent). In these instances, the manager avoids being deemed a fiduciary under ERISA. Thus, the investing plan fiduciaries don’t have the protections provided under – and the hedge fund

manager is not governed by – ERISA. In performing due-diligence, plan fiduciaries, with the advice of their counsel, should understand how their prospective alternative investment vehicle is structured with respect to this issue. On a related matter, you may be aware there is a provision in a bill currently moving through Congress which would effectively increase the 25 percent “plan asset” threshold by excluding public employee pensions and foreign pensions from the limit. If passed this provision could open the doors for investors into many hedge funds that were previously closed to additional ERISA plan investments. However, relaxing this provision could also facilitate the already significant asset flows into hedge funds, thereby muting the returns of certain strategies and strain the capacity of some hedge funds going forward. Finally, it’s conceivable the provision could effectively change the status of some hedge fund managers to “non-fiduciaries” if their funds are no longer deemed “plan assets.”

Other Investment Characteristics

In addition to the alternative investment vehicle structural factors I just noted, we believe there are several additional key investment characteristics that plan fiduciaries need to evaluate in their alternative investment due-diligence process.

Transparency

First, the degree of “transparency” investors receive regarding their alternative investment fund holdings can vary greatly. In the typical private equity example, the manager’s disclosure documents describe the manager’s intended investment focus and approach, but investors normally commit capital to the manager’s fund before the first investment is even made. Thereafter, investors normally receive information regarding companies held in the portfolio and a general description regarding the manager’s objectives with respect to each investment. In the case of hedge funds, managers may provide investors with limited information regarding actual securities held within the portfolio for fear that other investors could exploit this information to the detriment of their partnership if it became widely known (this is particularly true with respect to short positions). Depending on the hedge fund manager and strategy, investors may receive summary portfolio characteristics and risk statistics for monitoring purposes or a list of portfolio holdings only if they agree to keep the information confidential. In any case, plan fiduciaries should clearly consider the level of transparency they believe they need to monitor the investment relative to the information they will be provided.

Valuation

Secondly, plan fiduciaries must be aware of the process the alternative investment manager follows in valuing the portfolio assets, and be comfortable the process results in a fair and objective valuation. In the case of private equity, initial investments are often carried at cost until some kind of event (company transaction, additional round of financing, etc.) drives re-valuation of the company by the manager. While there are common approaches to arriving at a company valuation, there is no single approach that is consistently used by private equity managers to value companies and portfolios. With

respect to hedge funds, the portfolio valuation process may or may not be more apparent. In the case of a long-short equity manager buying and selling listed stocks, portfolio valuation is reflected by readily available exchange prices. Similarly, pricing information on portfolio holdings in derivatives traded on various exchanges, or in some developed over the counter markets, can also be obtained relatively easily. However, less liquid non-exchange traded securities like distressed bonds and hybrid securities with imbedded options (convertible securities) present more difficult valuation challenges. Here again, plan fiduciaries must understand and be comfortable with the valuation process used by the alternative investment manager.

Leverage

Finally, some alternative investment managers use borrowed funds, or leverage, to increase portfolio returns. While leverage will magnify positive returns, it will also magnify losses. In private equity, LBO funds rely to a great extent on leverage. However, leverage is most typically associated with hedge funds given the collapse of Long-Term Capital Management in 1998. To varying degrees, many hedge funds use leverage as one of many investment tools. Generally speaking, managers tend to use a greater degree of leverage in “relative value” trading than in other forms of hedge fund strategies. Whether or not a hedge fund uses leverage, and if so to what extent, can vary considerably from fund to fund. We believe plan fiduciaries should be aware of and comfortable with the use of leverage in any alternative investment vehicle they consider for investment, and if an investment is made, to establish a process for monitoring it going forward.

Fund-of-Funds Structure

Over the past several years, many investors in alternative assets have made investments through a “fund-of-funds.” Simply stated, a fund-of-funds is a structure wherein multiple investors commit capital to a fund which in turn allocates capital to multiple underlying managers. The fund-of-funds manager is responsible for manager screening, due-diligence, selection and monitoring. The fund-of-funds structure exists for both private equity and hedge funds.

Accessing alternative investment through this type of structure can provide several potential benefits. First, most investors can realize more underlying manager diversification with one fund-of-funds investment than they could reasonably achieve by building their own diversified private equity or hedge fund portfolio. Also, fund-of-fund investors can benefit from the extensive experience that many fund-of-funds managers provide in screening and selecting managers and providing on-going manager and portfolio monitoring. Finally, many fund-of-funds are structured specifically for ERISA qualified plan investors and thereby their GPs accept fiduciary responsibility for their activities. While this structure introduces an additional layer of fees into the investment equation, many plan fiduciaries conclude these are justified by the benefits this structure can provide.

Conclusion

In our view, the appropriateness of alternative investments for a plan is driven by specific plan and plan sponsor circumstances and objectives. Depending on a plan's overall financial and actuarial situation and the plan sponsor's objectives, we believe a modest allocation to a properly structured and implemented alternative investments program can play an important role in a plan's overall asset allocation. Alternative investments should not be viewed as a panacea for addressing the return objectives of plan sponsors. However, private equity and hedge funds present a number of additional nuances that plan fiduciaries should consider. As noted, alternative investments present some unique challenges in terms of investment and legal due-diligence, planning and risk controls. Prospective investors should remember the terms "private equity" and "hedge funds" are often used generically and represent a wide range of investments with wildly different levels and types of risk and return.

Finally, we believe plan fiduciaries should not evaluate and select alternative investments without the expert advice of ERISA counsel and an investment consultant with the knowledge, objectivity and experience to lead the due-diligence process and to monitor the investment on an ongoing basis.

Thank you for the opportunity to discuss this matter with you here today.

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