

Investment Tutor

Dipping your toes into alternative waters



The rationale for pension schemes moving into alternative assets is predicated on a number of fronts. Firstly, at a time when we have come to expect lower returns from traditional asset classes, alternatives prospectively offer a higher expected return than bonds and, in many cases, equities. Alternatives also seek to generate positive returns regardless of market conditions; that is, they focus on absolute returns. Some, such as infrastructure assets, utilities for example, appeal to pension schemes as the long duration of the projects they undertake and the typically stable inflation linked cash flows they generate means they are ideally suited to matching long dated liabilities. Finally, alternatives offer the prospect of diversification, or risk reduction, when combined with traditional assets, by producing a series of returns that potentially differ from those deriving from bonds and equities.

In investment speak, alternatives have the potential to move the traditional asset mix onto a higher efficient frontier. The higher the efficient frontier, the better the prospective risk/return trade off and the greater the free lunch. This is not to say there is no longer a role for traditional assets: there is. However, trustees should perhaps be casting their asset mix net a little wider.

Although UK pension schemes' current appetite for alternatives has been generally low, this rationale of potentially higher returns and lower risk has certainly been accepted by some of the world's biggest and most progressive pension schemes. The mighty CalPERS in the US, ABP - Europe's largest pension scheme and more recently the British Telecom pension scheme - the UK's largest, have all moved aggressively into alternatives in their various guises and intend to further raise their allocations in the near future. Given that most market trends tend to be driven by high profile early adopters, it would seem that change is afoot.

So what do alternative assets comprise and what should trustees look out for when dipping their toes into alternative waters? Although the term "alternative" captures increasingly weird, wonderful and esoteric investment media, the main categories comprise commodities, infrastructure assets, tactical asset allocation (TAA) and currency overlay funds, private equity and hedge funds. However, this rapidly expanding asset class now extends to such exotica as volatility derivatives and carbon emissions trading, to name but a few.

Despite all being bound together by that one common objective, to move the traditional asset mix on to a higher efficient frontier, each alternative and the approach and methodologies underlying the management of each is quite unique. When buying into alternatives, more so than when seeking to gain exposure to traditional asset classes, you're not simply buying into an asset class rather a strategy and a skill set. This is particularly evident within



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TAA funds, hedge funds and private equity, where performances differ markedly. For instance, between 1980 and 2005 whilst the median private equity manager generated a compound annual return of 0.5%, the top 25% produced 22.9% on average (Source: EVCA).

That said, when investing in alternatives you should be fully aware of the shortcomings of the data. For instance unlike traditional asset class data the performance data of many alternatives doesn't extend back very far making it extremely difficult to determine whether recent returns are typical or atypical. Hedge fund index data in particular is often cited as flattering returns and downplaying risk. This it does by only capturing the performance of those successful hedge funds that voluntarily report their performance numbers, many of whom apply conservative monthly values to those illiquid assets in which they typically invest, thereby reducing the apparent volatility of their performance.

Another contention frequently levelled at many alternatives is that their higher returns are not necessarily the result of employing strategy and skill. Rather, their performance may simply derive from using derivatives to magnify underlying market returns. In other instances, higher performance may just be a reward for assuming those aspects of risk that traditional risk analysis (and the efficient frontier) can't capture, such as the illiquidity faced by alternative investors and the risk that returns can periodically dip into extreme negative territory.

Finally, one cannot underestimate the effect that the sheer weight of money finding its way globally into alternatives can have on the underlying investment rationale. Take commodities for instance. Over the longer run commodities, like many other alternatives, have provided equity-like returns but at a lower risk and with greater diversification and better inflation protection. However, compounding recent falls in commodity prices has seen commodity futures prices quite unusually trading above that of the underlying commodities, as a result of the sheer amount of money accessing this asset class via futures contracts. Unless commodity prices rise significantly, this creates a loss at the expiry of the futures contract. Indeed, strong demand has, to varying degrees, upset the economics of investing in many other alternatives. For example, during 2006, whilst over \$150bn and \$400bn respectively (source: Financial Times) was committed to infrastructure assets and private equity investment globally, much of this cash has yet to be invested for lack of attractively priced opportunities. Strong demand can also dilute the diversification potential of alternatives.

Despite all of these issues, alternatives remain a great portfolio tool and continue to prospectively offer something over and above that which the traditional asset mix delivers. Moreover, with a greater focus on reducing scheme deficits and on adding value through asset allocation, the case for pension funds investing in alternatives remains robust.

However, it goes without saying that careful asset, manager and strategy selection are imperative. Therefore, perhaps the most sensible way to dip your toes into alternative waters, especially when seeking to gain exposure to private equity, hedge funds and infrastructure assets, is by taking a diversified fund-of-funds or multi-strategy route, as both remove a substantial proportion of the due diligence and subsequent monitoring involved with single asset/manager/strategy investing. Although this approach may potentially provide a smaller free lunch than a more adventurous strategy may deliver, as in so many aspects of life, less is probably more.

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