

# Retirement Plan News Update

Brought to you by the Barnes Dennig Employee Benefit Plan Audit Team

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## The Challenge of Alternative Investments

Hedge fund hustler extraordinaire Bernie Madoff has certainly brought new attention to the world of alternative investments, bilking investors out of a collective \$50 billion with a Ponzi scheme built on a house of shaky hedge funds.

To be sure, alternative investments like those found in hedge funds and private equity funds can be complex and often come with unique investment and fiduciary risks.

But employee benefit plans are increasingly focusing their attention on alternative investments for at least a portion of their overall investment portfolio. Indeed, as plans have chased returns, they've gotten more esoteric, and alternative investments have crept in.

Of course, that's not necessarily a bad thing. Alternative investments can help with plan diversification and reduce the volatility of investment performance. The key is that alternative investments should always be subject to the specific financial and actuarial condition of each plan and the risk tolerance of the plan fiduciaries.

### The Downside

Loosely defined, alternative investments are those that are not quoted on an exchange or other public market. This could include anything from hedge funds and private equity funds to real estate, timber, oil & gas, LBOs and commodities.

Alternative investments often come under limited regulatory oversight, making it critical for plan fiduciaries to perform thorough due diligence and ongoing monitoring. Investments in unregulated or less-regulated markets do pose some risks that might not be understood by plan fiduciaries in the same way that the risks of diversified stock and bond portfolios are understood. Especially within a defined contribution plan, where the risk-return

profiles are being placed upon the participants, alternative investments are generally not appropriate as a core investment.

Hedge funds, in particular, pose some unique challenges. They typically employ leverage (options, futures, swaps and short selling) and offer limited liquidity. Then, there is the issue of lack of transparency. However, a hedge fund that provides access to information about underlying investments would certainly allow fiduciaries to execute their responsibilities

### The Valuation Challenge

Perhaps the biggest challenge of alternative investments lies in establishing an accurate value. By their very nature, these are investments for which a readily determinable fair value does not exist. A hedge fund is not listed on NASDAQ, and you can't pick up *The Wall Street Journal* and get a share price for a private equity fund.

Unfortunately, it is actually quite easy to land in the murky waters of alternative investment valuation. Plenty of plans offer investments that are outside of the traditional stocks, bonds and mutual funds. For example, some plans allow participants to direct their investments into real estate holding companies, where it may be a challenge to establish a fair value on the real estate.

### What A Fiduciary Needs to Know

While generally accepted accounting principles require alternative investments to be valued at fair value, these values can be hard to determine. Typically, the outside investment manager, the custodian or the issuer of the alternative investment ends up determining a value, which plan fiduciaries simply accept at face value.

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The danger here is that the Department of Labor holds plan management responsible for the proper reporting of plan investments. So, you must have sufficient information to evaluate and independently challenge the valuation.

That means fiduciaries must have a sufficient understanding of:

- The underlying investments.
- The portfolio strategy of the alternative investment.
- The method and significant assumptions used by the fund manager to value the underlying investments.

### What You Can Do

Of course, some plan administrators avoid investing in funds where no underlying investment detail is available. But there are steps you can take to gain sufficient understanding of the alternative investment:

- Periodically interview fund managers so that you understand a fund's strategy, positions and valuation methodologies.
- Compare data obtained from the fund manager with other available information, such as sector data, indexes and cash distributions.
- Corroborate this information through the annual audited financial statements of the alternative investment.

### The Limited Scope Audit Trap

Additional valuation challenges occur in situations where an audit of plan assets is required. In a "limited scope" audit, the Department of Labor allows the auditor to accept the fair value that a plan custodian assigns to an alternative investment. (By comparison, in a full scope audit, the auditor may need to test the model used for determining the alternative investment's fair value.)

The danger arises when plan administrators simply rely on that certification with no further understanding of the investment or the valuation methods used. Here, they may receive a certification stating that the investments are valued at fair value and think that they don't ever have to look any deeper at these investments.

### Your Responsibilities

Ultimately, a plan fiduciary is responsible for complete and accurate financial reporting of all plan investments. To that end, you'll need to:

- Establish processes for determining fair value measurements and disclosures.
- Select appropriate valuation methods.
- Identify and adequately support any significant assumptions used in preparing the valuation.
- Ensure that the presentation and disclosure of the fair value measurements are in accordance with Form 5500 reporting requirements and generally accepted accounting principles (GAAP).

In the end, plan sponsors may want to think hard about the additional cost/oversight related to adding alternative investments to their portfolio mix. We invite you to contact our office to discuss the pros and cons of these investments — and to learn ways for properly valuing them.

If you would like to talk further about alternative investments, please contact us at Barnes Dennig at (513) 241-8313 and we would be happy to help you.

