Pension funds investments in hedge funds – a necessary regulation

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Abstract: *When it comes to investment strategies, generally, pension funds have proved to be conservative investors with a long term approach on investments and constant preoccupation for asset diversification as well as tendencies to secure their portfolios through investments in established financial products.*

Nevertheless, within this constant preoccupation for portfolio diversification as well as gain of notable profits, private pension funds have invested to a certain degree also in less cautious products respectively have conducted less stable investments.

The financial turbulences that hit the US towards the end of 2007 and spread globally to become one of the most severe financial crisis witnessed, haven't left pension funds immune to this phenomenon. Although, as previously stated, the special feature of pension funds is based on long term investments, which confers a certain degree of natural protection, there can not be the talk of absolute immunity either.

Keywords: hedge funds, financial turbulences, diversified portfolio, aggressive investment strategies, risk control measures, derivative products, systemic risks, hedge fund industry, transparency, qualitative and quantitative restrictions, supervisory authorities.

Private pension funds have been especially affected by the financial crisis, although public pension plans have been pressured and suffered tremendously due to low global productivity and rise of unemployment as concrete consequences of the crisis, not to mention the well known demographic stress.

According to the prestigious French journal "Le Figaro", the total losses registered by private pension funds across the entire OECD zone in October 2008 amounted 3300 billion dollars, respectively 20% of the total assets, by comparison with December 2007. If other types of assets were to be taken into consideration, as for example, the ones owned within the individual saving pension accounts in the US and similar schemes in other countries, the registered decrease would come to 5000 billion dollars (Laboul, OECD 2009).

The impact of the financial crisis upon pension funds varies from country to country within the OECD zone, depending on the type of pension schemes (Defined Benefit respectively Defined Contribution) as well as on the type of invested products. Pension funds investing notably in shares have been exposed on the stock market and consequently registered important losses. This is the case of Ireland with 66% of the Irish funds' portfolio being oriented towards investments in stocks. US, Great Britain and Australia follow.

In the past years, ascendant tendencies in view of investments in hedge funds have been noticed among private pension funds. Considering the financial crisis, the dimension and the impact upon pension funds, although to a much smaller extent compared with other financial institutions, many prestigious international financial and economic organizations and institutions such as OECD, IMF and World Bank have drawn the attention upon the risks related to this type of dangerous investments as well as concluded thorough analyses in order to show the necessity of risk control measures and regulatory framework.

Dating from 1949, when the sociologist, author and financial journalist, Alfred W. Jones was accredited with the constitution of the 1st hedge fund, hedge funds represent usually funds used by private investors – wealthy persons and institutions – structured as partnerships and opened only to a limited number of investors, due to a extremely high minimum accepted investment limit, practicing aggressive investment strategies at national and international level with the aim of gaining significant profits.

Hedge funds are exonerated from complying with many rules and regulations governing the activity of investment funds, permitting thus the attainment of aggressive investment objectives.

Hedge funds have drawn the public's attention in 1998, when the Long Term Capital Management fund (LTCM) in the US nearly reached collapse, needing a financing rescue plan of approx. 3,5 billion USD organized and coordinated by the Federal Reserve Bank of New York and paid by private banks. In the year 2006 another large hedge fund collapsed. Amaranth Advisors cost the investors more than 6 billion USD.

Critics sustained the idea that hedge funds carry systemic risks, which became notable once the disaster of LTCM took place. The exposure of hedge funds to derivative products, in order to obtain very high returns, has been revealed as one of the main factors contributing to the creation of systemic risks.

The systemic risk represents the risk of collapse of an entire financial system or of a market in its totality. It refers to the risk imposed by interdependences within a system or market, where the collapse of an individual entity or a group formed of several entities can cause a "cascade" disaster leading to the downfall of the entire system or market. It is actually what happened starting with the year 2007 in the US and spread to global scale up to present – the financial turmoil.

In 2006, the European Central Bank (ECB) warned referring to the potential of hedge funds in view of systemic risks threatening the financial stability. This warning was sadly disputed by several parties in the financial industry.

In February 2007, the Bush administration and the American regulatory financial institutions rejected the idea of regulating the activity of these funds and recommended instead, that the persons, institutions and banks conduct healthy practices before investing or borrowing money to hedge funds. The American "Securities and Exchange Commission" (SEC) had introduced a list of requirements for hedge funds, which was later rejected by the Federal Court.

The potential of hedge funds in regards to systemic risks has been highlighted by the collapse of the two Bear Stearns funds in June 2007. These funds had invested in mortgage backed-up securities.

Regarding the dimension of the hedge fund industry, estimations vary a lot due to the lack of central statistics, the difficulty of classification of hedge funds as well as due to the rapid growth of this industry.

Indubitable though is the fact that the hedge fund market developed in the past years, the growth of the assets administered by the approx. 10.000 funds being estimated at more than 1 trillion USD.

This growth is based, to a large extent, on investments of institutional investors and in particular, of pension funds. According to recent OECD data, approx. 20% of European and American pension funds and approx. 40% of Japanese pension funds invest in hedge funds. Despite this, the total amount of pension funds' assets dedicated to investments in hedge funds is relatively small. According to IMF evaluations, there are few funds allocating more than 5-10% of their assets to investments in hedge funds.

Nevertheless, the past has shown a tendency of increasing this percentage. Due to the periods of low performance registered by pension funds and to the objective to avoid under funding, pension funds have been tempted to invest in a larger range of products.

International organizations and surveillance institutions have drawn the attention on the necessity that fiduciaries are in perfect knowledge of the complexity of the invested products and that they take appropriate measures for risk control and management.

Often, the risks involved with these investments, the type and exposure to these risks are hard to evaluate, due to low transparency. Besides that, the strategy of hedge funds can modify rapidly, as in the case of Amaranth Advisors, where investors didn't know that the fund owned 10% of the global natural gas market. Fraud has also been related to the lack of transparency and is a serious danger when investments are exonerated from rules, regulations and reporting requirements.

Pension funds investing in hedge funds could also experience problems referring to the difficulties to withdraw from these investments, due to illiquid feature of hedge funds as well as due to high withdrawal taxes.

Some countries have chosen to forbid investments of pension funds in hedge funds, while in some other states authorities considered that measures for risk management and control as well as reporting to supervising authorities are supposed to cover the associated risks.

Although percentages of investments within the total portfolio of pension funds can appear, at first glimpse, rather low, these can hide quite large amounts of money – for example 2% of the pension funds' assets in Holland invested in hedge funds amount to approx. 15 billion USD.

In order to control implicated risks, quantitative and qualitative restrictions have been imposed in the majority of OECD countries. While some countries apply restrictions related to a certain investment limit – Greece, Spain and Portugal imposing a limit of 5% - other states foresee restrictions regarding the type of allowed financial products – unlisted securities are not allowed in Ireland, Estonia and Austria.

In view of qualitative restrictions, Prudential Rules and compliance with general risk management requirements are imposed in most countries. Additional to these restrictions, many countries have introduced requirements related to directive principles, education measures and risk assessment before investing into hedge funds.

In conclusion, there are regulations which help the supervising authorities to monitor the activities of pension funds. Nevertheless, due to the general tendency of exposure to hedge funds, a more careful concentration on transparency, fulfillment of requirements as well as improvement of the measures for risk control and management are necessary. After all, who can play with the security of generations of people and can fund managers prove their total engagement and experience when investing the money of society?

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