

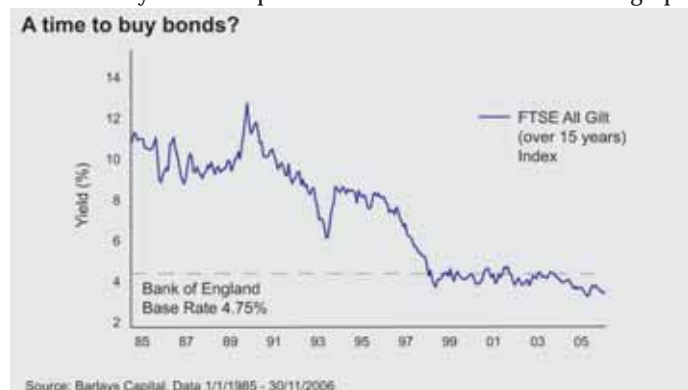
Why should pension funds look at alternative asset classes

by Andrew Raisman, Director - Marketing, Hermes

Pension Scheme interest in alternative asset classes and strategies has increased markedly since the peak in equity markets in 2000. This is not surprising given the growing focus on the mismatch between Scheme assets and liabilities and the need to diversify from core assets of equities, bonds and UK property to try and seek stronger and more diversified returns. Indeed our owner, the BT Pension Scheme (BTPS), has made just such a move into a range of alternatives (private equity, hedge funds and commodities), moving from a 2% weighting in 2004 to 7% in early 2006 and now has a new target of 15%. In a few years such weightings are likely to be commonplace amongst UK pension funds.

Assessing alternatives has to be set in the context of the strategic asset allocation decision and the funding needs of a scheme. The BTPS, in common with many UK Schemes, is in deficit. The focus of strategic asset allocation is therefore on closing this gap whilst protecting against future volatility. Schemes and their sponsors are sensitive to volatility of returns and particularly potential downside scenarios which could cause a marked further deterioration in their funding ratio. Ultimately shortfalls need to be covered, whether by sponsoring companies or, in the local government sector, by the tax payer.

Hermes alternatives strategy is set in this context. We start from a position of recognising two potentially conflicting needs. With the majority of defined benefit pension schemes in deficit, without altering the liabilities, the only way this can be reduced or eliminated is by, either increased contributions from members or employers, or by improved investment returns. Asset allocation therefore needs to be reviewed to determine whether higher returning asset classes or strategies can be introduced. At the same time, volatility must be controlled to protect the sponsor against downside scenarios in global markets. To achieve this, Schemes necessarily need to diversify away from the dominant asset class, typically equities. But this leaves the question of what to buy. Traditionally the first port of call has been bonds. The graph



below shows the yield of the FTSE 15 year plus All Gilt Index over the last 20 years. When there was value in this asset class this was a sensible course of action, given expected returns and low volatility. With the same index yielding nearer 4%, allocating away from equities to bonds, whilst dampening volatility, would more likely widen any funding gap rather than close it.

In this context we come to look at alternative asset classes and strategies – any allocation driven by the need to reduce under-funding risk without giving up significant return.

How to analyse alternatives

We follow an identical approach analysing each alternative solution. We begin by looking at the specific risk and return characteristics of the individual strategy. To interest us it will have to either have a low correlation with equities, and/or superior returns. There is no advantage investing either in an asset class that is highly correlated with equities, if there is no return advantage, or in a lowly correlated asset class if the returns are too low (unless it has positive tail risk properties, i.e. reacts positively to extreme events).

Once we have analysed and tested the risk return characteristics in isolation we then look at the impact allocating to such a strategy would have on the overall risk and return profile of the Scheme. Crucially we stress test this to ensure our analysis is robust enough to stand up to changed market conditions. We look at the expected future funding position of a Scheme in the future (10 or 15 years) based on the old asset allocation and how this would change should we allocate from equities to bonds or various alternatives. What is vital is to seek to improve the potential worst case funding scenarios, which might leave the Scheme under-funded, looking to alternatives to provide a stronger future funding position than we could expect from bonds.

What different alternatives deliver

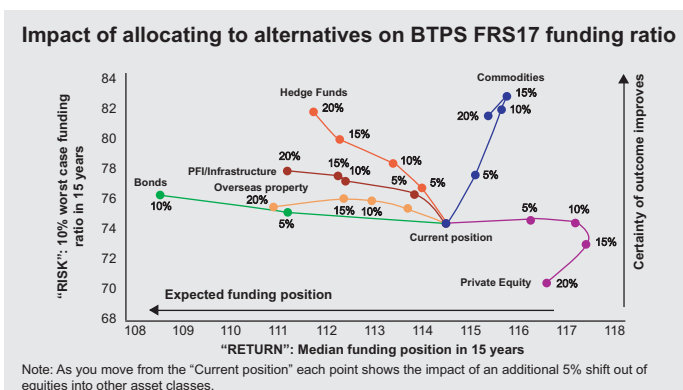
All alternative asset classes are not equal. Commodity futures have delivered equity-like returns historically. According to a Yale International Centre for Finance paper (“Facts and Fantasies About Commodity Futures”), from 1959 to 2004 the risk premium on a basket of commodity futures was almost identical to that of the S&P 500 index at just over 5%. However, they derive their main benefit from their beta which has been negatively correlated with equities and bonds. Indeed our analysis suggests commodities add value to BTPS at returns as low as LIBOR +2%. On the other hand, hedge funds provide diversification both because they are looking to achieve alpha, which is by definition uncorrelated with asset class moves, and

because they provide access to different betas or risks. Private Equity is included less for risk reduction (given a higher correlation with equities and higher volatility) and more for return enhancement. As one of the least liquid and least efficient asset classes, private equity provides a return premium both for its lack of liquidity as well as manager skill in extracting returns from this inefficient market.

Summary

It is important for Schemes facing a funding shortfall to look at improving the risk return profile of their scheme. Allocating to alternative asset classes can provide a low-cost means of reducing scheme risk without return reduction through the benefits of diversification. However, before allocating it is vital to understand what adding any alternative asset class can do for a Scheme's funding ratio and be clear as to its purpose within the overall asset allocation.

If you would be interested in learning more about Hermes alternative asset solutions please contact Andrew Raisman, Director – Marketing, who is responsible for UK local authority business on 020 7680 2815 or a.raisman@hermes.co.uk.



The graph above shows an analysis of the impact on the BT Pension Scheme of investing from equities in increasing proportions to a range of asset classes, considering both the median funding position in 15 years time (x-axis) and the 1 in 10 worst case scenario (y-axis). It shows that private equity increases expected returns and hence the median funding position with little increase in risk up to an additional 10% allocation. But above 15% diversification goes into reverse as risk concentrates and returns start to fall.

One can perform the same analysis with other alternative asset classes and strategies. A strong case for including up to 15% in commodities can be made: both the expected funding position improves and risk falls despite an assumption that commodity futures return less than equities. This is primarily due to the negative correlation between equities and commodities, which can be most pronounced when equity and bond returns fall. It is also because commodity futures returns tend to spike upward, not downward, as in the case of equities, in response to unexpected events. Hence, even if commodity futures returns are, on average, less than equities, in those scenarios when equities/bond returns are poor, commodities tend to outperform. The net effect being that the median scenario leads to a higher overall funding ratio.

An allocation to hedge funds also reduces risk, but at the expense of the median funding position. A similar trade-off is evident when investing in PFI/Infrastructure and overseas property. In both cases the benefits are not as great as with hedge funds or commodities, but are better than investing in bonds.



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