Rebuilding confidence, recovering value

ON THE ROCKY ROAD TO RECOVERY, TRUSTEES AND FUND MANAGERS NEED TO LOOK AGAIN AT THEIR ASSET ALLOCATIONS IN ORDER TO REBUILD CONFIDENCE THAT THEIR SCHEMES MIGHT THEN BE SUFFICIENTLY ROBUST TO FACE THE MANY RISKS AND CHALLENGES POSED BY THE UK PENSIONS ENVIRONMENT, ARGUES JOHN MULLIGAN OF THE WORLD GOLD COUNCIL.

John Mulligan
Investment Marketing Manager
World Gold Council

"there are signs that UK pensions trustees are adopting a fairly cautious perspective regarding the way forward, with several recent surveys suggesting risk hedging is at the top of the agenda for the majority"

The recent global crisis still continues to define global financial markets and, even as a renewed spirit of optimism starts to permeate the asset management community, there is, perhaps, little of real substance to raise the spirits of the UK's pensions industry. The crisis inflicted damage not only on asset values but also on the confidence of trustees and members in the investment solutions and strategies on offer. Frequent reminders of the fragile state of the current economic recovery and, more specifically, the pressing need to address the wide range of risks and burdens facing Europe's largest and most challenging pensions market make it difficult to shift the gloom.

Additional stress is being placed on scheme liabilities by the continuous march of longevity improvements – currently estimated to be improving globally by three to four months every year. As liabilities extend, strategies must be revised to restore confidence that appropriately scaled asset returns can be secured over the length of the investment horizon. Growing concerns about the eventual impact of quantitative easing on future inflation is further complicating the options with which schemes are faced.

So, pension funds face some tough decisions in coming months and years. All other things being equal, pension schemes struggling to improve funding levels and rediscover positive asset performance must find some room to manoeuvre in the current environment. It can be argued that reorganising asset allocation strategies, broadly recognised as the single biggest source of return, should be at the top of the list for many schemes.

That said, for many asset managers, the focus has quickly shifted and, looking forward, their eyes are firmly fixed on rapid recovery through the timely pursuit of opportunity. And who could argue against such a goal when faced with recent savage losses? Fortunately, there are signs that UK pensions trustees are adopting a fairly cautious perspective regarding the way forward, with several recent surveys suggesting risk hedging is at the top of the agenda for the majority. Hopefully, they now recognise that aggressive pursuit of opportunistic returns must be underpinned by longer-term strategic objectives, and offset by matching risk controls and counter-balances.

Much time, effort and printing ink has recently been devoted to discussing the correct balance of active versus passive asset management, and whether liability-driven strategies should form the bedrock of current and forward-thinking allocation policies. While the future direction of pensions investment strategy may well be shaped by these debates, unfortunately, the vast majority of them still only reference a very narrow pool of assets, which can undermine the strength and validity of many of the points being made.

Market recovery alone will not solve this situation as the road to recovery is likely to continue to be bumpy and the chance of encountering 'improbable events' along the way appears to becoming ever more likely. The ability to select assets which will meet both long-term liabilities and growth objectives yet offer downside protection will require the industry to think well beyond the usual asset mix and prevailing mindset.

Fortunately, there are some signs that an increasing number of investment consultancies are attempting to define strategic frameworks for asset allocation that seek to dynamically hedge risk, therefore affording managers the freedom to return to risk assets. That said, with any move to increased 'dynamism' we should be wary of a concurrent drift to 'short-termism'. A recent survey suggests that many fund managers have far shorter investment horizons than they intend or declare, even though they may be aware that such tendencies may have destructive implications.

But if we accept the principal motivating such initiatives, i.e. that diversification strategies

need to be overlaid by dynamic de-risking, otherwise a scheme's strategic objectives may be undermined by the economic sensitivities of its liabilities, we must also, as a pre-requisite, examine whether a scheme's diversification strategy is fit for purpose.

Effective portfolio diversification, as most readers will doubtless know, relies upon investment in a range of assets which have a fundamentally low to negative correlation with one another, such that the portfolio is sufficiently 'balanced' to be robust and stable when faced with a range of market conditions. Unfortunately, many investment strategists clearly felt disappointed by the failure of their diversification strategies to weather recent storms, with several stating that they believed diversification was likely to fail again in a high volatility environment.

However, it can be argued that, rather than dispense with diversification theory, greater attention should be given to the search for effective diversifying assets through which it might be implemented. This would seem particularly pressing in light of recent experience; the unexpected global asset convergence during the credit crisis and growing awareness of tail risk, the possibility that an asset will move beyond the bounds of 'normality' or three standard deviations from the mean.

One asset that has been shown, both historically and statistically, to consistently stabilise portfolio returns and mitigate risk is gold. Gold offers a hedge against tail risk because of its low to negative correlation to other assets and its outperformance when portfolios are threatened by 'extreme' events.

Gold's fundamentals are much more geographically and sectorally diverse than those which underpin most other assets. As a consequence, its price is driven by a far broader range of factors than those which influence most markets and thus it can be used to add diversification and balance to an asset allocation strategy.

While the geographical diversity of its supply and demand factors mean gold does not react consistently during periods of geopolitical tension, and therefore should clearly not be viewed as a panacea for all ills, it does generally tend to act as a buffer to other assets when markets are in 'shock' decline. In this respect, gold can mitigate bad beta.

Gold also provides a stabilising effect in the pursuit of alpha. It is proven to balance the downside risk inherent in other return generating assets precisely because its price is generally independent of the tendencies of other investments and prevailing economic indicators. Put simply, gold can minimise the variability of returns.

Portfolios that contain even a small allocation of gold are proven to be generally more robust and better able to cope with market uncertainties than those that do not, showing improved stability and predictability of returns. Recent empirical research for the UK market suggests that the optimum investment in gold for a long term institutional investment portfolio may range from around 4% to 10%, depending on the risk appetite of the institution. Furthermore, contrary to popular opinion, the unique qualities that gold adds to an investment portfolio cannot be duplicated through a broader commodity exposure.

While, on the road to recovery, investment strategists might well be attracted to riskier investments in pursuit of significant return opportunities, they first need to be confident they define strategic allocations that can be relied upon to provide both a stable foundation for growth and a cushion for risk. This is the confidence gold can offer; a proven ability to enhance the consistency of returns whilst reducing risk.

"Effective portfolio diversification, as most readers will doubtless know, relies upon investment in a range of assets which have a fundamentally low to negative correlation with one another"