MANAGING PENSIONS FUNDS

MICHAEL SJ HART AND **NAT MANKELOW** INVESTIGATE SOME OF THE DATA BEHIND PENSION FUND MANAGEMENT AND OUTLINE THE BEST OPTIONS AVAILABLE FOR TRUSTEES TO MANAGE THEIR FUNDS.

As interest rates hit historical lows and the global stockmarkets continue their bumpy ride, hedge funds can offer a low correlation and risk diversification to traditional investments. The introduction of the euro has eradicated the diversification benefits of cross-border bond investing for UK pension funds and low correlation is increasingly important, with pension funds with large bond portfolios wanting hedge fund strategies to offer a risk profile similar to fixed income.

Recent data has revealed that hedge funds are slowly becoming the alternative investment product of choice for pension funds, looking for better returns and limited exposure to global market volatility. CAPS, the actuary data measurer, recorded a 7% fall in the returns of UK pension funds for the first half of 2001 – in stark contrast, hedge fund investing over the same period would have delivered net gains of 3%.

The Myners Report on institutional investment – instigated at the behest of the Chancellor, concerned that there might be factors "encouraging institutional investors to follow standard investment patterns, limiting the security and impeding the growth of pension funds" – recommended that pension funds should lose their "play-it-safe" FTSE and bonds bias.

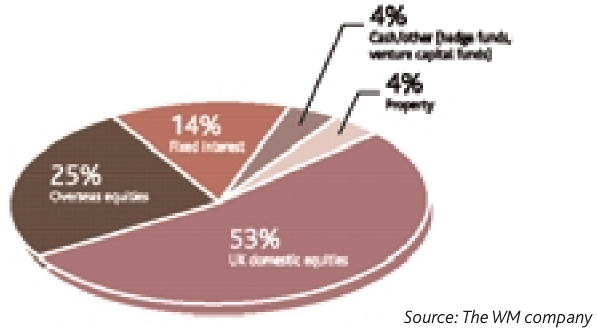
In the report, Paul Myners asked: "Have we, as an industry, become too risk-averse, concerned more about the risks of underperformance versus some benchmark, rather than the rewards of outperformance?" He also recommend that pension funds consider alternative forms of investing as part of the "best practice" process of delivering higher returns. And there is plenty evidence to support this move. According to the Credit Suisse First Boston/Tremont Index, hedge funds posted returns of 2.2% in first half of 2001, while the Dow Jones and S&P 500 posted -18% and -21.2% respectively.

While only 1% of total pension fund investment is currently made up of either hedge funds or venture capital, fund managers such as Gartmore, Lazards, Deutsche and Schroders view the pension fund industry as a lucrative source of new business. According to investment bank Goldman Sachs, hedge fund investing by UK pension funds is expected to increase to 3% of total asset allocation over the next 18 months.

Figure 1 shows the overall total asset allocations for UK pension funds last year. Clearly, equities dominate the picture, with fixed income investments (corporate bonds and gilts) accounting for just over 14% of total asset allocation. Cash/other, at 4.1%, includes hedge funds, property, venture capital and private equity fund-of-funds. This typical split includes both 'mature' pension funds and 'immature' pension funds. It should be noted that asset allocation for local authority funds is similar to that for corporate pension funds and therefore so is their aversion/liking for 'alternative' investments such as hedge funds. So whereas Myners called for trustees to consider actively all major asset classes, this has not always come to fruition.

Recent research from Bacon & Woodrow adds new light to this topic. According to them, many asset classes, such as private equity, property and hedge funds, are unsuitable for the quantitative modelling approach of asset-liability studies and their inclusion/exclusion from a fund's asset allocation can only be based on mostly qualitative factors. This point is important, because with the absence of any quantitative basis on which to form an investment decision, it boils down to the knowledge and judgement of trustees and whether they are capable of deciding what is appropriate for their fund, given training and competent guidance.

FIGURE 1
ASSET ALLOCATIONS FOR UK CORPORATE AND LOCAL AUTHORITY PENSION FUNDS 2000.



Source: The WM company

DEFINING HEDGE FUNDS. It is crucial for pension fund trustees to, at the very least, equip themselves with a basic knowledge of hedge fund definitions and practices. 'Equity hedge' is bottom-up research looking at undervalued/overvalued securities and then taking long/short positions. Via this approach, you can go net-long and net-short or choose value, growth or small/large cap investing.

The 'market neutral' approach has a low correlation to equity and fixed income markets and attempts to take advantage of short-term anomalies in equities and fixed income securities, with allocations on the long and short sides of the market. 'Global macro', the type of strategy used by George Soros, is a top-down macro approach aimed at 'second-guessing' movements in the market. They can invest in currencies, equities or bonds, using leverage and derivatives to improve their position.

The event-driven strategy focuses on companies in the midst of reorganisation, bankruptcy or a takeover. The strategy usually involves taking a long position in the firm being acquired, and a short position in the buyer. The main risk here, unlike the other strategies, is not market risk but whether the takeover goes ahead or not. The increasingly popular 'fund of funds strategy' allocates capital to a variety of fund types by investing in portfolios diversified by both strategy and fund manager, offering increased liquidity and hopefully less risk of failure as it can offer greater access to experienced managers.

'Short sellers' is a type of fund that borrows stock in what it deems to be overvalued companies and then promptly sells in the expectation of buying it back at a lower price. This approach was used widely during Marconi's recent stockmarket tribulations, with critics of the 'shorting' technique arguing that Marconi's massive stock haemorrhaging was instigated by predatory hedge funds.

PROFILE OF THE PROVIDERS. The profile of hedge find providers has changed significantly in recent years. The hedge fund world used to be the domain of the small specialist boutique, set up specifically to run independent hedge funds. However, increasing numbers of Europe's asset management heavyweights are now launching or looking to launch their own in-house hedge funds.

Some experts in the industry, however, have concerns over the ability of the large well-established asset management houses to effectively run their own in-house funds. The longstanding approach of these houses – measuring against a specific benchmark the relative return of a fund – will require a dramatic change if the 'absolute return' approach of hedge funds (where success is measured in terms of real gain or loss) is to be successfully and comprehensively embraced. The well-established houses offering 'funds-of-funds' hedge funds argue they have some key advantages for the cautious institutional pension fund compared with their more entrepreneurial boutique competitors.

The 'superior in-house infrastructure' such as stringent risk controls, a full middle and back office administrative support, client servicing, research and IT, and having a recognised brand name, is often cited by the big players. The primary issues that concern potential institutional pension fund investors are transparency, risk management and, of course, fees, and these need to be fully addressed and satisfactorily dealt with before the pension funds are completely comfortable investing in hedge funds. Institutional pension funds have a fiduciary responsibility to their members, which makes them far more risk-averse than the old traditional hedge fund investor. However, this poses a number of challenges, the majority of hedge funds are offshore and unregulated, which makes it almost impossible for the pension funds to obtain a clear and accurate perspective on the hedge fund manager's strategies and positions. Institutional pension funds will only consider investing in hedge funds with a 'decent' infrastructure and reputable reporting practices.

The industry is starting to address this problem as the relationship between pension funds, prime brokers and hedge funds flourishes. Prime brokers such as Goldman Sachs assist their pension fund clients in due diligence matters largely by garnering detailed information on the hedge funds' investment process and their portfolio compositions, positions and risk profiles.

Since the Long Term Capital Management debacle of 1998, hedge fund managers have embraced 'cutting edge' risk management techniques such as value at risk (VAR), Monte Carlo, portfolio optimisation and stress testing, to appeal to and appease investor-shy pension funds. Yet critics of these methods argue that these techniques are irrelevant when attempting to predict future events. For instance, no theory exists to show that VAR is the appropriate measure upon which to build optimal decision rules and VAR does not measure 'event', such as market crash, risk.

In response, portfolio stress tests are recommended to supplement VAR, although it does not readily capture liquidity differences between instruments. As VAR also cannot capture a model risk – which is why model reserves are also necessary – it is ideal to use it as a tool in the hands of a good risk manager.

A disadvantage of investing in a fund of funds with a well-established asset manager is the additional layer of fees, on average a typical management fee for a pension fund is between 25bp-30bp. The underlying hedge fund manager charges 1%-2% a year and an average performance fee of 20% and in addition the pension fund must then pay the fund of funds manager. Unless the trustees are fully convinced that the added benefits are worth it they could baulk at paying the additional top layer of fees. Many of the more established teams have now closed their funds to new investors – their strategies are not as effective once they pass the £500m mark, becoming cumbersome and slow to react.

The recent increase in demand for what was once an little known segment of the industry has led to a shortage of talent among fund of fund managers a fact that pension funds would be wise to take note of when conducting due diligence on potential fund of funds. The development of standardised benchmarks to measure accurately hedge fund performance will address the concerns of the more risk averse institutional investors.

Institutional investors need to be aware that while a high percentage of hedge funds are unregulated and located offshore, the majority of London-based hedge fund managers are, of course, subject to regulatory control via the FSA. The main reasons for an institutional pension fund to invest in hedge funds are potentially higher returns and a low correlation with the overall portfolio of the fund and therefore reduce risk. A word of warning, however: constructing a hedge fund portfolio is a complex task and pension fund trustees will need experienced investment advisers to help them evaluate the risks, but not every investment adviser has the necessary experience in this emerging and complex field or the full list of all the hedge funds out there.

Michael SJ Hart is the Director of asset management at bfinance.
Nat Mankelow is the asset management correspondent for bfinance.
mhart@bfinance.co.uk
nmankelow@bfinance.co.uk
bfinance.co.uk