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Hedge fund investment by superannuation funds

While Australian superannuation funds were among the earliest globally to invest in hedge funds, the level of this investment has not increased at the same pace as in other jurisdictions. Given recent developments in hedge fund practices and investment practices generally, it is opportune to examine superannuation fund investment in hedge funds, for the regulator to restate its expectations when hedge funds are part of a superannuation fund investment portfolio, and to review lessons from the global financial crisis.

Expectations when investing in hedge funds

APRA's expectations of trustees, where they choose to invest superannuation fund assets in hedge funds, fall into the following areas:

- a well thought-out investment strategy addressing the needs of the superannuation fund;
- consistency with that strategy, and a clear role for hedge funds within that strategy;
- due diligence around specific hedge funds and their underlying investments; and
- ongoing monitoring of hedge fund investments.

At its simplest, expectations of trustees of superannuation funds that choose to invest in hedge funds are no different to expectations in respect of any other investments they undertake. There are, however, some specific nuances due to the specific nature of hedge funds.

It is fundamentally critical that trustees understand what they are invested in, including how that investment is likely to behave in a range of market conditions (i.e. what drives risk and performance).

Investment strategy

Under law, trustees of superannuation funds are required to develop an investment strategy to meet the needs of the fund having regard to, amongst other things, diversification and liquidity. There is a clear need to determine the return objectives and the desired risk appetite, as well as determining the types of risks that the trustee is willing for the fund to accept.

Any investment in hedge funds needs to be consistent with this strategy and risk appetite. This extends to individual hedge fund investments that are being undertaken as well as to the aggregate investment in hedge funds.

While many superannuation funds have an allocation to 'alternatives' with a sub-allocation to 'hedge funds', a number of others include hedge funds as sub-categories within underlying asset classes. It is important that when this categorisation is made, it is reflective of the risk and return behaviour of the different hedge fund strategies.

Trustees need to determine the purpose of their allocation to specific hedge fund strategies and how those strategies are expected to behave in various market conditions. This extends to how they are expected to interact with the broader investment portfolio of the fund as a whole. Critical to this assessment is an understanding of the strategies that the investee hedge funds are pursuing.

Due diligence

Once decisions have been made on which categories[1] of hedge funds to utilise, trustees then need to select the actual hedge fund managers (or FoHFs: Fund of Hedge Funds) to invest in. Again, understanding the strategy (or strategies) being followed by individual hedge funds is critical. AIMA already provides guidance on factors to be considered when evaluating hedge funds. These include:

- understanding the strategy, specifically how it generates returns and adds value;
- understanding the risks inherent in that strategy;
- identifying markets covered and instruments used;
- research process;
- track record of key investment staff;
- performance through market cycles;
- segregation (and effectiveness) of reporting and valuation;
- operation of key service providers (eg prime brokers, administrators);
- jurisdictional issues;
- the use of leverage;
- liquidity issues – given the strategy pursued; and
- collateral management – where collateral is required for trading activities.

For FoHF investments, the ability of the investment manager to evaluate and monitor constituent hedge funds needs to be assessed, as does the manager's ability to construct portfolios of hedge funds by considering multi-factor exposure and even complementarity analysis. FoHFs also need the systems and processes to be able to combine positions from hedge funds and to take action as needed; there needs to be a clear management process when investments are not meeting expectations.

One lesson from the global financial crisis is the criticality of understanding where money is actually invested, what the underlying exposures and risks are, and how they may behave in a crisis. This applies irrespective of whether an investment is in a structured investment (like a collateralised debt obligation) in a 'traditional' investment fund, or in a direct or intermediated hedge fund.

[1] Categories will be based on the hedge fund strategy: e.g. global macro, equity long/short

The crisis highlighted the often opaque nature of hedge fund strategies and investments, and pointed out the benefit of greater transparency for investors.

Monitoring

Investment monitoring is critical as well; while historically there has been limited oversight by investors, this has changed in recent years. Trustees have an obligation to understand how funds are being invested. There is now much greater reliance by trustees on third party administrators to provide position, or at least exposure, data. However, this does not obviate the need for trustees themselves to understand what is happening.

Related to this is the requirement to measure performance; the nature of hedge fund investing, frequently involving high-conviction strategies, often renders standard benchmarks of limited value. Trustees need appropriate benchmarks that reflect the investment universe and the market risk of the opportunity set.

While performance measurement will often be backward looking, effective performance measurement can often highlight areas of style drift or more insidious conduct. When performance does not make sense, given the underlying conditions and the declared strategy, this must be viewed by trustees as a flag for further investigation. This includes when performance is inexplicably good.

Additional risk information is often needed, highlighting exposure to specific factors, extent of leverage or details on liquidity. While deliberate decisions can legitimately be made by trustees regarding these parameters, it is important that they are constantly monitored. Trustees also need a clear process for acting on information received; while knee-jerk reactions are counter-productive, action needs to be taken when responses are not forthcoming or when performance cannot be explained adequately.

Lessons from the global financial crisis

Related to investment decisions are some critical observations from the global financial crisis. These include:

- the importance of knowing, and understanding, the ultimate investment;
- the criticality of understanding the sources of risk and return;
- the importance of looking, not just at underlying assets, but through structures to understand embedded or downstream leverage;
- consideration of the ‘funding’ side of the balance sheet. There is a need to understand the possible redemption behaviour of members as well as other pressure points for funding throughout the investment structure. This also applies in situations where, for example, member entitlement is based on underlying asset value but they have a right to redeem within a certain period of time; and
- contagion risk where associated parties are subject to adverse media comment that affects market confidence.

The Australian Prudential Regulation Authority (APRA) is the prudential regulator of the Australian financial services industry. It oversees banks, credit unions, *building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most members of the superannuation industry.*