

Checking out the alternatives

JP Morgan Asset Management released the findings of its Alternative Asset Survey 2010: *Uncovering the latest trends in alternative investments* in September. Based on those findings, a panel of experts, in association with JP Morgan Asset Management and Pensions Age, met on 12 October in Central London to provide their insight on alternative asset allocation by UK pension schemes

Definition and popularity

Simon Chinnery (Chair): What do we mean by alternatives and alternative strategies? Are there any assets that should no longer be classified as 'alternative'?

Mike O'Brien (MO): I would question whether real estate should be classified as an alternative. It has only earned that status due to it being an asset that was hard to model from an asset-liability modelling perspective. As for 'alternatives', that is yesterday's phrase. I've seen the term 'emerging

assets' used, which makes more sense in today's environment.

Kevin Frisby (KF): Going back in time, you would say that the conventional asset classes were cash, equities, bonds – everything else was alternative. But the picture is becoming more blurred as the so-called alternatives become more mainstream. Another grey area is LDI – is that an alternative strategy? How do you define it?

Andrew Clare (AC): The term 'alternative' is very much in the eye of the beholder. There are some pension

schemes, for example, who do not have any allocation to property at all. So for them, it's an alternative. But 'alternatives' is a misleading phrase nowadays. It's more about 'real assets' today.

Penny Green (PG): One of the criticisms of the restrictive nature of consultants' modelling is that everything that we can't model easily goes into the 'alternatives' box. So if you're very reliant on consultants, then there are a whole range of assets that are put in this box which make a scheme less keen on going down the route because they're 'alternative'.

Phil Irvine (PI): LDI does not fit into an alternative category for me. Hedge funds are not really assets but hedge fund strategies are now migrating into more mainstream products like absolute return bond funds – I'm not sure the participants of the survey saw those products as an alternative.

Chair: I suppose the modelling issues and novelty of some of the assets for investors make people more cautious.



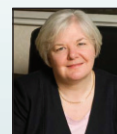
Chairman:
Simon Chinnery, is vice president, and a client advisor in the UK institutional team at JP

Morgan Asset Management. He joined the company in the spring of 2005 and was previously director of UK institutional client service with ABN AMRO Asset Management. Prior to this, Chinnery was an assistant director with Schroder Investment Management for five years where he worked with both defined benefit and defined contribution institutional clients in the pooled pensions team. Before this he worked at Gartmore Investment and he began his career as a stockbroker in 1983.



Panellist:
Mike J O'Brien is managing director and global head of JP Morgan Asset

Management's institutional client group. He is responsible for overseeing the firm's institutional client business and is a member of the JP Morgan Chase & Co. executive committee and the asset management division operating committee. Previously, he was at BlackRock where he was head of institutional business for Europe, the Middle East & Africa. O'Brien has also worked at Towers Perrin and sits on the National Association of Pension Funds' Investment Council in the UK.



Panellist:
Penny Green is chief executive of SAUL Trustee Company – trustee for the non-

academic staff pension scheme of the University of London. Green's career started as a pension administrator at Brown & Root (now Halliburton). She then moved to Texaco and in 1992 became deputy chief executive of The Pensions Advisory Service, a post she held for five years. In 2007 BESTrustees welcomed Green to its team. She is also chairman of Raising Standards of Pensions Administration, and was the first female President of the Pension Management Institute.

Having said that, there is a greater move into alternatives, but what's the story behind it?

MO: Diversification as a core objective (versus just return generation) has become more mainstream now and we've seen this around the world as high allocations to equities have come down. The challenge with the shift to bonds due to de-risking, for example as has been the case in Japan, is that local bonds have delivered extremely low returns. What we've seen is a greater appetite to diversify the search for investment returns. Added to that the fact that asset-liability modelling technology has got more sophisticated and the result is a higher degree of comfort incorporating non-traditional asset classes into portfolios.

PI: There's also been a move away from low-tracking equity mandates to index funds on the one hand and more unconstrained mandates on the other. The aim is to try to get a bigger bang for your buck when it comes to using managers that really are going to be active or pursue alternative strategies.

KF: A lot of our clients are trying to get an absolute return from their assets – whether that's from alternative or conventional assets. They may be looking to gradually close the deficit; and if you feel you're on the last ten years before settlement of liabilities you want to go forward with small steps without suddenly lurching backwards. In this instance an absolute return focus with a variety of alternatives is a good approach.

PG: You have to look at the whole piece – not just equities and bonds – to get that 'whole piece' and find absolute return. That's exactly what we're doing – refocusing our skills on identifying equity managers so that we've got unconstrained mandates, mandates in emerging markets and then on top of that you look elsewhere to make sure you've got that diversification to protect that absolute return.

Chair: Is the shift towards alternatives going on because of better risk analysis or do you think that it's because we've been through 2008 and everyone has snapped to attention?

AC: People say that diversification didn't work in 2008, but almost all of those asset classes had claims on the real economy. If there's risk in the real economy, there's risk in asset claims on it. You can't get away from that. The reason why investors are focusing on diversification is partly because equities have gone nowhere for the last ten years, but also because most schemes are now closed to new entrants and some to new accruals. So all of a sudden, you have a point to aim at, and you can no longer risk swerving around the road – you have a very narrow road to drive along. So diversifying your claims on the real economy should keep you on that road.

MO: There is a move to indexation and to a world where typical +1%/+0.5% 'active' or core mandates are on the descent. At the same time there is a counter move towards absolute return/high alpha mandates. But in the absolute return equity space, is it understood that even though it's an equity portfolio benchmarked against LIBOR, there's still a significant equity beta in those portfolios?



Panellist:
Kevin Frisby joined LCP's investment team in 2008 and became a partner in 2009. He is involved in the provision of investment advice to trustee and corporate clients, bringing his investment advisory and research experience together to assist in the formulation and implementation of investment solutions. Prior to joining LCP Frisby gained 12 years of investment consulting experience; eight with HSBC Actuaries, and prior to that four years with the £5bn IBM UK pension scheme as an in house consultant.



Panellist:
Andrew Clare is the professor of asset management at Cass Business School and the associate dean responsible for the School's MSc programme, as well as chairman of Fathom Consulting. A prolific finance writer, Clare also finds time to be an advisor to the trustee board of the GEC Marconi pension plan where he serves on the investment committee. His previous roles include being a senior research manager in the monetary analysis wing of the Bank of England, and working as the financial economist at Legal and General Investment Management.



Panellist:
Phil Irvine is a director of PiRho Investment Consulting which he co-founded in 2008. The company advises institutions on investment strategy. Prior to that Irvine joined Liability Solutions in 2003 as director of advisory services. Before that, Irvine was chief investment officer for TriAlpha (the offshore investment arm for South African bank, ABSA) a company he helped set up in 1999. Previous to TriAlpha, he spent 15 years at the UK assurance company, Colonial Mutual, where he held a number of positions.

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PG: Generally, trustees do not understand that. And there is a big risk that if trustees do put in an equity mandate and benchmark it across LIBOR then what will happen is that in a strongly rising market they will under perform that and be very disappointed without realising that that is exactly the pattern they should see. There's a huge learning curve that trustees need to go through and there is a responsibility on managers and consultants to help with that. I've seen consultants and managers sell products that claim to be unconstrained which expect to outperform the benchmark by between 4 and 6%. That is not in my book an unconstrained mandate. When managers start to muddy the waters by changing the terms you end up with a whole bunch of confused and disappointed trustees.

Chair: I would concur with that. There's usually a discussion about unconstrained, everyone gets it and then inevitably someone says 'so, what benchmark shall we use?' But I'm not too sure what form education should take on this matter.

PI: If you look at the survey, it's been a tough time for hedge funds not delivering much in the way of returns, but it seems that respondents were broadly happy with the results and intend to increase allocations in the area. So that would indicate that there has been some work or education done by somebody. When it comes to absolute return – you have to remember that managers are trying to target absolute return, but it's not a guarantee – it's an objective. So there's some misunderstanding over that.

KF: I was slightly surprised by the survey in that hedge funds were the most popular alternative and that

“There's usually a discussion about unconstrained, everyone gets it and then inevitably someone says 'so, what benchmark shall we use?’”
– Chinnery

there was an appetite to increase that allocation. We may be slightly different in terms of our practice at the moment, but we're not seeing much traction for hedge funds because, in terms of looking for an absolute return, of say cash + 5%, that's becoming a crowded space now.

AC: To some extent the hedge funds that survived 2008 are the ones that are going to survive over the long-term – what's happened is that the crisis has shaken out all those funds that couldn't survive, so many pension schemes are making allocations to macro and multi-strategy hedge funds, the big ones that survived during 2008/09.

PG: Five years ago if you used the expression 'alternative', the only expression that word was used for was a hedge fund. So five years down the line, trustees feel much more comfortable with the concept of hedge funds so I don't think it's surprising to see trustees much more open to investing in funds because it's seen as an acceptable alternative.

AC: What about commodities, are schemes not interested in them too? At least trustees could always understand them, where do they fit in?

MO: There are two categories there that seem to have experienced some-

what of a turnaround with respect to their popularity among investors – commodities and currency management. With commodities there is a school of thought that there is no persistent risk-premium associated with commodity exposure and hence questioning whether there is a role for commodities in the pension fund mix.

PG: I recently read an article in the national press which was saying that there were investors in commodities who were deliberately driving up prices which was a direct cause of famine in Africa. Now as a general rule you can fudge investment in a firm that uses child labour for example and finesse it in communication with members. But if you're in commodities it's much more difficult. That is possibly why commodities are still much less mainstream.

AC: Well they're not a financial asset they're a consumption good and some would question whether they belong in an investment portfolio at all.

Need for transparency?

Chair: In the survey we looked into reasons as to what schemes liked and didn't like about various asset classes and transparency came up a lot. Do you believe its important to go through the underlying components of what's actually in a fund's structure?

KF: With our clients we have complete transparency so that they can get comfort from what they're doing. Transparency for us is a pre-requisite.

MO: That's an interesting point because there's a lot of argument about what transparency looks like for hedge funds. So if you open up a strategy, a bit like opening the bonnet of a

car, it can be very complicated. So as a trustee is it better to have total transparency into the underlying working of a complex hedge fund or to have some risk-metrics agreed, carried out by a professional risk manager? I wonder whether transparency can go too far.

KF: I would distinguish between a fund of hedge funds and a single hedge fund. In terms of the former, we would look at their processes and the underlying workings of their hedge funds and draw the line there. You can dig too deep and you have to rely somewhat on your assessment of their due diligence. But if it's a single strategy then we'd like to look a bit more at what is going on there particularly in assessing counter-party exposure and how diversified it is.

AC: The looking under the bonnet analogy is an interesting one. Suppose that I don't know what the engine of my car does. I look at it, then I drive it around and open it up again later – and things haven't changed. But, looking under the bonnet of a single hedge fund is different, what's underneath can change from day-to-day so it's extremely difficult to understand what's going on. I'm not saying they change things a lot but there have been some hedge funds in the past that have been doing things that they shouldn't have been doing, or said they wouldn't be doing.

PG: That's why we need a broad strategy. No-one is going to put all their money into one fund. So if you've bought an equity-based hedge fund strategy and they've converted it into a debt-based one, that doesn't do what you wanted in the first place, then you have to have options. But I would like to see hedge funds become a little more open.

PI: Transparency has been an ongoing trend and it really hit a crescendo about a year or so ago, when the industry started to really move into using managed accounts, but it all comes down to appropriate transparency. So if a manager is taking, for example, short positions on a long-term basis, then it may not be appropriate to disclose these positions widely. Institutional investors in fund of hedge funds certainly should be able to get good transparency in terms of the portfolio, the operational due diligence processes conducted on managers and the net exposures to differing asset classes.

KF: Within the class of diversified growth managers it's a very broad church. But what we've found is that there's a lot of commonality across those managers who are looking for cash + x%. What they have is what I would describe as matrix management in order to eke out positive returns from investment themes. The themes translate into securities which will play different roles – either to look for returns and/or they will have some defensive characteristics. They're looking for a good blend. The good thing is that they all worry a lot about the downside. They may be worried about different things – inflation or deflation and if they're trying to cover different outcomes, then having more than one manager makes sense.

Chair: Ultimately it comes down to trust because trustees will not be able to look under the bonnet to the extent that gives them full assurance. So what is the balance – what's needed to make sure that these things keep working for trustees?

MO: Well is it the Regulator's role to do that? At the moment one of the

dangers as I see it is that as hedge funds become mainstream via UCITs so investors assume that they must be fit for purpose.

AC: There is a danger that getting that status is seen as a replacement for due diligence.

PI: The most regulated entity prior to the crash was AIG. How many different regulators were involved there? Is regulation really the full answer? Investors have a duty to understand the risks the manager is taking rather than rely on the regulatory wrapper or the brand name of the product.

Catalyst for further allocation

Chair: Despite the clear push towards diversification in the survey, when you sliced and diced that figure of an average 28% allocation to alternatives, you find some schemes that are still very top heavy in equities, such as local authorities. What's going to be the catalyst for such schemes to move towards diversification?

AC: Legislation. The Hutton Report or something else is going to force them to change their DB schemes. One aspect will be closure, but the other one will be the council taxpayer realising the risks that they are actually bearing within these schemes and realising that there's an x % chance that they're going to have to pay a huge amount of money to save the schemes.

MO: And that started with an increasing political focus on these schemes. The accountability will come when the cost is fully understood as is becoming the case right now.

PG: And what has to come is greater consolidation in that area. These are

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statutory schemes that have the same rules, they are identical. They're local authorities, their demographics are really similar, so why not pool them? Instead of having 84 separate schemes, you could end up with 4 or 5 schemes. The West Midlands scheme has got a much bigger allocation in alternatives than many private sector schemes. That's because they can employ professional investment individuals who have the knowledge and the confidence.

AC: At Cass Business School, partly funded by JP Morgan, we have undertaken some research on local government plans. What we have done is to aggregate all of the liabilities of the LGPS and look at it as one scheme. I put exactly your point to a scheme actuary recently and they said that it would be a nightmare to try and bring all of these things together in practice. This is the problem, they have a stranglehold on doing this and if they tell us that it's impossible then, perhaps it is.

PG: There are huge vested interests here for consultants and managers. It would take government action. But you could save millions doing that.

MO: There is a direct correlation between the size of a fund and its governance budget and performance. There are a number of more 'exotic' strategies out there, that will generate return depending on how fast you move to invest, such as distressed debt, or loans. However, they require time and effort in terms of due diligence and comfort and hence are not often available to smaller pension funds. That's been a major problem.

PG: The Dutch model isn't perfect but it's useful to look at how sophisticated they are as investors and in terms of

running a pension scheme. They were the first people to use fiduciary management because they had great big multi-employer industry wide pension schemes. They've got sophisticated individuals working on those schemes.

AC: Consolidation is definitely the way forward to share experience and share fees on asset allocation advice, and I really think the industry should do something to make that happen.

MO: One thing that we can do is create easier access to more exotic strategies. The question is how do you provide that access?

PG: There is a huge amount of snobbery that says 'oh you're small so you have to invest in a pooled fund'. Well there's nothing wrong with a pooled fund – there's this perception that somehow they're second best. You see schemes insisting on having segregated mandates to see what the manager is doing to a certain degree, but my guess would be that they have segregated mandates for which they are paying more but they never once exercise those degrees of control that they are so desperate to have.

PI: There's a concern in this area which involves the ladder of liquidity which you often have within collective vehicles focusing on alternative strategies. Some investors are more liquidity-hungry than others and certainly quick on the trigger when liquidity starts to dry up: they're out first and the portfolio can be left unbalanced, as they are more exposed to less liquid securities. I get the feeling we may be beginning to see the start of this problem again. I raise a question mark, for example, over a number of emerging market bonds which are now flavour of the month.

KF: The liquidity thing is a real issue with these commodity asset funds. If you try to address the liquidity by going into listed proxies for the asset class, you introduce equity-like volatility and then the whole purpose of diversification becomes undone.

Chair: What about others who haven't entered the world of alternatives – what's going to nudge them?

AC: Products need to be there from the fund manager. It was almost impossible to invest in commodities in the 1990s. They have to have the products there and they have to have the right packaging and liquidity. And the industry has made huge strides in this regard.

KF: Investing should be on a multiple asset basis. That's less risky than taking a foray into one [alternative] asset class. There need to be good vehicles available for this. Once the trustees have made their first step then that's part of the learning process – if you've actually got some assets invested then you can get more of an appreciation of those asset classes while you're engaging with the consultants and engaging with the fund manager. So a multi-asset pooled fund is an essential first step for a lot of clients.

PI: According to the survey, one of the biggest concerns about investing in hedge funds is volatility. The reality though is that most hedge funds have far lower volatility than equities. Hedge funds can lull you into a false sense of security as the steady returns can mask the build up of underlying problems, such as increasing leverage, or investments in illiquid securities. Given the time it takes to redeem these funds, trustees can find themselves in a situation where when

things do go wrong, there's not much that they can do about it.

Liquidity needs

Chair: What is a genuine requirement for liquidity for a pension fund with long-term liabilities? Is there a knee-jerk reaction which has led to people insisting that they have liquidity without perhaps needing it so much?

AC: It depends on the position of the scheme. There are certainly some that are more mature and need liquidity and need to be very careful about what they invest in. You can always get a price on a financial security, the problem is do you want to deal at the price?

MO: The bulk of pension funds have been looking at mark-to-market solvency and actuarial values and were not that focused on their liquidity requirements. The financial planning and risk management of pension funds in the last ten years has changed and will continue to evolve particularly with the lessons of 2008/2009 in mind.

PG: Looking at the cash flow is not the same as liquidity. Why does liquidity matter? It matters because you have to sell the asset so we have to ask ourselves, when does the investment income run out and so when do we have to start selling the asset? That tells me what kind of liquidity we can give up and still be comfortable in what we've got. And there aren't many pension funds that look at that.

AC: If you're cash-flow negative and slowly running down the assets there's a path dependency problem. After a fall like 2008 to get back to where you were before is almost impossible and if you don't model that

cash flow need and the trigger points, then there may be no recovery for a scheme, even if the markets go backwards for years, because it's dead-weight loss.

PI: Another issue concerns the collateral used within LDI products. A number of LDI products aimed for slightly higher returns than LIBOR on their cash collateral. For example, many 'enhanced cash' solutions involved investing in mortgage backed securities which became completely illiquid in 2008. The nature of an LDI product is that collateral needs to move in and out of them on a frequent basis. So even if you were a scheme invested for the long term, liability driven solutions based on these types of securities didn't fulfil their function.

MO: Currency hedges were a problem and hit a number of schemes quite hard due to high cash calls to cover large fx losses. For example, a number of funds hedged their dollar exposure and incurred significant losses on the hedge and ended up literally fire selling what they could to raise cash.

Chair: How do you advise on getting the balance right in terms of liquidity?

AC: First of all the scheme has to define its liquidity budget. Once you define that then you can go and spend however you like.

PG: You need to understand what it is you're trying to achieve. Most trustees just say that they want to get the best possible return with the least amount of risk. What is it we need to achieve? A certain cash flow or rate of return? Until you know what liquidity you can give up then it doesn't really matter if it's a diversified growth fund or a hedge fund or infrastructure.

"Hedge funds can lull you into a false sense of security as the steady returns can mask the build up of underlying problems"
– Irvine

AC: Even if you don't know the answers you need to be able to ask the right questions and that takes experience, unfortunately.

KF: From our perspective you'd be amazed from what could be around the corner in terms of demands on the portfolio, such as an ETV exercise. That's an immediate call on the assets to liquidate. Or you can have schemes which are being de-merged. So you need to list down all the things that could happen with the scheme. But once you've done that you will be left with quite a substantial residue which you can allocate for the long-term. You could say 'this is the last element of the portfolio – we are probably not going to need this for some time so we can give up some liquidity and go into alternatives'. If somebody's selling you something which is a supposed genuine range of alternatives and is daily dealt, then you should be extremely cynical about it, because a lot of them are illiquid.

PG: You have to get employers and trustees talking together. If there isn't a genuine dialogue and trustees don't understand what's driving the employer's interests, then it's counter-cultural because there is this separation between the employer and the board of trustees. This will mean that the sophisticated broad-ranging investment strategies that really deliver more than we've seen in the equity/bond mode won't happen.