Alternative Investment Strategies for Pension Funds

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Outline

- Traditional investment strategy
- Problems of traditional approach
- Managing returns and risks
- Alternative strategies
- Conclusion

Traditional Asset Allocation

UK pension funds		Iceland pension funds	
Equities:	70%	Equities:	35%
Bonds	25%	Bonds:	60%
Other	5%	Other:	5%

Will either of these match liabilities over time?

Pension fund investment strategy

- Iceland funds concentrate on liabilities – minimise risk
  - Insurance company approach, low volatility
- UK funds concentrate on assets – maximise returns
  - Expected equities to outperform bonds, therefore hope to fund pensions more cheaply over time!
- Rely on long-only equities or bonds to deliver long-term outperformance and/or pay pensions
- Both approaches entail mis-matching between assets and liabilities

Pension fund objectives

- To be able to pay the pensions
- Not just to maximise returns or outperform an index
- Not just to minimise risk – need returns too
- Maximising returns won't necessarily mean higher pensions
- Minimising risk won't necessarily mean sufficient returns to keep up with pension liabilities

Pension fund risks can't be ignored

- Must consider <u>all</u> the risks
  - Salary inflation
  - Duration
  - Longevity
- There is no perfect match for these
- Need to reduce the mis-match where possible
- If want to reduce risk, do so in most efficient way
  - To get lowest reduction of expected return
- Find alternative ways to add value

Relying on equities <u>too</u> 'risky'

- Equity returns carry two kinds of risk:

1. volatility associated with equity risk premium – can hope to be <u>rewarded</u> for this over time
2. risk of not keeping up with pension liabilities, as interest rates, inflation and mortality change - <u>unrewarded</u> risk

- These other risks caused damage as not been controlled
- Large losses can be fatal – can you wait for bull market?
- So should investors rely on bonds instead then?

Probably not - bonds also ‘risky’

- Yes, bonds reduce ‘risk’ measured by volatility of return
  - But in exchange for biggest reduction in upside potential
- Bond investments still contain ‘unrewarded’ risk
  - e.g. salary inflation, credit, longevity, duration
- So, switching to bonds does not ensure **all** risks reduced
- Bonds are not a perfect match for pension liabilities
  - Taking on credit risk can be dangerous
- Investment strategy is more complex

Pension fund problems in past

- Not enough consideration of different scenarios
- ‘Expected’ returns, not same as *achieved* returns
- Protect against falling assets **or** rising liabilities
- No insurance
  - Corporate treasury hedging routine, not pension funds
- Not take advantage of modern investing

Traditional investment thinking

- Traditional attitude: Manage returns and **TAKE** risk
  - Passive acceptance or even welcoming of risk
  - High ‘expected’ long-term returns from risky equities
  - Aim to maximise returns relative to index, not liabilities
- Modern approach: Manage returns AND **MANAGE** risk
  - Control unrewarded risks relative to liabilities
  - Diversification of sources of alpha and beta
  - Need some ‘insurance’ against unexpected outcomes

Managing returns and risks

- Sufficient returns, not maximum returns
- Controlled and conscious risks, not minimum risk
- Hedging of risks and diversification of assets
- Corporate techniques new to pension funds
- Set explicit risk/return objectives relative to liabilities
- e.g. fixed income based measure of liabilities + 1.5%
  - To allow for salary inflation and longevity

Improve portfolio efficiency

- Diversification of sources of investment return
  - Wide range of asset classes, lower correlations
- Diversify returns and risk premia from inefficient markets
  - Equity risk premium only one source – others available
- Different sources of beta and alpha
  - Must monitor managers and strategies over time
- Will underperform strong bull market
  - But returns should be more stable/reliable in long-run

Avoiding big losses important

- Falling markets are very damaging
- If market halves then doubles, only back where started
- If can protect from severe falls, required returns lower

	£100 invested	£100 invested	£100 invested
Yr. 1	- 30%	- 30%	- 3%
Yr. 2	+ 30%	+ 43%	+ 5%
End value	**£91**	**£100**	**£101.85**

- Absolute return investing

Key questions to consider

- Balancing risks and ‘expected’ returns
- How much investment risk to take?
- What type of risks to take?
- Do I expect to be rewarded for taking the risk?
- Will derivatives be useful?
- What if it goes wrong – do I have insurance?

What can investors do?

- Can seek asymmetric return profile
  - Limit downside, but retain **good enough** upside
- Access sources of market inefficiency and manager skill
  - Selecting right managers vital for achieving returns
- More than just equities and bonds – use of alternatives
  - Alternative assets portfolio – hedge funds, private equity, commodities, property, currency
- Flexible over time

Pension fund investment strategy

- Aim to achieve consistent liabilities + 1.5%
- Could divide assets into two equal parts 50%/50%
  1. Liability-matching assets

     - deliver bond-based measure of liabilities
  2. Return-seeking assets

     - deliver bond-based measure of liabilities + 3%
- Proportions can vary over time depending on performance and maturity of fund

Alternative asset allocation approach

- Return-seeking assets, aiming to generate high returns
  - Absolute return active managers for alpha e.g. hedge funds
  - Passive strategies or derivatives for beta returns
  - Alternative assets benefit from market inefficiencies
- Liability-matching or hedging assets, to protect downside
  - Use some fixed income assets for cash flow
  - Aim to minimise unrewarded risks
  - Use derivatives and swaps for closer liability match

Benefits of including alternative assets

- Improve portfolio efficiency with diversification
- Low correlation with traditional asset classes
  - Of course correlations can change over time
- Capture different risk premia
- More than one sources of alpha and beta
- Reduce risk in most efficient way – don’t sacrifice expected returns
- Absolute returns rather than relative returns

Barriers to using alternative assets

- Investors nervous of the unfamiliar
  - Rather fail conventionally than succeed unconventionally
- Lack of understanding
- Lack of experience
- More complex
- High fees?
- Due diligence can be expensive and time-consuming

Overcoming the barriers

- Trustee education
- Banks or consultants to offer advice in language trustees can understand
- Improve familiarity
- Focus on risk reduction and return enhancement with respect to each scheme's liability profile
- Build trust over time
- Investment banks to structure suitable vehicles

Including alternative assets in pension fund portfolios

- Emphasis on uncorrelated, absolute returns
- Over long-term, successful absolute return managers outperform long-only
- Truly active management – not benchmark constrained
  - Outperforming falling markets not much help
- Use in different ways – for example:
  - Long/short equity for core-satellite portfolio in preference to long-only active – passive beta
  - Non-correlated market neutral – pure alpha skill

Pension funds have adopted new approaches in the past

- Mutual funds: 1950's these were thought too illiquid, now recognise benefits of diversification, spread risk
- International: 1980's said too risky (poor reporting, no transparency) – now appreciate low correlation benefit
- Corporate or high yield bonds: 1990's said high risk, less liquid – now chasing yield pick-up

- Alternative assets becoming mainstream now

More sophisticated and complex

- Corporate finance departments use modern tools routinely
- Pension funds slower to adopt
- Need good investment consultants to advise
- Derivatives use spreading among pension funds
  - UK 14%, Holland 50%, Sweden 70%

Conclusion

- Alternative investment approaches offer better risk/return profile than just bonds or equities
  - Benefits of diversification and low correlation
- Manage risks **and** returns: reduce mis-match of assets vs. liabilities – take risks you expect to be rewarded for
- Two parts to portfolio: Liability matching + return seeking
- Benefit from modern methods of money management
  - Hedge funds, currencies, absolute returns
- Help to pay the pensions over time

Thank you for listening...

ANY QUESTIONS?

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