THE GREAT PENSIONS MIGRATION?

BFINANCE'S **MICHAEL HART** ASKS WHETHER THE BIG ASSET MANAGEMENT INSTITUTIONS' FUND OF FUNDS REALLY HAVE THE IN-HOUSE EXPERTISE TO GUARANTEE BETTER RETURNS FOR PENSIONS FUNDS.

Despite the government's acceptance of the conclusions of last year's Myners report on institutional investment, this support has not yet led to concrete proposals for an overhaul of the framework for corporate pension funds. Former Gartmore chairman Paul Myners recommended that pension funds redirect a greater proportion of their asset allocation to non-traditional investments, such as hedge funds and venture capital, as part of best practice process of delivering higher returns. But other developments are likely to force the hand of corporate pension fund trustees before legislation compels a change of approach.

The shift of responsibility for pension provision is moving ever further from the state to the private sector. At the same time, the first successive annual decline in the value of leading UK stocks in nearly 30 years (the last was 1973-1974) has left corporate pension fund trustees facing alarming shortfalls. It is becoming imperative for UK's corporates to identify a low-risk means of increasing the returns on pension contributions.

Hedge funds are regarded with suspicion by all treasurers who remember long-term capital management. But are fund of funds products (typically run by big-name asset management firms as a means of spreading investment risk among a number of independent hedge funds) a viable option?

'NO CHANGE' IS NOT AN OPTION. First let's look at the case for switching from the traditional equity balanced fund. Why can't pension funds afford to accept the poor returns currently on offer from traditional investment options? Put simply, beneficiaries of corporate pension schemes are living longer and are drawing on the schemes' funds for longer than was expected when they were originally established. Both the Myners report and the introduction of stakeholder pensions for low earners indicate that the government envisages a reduced future role in pension provision. Therefore, companies are left with little alternative but to find a way to meet their increasingly costly obligations.

As the UK population ages, the maturing profile of beneficiaries of existing defined benefit pension plans is resulting in a movement from equities to safer, more conservative vehicles such as bonds (for example, Boots Plc's pension fund has moved completely into bonds – see the article by John Ralfe in the December issue of *The Treasurer*). But pension funds also need to consider alternative products in the search for higher investment returns in the prevailing low-inflation environment. With the Bank of England targeted with keeping inflation close to 2.5% a year and most economists forecasting a period of low GDP growth, the returns on offer from the traditional alternative to equities, such as bonds and gilts, are far lower.

Pressure on employers offering defined benefit schemes has steadily increased over the past few years due to longer life expectancy among beneficiaries and more uncertain/falling investment returns. Under a defined benefit pension (or final salary) scheme, the cost of funding is largely unknown to the sponsoring employer since it depends on future investment returns. Moreover, the employer bears the risk that returns turn out to be lower than expected.

'HEDGE FUNDS ARE REGARDED WITH SUSPICION BY ALL TREASURERS WHO REMEMBER LONG-TERM CAPITAL MANAGEMENT'

However, defined contribution (or money purchase) plans shift the risk of any shortfall in benefits onto the individual, hence the current drive by corporate pension funds to reduce risk and cost of pension funds by adopting money purchase schemes. Although the switch to defined contribution schemes enables pension fund trustees to plan for the long term with greater confidence, it is not necessarily sufficient in itself.

Firms such as BT and ICI might have plugged up one end by freezing new members of defined benefit schemes, but this is only half the battle. Trustees cannot continue to accept poor performance due to a greater fear of underperformance compared with a benchmark, thereby severely compromising potential outperformance. They need to adopt a more pragmatic long-term strategy, which in many cases entails a fundamental change in a very entrenched mindset.

'ONE OF THE REASONS WHY HEDGE FUNDS TYPICALLY OFFER BETTER RETURNS IS THAT THEIR SIZE AND INVESTMENT APPROACH ALLOW MANAGERS TO BE MORE NIMBLE'

One further point: many pension schemes also feel that the new accounting standard FRS17 also makes it less attractive for companies to continue to offer a defined benefit scheme. Under FRS17, firms will have to show on their balance sheets the market value of their pension fund assets' surpluses or shortfalls compared with pension fund liabilities. This will make the companies' annual profit and loss report very dependant on the performance of their pension fund. Understandably, treasurers of listed companies will be concerned that subsequent earnings volatility could reduce their firms' market valuation on the equity market, thereby increasing the cost of raising capital.

PERFORMANCE VERSUS RISK. But are hedge funds the solution to the trustee's dilemma? Is the extra performance promised by hedge funds worth the risks associated with this asset class? In November, tracker CSFB Tremont reported that the average hedge fund had returned 4.4% for 2001 compared with a loss of more than 13% in the Standard & Poor's 500 Index for the same year.

One of the reasons why hedge funds typically offer better returns is that their size and investment approach allow managers to be more nimble. The ability to react far more quickly than traditional fund managers to sudden changes in the market typically gives the manager greater opportunity to limit potential loses or increase potential gains.

However, this only works up to a certain size of hedge fund. It is important that hedge funds do not become too greedy when it comes to the amount of money accepted into the fund. A fund should be closed to new investors when it reaches a pre-set optimum size. It is imperative with many strategies (especially 'market neutral') that the hedge fund manager is able to exit a losing position without having too significant an affect on pricing. The larger a hedge fund, the greater the impact on the price of shares it is trading on and the less nimble it becomes.

But it cannot be denied that the investment strategies followed by hedge funds entail greater risk. According to a recent survey by the University of Reading, two out of five hedge funds fail within their first five years. Nevertheless, the benefits far outweigh the risk of failure if use of hedge funds is conducted within the appropriate controls environment. Given this vital caveat, the pension fund should benefit from more appealing risk-adjusted returns (especially in volatile market conditions) and diversification generally uncorrelated to the markets. Volatility has been the prevalent argument against hedge fund products, but the increased volatility of traditional asset classes, and their increased correlation to each other domestically and internationally, has significantly weakened this argument.

If convinced that hedge funds demand further investigation, the trustee faces the choice between direct and indirect investment. A fund of funds is an investment vehicle available from an increasing number of established asset managers which enables pension funds to spread the risk of investing in hedge funds between a range of independent houses. It provides access to wide range of hedge fund strategies, investment styles and star managers, while avoiding the often time-consuming and costly administration implications. In addition, the pension fund obtains exposure to a diversified portfolio of generally uncorrelated hedge funds with lower levels of risk uncorrelated with the performance of the stock market.

But investors still have to keep in mind the extra cost inherent in investing with a fund of funds: two tranches of fees. Each individual hedge fund manager charges a basic percentage management fee and a performance fee if certain pre-agreed performance targets arereached. On top of this comes the second tranche of fees – that is, those charged by the fund of funds manager. Each situation will be different so the individual pension fund will have to assess whether the extra fees are sufficiently justified by the extra layer of safety provided by the fund of fund structure. Naturally, the impact on performance of spreading investment amongst a range of funds must also be considered.

THE COMFORT ZONE. There are a number of factors that will tend to point the trustee toward choosing a fund of funds over direct investment. Fund of funds are clearly a more acceptable entry point to other investments for reticent pension funds until they are more familiar with the product, at which point they may feel more comfortable with investing directly in hedge funds.

It is increasingly likely that most pension funds' existing asset manager offers a fund of funds. As a long-standing client, they will know the company's attitude to risk, its policies and procedures well. It is also safer in retrospect to use a fund of funds from a big company if things go wrong. Multi-manager fund providers offer pension fund trustees the opportunity to delegate some of the investment decisions necessary in the ongoing management of their pension schemes.

Other advantages of established in-house fund of funds over entrepreneurial individual competitors include:

- administration and IT backup capabilities;
- rigorous risk controls;
- research support; and
- the comfort of a high-profile brand name.

MIND THE INFORMATION GAP. But do the big institutions' fund of funds really have the in-house expertise to guarantee better returns? Even if the house does have the requisite experience to fully analyse and evaluate the underlying hedge funds, they may not have the necessary information. Hedge funds are famously reluctant to allow a clear insight into their business processes or strategies, as many use unique proprietary investment techniques which they do not want copied or emulated by their competitors.

This barrier also stumps investment advisers. Consultants are among the first to admit they have limited expertise when it comes to hedge fund manager selection. Hence, the pension fund trustee's closest adviser is better placed to evaluate in-house fund of funds offered by the more established fund management houses. Ultimately, it may be the lack of a comparative basis for evaluating rival funds makes the up the trustee's mind. In the land of the blind, as the saying goes, the one-eyed man is king.

Michael Hart is Head of Asset Management at bfinance.co.uk, the business finance transaction portal.
mhart@bfinance.com
www.bfinance.co.uk