The Benefits and Pensions Monitor Interview


Q: There is a lot of interest in alternatives these days. What do you see as the key drivers of this interest?

The interest is across a range of alternative investor types from pension funds – both corporate and public – to foundations and endowments.

Alternatives are really about returns and volatility. From a return standpoint, the issue is that pension funds have to continuously shore up funding gaps. This is particularly the case with a lot of pension funds in the United States. They are underfunded, and they need to take action to fund their liabilities so that they can meet their actuarial targets.

Non-profits, or foundations and endowments, don’t have to contend with funding gaps, but they need to generate returns to achieve their respective missions. For example, these organizations may have a requirement to pay out a certain amount of their earnings each year, so they have a strong focus on returns.

Volatility is also important. What we have seen over time is that the long-only equity markets tend to be pretty volatile, and there is somewhat less of an appetite now to handle this long-only equity volatility. As we saw in 2008 when equity markets were down as much as 30 to 50 per cent, it was very difficult for a pension fund to stomach, as it was going to affect their ability to fund their liabilities.

Alternative investments can be a very effective way to invest in order to obtain the returns that you need to meet your liabilities. They can also be much less risky relative to the volatility of long-only equities.

Q: What alternatives then are institutional investors finding most attractive to satisfy their return desires and to reduce the volatility?

One important point to bear in mind is the fact that alternative investments by their nature all have extremely diverse risk and return objectives. They also have very different liquidity profiles. So, it comes back to the goal at hand.

Hedge funds have typically been used to help dampen the volatility of an overall portfolio. Today investors might look at hedge funds in a broader context and in a more holistic way, and question whether they can use strategies such as distressed credit or global macro or tactical trading to help their equity portfolios achieve the returns that they are looking for, but in a much less risky fashion.

Private equity has also become a popular mechanism for people who are looking to achieve greater returns through the private markets.

Real estate has also had a role to play. Core real estate is an example where the risk/return profile tends to be more moderate, with high single digit returns and a significant proportion of that return coming in the form of income.

We are also talking more and more to our clients in the United States about infrastructure. Infrastructure is not yet seen widely in people’s portfolios, but increasingly people are beginning to include it. The focus here tends to be more about mature assets with steady cash flows that help investors better match their liabilities,
as infrastructure assets tend to be very long term in nature.

The alternative spectrum is wide and varied, but people are using this particular strategy in ways that really help them solve their specific investment objectives.

**Q: Some estimates say that more than 70 per cent of long-only equity markets are being held by institutional investors. How much of the interest in alternatives is a result of the fact that there is not that much room to play with equities out there?**

Let's face it; up to the year 2000, people had a pretty good experience by investing in equities.

Then, we found ourselves in a situation where the returns from equities were arguably not so good. In fact, if you look at the returns for the S&P 500, the actual returns through the 2000s are negative. With this scenario, if you are a pension fund and you need to fund liabilities, these negative returns are just not going to work.

So, if a pension fund has the largest portion of its portfolio in equities, it still needs to generate the returns required to meet its liabilities. However, you want to be doing it in a much less risky fashion. When I say risky, I mean not only in volatility of returns, but actually in providing a better chance of meeting your liability funding (i.e. hitting your return target) because if an equity allocation is generating negative returns, there are serious consequences for a pension fund.

Now, to consider the smaller, fixed income portion of the portfolio, which is also currently operating in an environment where yields around the world are generally at extremely low levels.

While most people would argue that the only way that interest rates are going to go is up, the point is that the yields on the fixed income allocation of a portfolio are exceptionally low. In the event that interest rates rise, an investor might actually receive a capital loss on that as well. There are nuances around this situation for pension funds if interest rates rise, because a pension fund gets some relief on the liabilities side when liabilities decline as a result of using a high discount rate.

**Q: Which of the alternative asset strategies do you feel are being under-utilized?**

There are three main alternative asset strategies that are being under-utilized.

**Hedge funds are one.** The large pension funds in Canada have alternatives, and there are a few pension funds that have hedge funds in the $2 to $10 billion range, but I think hedge funds in Canada are very under-represented.

Hedge funds are more common in the United States, particularly if you look at public pension funds. They are becoming more popular with corporate pension funds and endowments, and they have always had a role in foundations. Within the hedge fund spectrum, strategies that we think are very compelling at the moment include tactical trading strategies (i.e. global macro) that are well positioned to be able to take advantage of global fiscal imbalances, dispersion in growth rates, and monetary policy across different countries, as well as the unwinding of central bank liquidity. There are many economic factors that, as they start to play out, make global macro a strategy that will be well positioned to take advantage of some of these movements.

Another area that I would say is under-represented, but that is changing (we are having a lot of conversations with our clients today about this), is in the area of commodities and natural resources. We think this is an area that will be increasingly important moving forward for a number of reasons, including global competition for resources and urbanization. As people in developing countries start living lifestyles that require modern conveniences, the demand for all those commodity inputs into production will grow. So I think including commodities makes a lot of sense for pension funds around the world – particularly in the U.S., where natural resources and commodities are under-represented.

I also think that the credit or distressed area is under-utilized, and it is a strategy that I find very interesting right now. Basically you have a situation where, depending on whose numbers you look at, there is an estimated $5 to $10 trillion of asset sales that need to take place in terms of the large banks around the world, as well as other investors who need to deleverage after the financial crisis. There are also some regulatory requirements, particularly in Europe at the moment, where the banks are required to divest assets to help them meet capital requirements under the Basel 3 Regulations and various investors around the world selling assets to deleverage. We think this is an area that can provide excellent opportunities for smart investors who can potentially access this opportunity set and purchase assets at a discount to their intrinsic value, which, over time, should provide attractive return potential as assets mature at par. These investments are also idiosyncratic in that a profitable outcome for an investor is not dependant on the general direction of equity markets or credit spreads.
Q: Are most pension funds nimble enough to take advantage of things such as global macro strategies that can take advantage of imbalances? After all, if you were a pension fund that wanted to take advantage of the financial crisis in Greece, shouldn’t you have already been there?

This gets back to having an allocation towards hedge funds and, more specifically, an allocation to global macro hedge funds. For example, if you are a Canadian pension fund, you might have a five percent allocation towards hedge funds and want to weight that, or have a significant portion of that in global macro strategies.

Q: Why do you think hedge funds are being under-utilized in Canada?

There could be a number of reasons. It could be the fact that they are perceived as being complex or that the fees are higher – and they are – but implementing a good hedge fund program really does add significant value to investors’ portfolios. When I have worked in Canada, I spent a lot of time with boards and trustees educating them on the virtues of hedge funds.

Q: How are DC plans elsewhere bringing alternatives into their plans? If we see a move towards target benefit plans and lifecycle funds, will the manager of those assets be contributing money to achieve returns?

I have a little bit of a perspective given that I am Australian and am very familiar with the Australian Superannuation System, which is essentially a defined contribution system. Australian pension funds, or superannuation funds as they are called, do have allocations towards alternatives. It is quite common.

The one area in which we are seeing implementation activity in DC plans, not just people talking about it, is real assets. This would include commodities, global listed infrastructure and global listed real estate – which are at the more liquid end of the alternative spectrum. That trend is really starting to take off now. At this point, we are not really seeing hedge funds or private equity being incorporated into DC plans.

Q: Are alternatives now mainstream?

Alternative investments are becoming increasingly mainstream. We are seeing them more and more in people’s portfolios and in greater proportions. If you look at alternatives in their simplest form, you could actually say there is really no such thing. If you take it down to a basic framework, you are essentially investing in areas like equities or credit, but the difference comes in during the implementation phase of the investment process.