Broader horizons

In the fourth article in this series, **Paul Greenwood, Marcus Mollan** and **Udit Kapoor** of the Pension Solutions Group, RBS Global Banking & Markets, consider some of the alternative investment solutions available for diversification and efficient portfolio management, together with some of the challenges associated with credit mandates.

Executive summary

- UK pension schemes still take the vast majority of their rewarded risk in the equity markets.
- Diversifying into alternative assets and use of structured solutions is a way of reducing risk without necessarily reducing expected returns.
- Other mainstream sources of return such as credit risk are currently being underexploited.

Previous articles in this series have covered the two key principles of investment risk management: eliminating unrewarded risks, and diversifying sources of rewarded risk efficiently. Some pension funds have embraced one or both of these principles, but many continue to rely on equities as their prime driver of return.

For those looking to diversify, the spectrum of 'alternative' asset classes ranges from the established (hedge funds, property and private equity) to the new (commodities and infrastructure) to the slightly esoteric (timber). *Box 1* outlines how the diversification challenge is typically approached, and attempts to provide a wider view of the concept of alternative investing.

Missing from the usual list of alternatives is an important ingredient of a solid investment strategy that has usually been neglected or misused in the past: **credit risk**. As credit markets have evolved significantly over the last decade, we should revisit this asset class to see what opportunities are being missed.

CURRENT APPROACH Over the past 10 years pension funds have increased their weightings to non-government bonds because these have been seen as partially matching assets with a slightly higher expected return than government bonds. Most of the potential return comes from the interest rate component rather than the credit risk component. This approach has meant that credit investment is synonymous with low returns. However, this need not be the case. Credit risk has interesting characteristics:

(i) Credit spreads do not move in tandem with equity markets, and therefore are a good diversifier of equity risk, but this advantage diminishes if you head down the ratings bands to high yield or emerging market debt.

(ii) Credit is a very asymmetrical asset class, having an upper limit for its potential returns but large potential downside if there is a default or downgrade. Traditional credit investing can be likened to picking up pennies in front of a bulldozer. Most of the time you make a modest return, but there is a small risk you will get flattened. This highlights the need for solid active management of credit mandates to manage downside risk effectively, as well as other potential structures to limit downside risk.

Interest rate and inflation risks can be effectively and easily controlled through the use of a swap overlay, so how should exposure to credit risk be structured? Existing credit mandates usually have three shortcomings:

(i) Benchmarks are weighted by market value, so the more a company borrows, the higher the weighting of its bonds in the index. For example, if a large struggling car maker issues more debt, do you want your investment manager to buy more of its bonds just because the manager is closely monitoring its risk levels against the benchmark?

(ii) Benchmarks usually exclude non-sterling bonds, which make up over 90% of the global credit market. This is a large opportunity cost and results in portfolios that are not as diversified as they might be. (The currency risks of a more global approach can easily be removed.)

(iii) Investment managers are not usually given the freedom to take short positions (i.e. the ability to benefit from a default or credit

Box 1. DIVERSIFICATION AND STRUCTURED SOLUTIONS

DIVERSIFICATION: THE TRADITIONAL APPROACH TO ALTERNATIVE ASSET CLASSES

A logical approach to considering whether an allocation to an alternative asset class should be made is to consider the marginal risk/return benefits gained from an exposure to the asset class, usually by using an optimisation model. But even if modelling highlights that a certain asset class should be considered, some frictional factors might preclude some of these asset classes from being pursued, including:

(i) **Governance costs** Trustees might require education, and monitoring structures would need to be put in place;

(ii) **Fees** Fee levels for alternative asset classes can be much higher than traditional active management, and some trustees might not feel comfortable with them, even though in many cases these fees are justifiable;

(iii) **Timing** Just as with equity markets, there are times when certain alternatives appear to be subject to a bubble mentality.

Many pension funds consider these issues as part of a strategy review, and then decide to allocate small portions of their assets to alternatives, sometimes as little as 2%, as a 'toe in the water' approach. Unfortunately, this conservative approach misses much of the point of diversification and at some point bolder steps are required to have any meaningful impact on risk.

STRUCTURED SOLUTIONS: THE ALTERNATIVE APPROACH TO TRADITIONAL ASSET CLASSES

There is, however, another aspect of 'alternative' investing that is not given much coverage, and that is the concept of alternative **routes** of accessing market risks, such as using:

(i) **synthetic** exposure through derivative instruments, instead of buying physical assets;

(ii) **leverage** allows larger exposures to risks with desirable properties, without being constrained by the amount of scheme assets available;

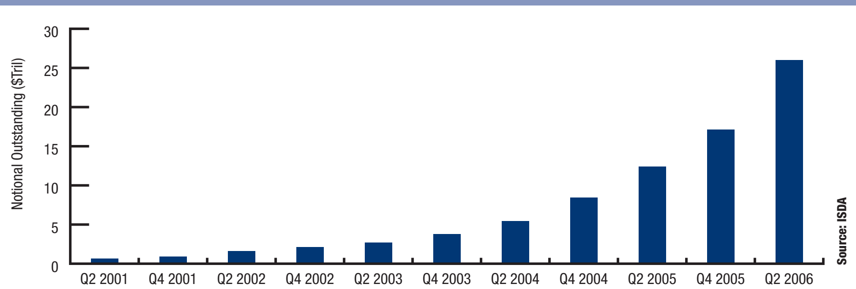
(iii) **strategies** with asymmetric payoffs, such as options, swaptions and portfolio insurance;

(iv) **tranching** of risks, thereby targeting particular slices of risk, such as the approach used in securitisations;

(v) **dynamic** exposure, where the amount of market exposure varies according to market conditions, rather than static exposure.

While not necessarily providing diversification, the risk/return benefits of combining some or all of these five ideas into a structured solution can be huge – e.g. restructuring existing equities to achieve exposure through a combination of call options and cash might result in a more efficient portfolio than introducing a moderate exposure to hedge funds. The governance challenges of this type of alternative approach are similar to those shown alongside.

Chart 1. Growth in CDS market



deterioration). This means that a talented manager is not fully able to express views on bonds or to adapt the investing style to sectors that might be at different phases of the credit cycle.

A BETTER WAY One of the solutions to the problems above is to make use of credit default swaps (CDS). The market has evolved significantly over the last five years. *Chart 1* shows how the size of the market has grown exponentially.

Using credit default swaps allows a manager to isolate the credit risk from the interest rate (and sometimes inflation and currency) risk inherent in a bond. In addition, allowing managers to enter either side of a CDS means they can gain credit protection on individual names by buying a CDS, or create a synthetic bond by selling a CDS. Credit default swaps also allow managers to leverage their views on credit quality and credit curves efficiently, and potentially to create synthetic credit portfolio with equity-like returns.

Since credit spreads are near record low levels, many consultants are wary about the role that credit might play in current investment strategies. We would argue that these are precisely the conditions in which it is important to structure credit portfolios to give flexibility to investment managers. One example is the use of short-dated CDS to avoid locking into current low credit spreads for a sustained period – such an approach would not be possible with a traditional mandate. Good investment advice and a dynamic risk management approach can transform traditional bond mandates into portfolios targeting high returns with excellent equity diversification characteristics.

THE ROAD AHEAD This series of articles has so far shown the reader how to structure and implement an effective risk management programme. For those treasurers who want to turn some of these principles into action, we offer some advice in conclusion:

- Ensure the sponsor and trustees have access to independent, proactive advice from a consultancy that has expertise in derivatives, structured solutions and alternative assets.
- Ensure that trustee time is budgeted in a way proportional to the significance of each decision. For example, it can be shown that getting the investment strategy right is very much more important than getting the manager selection decision right.
- Ensure that enough time is budgeted by the sponsor and the trustees for training sessions and extra meetings, but recognise that training is no substitute for having investment expertise on the trustee board.
- Forming a joint working party (with both sponsor and trustee representatives) for specific projects can help expedite the process, as well as resulting in clear communication between the parties.

The potential downside risk of a mismanaged pension scheme can be disastrous for a company and for members. But the potential returns from efficient portfolio management are large, and treasurers have an important role to play in managing this risk.

For more information call the RBS Pension Solutions Group on 020 7085 1362 or visit www.rbsmarkets.com/pensions

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