Institutional Investor

Will Public Pensions Regret Dumping Hedge Funds?

A slew of public pension funds cashed out of hedge funds last year amid continued lackluster performance and high fees. But hedge fund critics almost never answer the more fundamental question: What's the alternative?

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February 15, 2017

When America's largest public pension fund, the California Public Employees' Retirement System, announced in late 2014 that it was exiting its $4 billion allocation to hedge fund investments, it cited the need "to reduce complexity and price" as a reason. The then-$300 billion fund said it couldn't achieve the necessary scale or impact with such a small allocation — despite a decade earlier being the very fund that legitimized the act of a large pension plan investing in hedge funds.

Critics had another way of putting it: To many the move was just CalPERS being CalPERS. Some, ranging from Elliott Management Corp.'s Paul Singer to Fortune magazine, shrugged off the decision as a mistake. A minority argued that CalPERS had actually waited too long, that hedge funds for a decade had failed to generate excess market returns despite rich 2 percent management and 20 percent performance fees. And some academics insisted that alpha itself is a kind of mirage, certainly at the levels hedge funds claimed.

But since then CalPERS has looked prescient.

As hedge fund performance has continued to lag — average 2016 returns rose to 7.4 percent (versus the S&P 500's total return of nearly 12 percent), according to alternative-asset data provider Preqin, after returning only 2.02 percent in 2015 — outflows have mounted: some $83 billion by the end of November, according to investment analysis and analytics firm eVestment. And a pack of public pension funds have joined the flight: The New York City Employees' Retirement System redeemed all of its $1.45 billion in hedge fund assets last April; the New Jersey State Investment Council, the investment arm of the New Jersey pension system, cut its allocation by 52 percent in August; Rhode Island slashed more than half of its $1.1 billion commitment in late September; and Kentucky pulled at least $800 million of a $1.1 billion allocation in early November.

Adding insult to injury, the $129 billion Teacher Retirement System of Texas (TRS) — a well-respected fund that peers and media watch religiously, with an 8.3 percent hedge fund allocation — said in November it would put its commitment up for review. "It seems like at the next gas station, we should stop and tell these guys to get out and get us something to eat, and then drive away as fast as we can," The Street quoted TRS chairman R. David Kelly, speaking at a trustees meeting.

Nearly all of these moves were attributed to nosebleed hedge fund fees and mediocre returns, and have been accompanied by fratricidal attacks on the policymakers who built the allocations in the first place. For instance, in mid- October the New York State Department of Financial Services took direct aim at Comptroller Thomas DiNapoli, who oversees the state's pension, in a report with a rambling, tabloidlike headline: "State Comptroller-Managed Common Retirement Fund Pays High

Fees Year After Year for Poor Hedge Fund Performance and Lacks Transparency on Costs of Other Alternative Investments."

But in criticizing hedge fund fees, performance, and transparency, critics almost never answer the more fundamental question: What's the alternative?

Much of the recent hand-wringing over hedge funds has had an apocalyptic air: Are hedge funds, which had amassed $3.2 trillion in assets globally by the end of 2015, dying like dinosaurs? Third Point founder Daniel Loeb famously declared last April that "we are in the first innings of a washout in hedge funds and certain strategies" and said the industry would have to rethink its fees. In May, Blackstone Group president Tony James predicted the business would shed a quarter of its assets in the next year. Still, it will take much greater outflows to significantly shrink the industry, which has continued to grow — albeit more slowly than in its high-flying past.

Part of the problem is that too much money has been chasing too few opportunities. Markets have wrong-footed active managers with concentrated positions, and iconic funds like Paul Tudor Jones's Tudor Investment Corp., Och-Ziff Capital Management Group, and London's Brevan Howard have been hit by redemptions. Others, like Perry Capital, Chesapeake Partners, and Tyrian Investments, have announced they are shutting down altogether.

Related to this is the larger, if still incipient, asset management trend toward passive investing. Despite the postelection market rally, the past 30 years of exceptional returns — a product of globalization, financial deregulation, and technological innovation — may now be winding down. If so, high-beta returns can most efficiently be captured by low-fee passive strategies. But will those returns continue? A recent McKinsey & Co. report with another unsettling title — "Thriving in the New Abnormal" — anticipates that some $8 trillion in "benchmark-hugging active assets will be up for grabs over the next few years" in a low-return era that could last two decades. Mc Kinsey predicts these trends will drive investors toward private market alternative investments.

Prediction, however, is always risky. From the 1970s to the 1990s, many pensions could essentially fund themselves with 7 to 9 percent returns that were relatively risk-free because that was roughly what 30-year Treasuries paid, writes Donald Boyd, director of fiscal studies at the Rockefeller Institute of Government at the State University of New York. Today that roughly remains the target return for most pensions, even though the Federal Reserve hammered down short-term Treasuries almost to zero after the financial crisis, and the risk-free rate skidded to 2 to 3 percent. The result: Funds had to shoulder more risk to hit their returns. Even worse, the ratios of workers to beneficiaries, and the cash flows, of some pensions went negative as long ago as 1993 — at about the time they discovered hedge funds — and has accelerated as baby boomers have hit retirement. In a maturing pension, short-term investment gains and losses grow larger relative to payroll and government contributions, and the odds soar of an ugly underfunding crisis in which investments have to be sold to pay retirees.

Many pension funds reacted to these pressures by embracing strategies associated with Yale University endowment chief David Swensen, who for years generated outperformance with hefty allocations to alternative assets — initially, private equity and hedge funds — seeking returns in exchange for illiquidity and risk. Hedge funds sold an absolute- return strategy that was not correlated to broader equity markets, providing a theoretical hedge against slumps. However, few pension fund managers possess Swensen's patience, ability to extract lower fees, and capacity to invest for the long term in top-quartile funds. Furthermore, endowments don't suffer from aging demographics. And even Swensen, who remains at Yale, took a major hit in 2008.

Meanwhile, hedge funds became a target. Increasingly, critics, many affiliated with unions, attacked the fees that often-opaque alternative- asset strategies charge. After Wall Street nearly collapsed in 2008–'09 and concerns over income inequality surfaced, the controversies surrounding fees grew rawer, more pervasive, and more populist. (Private equity also drew criticism for fees and carried interest, but buyout shops were generally viewed as longer-term investors, whereas hedge funds were short-term speculators.)

Pension funds often resemble a man on a high wire in a hurricane, frantically swaying to and fro. Many are strapped — the Employees Retirement System of Texas last year said it had not been fully funded for 19 of the past 20 years — with rising numbers of beneficiaries living longer and short-staffed and underpaid investment teams. Their exposure to politics makes them vulnerable to sudden shifts. Today's conventional wisdom, often demanded by union critics, pushes pensions toward low-fee indexed funds or exchange-traded funds (ETFs) — John Bogle rather than Swensen — that have mushroomed as stock markets have set record highs. Still, although fees for passive investments are very low — and, as Bogle has long preached, a fine approach for individual investors — these investments may not be able to achieve the returns pension funds require, particularly in volatile postrecovery markets without a lot of returns.

Would anyone be shocked if pension funds zigged when they should have zagged? The Fed has finally raised interest rates despite an aging recovery and as the Trump administration, which many believe will fire up inflation with infrastructure spending and tax cuts, enters the White House. In short, there's been a broad flight from active management — including hedge funds — just as stock picking seems to be making a comeback. Meanwhile, pension funds must generate enough performance to meet daunting return targets. Rhode Island, which underwent a tempestuous reform process led by now-Governor Gina Raimondo, has been discussing the possibility of reducing its target rate from its current 7.5 percent. The problem: The state would have to raise taxes to close its funding gap, or reduce benefits further — neither a popular step.

New Jersey, which for years has been embroiled in a struggle over its pensions, is in worse shape and a telling example of all that can go wrong, and right, at the nexus of public money and high-fee hedge funds.

The scene: The $73 billion New Jersey public employee pension fund was only 37.5 percent funded last year, according to a Bloomberg study— the largest deficit in the U.S. — and infighting between unions and Governor Chris Christie had grown bitter. Christie drove through a bipartisan bill to force unions to pay more for their members' pensions, then failed to meet state funding targets. Public sector unions attacked alternative investments, which had doubled under Christie, charging the firms with political ties to the governor and complaining about a lack of transparency and steep fees. Pension administrators argued that alternatives — hedge funds, private equity, and real estate — had overperformed net of fees.

But Christie's star fell, and performance slipped. For the fiscal year ended in June 2016, overall returns came in at 4.16 percent, well below the 7.9 percent needed to avoid adding to New Jersey's already crushing liabilities. The plan's hedge funds — some 12.5 percent of the total, including such high-profile names as JANA Partners, Pershing Square Holdings, and Third Point — posted negative returns, and although the state said it had begun to redeem hedge fund assets and move into lower-fee alternatives, fees were still in the 1.5 percent management and 18.5 percent performance range. Peers in other states were dumping hedge funds, giving support to anti–hedge fund arguments, and criticism of the State Investment Council grew; at one meeting the council got hammered for having no women trustees. Finally, after months of contention, the council agreed to reduce the hedge fund allocation to 6 percent and lower fees to 1 percent and 10 percent under a program dubbed FAIR, for Fund Alignment and Incentive Reform. The good news: New Jersey estimates it could reap annual fee savings of $127 million when the process is completed.

But therein lies perhaps the most underappreciated and essential question in today's discussion of pensions and hedge funds: Given New Jersey's return target, how will those assets be reinvested?

In July the pension plan proposed an investment of as much as $1 billion in a customized fund of hedge funds from BlackRock Alternative Advisors (BAA), with FAIR-level fees. With $5.1 trillion in assets under management, BlackRock is best known as a provider of low-cost ETFs, but it has been quietly building an alternatives operation, which includes BAA. The firm formed its first hedge fund in 1996 and began to knit together various units in 2011. Today it has $139 billion in alternative assets, including $50 billion in hedge fund strategies ($20.6 billion in BAA), with the rest in real estate, private equity, credit, and energy.

BAA offers a different model from conventional hedge funds, which are often dominated by their founders and proudly autonomous. Cal PERS had a point: Contrary to Elliott's Singer — who suggested that the California pension did not recognize the diversification that complexity provides — managing a sizable portfolio of hedge funds requires resources and manpower to analyze, assemble, and monitor funds with varying fees, personalities, lock-up terms, strategies, and tendencies. "The traditional hedge fund bucket could have been working better," says Josh Levine, who in November was named head of BlackRock Alternatives Specialists for the Americas. "We thought there was a way to allow [New Jersey] to have its cake and eat it, too — to have the contents of a hedge fund without the container." BAA identified a range of hedge fund strategies with a focus on mitigating risk. In a memo describing the BlackRock mandate, Christopher McDonough, director of the New Jersey Division of Investment, pointed to low fees, the firm's early entry into hedge funds, and the flexibility of customized mandates.

The BAA deal didn't emerge from thin air. BlackRock and New Jersey had been working together in alternatives for years. In 2006 the firm won an allocation from New Jersey for a private equity program, which the state had grown to $800 million by early 2016. Three months before the hedge fund compromise, New Jersey added a further $500 million to the program. That arrangement, the state reported, paid 0.45 percent in management fees and 10 percent for performance on co- investments above an 8 percent hurdle and a net 20.5 percent internal rate of return. New Jersey had edged into hedge funds with the firm in 2007, putting $400 million into a BlackRock credit fund, then an additional $144 million to help BlackRock avoid a breach of its loan terms after leverage evaporated.

There's a larger context and some irony here as well. The past decade has witnessed the emergence of a number of alternative- asset giants. Many, like Blackstone, KKR & Co., Apollo Global Management, and Carlyle Group, built upon successful private equity businesses but have long since diversified, globalized, and gone public; Blackstone, with $361 billion in assets under management on September 30, has the largest real estate and fund-of-hedge-funds operations in the world. BlackRock has more than enough scale to join that group — its passive-strategy roots take some edge off its Wall Street label — along with a handful of large, diversified hedge funds, such as AQR Capital Management and Bridgewater Associates.

These burgeoning alternative-asset giants have the scale and diversification to offer separately managed vehicles, fund-of-one structures, or customized mandates — the nomenclature varies — to large institutions: long-term collaborations between, say, a pension and a diversified alternative-asset provider that trade a hefty slug of money for lower fees and greater flexibility. The investor gets transparency, the ability to customize, the expertise of a sophisticated partner, and full control without limited partners.

Like many financial trends, the managed, or custom, fund trend was first declared a revolution, then dismissed as hype, but now appears to be evolving and proliferating, even as hedge funds lose luster.

Many of the early custom deals had a private equity flavor. In 2011, Texas's TRS handed KKR and Apollo $3 billion each for separately managed accounts in private investments such as real assets, debt, and buyouts. (TRS had already experimented with managed accounts, allocating $4 billion in 2008 for public investments with BlackRock, Morgan Stanley, J.P.Morgan Asset Management, and Neuberger Berman.) After the mandates to Apollo and KKR, TRS was criticized, and the trend discounted, when much of the initial funding went into commingled funds and it was unclear whether the Texas plan was getting lower fees. Nonetheless, in 2015 TRS expanded its programs with the two firms by $4 billion. In November the plan boasted it had the highest ten-year return for private equity among the top pension funds: 15.4 percent annually.

Against a performance like that, current hedge fund returns look paltry. (And the squeeze continues: The Texas County & District Retirement System, with one of the highest allocations in the U.S. to hedge funds — 25 percent, or $6.2 billion — said in December it was keeping its allocation, but it culled five of36 managers, including Brevan Howard.) Generally, there has not been the same flight from private equity as from hedge funds, mostly because of the former's better returns. A UBS survey of family offices produced by Campden Wealth Research in September showed that private equity's portion of the average portfolio rose 2.3 percentage points, to 21 percent, in the past year, chiefly at the expense of hedge funds, which fell to 8.1 percent from 9 percent. A Preqin survey reported recently that 94 percent of investors were happy or neutral about buyouts as an asset class.

Are so-called custom, or separate, funds a long-term pension panacea? Well, they can't hurt. But arbitrage and commoditization always lurk in Malthusian finance. Early adopters outperform; once funds embrace a strategy, fees edge up and performance flattens — and the risk remains. Customized funds require lots of labor and offer no guarantees of alpha. And even if a surge in alpha occurs, pensions with underfunding woes will still need to undertake painful reforms. As Rockefeller's Boyd suggested in a 2016 study, maturing demographics — fewer workers than beneficiaries — pose the real threat to pension viability, explaining not just the rush to hedge funds 20 years ago but the lunge to cheaper options like ETFs and custom funds today. Aging beneficiaries, volatile markets, and feckless politicians are a lot to cope with for anyone swaying up there on the high wire.