DOL ERISA ADVISORY COUNCIL
"The Conundrum Facing ERISA Plans that Invest in Hedge Funds and Fund of Funds"

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Good morning, Chairman Tomasek and members of the Advisory Council, my name is Gregg Hymowitz. I am the Managing Partner and co-founder of EnTrust Capital, an independent investment advisor registered with the SEC, which was founded in 1997 by myself and two former colleagues from Goldman Sachs. The lion's share of EnTrust's assets are managed in a variety of fund of hedge funds, or "fund of funds," investment vehicles. Our flagship fund invests in approximately 40 different hedge funds. EnTrust Capital currently manages money for over 130 Taft-Hartley, multi-employer pension plans, and over 80% of the money in EnTrust's flagship fund has been contributed by pension plans that are governed by ERISA.

I greatly appreciate the opportunity to share my views with the Council. Given my experiences, I hope to lend helpful insight into what I believe is the prevailing challenge and conundrum currently facing most Taft-Hartley and other ERISA plans, namely: (a) the need to generate stronger risk-adjusted returns at a time when many of these plans are underfunded; while (b) having inadequate resources to undertake the necessary research and due diligence on those investment vehicles that offer better risk-adjusted returns. In the interests of being judicious with my time, I will limit my presentation to four areas that I believe answer many of the questions posed in the Advisory Council's materials and address the conundrum raised above. These areas are:

(1) An overview of hedge funds and fund of funds, including the differences between these investment vehicles and the value they offer ERISA plans over, or as a complement to, more traditional investment vehicles.

(2) Address the perceived risks surrounding hedge fund and fund of funds investments, explain whether these perceptions are warranted and, in those instances where they are, provide guidance to address those risks.

(3) The key legal and regulatory issues for plan sponsors of ERISA plans as well as funds with a material percentage of ERISA-based investors.

(4) The evolving landscape of defined benefit and defined contribution plans, and their current and prospective ability to invest in hedge funds and fund of funds.

I. Hedge Fund/Fund of Funds Overview

Since 2007, Taft Hartley and other pension plans governed by ERISA have begun increasing their allocations to hedge funds and fund of funds. Between 2007 and 2009, the average allocation of Taft Hartley assets to hedge funds and fund of funds grew from 2.6% to 4.5%, or a 73% increase.[1] On a broader scale, investments in hedge funds and fund of funds by the 200 largest U.S.-based defined benefit plans increased by 55% in the year ended September 30, 2010.[2] These increased allocations are borne out of funds' better risk-adjusted returns and greater protection during periods of market volatility. In terms of outperformance, from 2001 to 2010, hedge funds' net returns (as measured by the leading industry index) were nearly double (96.3% higher) those of the average pension plan comprised of a traditional 60%/40% mix of equities and fixed income instruments, respectively ("60/40 Plans").[3] Moreover, hedge funds were able to generate this outperformance with only 65% of the volatility of traditional 60/40 Plans. In terms of downside protection, during the two most recent bear markets, hedge funds similarly outperformed.[4] During 2001 and 2002, when the average 60/40 Plan was down 13.16%, the average hedge fund was up 3.12%.[5] Here too, hedge funds achieved this outperformance with approximately 53% of the volatility of 60/40 Plans.[6] During 2008, when the average 60/40 Plan was down 22.06% and the S&P was down over 37%, the average hedge fund was down 19.03% with only 71% of these plans' volatility.[7]

Put simply, hedge funds and, by extension, fund of funds consistently outperformed more traditional 60/40 Plans across various market cycles and have better preserved capital during periods of market stress. In order to explain this phenomenon, I think it would be helpful to provide a brief overview of these vehicles and explain why certain plan sponsors prefer one vehicle over the other.

A hedge fund is a private investment fund that seeks to achieve superior risk-adjusted returns by employing a wide range of investment strategies, including undertaking certain "short" positions that either generate positive returns or function as a hedge against the fund's other long positions. While these short positions may partially offset gains during a bull market, more fundamentally, they are intended to protect the fund's investors and mitigate losses during market downswings. Additionally, hedge funds look to identify investment opportunities that are less correlated with the broader debt and equity markets and do not track market vacillations. Because hedge funds commonly employ strategies or identify specific investment opportunities that differ from those in traditional 60/40 Plans, investing in these vehicles enables pension plan sponsors to meet their fiduciary obligations to diversify their

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1 "Multiemployer Pension Plans: Main Street's Invisible Victims of the Great Recession of 2008", April 2010.

2 This figure includes certain defined benefit plans that did not report asset allocations prior to 2009. By excluding these plans, allocations year-over-year by previously reporting defined benefit plans to funds increased by 30% in 2009. Pensions and Investments, "Pension Funds Pump 55% More Into Hedge Fund Strategies", February 7, 2011.

3 HFRI Fund Weighted Composite Index, S&P, and Barclays Capital Aggregate Bond Index.

4 *id*.

5 *id.*

6 *id.*

7 *id.*

portfolios under ERISA. Additionally, hedge funds generally offer better liquidity relative to private equity vehicles and real estate investments.

A traditional fund of funds vehicle invests its assets in a diversified mix of hedge fund strategies and managers whose investment strategies and returns complement one another. This mix is intended to generate competitive but relatively conservative returns with low volatility, a return profile that resonates with those more risk-averse pension plans. At a high level, the fund of funds vehicle offers investors exposure to hedge fund investments but also provides additional downside protection, as it offers investors diversification against the performance or business-related risk of an individual hedge fund.

Consulting firms have recommended fund of funds to Taft-Hartley plans for a variety of reasons apart from hedge fund diversification. Fully understanding hedge fund strategies and sourcing the “best” hedge funds from the known investment universe can be exceedingly daunting and time consuming. As a result, building out a direct hedge fund platform and allocating a meaningful percentage of a plan’s assets to individual hedge funds (which could materially impact overall returns within the plan portfolio) often takes several years. An effective fund of funds is specifically constructed to tackle these issues, expedite the hedge fund investment process and de-mystify hedge funds for investors. By way of example, EnTrust employs various specialized personnel, including:

> (a) an operations group comprised of CPAs who, before coming to EnTrust, specialized in hedge fund auditing. They monitor our underlying hedge funds on a continuous basis to ensure these funds are not experiencing any business-related operational issues;
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> (b) a team of investment analysts that regularly communicate with our underlying hedge fund managers about their respective portfolios and track various qualitative and quantitative metrics relating to the investments in these portfolios. EnTrust’s analysts also source and conduct extensive due diligence on prospective hedge funds to add to the portfolio. Finally, the information our operations and investment teams receive from our underlying managers, coupled with broader market trends, drive our decisions to overweight allocations to specific investment strategies or hedge fund managers during a given time frame;
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> (c) in-house legal personnel that specialize in hedge fund regulatory, legal and compliance issues;
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> (d) a controller’s department which tracks fund inflows/outflows, performance and fees at the hedge fund and fund of funds levels; and
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> (e) other financial analysts who conduct quantitative analyses to assess the overall risk profile of the fund of funds.

Many plan sponsors and the consultants they retain do not have the resources to build a group of personnel with these areas of expertise, which in my opinion is necessary to sufficiently evaluate the merits of a large number of hedge funds. This research and monitoring process is difficult to re-create and is one of the primary reasons why plan sponsors make allocations to fund of funds before direct hedge fund investments.

Also, through a fund of funds investment, investors can possibly receive better terms than they otherwise would by investing directly in hedge funds, since fund of funds are commonly among the largest investors at particular hedge funds and often enter into "most-favored nation" side letters in return for their large allocations. Other advantages a fund of funds offers includes insulating its investors from "headline risk," or the potential for adverse publicity that can undermine the business operations and investment strategy of a particular hedge fund manager. When investing directly, adverse headline risk can subject a plan sponsor or fiduciary to increased scrutiny from plan beneficiaries. Lastly, a fund of funds allows investors to invest in a broad array of hedge funds without having to make the requisite minimum investment for each underlying fund. In return for these advantages, investors pay an additional layer of fees. In other words, investors pay the fees of the underlying hedge funds as well as the fee charged by the fund of funds itself.

II. <u>Real and Perceived Risks for Plan Sponsors</u>

Plan sponsors' reluctance to allocate even greater portions of their plan assets to hedge funds and fund of funds stems from the perceived risks that some investors believe are related to investments in these types of vehicles. Many of these perceptions originate from well publicized "blow ups" of larger hedge funds (and other non-hedge funds), such as Madoff Securities, Amaranth Advisors, and Long-Term Capital Management. The downfall of these funds was caused by either outright fraud or excessive leverage, which are relatively uncommon in the current hedge fund and fund of funds industries and have created somewhat irrational fears that such abuses are more rampant.

In fact, the hedge fund and fund of funds industries have made notable pro-investor strides in recent years. In spite of these strides, some investors still view hedge funds and fund of funds as risky, generally opaque vehicles that are overly leveraged, provide limited transparency, have heavily concentrated positions in illiquid securities, and are insufficiently regulated. Before debunking what I consider to be these "legacy" risks from the early 2000s, I think I should begin with what I believe are a plan sponsor's current primary risks. In my view, the biggest risk for a plan sponsor is being able to meet the obligations it owes its plan beneficiaries. Following the market drawdown in 2008 and 2009, many Taft-Hartley and other ERISA pension plans became significantly underfunded. In fact, the Government Accountability Office reported in 2010 that the percentage of multi-employer plans that are less than 80% funded rose from 23% in 2008 to 68% in 2009. Even on the heels of a bull market in 2009, a 2010 study conducted by the Segal Company found that 46% of calendar-year Taft-Hartley plans remain less than 80% funded and 30% remain less than 60% funded. In 2008, only 7% of these plans were less than

60% funded.[8] It's fairly obvious that ERISA plans need to look to investments that offer better risk-adjusted returns in the coming years in order to avoid defaulting on future obligations.

A second key risk for ERISA plan sponsors is their ability to conduct in-depth operational and investment due diligence on underlying hedge funds to ensure that (a) they are choosing the "right" funds, and (b) on a going forward basis, that the risk-reward profile of these funds matches the plans' investment objectives. By way of our own business model and as a follow-up to the discussion above, EnTrust conducts extensive operational due diligence on every prospective hedge fund and continues its due diligence on those hedge funds once an investment has been made. I believe our investors expect us to take investment risk, but not business-related risk. In my view, it is of paramount importance to make sure that the hedge funds with which you invest are stable businesses. This determination can be made through fairly fundamental inquiries, such as the background checks of key professionals, the service providers utilized by the funds, the strength of the fund's control environment and whether the fund has a culture of "doing the right thing."

Many other perceived risks to hedge funds and fund of funds investing are overstated in the current investment environment. For example, many hedge fund critics claim that hedge funds and fund of funds are not transparent. Since 2008, I believe that hedge funds have taken noteworthy strides to be more transparent with their investors. Transparency can be, and frequently is, now demanded by investors and adequately conveyed by funds. In order to provide a high degree of transparency to our investors, EnTrust demands a high degree of transparency from its underlying hedge funds and will withhold investment if a fund is reluctant to provide information about its portfolio. As a fund of funds, there are several ways we bridge the informational gap between our investors and underlying hedge funds, including comprehensive monthly reports on the performance of our managers and specific positions that drove performance, conference calls with our underlying managers to provide insight into their views on the markets and their specific portfolio, intermittent reports on broader issues impacting the portfolio, as well as weekly updates about our managers on our website. Although time consuming and resource demanding, these are fairly straightforward and effective ways of ensuring investors have up-to-date manager transparency. Similarly, some investors claim that fund managers' reporting of fees is not sufficiently transparent. Again, in our experiences with our underlying hedge funds, I don't find this to be the case. We and each of our underlying managers provide monthly gross and net performance figures to our investors, which inherently capture the fees being accrued and charged.

Another perceived risk is that hedge funds are highly leveraged. Over the last few years, hedge funds and investors have become much more cognizant of the leverage these funds employ in order to meet return targets. Here too, with the appropriate amount of due diligence, an investor can choose to invest only in less levered funds and prevent its exposure to highly leveraged vehicles. In order to safeguard the assets of our investors, EnTrust does not invest in hedge funds that employ more than a modicum of leverage (the average net long exposure of our underlying funds is 58.9%), and we use no leverage at

[8] "Spring 2010 Report of Results from the Survey of Calendar-Year Plans' 2010 Zone Status", Segal Company.

the fund of funds level. In contrast, private equity firms typically employ much higher degrees of leverage, preferring to finance their acquisitions with debt rather than equity capital in their own funds. According to a recent report from the Financial Times,[9] a relatively extreme example of this leverage occurred in 2006, when two Boston-based private equity firms acquired Clear Channel, a media company, using only 6% of their own funds during a leveraged buyout transaction, or a leverage ratio exceeding 16 times. The remaining acquisition proceeds were financed through banks and other debt investors.

A third overstated risk, in my opinion, is that hedge funds have concentrated positions in illiquid investments. Since 2008, investor demand has caused hedge funds to generally reduce their exposure to less liquid investments. Given these reduced exposures, illiquid investments are much less likely to forestall a rash of redemptions because they are sized appropriately. But more fundamentally, I think plan sponsors often ascribe too much weight to the liquidity profile of an investment, and need instead to balance this characteristic against other investment objectives, such as returns. Investors are often paid a premium for investing in more illiquid instruments, which plan sponsors could view favorably given their underfunded status and investment horizons. On a related note, investors have historically expressed a reluctance to invest in hard-to-value assets, even though these investments may have material upside. Here too, I think investors and plan sponsors can gain comfort with hard-to-value assets assuming they are sized accordingly and by making sure the underlying hedge funds have the appropriate mechanisms in place to independently verify and value these assets on an intermittent basis.

A fourth commonly misstated risk is that hedge funds are lightly regulated. In my experience, the exact opposite is true. Using EnTrust as an example, in the U.S. alone, EnTrust is regulated by the Securities Exchange Commission, the Financial Industry Regulatory Authority, the Commodity Futures Trading Commission, and the National Futures Association. EnTrust is also regulated by the Financial Services Authority in the U.K. and is in the process of opening a Singapore office and will be regulated by the Monetary Authority of Singapore. Regulation by these entities subjects us to regular audits and requires us to provide significant amounts of information that is publicly available, including an overview of our business, ownership, biographical information on personnel, clients, investment approach, business practices, affiliates, any disciplinary events among principals and employees, fees, and conflicts of interest. Our underlying funds are subject to a similar degree of scrutiny but, since they directly trade securities, they must also disclose certain material positions in SEC-related filings.

III. <u>Key Legal and Regulatory Issues Under ERISA</u>

Investments by pension plans governed by ERISA in hedge funds and fund of funds raise unique legal and regulatory issues for managers of these funds. While ERISA law is exceedingly complex, a handful of

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9 The Financial Times: “Private equity: Uncertain prospects,” April 17, 2011.

legal concepts and principles shape how hedge fund managers structure their funds to address the receipt of ERISA funds.

The Department of Labor's plan asset regulations define what constitutes "plan assets." Generally speaking, when a pension plan governed by ERISA invests in a hedge fund or fund of funds, those assets will only be considered "plan assets" once ERISA investors' equity stake in any share class of the hedge fund exceeds 25%. This designation is significant because, once ERISA plan assets exceed this 25% threshold and the underlying hedge fund becomes a "plan asset fund," the fund essentially steps into the shoes of the plan trustee, becomes a fiduciary on behalf of each ERISA plan investor and becomes subject to enhanced obligations (and shoulders much of the trustee's potential liability). Practically speaking, as an ERISA fiduciary, a fund manager must act in the interests of the ERISA plan participants, diversify its own plan assets so as to prevent the risk of large losses, maintain a relatively liquid portfolio, disclose relevant information to plan beneficiaries and other plan fiduciaries, and generally discharge its duties for the exclusive purpose of providing benefits and defraying costs. A fund manager's breach of these fiduciary obligations can cause them to be liable for actual investment losses. In order to protect against incurring these potential losses, fund managers take out sizable insurance policies once they become a plan asset fund. In addition to these enhanced fiduciary obligations, a manager with over 25% of plan assets is restricted from certain prohibited transactions with "parties in interest." Qualifying as a Qualified Professional Asset Managers ("QPAM") creates an exemption to the prohibited transaction rule under ERISA and allows hedge funds to conduct these otherwise prohibited transactions, which, in certain instances, could handicap a hedge fund's ability to fluidly trade securities. Because of the enhanced fiduciary obligations that result from becoming a "plan asset fund," many hedge fund managers choose not to accept ERISA dollars as they approach the 25% threshold. This inherently limits an ERISA plan's options in terms of the vehicles in which it can invest. I believe the 25% limitation should either be altogether lifted or the relevant percentage increased to afford ERISA plans greater flexibility in making investments into different hedge funds.

Another key legal issue deals with the unrelated business taxable income ("UBTI") rule for certain tax-exempt entities that are typically regulated under ERISA. Under this rule, an otherwise tax-exempt entity will be taxed on income from those activities that are not related to the tax-exempt purpose of that organization and employ leverage to do so. Because hedge fund and fund of funds managers can employ leverage to purchase or short sell securities, some of the gains or losses earned as a result of leverage would be subject to UBTI. In order to address UBTI concerns for tax-exempt entities like ERISA plans, hedge fund and fund of funds have created offshore corporations that allow these entities to preserve their tax exempt status for income received from these investment vehicles. This is because under the Internal Revenue Code, "debt financed income" received from an offshore corporation is treated as a non-taxable dividend, which is exempt from UBTI. Then, through a master-feeder fund structure, the proceeds invested in these offshore vehicles ultimately wind up back in the U.S. anyway with cleansed tax status. In my opinion, this process sheds light on how ineffectual the UBTI rule is and how clearly it can be avoided. I believe the UBTI rule should be rescinded and that ERISA entities be allowed to preserve their tax-exempt status for all US-based income received from hedge funds and fund of funds. This would avoid the creation of offshore vehicles; additional onshore vehicles provide employment opportunities for domestic administrators and other service providers and would better enable the US regulatory authorities to monitor these funds.

IV. The Evolving Landscape of ERISA Plan Investments

The final area I would like to address is the evolving investment landscape for Defined Benefit and Defined Contribution Plans. As I noted above, Defined Benefit plans already invest in hedge funds and fund of funds, but are markedly underfunded following 2008. On top of these underfunding issues, union membership is decreasing, which likely means even fewer prospective plan contributions to meet future plan liabilities. In 2010, the percent of wage and salary workers who were members of a union was 11.9%, which is down from 12.3% a year earlier, 20.1% in 1983,[10] and, at its peak, approximately 35% during the mid-1950s, after a surge in unionization following World War II.[11] This general decline is even more dramatic among private sector unions. The percentage of private sector union workers fell to 6.9% in 2010, the lowest rate for private sector workers in more than a century, labor historians have said.[12] This drop has, for the first time in American history, caused government union employees to comprise over half of the nation's union membership. This only further highlights the need for Defined Benefit Plans to increase their allocations to vehicles with higher risk-adjusted returns, such as fund of funds.[13] As the mismatch between plan inflows and outflows becomes more evident with time, I believe the trend of increased allocations to these vehicles will continue.

Defined Contribution Plans ("DC Plans") do not offer beneficiaries a guaranteed stream of benefits and therefore do not grapple with the same issues faced by Defined Benefit Plans. However, most DC Plan participants cannot make investments in hedge funds and fund of funds because many individuals within these plans are not "accredited investors" under the applicable laws and regulations. For an individual to qualify as an accredited investor, he or she must have a net worth of at least $1,000,000 not including the value of one's residence or have made at least $200,000 each year for the last two years with the expectation to make the same amount in the coming year. I view this net worth gauge as an entirely arbitrary one for determining whether an investor has a level of sophistication to invest with alternative investments. I believe the following example highlights the absurdity of this hurdle – a winner of the lottery can invest with hedge funds, but a junior professor at Harvard Business School cannot. How is that fair and how does that make sense?

More broadly, I have difficulty understanding why lower income individuals are deprived access to hedge funds. Because DC Plans do not invest in these vehicles, participants in these plans are limited to having their money invested in long-only equity and fixed income vehicles. In a recent market downturn like 2008, DC Plans performed much worse than hedge funds. Also, in response to the argument that hedge funds employ complicated strategies that are not fully understood by plan participants, I have

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10 U.S. Bureau of Labor Statistics.

11 New York Times, "Union Membership in US Fell to a 70-Year Low Last Year", January 2011.

12 *id.*

13 Bureau of Labor Statistics U.S. Department of Labor News Release, January 2011.

trouble believing that plan participants have a much greater familiarity with their existing plan investments than they would if their plan assets were invested with hedge funds or fund of funds.

EnTrust has researched the legal and regulatory parameters of adding hedge fund and fund of funds options to DC Plan participants, and it is working on a structure that affords these options through a DC Plan fiduciary. While there are various hurdles and challenges that still need to be worked through and overcome, I believe such a viable structure can be created.

Availing this investment option to a DC Plan could be an extremely attractive investment option for DC Plan participants, especially with entities like EnTrust and the DC Plan fiduciary acting as fiduciaries in the best interests of these participants.

V. Conclusion

Pension plans governed by ERISA are at a crossroads. They are quite underfunded and currently make only relatively limited allocations to investment vehicles that offer superior risk-adjusted returns. Hedge funds and fund of funds are the premiere vehicles that offer these return profiles, while providing strong downside protection during periods of market disruption. While allocations into these vehicles have increased in recent years, dated fears about the industry have instilled in investors a reluctance to allocate more. These fears are mostly unfounded and can be addressed by conducting thorough due diligence on underlying hedge fund managers. As the Managing Partner of a fund of funds vehicle, I believe a fund of funds affords investors exposure to hedge funds at a time when they need it most, while also conducting in-depth investment and operational due diligence on these vehicles that many ERISA plans and consulting firms lack.

DC Plan participants, however, do not even have access to alternative investments because they are not deemed to be accredited investors. The existing gauge for evaluating whether an investor is accredited is, in my view, improper and does not speak to these investors' level of sophistication. DC Plan fiduciaries can establish platforms and avail hedge fund and fund of funds products to investors as another investment option where they can direct their 401k money. While it has not yet been created, I believe a structure can be fashioned that avails this option to DC Plan participants but complies with applicable law and Department of Labor rules and regulations.

Again, I would like to thank the Council for the opportunity to present our thoughts and views on these areas, and I would welcome any additional questions.

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