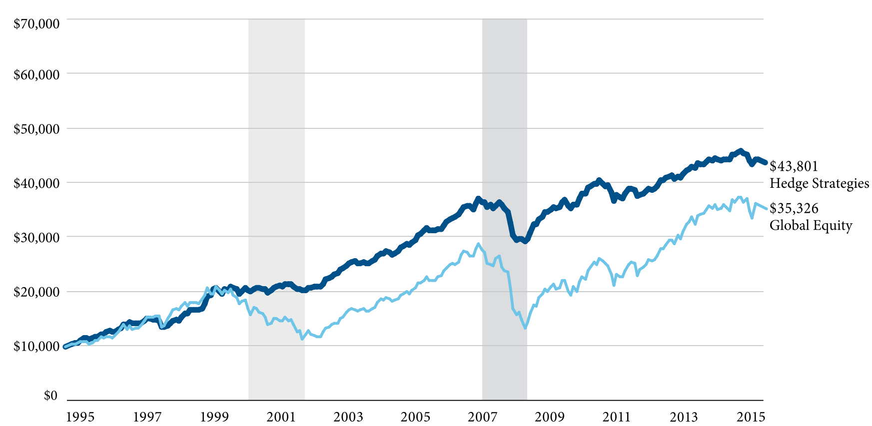
True diversifiers: Solutions for smaller DB and DC schemes

Peter Vincent explains how the new generation of multi-strategy, multi-manager alternative funds offer a practical way of reducing the overall risk of growth portfolios

Investors today are searching for a path forward. While traditional portfolios comprised of a blend of equity and fixed income securities may have served investors well during a period of unprecedented and globally-coordinated accommodative monetary policy and low inflation, the next stage in the market cycle is likely to be very different. Global equities may struggle in the face of stagnant growth and corporate profits. Fixed income investors face a conundrum in terms of limited income potential in a low interest-rate environment and the threat of capital losses induced by potentially rising rates.

DB schemes are preparing for this uncertainty by incorporating alternative investments into their asset allocations, with the goal of reducing risk and improving returns. Historically, the practicalities of investing in a broad range of alternatives has limited access to only the largest schemes, but alternative strategies are now available to all schemes and even potentially to DC investors in the form of onshore, regulated funds. These include highly diversified multi-strategy, multi-manager liquid alternative funds.

Chart 1: Minimising Negative Market Impact has Provided Strong Long-Term Performance Historically
Growth of a $10,000 Investment (20-Year Period Ending 31 December, 2015)



	11/00–9/02	11/07–2/09
Hedge Strategies	-0.9%	-21.4%
Global Equity	-40.5%	-53.7%

Source: FactSet. Global Equity represented by the MSCI World Index. Hedge Strategies represented by the HFRI Fund Weighted Composite Index. Both indices on a total return basis. Indices are unmanaged and one cannot invest directly in an index. The value of investments and any income received from them can go down as well as up, and investors may not get back the full amount invested. Past performance is not an indicator, nor a guarantee of future performance.

These alternative funds offer a valuable diversification tool for the traditional stock and bond portfolio, whether for DB schemes seeking uncorrelated sources of return or DC investors looking to reduce anxiety-inducing volatility. Such characteristics may be useful for many investor portfolios, including those near or already in retirement.

What is an alternative investment?
Alternative investments cover a varied set of asset classes and strategies that go beyond stocks and bonds. Alternative investment asset classes include real estate, real assets (e.g., commodities, infrastructure) and private equity, while alternative strategies primarily consist of hedge strategies. In this article we are focused on hedge strategies as they can offer a high degree of investment flexibility through the utilisation of various financial instruments including derivatives and hedging techniques such as short selling. The added flexibility provided by hedge strategies enables investment managers to pursue upside participation when their market expectations are positive and downside protection of capital when their views are negative.

Attractive risk/return characteristics
Alternative/hedge strategies have historically provided attractive returns over the long term when compared to traditional asset classes. As Chart 1 shows, hedge strategies more than kept pace with equities over a 20-year period—which included major swings

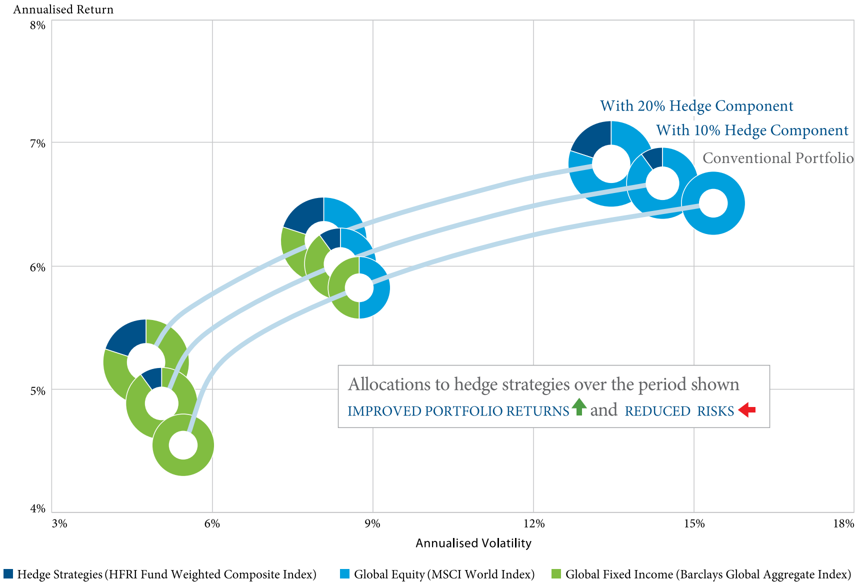
in the equity markets. The superior performance of hedge strategies during that period was largely driven by faring better during the dot-com bust in 2001–2002 and the financial crisis of 2008–2009.

At the same time, hedge strategies performed relatively well during periods of equity strength. Indeed, over this 20-year period, hedge strategies exhibited a level of risk more in line with fixed income with return comparable to equities.

Enhanced portfolio diversification

These benefits combine to make hedge strategies a valuable complement to a traditional portfolio. An investor who diversifies by adding exposure to a multi-strategy/manager alternative fund may be able to further improve the overall risk/return profile of the portfolio, as shown in Chart 2. An allocation to hedge strategies may help reduce the overall volatility of the portfolio. This may be compelling for many schemes and for DC investors sensitive to volatility or approaching retirement. Especially since the threat of capital losses due to a normalisation of long-term interest rates may lessen the general appeal of bonds.

Chart 2: Adding Hedge Strategies Could Have Helped Improve Portfolio Return Potential and Reduce Risk
Allocation Frontier (20-Year Period Ending 31 December 2015)



Source: FactSet. Initial allocations for the conventional portfolios are 100% Global Fixed Income, 50% Global Fixed Income / 50% Global Equity and 100% Global Equity. For the 50% Global Fixed Income / 50% Global Equity portfolios with hedge components added, the stated allocations to the hedge components are taken equally from the fixed income and equity portions. Illustration assumes monthly rebalancing. Global Equity is represented by the MSCI World Index Total Return. Global Fixed Income is represented by the Barclays Global Aggregate Index. Hedge Strategies are represented by the HFRI Fund Weighted Composite Index. Returns data represents average annual total returns in USD and assumes reinvestment of interest or dividends. Indices are unmanaged and one cannot invest directly in an index. The value of investments and any income received from them can go down as well as up, and investors may not get back the full amount invested. Past performance is not an indicator, nor a guarantee of future performance.

The value of a multi-strategy, multi-manager approach

Each of the various types of hedge strategies may perform differently in a given market environment so it can make sense to blend them. We believe that seeking out managers within each strategy with the strongest track records over time increases the opportunity to achieve strong long-term performance. Further diversification through selecting multiple managers within each strategy may also help provide a measure of protection against manager-specific risks. Managers can have varying styles or approaches within the same hedge strategy, possessing expertise within a certain area (e.g., region, sector or financial instrument).

Summary

Current equity and fixed income markets pose a unique set of challenges for pension schemes and investors alike, made all the more complicated by lingering scars inflicted by the financial crisis. The universe of alternative investments offers a potentially attractive diversification option, which has helped drive the rapid growth of this asset class. What's more, the increased ability to invest in alternatives through the mutual fund format has made it easier for pension schemes to access this asset class, either in DB portfolios, as a component of a DC fund, or even a standalone investment option for risk-aware members.

Written by Peter Vincent, head of alternatives EMEA, Franklin Templeton Investments

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Between the hedges

Sandra Haurant explores the state of the hedge fund market and what opportunities remain for pension fund investment

There was a time when hedge funds were seen as a relatively reliable way for pensions schemes to seek out decent returns with low volatility. They had their disadvantages, of course, but even so they tended, largely, to do what was expected of them. Indeed, PiRho investment consulting director Phil Irvine states: "Hedge funds performed well until 2007 in absolute terms and with low volatility, and while falling in 2008, they did, in general, outperform equities."

Because of this positive side to them, he says pension schemes generally put up with the "higher fees, complexity and opaqueness of the funds as they seemed to be adding value to portfolios".

Franklin Templeton head of alternatives EMEA Peter Vincent agrees. "I think for a time the role that hedge fund allocation was going to play in people's portfolios was as a growth asset with low volatility. And for a lot of pension schemes, particularly defined benefits schemes, the attraction of that low volatility diversified return was that it gave them the possibility of participating in market upside but limiting market downside," he says.

"A lot of DB corporate schemes have an asymmetric relationship to risk, because the corporate sponsor wants the funds to grow. If the assets grow so much they can't take money out, and if they go down in value they have to put money in. An allocation to an asset class that has that promise of an asymmetric relationship with the market had instinctive attraction."

A tidal wave of change

But in the wake of the global financial crisis, everything seemed to change. Hedge funds overall may have performed pretty well against very dark backdrop of the time, but the crisis shone a spotlight on what was shown to be a very complicated area of the investment world – an area where problems were not restricted to the funds themselves, but were also down to investors' perception of them.

Because, says Vincent, in those early days when pension funds first began to take a serious interest in hedge funds, there was an understanding that they were one single asset class, and funds would seek to have a certain allocation to that asset class within their portfolios. "You had, for example, a 5 to 10 per cent allocation to hedge funds in the same way that you might allocate to emerging market debt or global equities," he says.

"People tended to talk about hedge funds as if they were one thing, and I think that can lead to an awful lot of confusion and the wrong sorts of expectations," Vincent adds. "Hedge funds don't behave as an asset class. It's a very heterogeneous group. Hedge fund strategies are ways of managing money, but you have some hedging strategies that are equity based, some that are commodity based, those that are fixed income based, and so on. They all behave very differently because they are ultimately pursuing different goals."

But when the crisis came along, it became clear that not all hedge funds were created equal – indeed, far from it. "That is where people started to question the ability of some of the hedge fund managers to really manage the downside risk," Vincent adds. "Hedge funds as a whole came out of 2008 a lot better from a performance perspective than equity markets and other growth assets, but there was a differentiation between the funds that had a sound basis and some that were maybe a bit less secure."

There were significant issues surrounding liquidity, with some hedge funds failing to honour their terms, and it became evident that the level of opacity of many of these funds made them a questionable addition to a portfolio. "The crisis shone a light on the idea that these were not this homogenous asset class, there is a real difference between hedge fund strategies and managers and maybe you need to pay more attention to what you are getting when you invest in a hedge fund," says Vincent.

Following the crisis, the industry was forced to address the issues surrounding transparency, in particular. P-Solve director of solutions Alex Pigault says that these days: "Most hedge funds give us full transparency on investment process, portfolio, operations andfinancials."

Indeed, he adds: "Interestingly, in terms of transparency, there is now more resistance from boutique long-only mutual fund managers than from hedge fund managers."

And recently, the institutional investment community appears to understand more readily the purpose of hedge funds, and no longer views them as one single type of asset class, but rather what they really are.

"Hedge funds strategies are alternative ways of playing traditional asset classes," Irvine says. Yet, there remains a slightly skewed approach, perhaps, to be found within the pensions industry. "The interesting thing is that many pension schemes would not invest in hedge funds, but are happy to invest in diversified growth funds that employ hedge fund strategies, for example long – short asset classes, use of leverage, and so on."

For some, the reasons for avoiding hedge funds are largely down to value. Railpen, for example, one of the country's largest pension schemes, announced it was to cut almost all of its exposure to hedge funds in the last quarter of 2015. The scheme dropped its exposure to hedge funds from 10 per cent of assets to just 2 per cent, according to the *Financial Times*, and said the move was part of a cost-cutting campaign.

Another high profile scheme, this time in the US, has made a similar change to its portfolio. The public pensions scheme Calpers also decided to move out of hedge funds, claiming they were too complex and expensive.

Nonetheless, it appears that there is still a gap left for hedge funds to fill, although it may have shrunk and has certainly changed its shape. And with performance not quite as impressive as it could be, the scope for high levels of charging has reduced. P-Solve head of multi-asset Tamsin Evans says: "As an investment consultant and as a fiduciary manager, over the last few years we've been able to obtain the return our pension scheme clients need without using hedge funds much, although we and our clients still use them."

The overall picture

While each hedge fund is different from the next, the overall picture is interesting. "The average hedge fund's performance has been disappointing, especially relative to equities and other return-seeking multi-asset portfolios, and that has given more negotiating power to investors. So it's no surprise that investors, including pension schemes, have become more willing to negotiate on fees and liquidity terms, for both hedge funds and long-only funds. Good hedge fund managers can still charge high fees, but there is more scrutiny from investors and more willingness to challenge them," Evans outlines.

If, for hedge funds, the wheat was separated from the chaff at the time of the global financial crisis back in 2008, it seems that, to a degree, the better and worse funds can still be differentiated today – and charges should fit accordingly. But can they offer value to pension schemes? Since much of the returns that a hedge fund sees is down to the skill of its manager, it really depends on the hedge fund.

There is some good news for this broad section of the market, though, says Irvine. "The positive news for hedge funds is that every other asset class either looks expensive or unduly risky. Pension schemes that have been long term supporters have kept faith, given the lack of easy alternatives to switch the money to."

In a changed landscape, the hedge fund, in its many forms, has managed to hang onto a place within many pension schemes, and although there are challenges to be faced the industry does appear to be meeting them head on, to a degree. Indeed, as Irvine puts it: "The hedge fund is dead. Long live the hedge fund."

Summary

- Hedge funds performed well until 2007 in absolute terms and with low volatility, and while falling in 2008, they did, in general, outperform equities.
- For a lot of pension schemes, particularly DB schemes, the attraction of hedge funds' low volatility diversified return was that it gave them the possibility of participating in market upside but limiting market downside.
- In the wake of the global financial crisis everything seemed to change. Investor' perceptions of hedge funds changed. People started to question the ability of some of the hedge fund managers to really manage the downside risk.
- Significant issues arose surrounding hedge fund liquidity following the financial crisis.
- Not all hedge funds are similar, yet some investors seem to think of hedge funds as a single asset class, leading to confusion.
- The positive news for hedge funds is that every other asset class either looks expensive or unduly risky. Pension schemes that have been long term supporters have kept faith, given the lack of easy alternatives into which to switch the money.

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