TESTIMONY OF JACK MARCO,
CHAIRMAN OF THE MARCO CONSULTING GROUP,
BEFORE THE SUBCOMMITTEE ON HEALTH, EMPLOYMENT, LABOR, and PENSIONS
COMMITTEE ON EDUCATION AND LABOR
OF THE U.S. HOUSE OF REPRESENTATIVES
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Good morning Mr. Chairman and Members of the Committee. My name is Jack Marco. I am the Chairman of the Marco Consulting Group, an investment consulting firm I co-founded in 1988. We have nearly 400 benefit plans as clients; most are multi-employer, jointly-trusteed plans organized under the Taft-Hartley Act and subject to ERISA. In most cases we serve as investment consultant but in many situations we serve as a named fiduciary where we make the decisions on asset allocation and select the investment managers. Our clients' aggregate asset value is approximately $90 billion. In terms of assets, we are the largest investment consultant to Taft-Hartley plans in the country. I have been an investment consultant for 33 years.

The employee trustees of Taft-Hartley plans are electricians and bakers, bricklayers and nurses, janitors and plumbers. They work in our grocery stores and hotels and hospitals. They drive trucks and make clothes and care for the sick. They are the very best our nation has for building complex construction projects and providing necessary—in some cases critical--services. The employer trustees represent small business and large. They are contractors, HR specialists, labor relation specialists and representatives of trade associations. While they are not investment professionals, as leaders in their unions and businesses, they are smart, successful and accomplished individuals. As trustees they work tirelessly to provide a solid retirement benefit for their members and their employees. And for this they accept all of the liabilities of a fiduciary and receive no compensation.

When I first started providing investment consulting services to Taft-Hartley plans in 1977, their investments were overwhelmingly in the traditional asset classes of stock, bonds and insurance contracts. I was hired as an investment consultant to help them select and monitor investment firms which would manage their assets. Their investments in publicly traded stocks and bonds were held at custodian banks and independently valued by them. There was little debate about what they owned, what it was worth and the risks they were taking.

Today our clients still own stocks and bonds held in custody by many of these same banks and reported on accordingly. However, these assets now represent about 75% of their funds. The remainder is in real estate partnerships and commingled funds, private equity partnerships, LLC's and hedge funds. On the positive side, these asset classes have added important diversification to the portfolios and improved returns. On the negative side, many of these strategies have become very complex with little regulation and government oversight. The trustees are expected to be "prudent experts" when selecting investment firms which use these strategies. More than ever they rely on independent investment consulting firms such as ours to educate them on the risks and returns of these approaches, bring them the best managers and help them avoid the poor ones. That is becoming a more challenging task every day. I would like to focus today on two of these investment approaches: Private Equity and Hedge Funds.

Private Equity

By definition, "private" equity means making investments in companies that are not registered with the Securities and Exchange Commission ("SEC") as publicly traded securities. They are not generally followed by Wall Street analysts. Much has been written about the "Efficient Market Theory" which says there is so much information available about publicly traded companies that there is little opportunity for a money manager to provide above market returns. One of the advantages of Private Equity is that little is known about these privately held or startup companies, therefore the investor who seeks out these companies has greater opportunity to provide superior returns. It is also true that this same lack of information creates a risk to investors. Furthermore, because private equity managers may have a specialized industry or niche that they invest in, they may hold concentrated positions that are not well-diversified – this presents a greater opportunity for significant loss. While a manager of publicly traded equity may hold 50 securities, some Private Equity managers will make less than 10 investments.

These private equity investments are typically partnerships, the investment manager being the General Partner and the pension fund investors being the Limited Partners. At the time of the investment (commitment) there are no investments made yet and the manager begins the process of looking for companies in which to invest. The investor has to rely on his own due diligence and the information provided by the General Partner to provide some confidence that the General Partner will do well. The need to perform proper due diligence is further heightened by one of the unique aspects of Private Equity – contractual agreements that lock up investor capital for more than a decade after the initial commitment. Our clients typically meet four times a year to conduct all of the business of the pension fund. They have no capacity and no investment staff to perform that due diligence. Most often they look to an investment consultant to provide due diligence for them.

Our process examines the private equity manager's: Form ADV (if it is registered with the SEC); insurance; audited financial statements, valuation procedures; third-party service providers; offering memorandum, and marketing materials; personnel; biographies of key employees; client references; complete historical returns for all prior funds; and a history of all limited partnership investments, total capital managed and strategy for all prior products. We require this information to proceed; however the

General Partners are not required to provide it. If they refuse, we move on to another candidate. The General Partner moves on to another investor who may not demand these disclosures. The best General Partners provide all that is asked of them and more. The worst General Partners rely on slick presentations without appropriate disclosure.

The same can be said about disclosures after the pension fund has become an investor. We require quarterly detailed reporting on each investment including asset values, capital flows, and business plans. Of the General Partner, we continue to require reporting on their investment strategies, current market conditions and organizational issues. On an annual basis we collect and review Form ADVs where possible, insurance, audited financial statements and valuation procedures. Again all of this is a requirement we place on any partnership we recommend to our clients. Where this is not demanded by the investor it may not be provided because it is not required by law.

Our preference is for our clients to use private equity fund of funds instead of individual private equity funds. The fund of funds structure provides diversification of strategy, geography and industry. The fund of funds manager brings expertise, access, oversight and resources to the investment process and bears full responsibility for the evaluation, selection and timing of all investments in the fund. A good fund of funds manager demands all of the disclosures we listed and also has a good track record of discovering successful partnerships.

We believe this due diligence structure and the use of fund of funds are very effective tools for Taft-Hartley trustees. However requiring General Partners to provide these disclosures would ensure that all investors have the information they need to make intelligent, informed decisions.

Hedge Funds

There are over 9,000 hedge funds available to pension fund investors. They cover a multitude of strategies and approaches: Long/Short Equity, Merger Arbitrage, Relative Value, Distressed Debt, Fixed Income Arbitrage, Global Macro, CTA's and the list goes on. While the traditional manager invests in a stock or a bond in a long position, the hedge fund manager will also take that long position and then hedge it with a short position (short sale). This is done with publicly traded stocks, domestic and foreign, currencies, commodities, and bonds to name a few. These are some of the most sophisticated strategies executed in the industry. Consequently, it requires equally sophisticated supervision. That is why we prefer Funds of Hedge Funds for our clients. These are typically partnerships or LLC's that select a group of hedge funds and move in and out of them over time. The investor then owns shares of 30 to 50 hedge funds in a diversified portfolio rather than just a few they could select on their own. As a result, we focus on analyzing and monitoring the Funds of Hedge Funds.

We have developed a list of best practices for Funds of Hedge Funds. Generally, we will not recommend a fund of hedge funds that does not adhere to the majority of these best practices. We also expect the Fund of Hedge Funds managers to follow certain best practices in its due diligence and monitoring of underlying hedge funds.

Our best practices are divided into four categories of risk at the fund of hedge funds and underlying hedge fund level—people, investment, operational and business.

For people risk, we want a fund of hedge funds to provide client references and underlying manager references. We expect the underlying hedge funds to provide client references and to agree to background checks on their key investment and operations staff to the fund of hedge funds manager.

For investment risk, we want fund of hedge funds to agree to be an ERISA fiduciary, to provide the number of underlying funds and to report fund and client performance on a monthly and quarterly basis and aggregate strategy exposures on a quarterly basis. We expect the underlying hedge funds to provide the number of their underlying positions and to report on at least a quarterly basis to the fund of hedge funds. We want both fund of hedge funds and hedge funds to provide: monthly returns; strategy and geographic allocations; and portfolio terms for liquidity and fees.

For operational risk, we want both fund of hedge funds and hedge funds to hire third party firms to manage custody, audit and administration responsibilities.

For business risk, we want both fund of hedge funds and hedge funds to provide general firm information regarding their inception, assets under management and number of accounts for both institutions and non-institutions. We also want them to provide general fund information regarding inception, assets under management (strategy and fund level), number of accounts and minimum investment amount.

Let me make it clear that these are the best practices we believe are appropriate and that we follow. They are not required in the law or in regulation.

Finally, we believe SEC registration should be required for all hedge funds and Funds of Hedge Funds, and thus we welcome Congress' passage of the Financial Reform Bill requiring registration of those funds with $150 million or more under management as an important step towards that goal.

Conclusion

The investment environment that Taft-Hartley Fund trustees face today is exponentially more complex than it was when I joined this industry three decades ago. It is difficult enough to expect trustees to understand the many investment strategies, but without full and complete disclosure by the investment community, it is nearly impossible for these trustees to do their job in protecting the retirement security of millions of American workers. From the professional advisor and fiduciary's perspective, I know requiring these disclosures would certainly help us do a better job of scrutinizing these investments.

I have also provided the Committee with our list of best practices for Private Equity and Hedge Fund investing as well as background documents on them and model principles and valuation procedures. They can be viewed at http://www.marcoconsulting.com/cexhibits.html.

I welcome any questions you may have.