Ask the experts:
Pension portfolio shake-up

SHOULD TREASURERS AND PENSION FUND TRUSTEES LOOK FOR A FRESH APPROACH TO INVESTMENT AND ALTERNATIVE INVESTMENTS?

Ewen Cameron Watt
Managing director of multi-asset portfolio strategies group BlackRock

When you are looking at the return side of your portfolio, you need to look at alternative assets. The fundamental argument for investing in alternatives is that they are a return-seeking asset, but they have a low correlation with other return-seeking assets – principally equities. That is the key argument that pension funds need to think about.

One problem is examining the track record of alternative assets. If you look at five, 10 even 20 years, there is not always a good series for alternatives. However, it is clear that alternatives have been a significant diversifier even allowing for the decline in price that happened last year. For instance, since 2000 hedge funds have increased in value by 45%, even allowing for the falls of 2008, whereas in the same timeframe equities have fallen by 35%. And when equity fell by 50% last year, alternatives fell by between 5% and 25% which wasn't pretty but was a lot better. As ever, treasurers and pension funds need to ask themselves to what extent the past is a good guide to the future.

But bear in mind that a lot of the diversification benefit in the alternative space was accomplished by leverage. And the amount of leveraging was increasingly significant, especially in the last part of the time series.

The case for diversification lies in the fact that most alternative assets – commodities, hedge funds, private equity – all have a different driver of return from equity. For instance, there is not a direct connection between corporate profit and the return on investment in commodities. Hedge funds should take out a lot of market beta and produce a different pattern of returns. Private equity may be more like equity but it is possible to look at the longer term and it can be advantageous to be away from the public eye.

The trouble with dealing with equity losses is that the more you lose, the greater risk you have to take to make up for the losses you are trying to recoup.

The other appeal for alternatives is that, compared with equities, you can engage with either higher or lower volatility. That is where pension funds and treasurers should look for some alpha strategies for some idiosyncratic asset management skill to take advantage of that volatility.

One of the criticisms of the way that pension funds have approached their alternative strategy is that they have taken a rifle shot approach. For instance, they invested in property and then a few years later invested in hedge funds. Because alternative investments behave in different ways it is essential that pension funds take a portfolio rather than an individual investment approach. And because some of the drivers can be quite opaque, it is important to have a fiduciary manager who understands the volatility and the drivers and can give an overall diversification approach rather than the rifle shot approach.

And given the scandals of the last few years it is important to have good governance and oversight in place. This can also be achieved by treasurers and pension funds if they contract the task to a professional manager. Overall, there are a number of fresh approaches in the use of alternative investments which are well worth considering.

Paul Wilkinson
Group treasurer of Tomkins

I have responsibility for pensions at Tomkins. I can think of no better approach to investing the scheme's assets than in a way that closely matches the liability that has been promised to the members of defined benefit pension schemes in their retirement. This is the best way to maximise their chances of receiving the pension they contracted with the company.

For decades the starting point for the trustees' investment decision for the scheme's assets has been to intentionally take on risk. But I have struggled for many years to understand why the investment decision starting point has not been to hedge or immunise to as great a degree as possible, with a conscious decision to add additional risk if so desired. Rather than considering derisking as just another alternative investment strategy, it should be seen as the starting point for the investment decision.

I have worked on pension schemes for Tomkins in both the UK and US. In the US, where the company has a greater influence over the scheme's investment strategy, we hedged the US pension scheme back in 2005. But in the UK, where trustees have more autonomy, much slower progress has been made towards reaching a clarity of understanding and a sufficient comfort level with using the scheme's assets to hedge the liability.

Part of the problem is that while we can talk about the company's view and what the company would like to do, ultimately it is the trustees who, even though they have to consult the sponsoring company, generally have the power over investment decisions.

But the system that surrounds trustees and which has built up over many decades supports and encourages equity and other risk-based investments. This has been encouraged partly for economic and financial policy reasons. But if I am a pension trustee who loses a lot of the

members' money on my equity investments I cannot see it is a good defence to say that I was acting for the economic good of the country, especially if members of the scheme don't receive the full pension they were expecting in retirement.

Treasurers have a great opportunity to enter this debate. Trustees of defined benefit schemes are still encouraged to make risk-based investments and despite its increase in acceptability hedge-based investing is still viewed as an alternative rather than the norm. Treasurers are ideally placed to arbitrate between the different approaches of trustees, companies and advisors and help trustees and companies understand more clearly the true nature of the risks being taken on.

William Nicoll
Director, fixed income, at M&G
The last 20 years have seen fundamental changes to the UK's corporate funding and pension fund investment outlook. In that time the banks have crowded out pension fund investors from large areas of the market, such as corporate lending. This has had the effect of shrinking the bond market so that bond investment has been limited to the top 50 or so firms in the UK, and the need for credit ratings and big issue size have been large barriers to entry.

At the same time UK companies outside the top 50 have become dependent on cheap funding from the banks for long and short-term investment. In a highly circular fashion, the banks financed this lending through their use of the bond markets.

This has led to two big concentrations of risk:

- pension funds holding large amounts of bank debt; and
- large corporates sourcing all borrowing from a small number of banks.

This model is not going to continue as banks will not be able to raise capital so easily in the future and the taxpayer will not always be there.

For companies, the markets will need to provide more funding. Ideally, companies require three elements from the banks and the markets:

- choice of funding options;
- a diversified group of providers; and
- access to the right type of debt for their needs (in other words, long term or revolvers).

From my knowledge and assessment of the market I believe it is essential that we re-invigorate some of the "old" markets such as private placements, debentures and loan stock; and that the main providers of long-term financing need to be pension funds and insurance companies.

M&G has set up the UK Companies Financing Fund, which is aiming to be £2bn in size, to try to kickstart this change. However, pension funds trustees and consultants will also need to move away from their benchmarks, which favour only the largest companies, and embrace assets that do not fall neatly into the current boxes for investment.

As the banks retreat from long-term lending there will be an extraordinary opportunity for pension funds to obtain access to high-quality long-term investments to match their long-term liabilities.

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