

ROUNDTABLE

SPEAKERS PANEL



PETER BALL
Head of UK
institutional business
JP Morgan Asset
Management



MELANIE CUSACK
Client director
Pitman Trustees

“There is a trend to move away from equities and we are seeing clients put money into alternatives”

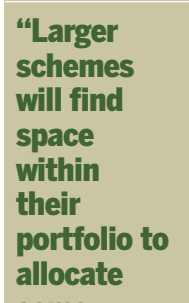


NICK DUFF
Principal
Aon Hewitt



NICK SYKES
European director
of consulting
Mercer Investment
Consulting

“It is all about education. Trustees have come along in leaps and bounds in the last three or four years in alternatives”



“Larger schemes will find space within their portfolio to allocate some money to private equity”



NICK WHITE
Managing director
Highbridge Capital
Management

ALTERNATIVES

Trustees do not want to follow the herd



CHARLIE THOMAS
EXECUTIVE EDITOR,
Pensions Management

How comfortable are trustees in getting to grips with alternatives, not only in terms of asset classes but also as an overall investment strategy?

MELANIE CUSACK: Trustees are a lot more comfortable considering alternatives as investments. It helps they are becoming more educated; greater education gives them a greater acceptance of thinking about what is out there. Trustees also do not want to follow the herd; they realise their own circumstances are terribly important.

PETER BALL: You can put pension plans into several boxes; those that have a number of investment experts on the trustee board themselves and those that go through trustee training, either with consultants or fund managers.

Each alternative asset class, whether it is formed of hedge funds or infrastructure, takes a fair amount of time [to fully understand]. A good example would be one scheme that was going to go into fund-of-hedge funds. We did trustee training at the beginning of 2008 – obviously the crash happened in the middle of 2008 and they put it all on hold – but they came back in 2009 and went ahead with the investment.

NICK SYKES: I agree. It is all about education. Trustees have come along in leaps and bounds in the last three or four years in alternatives. There was a bit of a hiatus in 2008 but, in a sense, that has helped. They now understand better than they did before 2008 what alternatives are really like in terms of risk-reward characteristics and the importance of illiquidity.

CUSACK: The big difference is trustees know what ‘alternatives’ means now, whereas five years ago they would say, ‘what?’.

SYKES: It is the wrong title as well – if we stopped calling them alternatives and called them growth assets they would be much more popular.

THOMAS: Do trustees see alternatives as a growth opportunity or do they still see them as a way to diversify?

SYKES: I think it is mostly diversification. Most trustees still have too much in equities; if you gave trustees a clean sheet of paper today and said: 'You have £1bn to invest, how much do you put in equities and how much in other growth assets?' the outcome might be 50/50, it might be 60/40, but it would not be where they are today, which is probably 80/20.

There is also a very interesting question about how alternatives play in defined contribution (DC).

NICK DUFF: It will vary according to the client in question. What you want is to add assets to your portfolio that will hopefully maintain or enhance your return profile and, at the same time, not increase the risk profile.

Private equity, for example, is something that is going to add returns and you could see real estate as being more of a diversifier relative to equities. It depends on the specific asset class within alternatives and I think it depends on the client in question as well.

NICK WHITE: Clearly education has been key in terms of getting people comfortable but what has really helped alternatives has been their performance. Immediately after 2008 it was actually a pretty tough time to get investors into hedge funds; we had talked about these absolute return strategies and yet the Hedge Fund Research (HFR) index was down 20%-plus for the year. Now, you actually see in black and white that in terms of absolute returns versus the equity market, over the last three years you had a stronger number overall.

While the public equity markets finished up 15%-plus last year, the way they got there was a pretty choppy journey; but it has been much less volatile for hedge funds than equities and if you put that together with performance over the past three years you get a much better risk-adjusted return.

The reason there is more focus on alternatives is because the numbers stand out versus some of the other asset classes out there.

SYKES: You are right in one sense but when you look at the numbers in terms of what hedge funds – or funds-of-hedge funds – are expected to achieve, which is maybe cash plus 4%, then on the whole they have not delivered.

The very best of them may have done better than equities, but they were not sold as being better than equities; we knew that would happen. When you look back over 2009/2010, the returns from hedge funds have been quite disappointing because they have done cash plus a little bit.

DUFF: Hedge funds did not deliver what they were promising to deliver, but equally they were fairly defensive in the downturn. Our clients are generally pleased with the way the likes of hedge funds have gone for them; hedge funds will derisk your equities portfolio; trustees like that sort of diversification benefit.

CUSACK: It goes back to why you went into hedge funds in the first place. If you went in for derisking your equities then great, but if you went in for performance – which is not necessarily the right reason – then it comes back to the old mantra about past performance.

DUFF: It is the same with any asset class. Whether you look at infrastructure or real estate, if you were investing during 2006-2008 – particularly some of the geared investments that were made – performance will have been disappointing. In fact, investors in real estate may have lost a significant amount of equity, if not all of it.

WHITE: If somebody said the long-term return for hedge funds was 4%-5% that is not necessarily a compelling case given the long-term expected returns for the public equity markets are higher. Of course these are absolute return strategies, but in 2008 we went through probably the worst markets in more than half a century and if hedge funds can come out the other side of that with even a slightly positive number within two years of that drawdown, they will have done a pretty good job.

SYKES: What trustees learned in 2008 was quite a lot of strategies

“Education has been key in terms of getting people comfortable but what has really helped alternatives has been their performance”

that were categorised as skill-based were actually beta-based strategies, and that is why they suffered so badly in the downturn.

They also had the disadvantages of being expensive and liquidity-constrained. That was a pretty unpleasant experience in some areas as we all know. Investors are learning there are parts of the hedge fund market that are very attractive but there is no point in paying the 2-and-20 for beta that is available very cheaply through other approaches.

Therefore the very broad-brush, hugely diversified fund-of-hedge fund strategies that have a lot of credit beta and a lot of equity beta are going to be the way forward.

THOMAS: Are there any early signs of where the strategies are likely to go for alternatives in the next year?

DUFF: As far as hedge funds are concerned, we are still positive. There is a renewed interest in infrastructure; certainly a lot of clients are actually considering core secondary-stage infrastructure investment at the moment.

Real estate is an interesting one; we actually did a lot of investment in the UK in the second half of 2009, held back in 2010 and will continue to be cautious at the moment for 2011, but that may change over the second half of the year.

Finally, the timing could be good for private equity but it is a case of persuading trustees that it is the right asset class for them. To actually generate returns of 300-400 basis points above equities over the long term, which is what you need to really expect from private equity to invest, is quite challenging.

BALL: I agree on the infrastructure point; high-yield, long-term pension plans are natural investors into that asset class, with inflation linking into it as well.

SYKES: The time horizon is quite important; investors are beginning to be divided by this and a lot of private sector schemes do not really have a very long time horizon anymore. They are thinking about derisking and matching their assets and liabilities on a seven to 10-year timeframe. This is partly guided by the Pensions Regu-



lator, which means the idea of starting up new infrastructure and private equity investments often goes in the 'too difficult' box, even if they liked the concept.

It is quite bemusing if you think about it; the original impetus, at least in part, for the Myners review of institutional investment was on why pension schemes do not invest more in private equity when the US schemes have invested a lot very successfully. Ten years on, here we are now saying that the regulatory framework almost disables schemes that invest in private equity because it is too much of a long-term investment.

WHITE: Private equity certainly seems to be the most challenging in terms of getting new investors to allocate, having just gone through the economic crisis.

It is actually a real shame because if you look historically, probably the period of the most significant outperformance in private equity typically tends to happen in post-recessionary periods. That is because valuations have just fallen on companies so you can pick them up for a cheaper price. Typically debt is relatively cheap.

In some instances this sort of environment really works against sound investment principles.

THOMAS: Increasingly we are seeing trustees talking about tactical asset allocation versus diversified growth funds (DGFs). Is one likely to be more attractive than the other this year?

SYKES: There are two or three aspects to that question. Trustees have recognised that setting a stra-

tegic asset allocation and then just sticking with it for the long term is no longer really fit for purpose; asset markets are so volatile that you are giving up a huge amount of return. They have now become a bit smarter, either through responding to changes in the funding level and taking risks off the table, or responding to changes in markets.

I would not call that tactical allocation; it is more a medium-term variation on a long-term strategy.

DUFF: No, we look at it on the basis of medium-term asset allocation rather than short-term tactical asset allocation.

SYKES: Yes, I would see tactical asset allocation as a sort of single-strategy hedge fund, which may have a value as a strategy or may be part of a broader group of strategies you can invest in. Diversified growth, on the other hand, is more about accessing both beta and alpha, and it is attractive particularly to small funds that cannot build their own portfolio of alternatives but want access to different sorts of beta and some alpha.

BALL: The largest plans do not buy DGFs, yet the smallest plans are ending up having to buy them because there is nothing better.

That market has evolved; DGFs came in around 2005 and now there are a number of products out there that actually give proper exposure to alternatives. The market will continue to evolve, there will be better solutions giving access to a wide range of alternatives to small to medium-sized plans.

CUSACK: If we are looking forward in terms of strategies for

“Efficient frontier modelling would lead you to recommend a higher weight into alternatives such as real estate. But then you always end up bringing it back because it is not liquid”

2011, alternatives are not a huge asset class in terms of most pension scheme portfolios; are there any thoughts on what sort of percentage it might be, on average, in six or 12 months' time?

DUFF: What you can say is there is a trend to move away from equities and we are seeing clients put money into alternatives. Even more of our clients are switching to liability-matching strategies and there's been increased interest in corporate debt as well.

CUSACK: So do you think it is taking away from equities or not?

DUFF: It is coming out of equities; that is certainly what we are seeing.

BALL: If you want a diversified range of alternatives and you have got sufficient length in your run of the pension plan, then I think you need to be in the 20s in terms of percentage allocation to alternatives to get yourself meaningful allocations that are going to make a difference to your portfolio.

CUSACK: Otherwise, what is the point?

WHITE: But if you think where pension plans are today, I know it is very difficult to average but if you took the industry as a whole, I would have thought they are still really only in high single digits within alternatives.

SYKES: If I could ask a different question: if you had a new pension scheme and were building a growth portfolio, what proportion of it would be in property and equities? I think the answer would probably be at least 50%.

DUFF: What has always restricted certain alternatives is the illiquidity. So if you look at efficient frontier modelling, that would lead you to recommend a higher weight into alternatives such as real estate. But then you always end up bringing it back because it is not liquid. Illiquid alternatives tend to come back to 10%-15% for a typical scheme's asset allocation.

SYKES: Yes, and it is about a time horizon, isn't it? This time horizon is really very important.

BALL: Unless you are going for a full buyout, you can still have a proportion in the illiquid asset classes, but the rest of your assets are going to be liquid. It is not unreasonable to still be able to make a meaningful allocation into illiquid alternative assets.

ROUNDTABLE

THOMAS: What about for a new DC scheme? Where would you start?

SYKES: There are probably even stronger arguments for diversifying investments into alternatives given the investment risk is being borne by the individual, but you do have this problem with liquidity; DC investors ought to be very long-term investors but you have the requirement for at least monthly, if not daily, liquidity. That constrains you very significantly, which is a shame.

BALL: There are rules about investing your money promptly and the market has interpreted that as we must give the daily dealing so they can switch between fund managers. Actually, is that really essential? I do not know whether it is. Maybe if we can scale back that daily requirement, which has become the market norm, we can encourage a slightly wider range of asset classes for DC.

CUSACK: The DC plan and the daily dealing contradicts the whole pension psyche; we are saying it is long-term horizon planning for your retirement, yet you can check daily what your plan is doing. It just seems to be crazy. There should be some way of allowing for illiquid assets if they are actually going to help your returns and improve your pot at the end, without focusing too much on the daily dealing.

SYKES: Real estate is a great investment for DC, for example, except for the fact that it is not very liquid.

DUFF: Yes, and that is the biggest frustration for me; opportunities are very limited for DC investors in terms of what real estate funds they can hold because you need this daily dealing. You are limited to literally two or three funds.

WHITE: The downside with high liquidity property funds is either they have to keep a significant amount of the asset in cash or you are not really investing directly in real estate, but rather vehicles like real estate investment trusts (REITs), where you take on equity volatility and characteristics. This defeats the objective of going into alternatives in the first place.

THOMAS: Are you seeing a push for default funds starting to use alternatives?

BALL: Yes, I think either cash-plus or DGFs definitely have the



“It comes back to the question of whether alternatives should even be called alternatives: how big does an industry have to get before you do away with the alternatives branding?”

right characteristics in mind; DC members would be delighted to receive 20%-30% in one year but are actually far more concerned about a -30%. A product that gives equity-like return but with some downside risk protection has got to be the right way to go.

DGFs and cash-plus have been around long enough that they have now got enough track record and trustees can now make that change.

CUSACK: There is an aspiration that individuals will become more sophisticated investors. There will be those who just love it and who cannot believe they can now have complete control over where their money is going – in the US they have 401(k) plans, daily dealing, there are apps on your iPhone for them, aren't there? – but it is not going to happen here in the short term.

WHITE: It comes back to the earlier question of whether alternatives should even be called alternatives: how big does an industry have to get before you do away with the alternatives branding? The hedge fund industry is somewhere between \$1.6trn (£1trn) and \$1.8trn (£1.1trn); that is a pretty large industry to be called alternatives.

CUSACK: It is unfortunate alternatives is the umbrella name but, given the percentage of the portfolio, I can understand it. However, if you break it down into hedge funds and infrastructure and words that people actually read about rather than alternatives, it is more comforting.

WHITE: Interestingly, some of the more sophisticated pension

plans have said they do not really run a hedge fund portfolio as such, but they will invest in hedge funds as part of an equity allocation or commodities allocation. In other words, they say: 'Within our equity bucket we want something that has got a better risk-adjusted return and lower beta protection on the downside, so we are looking for bottom-up fundamental long/short equities managers.'

THOMAS: In terms of strategies being developed for the next 12 months, how many of those will come from the fund managers and how many will come from the advisers who are assisting the trustees?

DUFF: It is two-way; we have delivered solutions for a number of clients where, certainly in the case of real estate, we wanted a specific approach or strategy. We went to a fund manager and they created a product for us. It is a working relationship we have with managers rather than just a fund manager launching products and hoping that is going to appeal to our client base and vice versa.

BALL: DGFs are a good example; in 2005 consultants sat down with the fund managers and said: 'This is what we want to try to build,' and the fund managers went and built it. The same thing is happening again now with the next phase, which is a pure alternatives version.

SYKES: The industry has become more specialist during the past few years and I suspect consultants are in part to blame for this. The growth of boutique managers is good in many ways, but it has

meant there are some product areas where you actually want a range of skills.

We do need to start building some of these broader-based products for clients, partly because clients don't have the appetite or the governance to be very specialist themselves. They need something that is easy to understand.

WHITE: The problem is if you take that entire range of asset classes or sub-strategies you are going to get some that are highly liquid and others that are less liquid. If you take the credit markets, for example, something like large-cap liquid loans, that is pretty liquid – the volume is almost as big as the bond market. Something like private debt has maybe somewhere between a four- and six-year maturity. The liquidity of the product has to be based on the least liquid asset.

There is a willingness to try to do this, but it is about understanding if there is demand and the ability to execute once that product is available.

CUSACK: Do the trustees actually have an appetite for this? I have sat on trustee boards where they have said: 'You are just coming in and giving us something new because you just want more money. Can't we just go with what we have got?'

DUFF: Consultants do have conviction about products and opportunities they present to clients. Certainly when looking at real estate and the global reach of managers, I did not have confidence about managers being able to properly implement global real estate

strategies and associated issues with currency.

Quite frankly, we shelved global real estate because I did not have any conviction that managers could deliver. That is changing, but certainly two, three or four years ago we just did not want to invest.

THOMAS: Peter, how significant a challenge is it to try to solve everybody's needs?

BALL: You have to be a fund manager that has a wide range of strategies to even be able to contemplate building a solution with a diversified number of asset classes underneath. Some people simply cannot play that game, but I think it is fine; I think you know which clients and which consultants will want that diversified solution.

THOMAS: How should schemes view their alternative strategies for the next year?

BALL: Large schemes will continue to lead the way; they have the governance time and they have the assets to be able to make material allocations to alternatives and will increase them. For small to medium-sized plans, they need new solutions. DGFs were a fine answer at the time but there are now better solutions – that's something fund managers need to continue to develop in 2011.

SYKES: The thrust for the very large schemes will be to continue trying to find genuine diversification, not just variations on a theme of equity and credit beta. They will want either new skill-based strategies or other asset classes.

Diversified growth is not a bad idea for small and medium-sized schemes but it is not the only

“Small to medium-sized plans need new solutions. DGFs were a fine answer at the time but there are now better solutions – that's something fund managers need to continue to develop in 2011”

answer, and over time we will see better diversified growth, multi-asset-type funds. There are relatively few managers out there who have the range of skills, both in terms of the underlying components of DGFs and the portfolio construction skills, to put them together in a very effective way.

WHITE: Larger schemes will find space within their portfolio to allocate some money – low single-digit figures – to private equity and I think we will see that increase.

Real estate spans both the large schemes and the small to medium, but whereas maybe it is private equity-style real estate for larger schemes, for the smaller schemes it could be more public vehicle kinds of opportunities.

But the thing that is driving schemes to search deeper within alternative strategies is what is going on in some of the traditional markets. There is a tremendous demand out there for yielding products because treasuries are yielding such low returns, forcing schemes to look into things like private debt and leveraged loans, for example.

CUSACK: The name alternatives should be scrapped; it should be broken down a bit. I think the smaller to medium-sized schemes would like to invest more in alternatives because the traditional markets are not providing enough and they are looking for somewhere new. But it is going to be slow.

On finding the products, I do believe the delegated consulting approach to alternatives will become quite important and used a lot, certainly for the medium-sized schemes. Maybe in two years' time there will be products out there that small schemes can run to quite happily.

DUFF: Larger schemes are where we are seeing a lot more pioneer investing in terms of some of the approaches and the strategies they are following, particularly on hedge at the moment.

The issue with larger schemes is to have the right level of governance structure in place and maybe that gives an opportunity for consultants to become more involved in terms of acting in a delegated role.

As far as smaller schemes are concerned, they are restricted. We are certainly seeing a considerable amount of investment into DGFs, but there is a lack of products out there. **PM**

