Summary

- Alternative asset classes remain popular due to diversification, income generation and better risk-adjusted returns.
- Private credit is still high on the list, although the market is getting crowded and investors have to be more discerning due to the end of the cycle.
- Infrastructure and real estate are also favourites although investors are moving more towards core assets.
- Alternatives would be beneficial to defined contribution schemes, but the structures are not in place, although this will change in time.

The new alternative

Alternatives have been popular with pension funds for several years, but with increased market volatility, pension funds are having to broaden the range of alternatives that they turn to. Lynn Strongin Dodds investigates

Alternative or real asset classes have been a regular feature in UK defined benefit schemes for the past few years, with allocations comprising roughly 20 per cent. Lower-risk, high-yielding assets have been a favourite but as volatility has spiked thanks to changing macro-economic conditions, funds are having to look more closely at the best opportunities.

The drivers behind the trend though remain the same – the low return outlook for traditional asset classes and the steady depletion of the coffers. It has been well documented that UK DB plans are heading into negative territory with a recent study by PWC predicting that 80 per cent are expected to be cashflow negative within five years. The doors of many are not only firmly shut to new entrants, but the workforce is ageing and the rate of transfers have been faster than predicted.

The benefits of alternatives, according to BlackRock head of UK institutional business, Andrew Stephens, is that they provide differentiated sources of return, diversify the scheme's investment risks and offer access to illiquidity and complexity premia that can improve portfolio outcomes.

"Increasingly, we are seeing DB schemes also thinking about illiquid asset classes that can provide income in excess of what is available in the public markets," he says. In general, "alternatives are a very broad term that covers liquid investments such as alternative risk premia, hedge funds and absolute return strategies, as well as illiquid investments like infrastructure, private credit and property."

Each pension fund of course has their own risk and return characteristics and constraints that will dictate the type of assets to be slotted in. "There is no one-size-fits-all solutions but exposure to alternatives continues to rise and the definition is broader than in the past," says Goldman Sachs Asset Management head of UK and Irish institutional business David Curtis.

The opportunities in credit though may not be as vast as the recent past as economists are predicting slowing global growth, tightening of monetary policy and a bumpier ride. While these soothsayers have been warning that the end of the bull run is nigh, the axe is expected to fall this year. This can be a difficult time for credit investors as spreads tend to widen and schemes need to be much more vigilant of the downside risk for individual credit holdings.

"Private credit has been hugely popular and in the second half of 2018, we had a lot of conversations that did not lead to investments because of fears over the end of the cycle," says Mercer senior consultant and UK alternatives leader David Willers. "However, defined benefit schemes have to spend money somewhere to generate returns and private markets still offer some of the most attractive opportunities."

Curtis adds: "We have seen large allocations to private credit over the years and while it may seem crowded it is still a sizeable market at $600 billion, with the US accounting for two thirds. He says while investors have to be more discerning there are opportunities in, for example, senior secured loans, which have the same credit quality as for example high yield but are floating-rate notes and also offer more investor protection, in that borrowers must repay senior loan debt before other types of debt if the company runs into trouble."

Looking farther afield, interesting prospects can be unearthed in the less fashionable, harder to enter areas of the market, according to Cardano investment manager Ben Cooper. These range from middle market distressed debt to China-A and other emerging-market debt strategies.

Although these require greater due diligence, LGIM head of institutional clients Mark Johnson believes that, in general, DB schemes are adopting a more granular approach and looking carefully at sector exposure, the ratings and credit quality of the holdings. Their mindset has also changed as to its role. "There have been three stages," he adds. "Five years ago, public credit was seen as a stand-alone allocation alongside equity but as schemes have de-risked and turned cashflow negative, they looked at more buy and maintain strategies to meet cash outflows. Now, private credit is also seen as part of the matching element of the portfolio, with a number of our clients having all three strategies in place."

A more conservative tone has also been struck with infrastructure and real-estate debt, which provide uncorrelated returns, as well as stable and predictable cashflows. "As we are at the end of the cycle, we are seeing a greater demand for core infrastructure and property than value add, speculative assets," says J.P. Morgan Asset Management's head of Emea pension solutions and advisory group Sorca Kelly-Scholte. "They are looking more at the stability of the income rather than the capital gains. We also recommend sector and international diversification to protect against political risks."

UBS Asset Management lead real estate strategist, real estate and private markets, Paul Guest, sees value in student and senior housing as well as medical offices. However, he also believes schemes should look to investigate the potential of data storage centres that cross the property and infrastructure divide.

There are different routes, such as buy and build or shell and core, which each have their own disadvantages and advantages. On the whole though they can offer long-term income, a dependable tenet base and a greater yield than industrial," he adds.

Aviva Investors investment strategist, Boris Mikhailov, would add long lease and commercial ground rents to the real estate list because "they produce long-term, high-quality streams of income and are inflation linked. Beyond real estate, certain types of infrastructure projects, if financed on an unlevered basis, could also have similar attributes, such as wind farms, solar panels and high-speed fibre broadband. Outside of real estate and infrastructure equity financing, I also think there are a number of opportunities in the structured finance space, such as swap repacks, fund or trade financing that can provide attractive risk-adjusted returns to investors."

On the more liquid end of the alternative spectrum, some fund managers are advising smart beta type of product, while others such as Redington Investment consulting director, Nick Lewis likes "high-quality structured credit such as asset-backed securities in the US and Europe or globally. A blend of senior investment grade tranches can generate Libor plus 2 whilst benefiting from high liquidity. In addition, strategies focused on riskier parts of the securitisations (below BBB) aim to return Libor + 3.5-4 per cent whilst giving up some liquidity."

As to other asset classes, there is a debate as to whether gold and currencies could be slotted into the alternatives bucket. World Gold Council director, John Mulligan, argues that gold is not just a safe haven but has a place in alternatives because it produces reasonably attractive long-term returns, offers diversification and a hedge against downside risk. "Gold is not as volatile as other commodities and if you look at the long term it is a growth market – over the past 30 years, it has doubled in volume and quadrupled in value," he adds.

In terms of currencies, Record Currency Management CEO, James Wood-Collins, says there has been more interest over the past four to five years in return seeking currency strategies, as well as the ability to manage currency risk in other alternatives, especially in credit. "Pension funds are looking more at how the risk premia can be exploited instead of currency as a discretionary trading strategy. This is not unique to currencies but can be found in other alternative risk premia such as smart beta in equities."

While many of these solutions are well-trodden ground for DB schemes, they are new territory for defined contribution plans. The products are far and few between but as DC grows in scale and maturity, alternatives are likely to be more prominent. "One of the biggest problems with DC schemes is the need for daily liquidity," says M&G investments director, global institutional distribution Annabel Gillard. "It is not a legal but defacto requirement by the operating systems that manage the flows of the different payrolls. However, the sooner we can crack this technological problem the better. It has gained more attention and there have been a few asset managers who have launched alternative type of products with daily liquidity. However, they do not give investors the full alternative experience."

Written by Lynn Strongin Dodds, a freelance journalist