



Trustees Need Leading Edge Strategy

By Frank O'Brien



The “perfect storm” of 2000/2003 – the combination of sharp falls in equity markets, low and falling bond yields and increased longevity – has prompted an ongoing reappraisal of pension fund investment strategy. Is there another storm on the horizon? Investment Consultant *Frank O'Brien* lays out a road-map to a leading-edge strategy that all trustees need to read:

In the context of the quite properly conservative pension fund industry, there have already been dramatic changes in trustee attitudes since the start of the new century - in the roles allocated to existing and new asset classes, in the determination of asset mixes and in investment strategy generally.

The previous perception on pension fund investment was captured in long term, equity-biased portfolios which reflected the view that the pension fund, as a self-standing entity, should attempt to maximise long term value by heavy investment in equities.

The new perspective is formed by the belief that the pension fund and corporate sponsor are inextricably linked and that pension fund strategy must embrace not just the long term imperative to pay pensions but also the short-term requirements of the Funding Standard and IAS 19. In other words, trustees now see a requirement to balance the long term objective of paying pensions with the short term need to protect against downside volatility which would embarrass the fund under the Funding Standard or the corporate sponsor under IAS 19.

PRAGMATISM, COMPROMISE

The international evidence, both from "equity-biased" jurisdictions such as Australia, the UK and the US and from "bond-biased" jurisdictions like Holland, Sweden and Japan suggests that trustees are adopting a pragmatic compromise. They appear to have rejected both return maximisation via heavily equity-biased portfolios and liability matching via bond portfolios. There appears to be convergence towards portfolios which are still equity-biased but are rather more balanced and diverse than heretofore.

Investment portfolios therefore have a dual role

- to generate return for the long run
- and, in the shorter term to match liabilities, i.e. to meet the Funding Standard or to avoid distortion to the corporate balance sheet.

Assets will be assigned to that element of the portfolio most appropriate to their characteristics:

- Matching Segment of portfolio
 - Swaps
 - Index linked bonds
- Return Generating Segment of
 - Portfolio
 - Equities
 - Private Equity
 - Hedge Funds
 - Commodities
 - Property

The initial step in portfolio construction is to determine the relative importance of the two goals. The trustees and their advisers will then proceed to weight up asset allocations accordingly, within the context of a sensibly diversified portfolio.

Table 1

ALTERNATIVE ASSETS:	% of total to end 2006
Emerging Market and Other Equities	5.3
International Property	5.3
Alternative Assets	2.4
	13

Table 2

NPRF TARGET ASSET ALLOCATION: END OF 2009	2001	2004	2006
Large Cap Equity		63	56
Small Cap Equity		4	5
Emerging Markets		2	5
Quoted Equities	80	69	66
Private Equity		8	10
Property		8	8
Commodities		2	2
Alternative Assets		18	20
Fixed Income	20	13	13
Currency Funds		0	1
	20	13	14
Cash	–	–	–
	100	100	100

Clearly, the effective implementation of this approach requires that there is absolute clarity (and, quantification) over:

- i) the funds objectives, in terms of long term returns (real or nominal) and risk appetite and appetite for short term downside volatility and
- ii) the return, risk and, importantly, the correlation characteristics of the different asset classes. This implies an informed assessment (not simply based on historical review) of the returns, volatilities and correlations of all asset classes but especially of the "new" relatively illiquid asset classes, such as hedge funds and private equity.

STRIKING CHANGES

The recently published IAPF Asset Allocation Survey shows already, even at the level of the €88bn total assets of all funds surveyed, that striking changes are taking place in asset mix. For example, exposure to what may loosely be termed "Alternative Assets" or non-mainstream assets at end 2006 emerges as follows (Table 1):

Included under alternative assets in the survey are forestry, private equity, direct currency, tactical asset allocation and derivatives both for hedging and other purposes.

Anecdotal evidence suggests that other initiatives taken by Irish funds include investments in infrastructure, in commodities, in bond-based liability matching strategies and in Irish venture capital.

Perhaps the highest profile Irish pension fund is the National Pensions Reserve Fund which is gradually moving towards its targeted asset allocation at end 2009. What is most striking is how the target itself has evolved since it was first established in 2001. (See Table 2)

In strategic terms the evolution of the targeted position has involved a switch to a more balanced and more diverse asset mix.

Impressively, despite its size, the Fund has been moving quickly towards its desired outcome. Restating its published end 2006 position for monies committed, but not yet drawn down, to property and to private equity shows the following position. (See Table 3)

Alternative assets, if emerging market equities are included, already account for 14.5% of the total fund. Over the next three years, to the end 2009 target, a further substantial move out of equities into alternatives is planned.

The fund's allocation to bonds and equities also illustrates a further development in strategic thinking. Some 50.6% of total assets are invested passively i.e. designed to capture market returns ("beta" in the jargon). Active equity exposure of 29.2% and active bond exposure of 4.0% are designed to deliver added value over market returns ("alpha").

The development of a manager selection skill is key to the successful implementation of these strategies. It is important in the selection of active bond and equity managers and hugely important in the selection of managers of a fund's private equity and hedge fund exposures given the alarmingly wide dispersion of returns across managers of these asset classes. Uniquely of the Irish investment houses, AIBIM have developed an in-house manager selection capability which has successfully managed AIBIM's suite of multi-manager products over the past number of years and which has developed an expertise and skill set which is transportable into the alternative assets.

NEW PRODUCTS

A number of the Irish institutions meanwhile, have been active in developing products to satisfy the needs of the "Matching Segment of the Portfolio" discussed earlier.

ILIM have successfully launched a pooled product which is designed to cope with inflation and interest rate risk and which is based on highly rated, investment grade bonds. "Buckets" of long duration, nominal or index linked, bonds are created over a range of maturities. A customised solution, based on the pension fund's liability characteristics, is created by an appropriate combination of the individual "buckets".

CONSIDERABLE CHANGES HAD ALREADY TAKEN PLACE, MORE ARE IN THE PIPELINE

The outcome is a tangible and transparent product which sits comfortably within the governance framework of the typical fund. By way of contrast, BIAM have drawn on the derivatives expertise of Bank of Ireland Global Markets to create synthetic bonds with long duration and inflation protection characteristics. In effect, the pension fund receives a return based on long dated nominal or inflation linked bonds by paying away (or swapping) a return linked to cash rates. BIAM manages the complexities of the swap process.

Cornmarket Financial Services, in an initiative aligned to the strategic developments discussed above have developed a new suite of funds for their AVC clients. These funds are designed to meet client requirements for a smoother ride to a more predictable destination (or long term outcome). The Cornmarket funds are notable for their more balanced allocation of monies over the various asset classes. This is illustrated below by comparing the new Cornmarket Balanced Fund against a recent mix of the ILIM Consensus Fund (See Table 4).

Irish pension funds and their advisors are clearly responding to the new strategic imperatives. Considerable change has already taken place, more are in the pipeline.

There is no fixed, final destination. This will evolve over time as new strategies, initiatives and products are developed. However, a significant pointer to the future may be available in the U.S. endowments which have outperformed U.S. pension funds by some 2/2 % per annum over the past ten years or so. Obviously, endowments have different objectives to pension funds but they do share important common characteristics, notably their long term time horizons and their need to protect their funds against inflation.

Table 3

NPRF ADJUSTED ASSET MIX AT 31.12.2006

Passive Equities	41.3
Active Equities	29.2
Emerging Markets	4.1
Small Cap	1.9
Equities	76.5
Passive Bonds	9.3
Active Bonds	4.0
Bonds	13.3
Private Equity	3.7
Property	4.8
Commodities	1.3
Currency Funds	0.6
Alternative Assets	10.4
Cash	0.2
TOTAL FUND	100

Table 4

BALANCED FUNDS COMPARISON	Cornmarket Balanced	Irish Life Consensus
Equities	31	78
Property	31	5
Fixed Interest	23	12
Cash	5	5
Alternatives	10	-
	100	100

Table 5

ASSET MIXES: 2006	Average US Pension Fund	Average US Endowment	Average US Large Endowment	Pension Fund Yale
Equity	59	58	45	26
Fixed Income	36	20	13	4
Real Estate	2	4	4	28
Cash	2	3	2	2
Alternatives	1	15	-	40
	100	100	100	100

PENSIONS WARY OF HEDGE FUNDS

Pension plans are still wary about investing in alternatives, especially in hedge funds, according to a new white paper by Northern Trust.

In a survey conducted by CREATE Research of some 300 fund managers and defined benefit plans sponsors in 37 countries, Northern Trust found that just half of respondents invested in hedge funds, and of those, only one out of 10 expects to invest more in the future. Another 10% that don't invest now, are contemplating HFs over the next three years, while one-third have no plans to allocate to them at all.

The average allocation to alternative investments by institutional investors, is around 3%, divided among hedge funds, property, private equity and commodities, which is surprisingly little considering the stated intention by many is to invest in them to achieve uncorrelated absolute returns and that more than 80% of those polled say their pension funds are underfunded.

"There is a yawning gap between the aspirations of institutional investors and what they actually do in practice," Mark Austin of Northern Trust says. "After the worst global funding crisis in living memory, most pension funds still don't have the governance structure and investment expertise to achieve radical diversification."

Amin Rajan, CEO of CREATE and author of the report, adds, "Before making big allocations to alternatives, investors want to see step improvements in the risk-return characteristics of investing in alternatives. They also want something done about lack of transparency, high fees and illiquidity in these asset classes."

Amongst the endowments, the most outstanding performer has been Yale University under the leadership of their Chief Investment Office, David Swensen. The clarity of his thinking, on fund objectives, on asset characteristics and on portfolio construction is exemplary. If there is currently a leading edge in institutional investment thinking I suspect that this may be where it resides. The end 2006 asset mixes of pension funds and endowments are shown below. As the table moves from left to right, we see progressively lower exposure to equities and bonds and corresponding increases in exposures to alternatives and real assets. (See Table 5)

At the extremes the asset mix of the Yale Endowment is radically different to that of the Average US Pension Fund.

Real Estate includes exposure to forestry and natural resources. Hedge funds and private equity account for the bulk of exposure to Alternative Assets.

immediately move to replicate Yale's strategy. Certainly not, in the first place, before trustees develop the same clarity around asset characteristics and roles as that which motivates Swensen. Secondly, timing is critical. Recent market turmoil highlights the extent to which private equity and hedge funds, in particular, had been bound up in an over-inflated, debt driven, credit bubble. Thirdly, access to a manager selection skill is key.

This assessment of the alternative assets might be put in the context of a wider review of strategy generally along the lines discussed above. Long-held assumption should be challenged. For example, just to take a few issues:

- does each asset need to be liquid at all times?
- what is the appropriate role for cash?
- how comfortable are we with the use, indirectly through private equity and hedge funds of leverage, derivatives and high fees?

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Underlying the Yale strategy, is Swensen's clarity over the expected returns, volatilities and correlations of the different asset classes. Equities are the classic high return, high volatility asset. Real estate and private equity give high returns but with high volatility and high correlations with equities. Hedge funds generate high returns with very low correlation with equities. Cash and bonds are allotted modest roles due to their low expected returns. Swensen believes he can get better returns for no higher risk elsewhere. However, Yale's success is not due to Swensen's clarity alone. They have been successful in building a manager selection skill, particularly in private equity and hedge funds. They have been investing in hedge funds for almost twenty years. I suspect that, in their early forays into the alternative assets, they enjoyed first mover advantage.

Swensen clearly believes that the alternative assets have a significant role to play in investment strategy. However, this does not mean that Irish pension funds should

The outcome of this review should be enhanced clarity over the full range of issues. Clearly, trustee training, as signposted recently by the Pensions Board, becomes a central issue. IAPF, working with Investment Faculty Ireland (of which I am a director) already provides investment training. IFI have recently launched a new initiative of customised, issue-specific training for trustee boards as they approach such critical issues as strategic reviews, manager selection, alternative investments amongst many other topics.

As I have shown above, the development agenda has progressed rapidly but still has a long way to run. The ultimate goal is hugely worthwhile – a strategy which will embrace the long term perspective of the pensioner whilst meeting the shorter-term requirements of the corporate sponsor and the Regulator.

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