The bottom line on alternatives

There's a lot of information out there regarding the New Hampshire Retirement System, some of it fact, some of it fiction. This document, along with others in the "NHRS ... Now You Know" series, is designed to provide you with straight talk about the retirement system.

NHRS pursues an investment strategy designed to achieve its long-term funding requirements. The goal is simple: meet or exceed the retirement system's assumed rate of return – currently 6.75% – over the long term, while at the same time carefully managing risk, including liquidity.

To achieve this goal, the retirement system holds a diverse portfolio of investments. The purpose of diversification is to reduce risk and volatility by allocating investments among various financial instruments – such as stocks, bonds, real estate, and alternative investments – to mitigate the impact on the overall portfolio caused by the underperformance of any single asset type. In other words, NHRS is careful to not put all of its eggs in one basket.

The Board of Trustees, with research and input from investment staff, outside experts, and a recommendation from the Independent Investment Committee (IIC), sets an investment policy that includes asset allocation targets and acceptable ranges – i.e. how much money will be directed to each type of investment. The IIC then manages investments based on this investment policy.

Per the NHRS investment policy, about half of the retirement system's assets are invested in stocks and a quarter are invested in bonds. Of the remaining assets, 15% of the portfolio is allocated to alternative investments and 10% to real estate.

Even to someone with a limited background in finance, stocks, bonds, and real estate investments are fairly straightforward. However, "alternative" investments can easily be misunderstood and could sound exotic, or even scary.

For NHRS, alternative investments include private equity and private debt (not hedge funds, gold, or commodities).

Private equity and private debt usually involve participation in a partnership arrangement with an investment manager who acts as the General Partner (GP) and makes investments or loans on behalf of NHRS and other Limited Partners (LPs). These investments are generally made by the GP in private companies (i.e. not publically traded) that need capital to expand or improve. Private equity and private debt investments generally have a life cycle of several years and the funds committed to the GP by LPs are typically not accessible ("illiquid") for the duration of each individual investment.

Since the re-start of the retirement system's alternative investment program in 2009, its contribution to the pension trust fund has been positive. In four of the past six, the alternative investment and real estate assets significantly outperformed the marketable assets (stock and bond holdings).

The dollar-weighted five-year return for the alternative assets committed since the restart of the program, net of fees, was 7.8%, through June 30, 2020. The dollar weighted five-year return, net of fees, for all alternative assets (including commitments made by the Board of Trustees prior to the creation of the IIC in 2009) was 7.7% through June 30, 2020.In short, the alternative investment program has been beneficial to NHRS. Most commitments are meeting or exceeding expectations and adding value to the portfolio.

This success is not limited to just NHRS and many public pension funds, as well as large university endowments, have increased their exposure to alternative investments in recent years. This has led to concerns that these types of investments can be riskier, more expensive, and less transparent than sticking with a "bread and butter" portfolio of only stocks and bonds. Here is how NHRS addresses these concerns:

Risk: There is an inherent risk in any type of investing. There are three main risks to private equity and private debt, all of which NHRS has strategies to mitigate: (1) liquidity risk – i.e. the investment is locked up for several years – which is managed by phasing in commitments to these investments over a multi-year period; (2) macro-economic risk, which is managed by selecting investments with varying strategies; and (3) manager risk, which is addressed through careful screening, vetting and selection of GPs.

Cost: The fee structure for private equity and private debt typically includes two components: a *management fee* and an *incentive ("carry") fee*. The actual fee structure is highly dependent on the specific strategy of the investment. In all new agreements, the retirement system requires a "most favored nation" clause, which requires that alternative fund managers afford NHRS the lowest fee structure offered to any similar investor, such as other pension systems.

Management fees typically range from 0.25% to 2% on either committed or invested capital and are designed to support the operations of the General Partner (GP) while searching for and evaluating investment opportunities. Although commonly referred to as a "fee," management fees are more like a loan made to the GP over the life cycle of the fund, which are typically paid back to the LP when the investment winds down. In fact, these costs are not considered an "expense" by Generally Accepted Accounting Principles (GAAP) but are instead capitalized.

Carry fees typically range from 5% to 20% and provide an incentive to the GP to generate profits – both the GP and LP "win" if the investment is successful.

When a successful fund completes its life cycle and liquidates, NHRS is paid back: (1) its initial investment, *including* any management fees paid; (2) 100% of a pre-agreed percentage of the profits (aka "hurdle rate," typically the first 6% to 8% of the profits); (3) a major portion of any return over and above the pre-agreed return – typically 80% to 95%.

Not surprisingly, these costs are greater than the fees an institutional investor would pay for the management of a stock or bond fund. However, investment costs shouldn't be considered in a vacuum; the important thing to keep in mind about fees is how they relate to performance. Higher costs make sense if the investments produce higher returns, net of fees. (All investment returns for all asset classes measured and reported net of fees by NHRS.)

Transparency: Because these investments are based on specific strategies and typically involve investments in private companies, many private equity and private debt GPs – as a precondition of doing business – require investors to sign a confidentiality clause protecting investment details that could put the GP (and therefore LPs such as NHRS) at a competitive disadvantage. Accordingly, NHRS has a Private Markets Disclosure Policy that allows for the disclosure of aggregated data, but limits the disclosure of information which is specific to an individual manager or investment. As outlined in the Private Markets Disclosure Policy, the Board of Trustees seeks to provide "the highest degree of public disclosure and transparency of its financial operations not in conflict with its paramount fiduciary duty to act solely in the interest of its members and beneficiaries and to prudently maximize a risk-adjusted return on NHRS assets for their exclusive benefit."

A final concern raised about alternative investments is that some pension funds are "swinging for the fences" by placing too much emphasis on this asset class in hopes of generating high returns. This argument may have merit in cases where alternative investments make up a significant portion of the overall asset base. However, NHRS, with a 15% allocation, treats alternative investments as just one of several components of a sound, diverse investment portfolio designed to serve the long-term needs of its members, retirees, and beneficiaries.

Sources: NHRS Investment Policy; NEPC;

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