Attorneys, academics unfazed by Calpers' hedge fund exit
The hedge fund industry is too big, attorneys say, but changes considered
By Dominic Fracassa
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News of the California Public Employees’ Retirement System’s plans to liquidate the entirety of its $4 billion position in hedge funds touched off an energetic public conversation last week about the efficacy of hedge fund investing.

As the nation’s largest public pension plan with about $300 billion in assets under management, Calpers’ investment activity is often viewed as a bellwether for institutional investors. As a result, Calpers' decision to pull out of 24 hedge funds and six fund-of-funds over the next year raised questions about whether other pension funds might reevaluate their own hedge fund allocations and possibly follow suit.

But attorneys representing hedge funds and other corporate finance experts are largely brushing off the notion that Calpers' shift away from hedge funds will result in a mass migration away from alternative investment strategies or a slowdown in hedge fund-related legal work.

"Most of the [hedge fund] managers who had Calpers accounts are very, very large. It's not going to disrupt their business," said Karl A. Cole-Frieman, a founding partner of the financial services boutique law firm Cole-Frieman & Mallon LLP. He added that shuttered hedge funds tend to spin out new investment managers, which can actually help to increase the overall volume of hedge fund work.

"I tell the people that work here that it's like the Disney movie [The Lion King], it's the circle of life," he said. "One fund closes and three open as a result. What affects their business doesn't affect the legal business."

Nicolas P.B. Bollen, a finance professor at Vanderbilt University's Owen Graduate School of Management, noted that institutional investors - like state pension plans and university endowments - benchmark against one another.

"So it's natural that when the largest player makes a move, others might ask themselves if they should follow suit," he said.

But, Bollen added, "These [hedge fund] investors, a lot of them are satisfied with their managers. And because they have certain targets for their portfolios, they're searching for yields and returns, and that desire is going to provide them with enough incentive to stay in hedge funds and maintain their allocations."

In a statement released last Monday, Calpers said it made the decision to wind down its hedge fund positions "as part of an ongoing effort to reduce complexity and costs in its investment program.

In February, Calpers said its board moved to recalibrate its asset allocations in an effort to reduce risk exposure while maintaining its overall return goal of 7.5 percent.

Many financial industry observers contend that hedge fund managers have been under pressure to justify their hefty fees in light of the comparably lackluster returns hedge funds have generated this year, ostensibly a central rationale behind Calpers' pivot away from such investments.

"The cost argument is one that the public will always accept," said University of St. Thomas School of Law professor Wulf A. Kaal, who specializes in hedge fund regulation and the strategic behavior of private fund advisers.
"Because they have a higher fee structure, the whole model is built in the assumption that absolute returns justify higher fees," Kaal said.

Calpers did not include any information related to the returns it received from its hedge fund positions in its announcement last week, and a representative of the pension plan could not be reached to comment. But according to data compiled by Bloomberg, Calpers' hedge fund investments returned an annualized average of 4.8 percent over the past 10 years.

Marketwide, hedge fund investments saw a 3.9 percent return through the first half of 2014, according to alternative investment research and consulting firm Preqin Ltd.

Other pension plans in the state reported mixed sentiments about the viability of hedge fund investments. The California State Teachers’ Retirement System, the nation's second-largest pension fund with about $187 billion under management, has pledged to review its three-year experimental foray into hedge fund investing beginning in November, according to spokesman Ricardo Duran.

"At that point the board would determine whether to continue studying [hedge fund investing], abandon it or make it part of the permanent portfolio," Duran said, though he stressed that there was no rigid timetable for the decision.

The Los Angeles Fire and Police Pensions plan opted out of its hedge fund positions in May of 2013. Tom Lopez, the plan's chief investment officer, said the rationale behind the decision "was pretty simple." "We got out of hedge funds because we were disappointed with the returns and they [represented a] disproportionate amount of our investment fee budget," Lopez said.

That sentiment does not appear to be universal, however. The San Francisco Employees' Retirement System is considering allocating as much as 15 percent of its assets to hedge funds, according to media reports, though a representative for the pension plan could not be reached.

"Just because Calpers decides it doesn't want to invest in hedge funds doesn't mean the rest of the industry will decide the same thing, but it will likely cause a number of pension funds to reevaluate whether they want to be in hedge funds," said Los Angeles-based Paul Hastings LLP partner Arthur L. Zwickel.

"In terms of the volume of [legal] work, I don't see a significant impact in the near term, or in the long term," he said, adding that while hedge fund investments may not have yielded the returns Calpers was seeking, other investors with different expectations and levels of risk tolerance will continue to find opportunities.

"There's always going to be investors who are committed to finding the best managers and who will continue to invest in this space," he said.

Nothing precludes Calpers from revisiting hedge fund investing at a later date, a strategy that may prove to be appealing if the now-soaring equity markets take a turn for the worse - a time when hedge fund strategies typically shine, according to New York Law School professor Houman B. Shadab, co-director of the school's Center for Business and Financial Law.

"Calpers will eventually regret its decision once the markets do turn sour again," Shadab said.

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