WSJ: Calpers Pulls Back From Hedge Funds.

California Pension Fund to Cut Investments by 40%

Public pensions from California to Ohio are backing away from hedge funds because of concerns about high fees and lackluster returns.

Those having second thoughts include officials at the largest public pension fund in the U.S., the California Public Employees' Retirement System, or Calpers. Its hedge-fund investment is expected to drop this year by 40%, to $3 billion, amid a review of that part of the portfolio, said a person familiar with the changes. A spokesman declined to comment on the size of the reduction but said the fund is taking more of a "back-to-basics approach" with its holdings.

The retreat comes after many pension funds poured money into hedge funds in recent years in hopes of making up huge shortfalls.

The officials overseeing pensions for Los Angeles's fire and police employees decided last year to get out of hedge funds altogether after an investment of $500 million produced a return of less than 2% over seven years, according to Los Angeles Fire and Police Pensions General Manager Ray Ciranna. The hedge-fund investment was just 4% of the pension's total portfolio and yet $15 million a year in fees went to hedge-fund managers, 17% of all fees paid by the fund.

"We were ready to move on," Mr. Ciranna said.

Before 2004, public pensions favored plain-vanilla investments and avoided hedge funds almost entirely, according to data compiled by consultant Wilshire Trust Universe Comparison Service. Public pensions began wading into hedge funds roughly a decade ago as they sought to boost long-term returns and close the gap between assets and future obligations to retirees.

Hedge funds typically bet on and against stocks, bonds or other securities, often using borrowed money. Hedge funds also charge higher fees, usually 2% of assets under management and 20% of profits.

Many hedge funds dropped less than the overall market during the financial crisis, and some even posted outsize gains by anticipating the collapse. That performance accelerated the flow of pension money into hedge funds.

The move was part of a wider embrace of alternative investments, including private equity and real estate, as pension officials looked to diversify holdings in case more conventional investments faltered. They also hoped bigger investment gains would help them avoid extracting larger contributions from employees or reducing benefits for current or future retirees.

With many hedge funds, that sort of outperformance hasn't materialized in recent years: Average public-pension gains from hedge funds were 3.6% for the three years ended March 31 as compared with a 10.9% return from private-equity investments, a 10.6% return from stocks and 5.7% from fixed-income investments, according to a Wilshire review of public pensions with more than $1 billion in assets.

After peaking at 1.81% in 2011, pension allocations to hedge funds dipped to 1.21% of total portfolios as of March 31, according to Wilshire's review.

The average amount committed to private equity, by comparison, still is climbing. Those investments jumped to a decadelong high of 10.5% as of March 31, according to Wilshire. Stocks and bonds are still the dominant investments for all public pensions.

The reconsideration of hedge funds as an investment option hasn't produced significant shifts inside all funds. Some big public pensions said they are holding firm on commitments or increasing allocations as they worry about how stocks will perform in any future downturn. About half of the U.S. public pensions still have some sort of hedge-fund investment, according to data tracker Preqin.

"We are seeing a little moving away from hedge funds," but so far it's "just on the margin," said Verne Sedlacek, the chief executive of Commonfund, a nonprofit that manages money for pension funds, endowments and other nonprofit groups.

How far Calpers goes with its hedge-fund review may influence decisions at other public pensions because of its size in the industry. The current value of its assets is roughly $301 billion. The examination began in March as officials inside the fund began raising questions about whether hedge funds are too complicated or can effectively balance out poor-performing stocks during a market crash, said a person familiar with the situation.

A Calpers spokesman said the investment staff will make a formal recommendation to the board in the fall. But some cuts already have been made, said the person familiar with the situation. Hedge funds represented 1.5% of Calpers's total assets, or $4.5 billion, as of June 30.

Other states have made reductions as well. The School Employees Retirement System of Ohio decided to lower its hedge-fund allocation to 10% by fiscal 2015 as compared with roughly 15% in fiscal 2013 after investment gains were lower than expected, according to a spokesman. New Jersey's State Investment Council lowered its planned allocation to hedge funds to 12% from 12.25% as part of its fiscal 2014 plan, according to a spokesman.

The debate in San Francisco is indicative of those under way nationwide.

Board members of the San Francisco Employees' Retirement System are considering whether to invest 15% of assets into hedge funds for the first time. A debate about that strategy dominated a June meeting, in which board member Herb Meiberger argued hedge funds have blown up in the past and aren't the only investment alternative. The fund's executive director couldn't be reached for comment Wednesday.

Mr. Meiberger said at the meeting that he had sought out Warren Buffett's advice on the matter. The billionaire investor's handwritten response: "I would not go with hedge funds—would prefer index funds."

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