

California law could help boost investment in emerging hedge fund managers

November 1, 2011 - The US state of California has signed a law that encourages giant pension providers Calpers and Calstrs to increase investments in emerging managers, including hedge funds.

A new California law could create greater opportunities for emerging hedge fund managers to win mandates from the state's giant pension plans.

California Senate Bill 294, signed into law by Governor Jerry Brown on October 9, requires the California Public Employees' Retirement System (Calpers) and California State Teachers' Retirement System (Calstrs) to create five-year plans for increasing emerging manager participation across all asset classes.

The law passed with support from California's pension plans, which already have dedicated programmes for emerging managers.

The original version of the bill, introduced by Senator Curran Price, set a 15% participation goal for emerging managers. At this level Calpers and Calstrs would have had to increase allocations to emerging managers to \$55 billion over five years.

However, the 15% target was eliminated in a last-minute amendment to the bill, which now leaves it to the pension plans to define 'emerging managers' and determine the appropriate level of investment in these managers.

Advocates of investing in emerging managers welcomed the legislation despite the absence of a defined participation goal. "The law encourages the use of emerging managers and creates an interesting framework for Calpers and Calstrs to achieve this," says Thurman White, CEO of Progress Investment Management, a manager of emerging managers.

"We think the legislation will facilitate more opportunities for emerging managers to demonstrate what they can do across different asset classes for the benefit of California's pension plans," White adds.

Calpers currently operates three dedicated emerging manager programmes. It does not have a multi-year plan or formal benchmarks for emerging manager participation.

"[Senate Bill 294] has the potential to improve Calpers' co-ordination of these efforts and refine its existing programmes and strategies as they relate to emerging investment managers," the pension plan said in a statement to Hedge Funds Review.

Calpers has been steadily increasing its allocations to emerging hedge funds in recent years. In 2007 its global equity unit launched the fund of emerging hedge funds programme to invest in multi-manager portfolios of new and small hedge funds.

The programme was funded with an initial allocation of \$450 million and received a further \$100 million

in May 2010. The fund of emerging hedge funds programme currently has \$564.9 million invested in three portfolios managed by 47 Degrees North, Rock Creek and Paamco.

Calpers also started laying the groundwork for an internal hedge fund seeding programme in 2009. In September it made a \$100 million seed investment in Breton Hill Capital, a global macro manager based in Toronto.

The allocations to emerging hedge funds are part of a broader push by Calpers to increase exposure to smaller managers.

Calpers' flagship emerging manager initiative, the Manager Development Program (MDP), was launched in 2000 and is overseen by its global equity unit. A follow-on programme, MDP II, was established in 2006.

Calpers currently has around \$1.7 billion invested in six emerging public equity managers through MDP and MDP II. The pension plan has a further \$700 million invested in equity managers through its emerging fund of funds programme.

Calstrs is in the process of developing its hedge fund investment programme. The pension plan had around \$1.25 billion allocated to emerging equity managers and a further \$1 billion invested in emerging private equity managers at the end of 2010.

Calstrs also welcomed the enactment of Senate Bill 294. In a written analysis of the law, it said: "Calstrs currently makes significant efforts to encourage a broad range of investment managers to participate in managing Calstrs funds. As a result Calstrs anticipates gradually increasing the number of emerging investment managers in all asset classes to meet its investment goals."

California is not alone in enacting legislation aimed at encouraging participation of emerging managers in managing its pension assets. New York, Illinois and Maryland have passed broadly similar legislation, though the rules in these states are aimed more explicitly towards encouraging allocations to women and minority-owned businesses.

There is good reason to believe increasing allocations to emerging managers will help pension plans improve their performance in the long term. According to a study from analytics firm PerTrac, hedge funds with less than \$100 million in assets have returned 13.6% annually over the past 15 years compared with only 10% from funds with more than \$500 million.

The performance gap is even wider when funds are assessed by age: funds that are less than two years old have returned 16% on average compared with less than 11% for those that have been around for more than four years.

"Investing in emerging managers can deliver excess returns and diversify business risk," says Progress Investment's White. "The bigger investment managers are not necessarily less risky. Smaller boutiques offer more transparency and typically have less exposure to complex or esoteric securities. They also stimulate innovation, which benefits pension plans in the long term."

However, there remain structural impediments to pension plans increasing allocations to emerging managers. Large public pension plans typically have concentration limits that prevent them from having

an investment in a manager that exceeds 10% or 20% of their total assets.

With minimum allocations often in the \$100 millions, that means it can be difficult for plans to allocate to managers running any less than \$500 million.

For this reason pension plans are likely to gain exposure to emerging hedge funds through funds of funds, says Ken Stemme, director of research for Larch Lane Advisors, a fund of hedge funds manager specialising in early-stage investing.

"Investing in early-stage hedge funds can be very rewarding, but it is also a lot of hard work in terms of due diligence. Given the structural constraints that large pension plans operate with, it is likely that they will look to partner with funds of funds with expertise in this area to expand allocations to emerging managers," he says.

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