SBA FLORIDA
STATE BOARD OF ADMINISTRATION
At A Glance

Alternative Investments

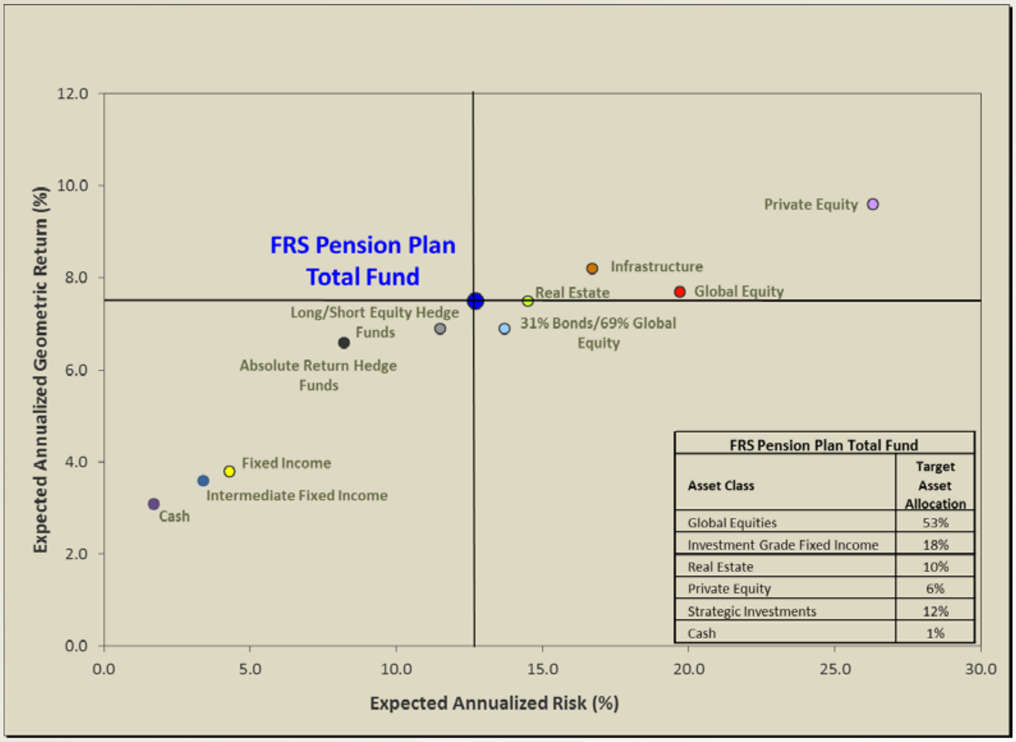
What Are Alternative Investments?
The term ‘Alternative Investments’ (alternatives, for short) refers to investments and strategies that do not neatly fall into the traditional ‘core’ asset classes of publicly traded equities (stocks) and fixed income (bonds). Traditional asset classes are each comprised of 8,000 to 15,000 securities that have similar characteristics in terms of risk, liquidity, legal structure, etc. On the other hand, the market for alternative investments is neither broad nor liquid and consists largely of privately negotiated partnerships that raise monies from pension funds, endowments, foundations, insurance companies, banks, high-net worth individuals, etc. Among institutional investors, alternatives commonly include strategies like Private Equity, Venture Capital, Hedge Funds, Private Debt, Infrastructure and Timberland.

How Do Alternative Investments Benefit the FRS?
A thoughtfully constructed portfolio will diversify across a sufficiently broad range of investments so that the portfolio has a high probability of meeting the investment objective, notwithstanding the wide distribution of performance often associated with individual investments. In other words, some individual investments may be poor performers, but in a highly diversified portfolio, their overall impact on the portfolio will often be offset by other investments that, at the time, are better performers.

While some view alternatives individually as more “risky”, adding alternatives to a portfolio of stocks and bonds can reduce a portfolio’s overall risk through diversification and increase the portfolio’s overall risk-return profile. It is difficult to generalize about all of the different strategies in alternatives, but they have the potential to provide a pension fund with one or more of the following benefits: diversification, potential for increased returns, capital preservation or protection against inflation.

A case in point was the financial meltdown of 2008 and 2009 when both stocks and large parts of the bond market experienced sharp declines. Through those turbulent times, many alternative investments performed far better. For instance, the average hedge fund return was −18.65% in 2008 (the HFRI Fund Weighted Composite Index return) but this compared very favorably to the S&P 500’s total return that year of −37.00%.

This graph shows the expected risk and return spectrum of various investment products and strategies employed by the SBA (net of management fees). With the FRS Pension Plan Total Fund at the center of the graph as the target, investments solely in products lower than the target, such as fixed income, real estate and absolute return hedge funds, while carrying less risk, would not be expected to earn sufficient returns to meet long-term obligations. Conversely, investments such as private equity, infrastructure, global equity and long/short equity hedge funds would be expected to exceed the needed returns, but carry added risk. One of the primary goals of choosing an investment strategy is obtaining a balance of investment products that result in meeting needed returns with the least amount of risk possible.



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Lack of correlation and hedging are desirable characteristics of investing in alternative investments. However, as is always the case in the investment world, this portfolio enhancement is not free, and investors in alternatives can expect to incur risks unique to alternatives and higher costs.

A common cost or risk associated with alternatives is illiquidity. General partners in private equity funds as well as debt and hedge fund managers generally require an extended capital commitment and place restrictions on capital withdrawals. Additionally, management fees are typically greater for alternative investments as these funds are actively managed. However, the SBA expects to earn a premium on alternative investments over typical public market investments in order to compensate the SBA for risks and costs associated with alternative investments' illiquidity and higher fees.

It is also important to note that many types of alternative investments are long term in nature and often will produce low or negative returns in the early years of the investment. Usually in the first few years of an investment, management fees are drawn down from contributed capital. The investment's interim returns may not be meaningful or indicative of ultimate performance during the early stages of the investment life cycle.

How Does the FRS Compare to its Peers?

The consensus among institutional investors such as endowments and major pension funds is that alternatives have a place in their portfolios, and many now have double-digit allocations to alternative investments. Currently, the allocation to alternatives in the FRS Pension Plan, at approximately 9%, is significantly lower than similarly sized peers, which average approximately 19%.

Are Alternative Investments Transparent?

Because alternatives managers often attempt to develop investment strategies and techniques that offer enhanced returns, they have a need to protect their intellectual capital and investment strategies, including private company information they obtain as part of an investment. Clearly, any manager that can consistently produce outsize returns will attract would-be imitators or competitors. While that attempted imitation might seem flattering, if successfully exploited, it would also be return-eroding and reduce the manager's likelihood for success. Consequently, many alternatives managers strictly enforce legal safeguards on disclosure of their investment processes and strategies.

These safeguards do not extend to information that allows stakeholders to monitor performance of the investments. The SBA is bound by Florida's public records laws to provide transparency that state, "Proprietary confidential business information" <u>does not include:</u>

a. The name, address, and vintage year of an alternative investment vehicle and the identity of the principals involved in the management of the alternative investment vehicle.
b. The dollar amount of the commitment made by the State Board of Administration to each alternative investment vehicle since inception.
c. The dollar amount and date of cash contributions made by the State Board of Administration to each alternative investment vehicle since inception.
d. The dollar amount, on a fiscal-year-end basis, of cash distributions received by the State Board of Administration from each alternative investment vehicle.
e. The dollar amount, on a fiscal-year-end basis, of cash distributions received by the State Board of Administration plus the remaining value of alternative-vehicle assets that are attributable to the State Board of Administration's investment in each alternative investment vehicle.
f. The net internal rate of return of each alternative investment vehicle since inception.
g. The investment multiple of each alternative investment vehicle since inception.
h. The dollar amount of the total management fees and costs paid on an annual fiscal-year-end basis by the State Board of Administration to each alternative investment vehicle.
i. The dollar amount of cash profit received by the State Board of Administration from each alternative investment vehicle on a fiscal-year-end basis.
j. A description of any compensation, fees, or expenses, including the amount or value, paid or agreed to be paid by a proprietor to any person to solicit the board to make an alternative investment or investment through an alternative investment vehicle. This does not apply to an executive officer, general partner, managing member, or other employee of the proprietor, who is paid by the proprietor to solicit the board to make such investments.