

PENSION FUNDS SHOULD THINK CAREFULLY BEFORE INVESTING THEIR MEMBERS' MONEY IN HEDGE FUNDS, WRITES PATRICK LAWLESS

HEDGE FUNDS: ARE THEY THE ELUSIVE HOLY GRAIL?

In the search for the 'Holy Grail' of investments, investors have pursued many mirages: railroad stocks in the 1800's; auto stocks in the 1900's; geared investment trusts in the 1920's; "nifty fifty", growth stocks in the 1960's; conglomerates, emerging market debts, telecom media and technology stocks, split capital trusts and precipice bonds in more recent times.

But now the asset "de jour" is hedge funds. Are these an investment option that pension funds should consider?

First of all: What are hedge funds? Very simply, they are unregulated private pools of assets, invested in a myriad of quoted and unquoted securities. They are often characterised by specialist investment management, heavy concentration in specific areas and often use leverage and derivatives. They claim that as an asset class, they are uncorrelated with traditional investment vehicles. Their risk appetites vary.

The most famous hedge fund, but for very much the wrong reasons, was LTCM, set up by John Meriwether in 1994. Meriwether has been described as a congenial, cautious, mid-Westerner, with a mind like a steel trap. Made famous by his time at Salomon Brothers, he was epitomised in the book "Liars Poker" written by Michael Lewis.

However, Meriwether was only the front man and surrounded himself with egg-heads PhD rocket scientist-types.

They downloaded into their computers historic asset prices on all of the assets that they could get their hands on and distilled the historical data into how these assets should behave in the future. These models didn't order them to trade. They provided the human manager with a reason to consider trading.

Initially Meriwether and his colleagues in LTCM enjoyed incredible success - \$1 invested in May 1994 was worth \$4 in March 1998 but was effectively worthless by October 1998. But while the LTCM model had racked up phenomenal gains, it had been unable to deal with individual calamitous or one-off events, particularly the default on its loans by Russia in 1998.

ORDERLY DEVIATION

The investment thesis was in effect based on an orderly standard deviation within inefficient markets, but there may be many extreme price movements away from a normal distribution. While markets were inefficient, volatility could be aggressive. Although hedge funds were a way to reduce much of the risk of a fund, it is extremely difficult from an investment management implementation point of view, to diversify away all of this risk.

Despite the LTCM debacle, hedge funds have grown exponentially over the last ten years and research suggests that they may have grown tenfold over this period with almost \$1 trillion invested in various types of hedge funds. About 80%

of their investors are private individuals which brings its own problems as individual investors tend to get emotional when there is volatility of investment returns.

Man Group, the hedge fund group which has expanded rapidly in recent years, announced a sharp slowdown in asset growth in the previous six month period. Man has €39 billion of funds under management but the company was hit by poor returns from its flagship fund. Man is showing the classic signs of a company whose growth is beginning to slow.

Is this symptomatic of the hedge fund industry? So far this year, the average hedge fund is up 2.75%. 2004 has been the worst year for hedge funds since 1998 (and the collapse of LTCM) and nearly half of all hedge funds are showing losses this year.

Hedge funds have moved on since LTCM. Not all hedge funds are as secretive and not all use the level of leverage that LTCM employed. However, risks remain.

The level of regulation is low, or indeed non-existent, in comparison to other types of investment classes. Even if regulation were to take place, to do so on a meaningful level could prove difficult, given the complexity and sophistication of these funds. Industry practitioners would have to be employed who understood these financial models. The head of the SEC,

William Donaldson, has recently stated that he had hired over 100 top executives to examine the industry because in his own words, "We do not want to wake up with a problem in two years time". Is enough being done from a regulatory point of view? The SEC wants to examine any potential conflicts of interest, namely funds having invested in other funds (similar to the split capital trust debacle).

LACK OF TRANSPARENCY

Other risks include the lack of transparency of the investments strategy. Managers can change their strategies if their "A" game is not working. Also, costs are higher, relative to investing in other asset classes, with the manager charging around a 2% management fee and a 20% performance fee.

Super normal profits in any industry are not sustainable. Competition will arrive, profits will fall and this may lead the managers to pressurise themselves to taking bigger bets and bigger risks. It should also lead to consolidation within the industry, just like the railway, auto and pharmaceutical industries before them.

Is this what is beginning to happen? One of the largest funds, GLG, is being

bought by Lehman Brothers and other banks have also purchased stakes in hedge fund houses. But critical risks remain in the short-term, namely coping with the high inflow of funds which are currently arriving at their door and also the ability to have sufficient human talent within an industry that has grown tenfold.

For one thing, hedge funds are not an asset class in themselves. Hedge fund investors invest in similar assets but from a different business model. There is no evidence that there is excess talent in managing these assets and in essence the hedge fund manager is no different than any other manager. They must use their judgement to decide which strategy is best. The most important capital in our business goes up and down in the lift every day: our people.

Perhaps the following are a few questions you would consider asking your hedge fund manager, should you decide to proceed with such an investment:

- a) Describe the investment team and their incentivisation;
- b) Describe
 - the riskiness of the fund
 - the volatility of the fund
 - the exposure to extreme events of the

fund

- correlations with other investments

- c) Describe the decision-making process of the fund;
- d) Describe the typical portfolio;
- e) List the capital structure of your firm;
- f) Describe your fee structure;
- g) What are your top 20 long and short positions?
- h) What is your maximum leverage?
- i) Who are your auditors and custodians?

These are only a few questions for starters and perhaps you might follow the advice of the legendary Peter Lynch, former investment manager who ran the Magellan fund for the Fidelity Group in the 1980's, who had a superb track record: "Never invest in any idea you can't illustrate with a crayon and a piece of paper".



Patrick Lawless is Managing Director of Appian Wealth Management, an Irish company that provides investment services to a range of pension funds, charities, credit unions and high net worth investors.

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FIRMS COULD USE LOANS FOR PENSION FUNDING - PWC

Companies could use corporate debt or bank loans to tackle their pension schemes' funding problems, a conference has been told by a PricewaterhouseCoopers UK partner.

Five years ago, he said, it would have made sense for a firm to keep a stand-off attitude to its pension scheme's funding problems. But legislation published by the government in February forbids sponsors to walk away, so "shortfalls will have to be made good at some point".

Terry Simmons of PwC said there could be many ways of tackling the issues.

Transferring assets to bridge the pension funding gap would make sense now. Simmons explained his model - giving the example of a company, which issues corporate bonds or asks for a bank loan to aid its pension fund. Assuming the debt was worth 16 million pounds, the company only need to raise 11 million as it would get back five million in the shape of tax relief. One of the counter arguments would be that the company would exchange known flexible funding for prescriptive funding. (IPE)

DUTCH WORKERS TO INVEST MORE

Dutch employees are prepared to invest an additional 6.5 billion euros to reach an acceptable pension level, Swiss Life has said. The survey covered 1,200 people and was conducted in cooperation with consultancy Samhoud.

Spokesman Eliot Schuchart said that the research has shown that most respondents are unfamiliar with their current pension situation caused by largely personal circumstances, such as divorce, the transfer of parts of their contributions to other arrangements, a shortage of years worked (less than 40 years), bad investment performances and franchise issues. (IPE)

Swiss Life found that 85% of all working people are willing to invest additionally to increase their pensions - resulting in a 6.5 billion euros in total. And people were also willing to give up holiday days (39%), or work longer (18%). A key finding is that most people still intend to stop at an earlier age than the government currently wants, with 74% wanted to stop at 62 years, while only one percent is willing to work beyond 65. (IPE)