Most Plan Fiduciaries "Ill-Prepared" to Evaluate Alternatives

By Editor Test *Wed, Aug 4, 2010*

Alternative investments could be a trap waiting for unwary or unprepared plan sponsors and fiduciaries, Matthew Hutcheson told members of the House Subcommittee on Health, Employment, Labor and Pensions on July 20.

Matthew Hutcheson, the independent fiduciary and 401(k) reformer profiled in today's issue of RIJ, thinks alternative investments could be a trap waiting for unwary or unprepared qualified plan sponsors.

As Hutcheson told members of the House Subcommittee on Health, Employment, Labor and Pensions last July 20, in a statement entitled, "Creating Greater Accounting Transparency for Pensions":

While "many plan fiduciaries are exploring alternative investments to improve portfolio performance and reduce risks… most fiduciaries of employer sponsored retirement plans are ill prepared to perform an appropriate level of due diligence" when choosing alternative investments for their plans.

Interest in alternative investments—"tangible assets (i.e. gold or art), commodities, private equity funds, hedge funds, and closely held stocks" as well as "derivatives and guru portfolios" like the ones peddled by Bernard Madoff—is rising as frustrated investors look for better returns and relief from "financial industry fatigue," Hutcheson testified.

Yet he listed several reasons why alternative investments are often too complex for the most plan fiduciaries. The fair market value of alternatives may be difficult to determine, there may be "unobservable inputs" that affect the value, little historical information may be available, and the costs of buying and selling alternatives can be high, he said.

Require audit of internal controls

Require that alternative funds have an independent auditor sign off on internal controls based upon the Committee of Sponsoring Organizations' ("COSO") definition of what it means to effectively evaluate internal controls.

Require understandable financial statements

Retirement plan fiduciaries want a "plain English" executive summary to an investment's annual report and more complete disclosures. Indentifying a reasonable expected return on capital will otherwise be difficult at a minimum and perhaps even impossible based on what those familiar with such matters would otherwise require before proceeding with an investment.

Enterprise risk management skills

Fiduciaries considering alternative investments must possess sufficient knowledge themselves to investigate whether alternative investments are being managed by individuals with strong enterprise risk management skills. There must be a common, standardized language between all alternative investment managers, auditors, and plan fiduciaries. Key principles, concepts, and guidance must be conveyed under a common framework. A fiduciary's ability to accurately compare two or more competing alternative investments depends on it.

Fair Valuation Standards

The Financial Accounting Standards Board recently published proposed amendments to its fair value measurement and disclosure rules that enhance and standardize the method of valuing alternative investments by the U.S. based Generally Accepted Accounting Principles (GAPP) and the International Financial Reporting Standards (IFRSs). It focuses on standardizing how elements of uncertainty that may affect a fair market value are disclosed. For example, disclosure of the use of one unobservable input over another in a fair market valuation, and how it might have affected the resulting value. This is particularly important for plan fiduciaries investigating the merits of international alternative investments.

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