The Case for Alternatives

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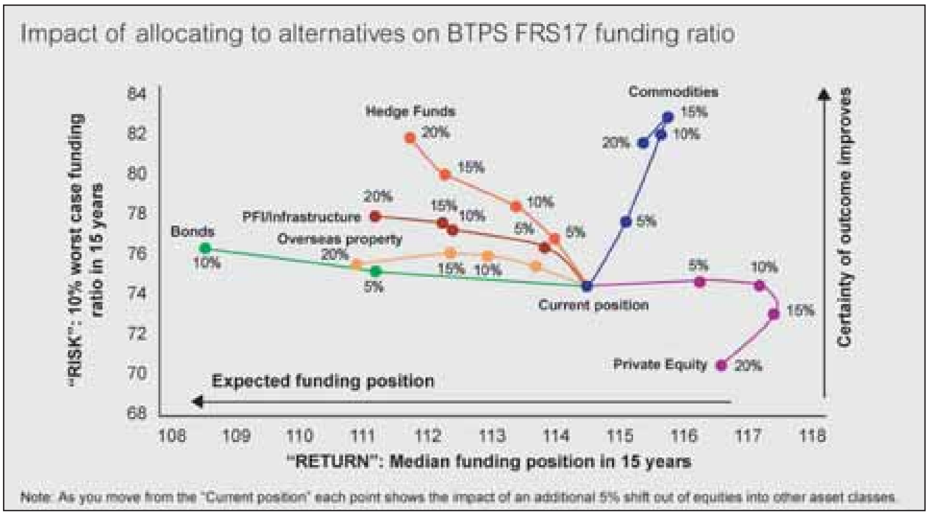
Borne largely of deficit funding necessity and the desire to diversify risk, the past five years has seen many pension funds allocate to alternative asset classes. Indeed Hermes' owner, the BT Pension Scheme (BTPS), has made just such a move into a range of alternatives, moving from a 2% weighting in 2004 to 15% in 2007. In a few years time such a weighting will likely be commonplace amongst UK pension funds.

Adding alternatives has to be driven by a scheme's strategic asset allocation decision in light of its financial health. Schemes and their sponsors are sensitive to volatility of returns and particularly potential downside scenarios which could cause a 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.

It is in this context that alternative asset classes can help. But only if the risk / return characteristics of a particular alternative asset class or strategy, when added to a portfolio, will enhance that of the pension scheme overall.

When analysing an alternative asset class we begin by looking at its specific risk and return characteristics and what it would add in combination with the total scheme 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). It is also vital to seek to improve potential worst case funding scenarios, which might leave a scheme under-funded, looking to alternatives to provide a stronger future funding position than other asset classes.

All alternatives have different characteristics. 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



Note: As you move from the "Current position" each point shows the impact of an additional 5% shift out of equities into other asset classes.

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.

By way of example, 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.

It is important for all schemes to look at improving their risk return profile. 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 are 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.