New thinking for pension funds

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Outline

- Traditional investment approach
- Managing returns and risks
- Diversification - different sources of alpha and beta
- Alternative approaches
- Conclusion

Traditional approach

- Some pension funds focus on liabilities – minimise risk
  - Insurance company approach, low volatility
- Others concentrate on assets – maximise returns
  - Expect equities to outperform bonds, so hope to fund pensions more cheaply over time!
- Rely on long-only assets (equities or bonds)

Problems of traditional approaches

- Risk of mis-match between assets and liabilities
- Too much reliance on equities or bonds
- Pure beta exposure, no downside protection
- Not enough sources of beta and alpha?
- Talented managers constrained by index benchmarks and tracking errors
- Lack of detailed understanding and management of risk

Long-only equities carry two risks:

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

- Need to minimise these unrewarded risks
- So should investors rely on bonds instead then, to eliminate interest rate and inflation risks?

Bonds also 'risky'

- Bonds can reduce 'risk' as measured by volatility of return
  - But in exchange for much reduced upside potential
- Bond investments still contain 'unrewarded' risk
  - e.g. longevity, duration
- So, switching to bonds cannot ensure **all** risks reduced
- Bonds are not a perfect match for pension liabilities
  - Taking on credit risk can be dangerous
- Need to consider more than just equities and bonds

Pension fund returns and risks

- Need sufficient returns, not maximum returns
- Controlled and deliberate risk taking, not minimum risk
  - Understand, manage and control
- Need to take some risk – controlled and deliberate
- Need to hedge some risk – unrewarded risks minimised
- Diversification of assets for better risk-adjusted returns
- More stable absolute returns as schemes mature

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**

Key questions to consider

- Balancing risks and 'expected' returns
- How much investment risk to take and what type of risks?
- Do expected returns justify taking the risk?
- How best to hedge or protect against changes in liabilities
- How to improve portfolio efficiency – what combination of risky assets and hedging?

Improve portfolio efficiency

- Diversification of sources of investment return
  - Wide range of asset classes
- Capture different risk premia from inefficient markets
  - Equity risk premium only one source
- Find alternative sources of beta and alpha
- Spread manager and market risk
- Lower correlations with traditional assets
  - Of course correlations can change

New challenges

- Set explicit risk/return objectives relative to liabilities
  - e.g. fixed income based measure of liabilities + 1.5%
- Seek asymmetric return profile
  - Limit downside, but retain **good enough** upside
- Access diversified sources of market inefficiency and manager skill
- More than just equities and bonds – use of alternatives
  - hedge funds, private equity, property, currency
- Selecting and monitoring right managers vital

Alternative asset allocation

- Return-seeking assets, aiming to generate high returns
  - Active managers for alpha e.g. hedge funds
  - Passive strategies or derivatives for beta returns
  - Diversification across alternative assets
- Liability-matching or hedging assets, to protect downside
  - Use some fixed income assets for cash flow
  - Aim to minimise unrewarded risks
  - Derivatives often more effective than bonds for protecting against liability changes

Barriers to using alternative assets

- Investors nervous of the unfamiliar
  - Rather fail conventionally than succeed unconventionally
- Negative headlines – high profile failures
- Complexity - expensive and time-consuming due diligence
- Lack of understanding and experience – some alternative assets and strategies are much lower risk than equities
- Need to find right combination of managers
- High fees?

Fund of funds can help at beginning

Problem	Fund of funds solution
Lack of transparency	*Monitoring & Reporting – better disclosure*
Risk of failure	*Due Diligence – experts know what to look for*
Complex due diligence	*Sophisticated Investment & Research processes*
Choosing the right strategies or asset classes	*Construct diversified optimal portfolios*
Must find best managers	*Early identification and monitoring of top talent*

The future?

- Easy to criticise new and unfamiliar approaches
  - Alternative strategies harder to understand
- Different skills required – education and advice
- Pension funds have diversified successfully before
  - e.g. international investing
- Hedge funds and other alternatives become mainstream
  - Need help from experts, beware manager risk!
- Derivatives use spreading among pension funds
  - UK 14%, Holland 50%, Sweden 70%

Conclusion

- Moving away from traditional long-only management
- Manage risks **and** returns: reduce mis-match of assets vs. liabilities – take risks you expect to be rewarded for
- More diversification should improve risk-adjusted returns
- Search for different sources of alpha and beta
- Benefit from modern methods of money management
- Think outside the box to pay future pensions more reliably

Thank you for listening...

ANY QUESTIONS?

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